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TIDELANDS OIL & GAS CORP/WA  
Form 10KSB  
April 17, 2006

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

FORM 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the year ended December 31, 2005  
Commission File Number 0-29613

TIDELANDS OIL & GAS CORPORATION  
(Name of small business issuer in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

66-0549380  
(I. R. S. Employer  
Identification No.)

1862 West Bitters Rd., San Antonio, TX 78248  
(Address of principal executive office)

(210) 764-8642  
(Issuer's Telephone Number)

Securities Registered Pursuant of Section 12(b) of the Act: None

Securities Registered Pursuant of Section 12(g) of the Act:  
Common Stock, \$0.001 Par Value

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment of this Form 10-KSB.

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

The issuer had operating revenues of \$1,861,323 for the year ended December 31, 2005.

This report contains a total of \_\_\_ pages. The Exhibit Index appears on page \_\_\_.

As of March 31, 2005, there were 79,805,815 shares of the issuer's common stock outstanding.

The aggregate market value of the issuer's voting stock held by non-affiliates was \$58,827,842 based on the low bid price on that date as reported by the NASD OTC Electronic Bulletin Board April 14, 2006. The sum excludes the shares held by officers, directors, and stockholders whose ownership exceeded 10% of the

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outstanding shares at December 31, 2005, in that such persons may be deemed affiliates of the Company. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

### TIDELANDS OIL & GAS CORPORATION FORM 10-KSB

December 31, 2005

	Page
PART I	
ITEM 1. Business.....	3
ITEM 2. Properties.....	6
ITEM 3. Legal Proceedings.....	7
ITEM 4. Submission of Matters to vote of Security Holders.....	9
PART II	
ITEM 5. Market for Common Equity and Related Stockholder Matters And Small Business Issuer Purchases of Equity Securities.....	10
ITEM 6. Management's Discussion and Analysis or Plan of Operation.....	11
ITEM 7. Financial Statements.....	27
ITEM 8. Changes In and Disagreements with Accounting and Financial Disclosure.....	27
ITEM 8A. Controls and Procedures.....	27
ITEM 8B. Other Information.....	28
PART III	
ITEM 9. Directors, Executive Officers, Promoters, and Control Persons: Compliance with Section 16(a) of the Exchange Act.....	28
ITEM 10. Executive Compensation.....	29
ITEM 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.....	31
ITEM 12. Certain Relationships and Related Transactions.....	34
ITEM 13. Exhibits.....	36
ITEM 14. Principal Accounting Fees and Services.....	38
SIGNATURES.....	39
EXHIBIT INDEX.....	

2

### PART I

#### CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This 2005 Annual Report on Form 10-KSB, including the sections entitled "Risk Factors," "Management's Discussion and Analysis or Plan of Operation" and

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"Business," contains "forward-looking statements" that include information relating to future events, future financial performance, strategies, expectations, competitive environment, regulation and availability of resources. These forward-looking statements include, without limitation, statements regarding: statements concerning projections, predictions, expectations, estimates or forecasts for our business, financial and operating results and future economic performance; statements of management's goals and objectives; and other similar expressions concerning matters that are not historical facts. Words such as "may," "will," "should," "could," "would," "predicts," "potential," "continue," "expects," "anticipates," "future," "intends," "plans," "believes" and "estimates," and similar expressions, as well as statements in future tense, identify forward-looking Statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by which, that performance or those results will be achieved. Forward-looking statements are based on information available at the time they are made and/or management's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in or suggested by the forward-looking statements. Important factors that could cause these differences include, but are not limited to:

- o our failure to implement our business plan within the time period we originally planned to accomplish; and
- o Other factors discussed under the headings "Risk Factors," "Management's Discussion and Analysis or Plan of Operation" and "Business."

Forward-looking statements speak only as of the date they are made. You should not put undue reliance on any forward-looking statements. We assume no obligation to update forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except to the extent required by applicable securities laws. If we do update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements.

All references to "we," "our," "us" and the "Company" in this Annual Report on Form 10-KSB refer to Tideland Oil & Gas Corporation and its subsidiaries.

### ITEM 1. BUSINESS.

Tideland Oil & Gas Corporation (the "Company"), formerly known as C2 Technologies, Inc., was incorporated under the laws of the State of Nevada on February 25, 1997. C2 Technologies, Inc. changed its name to Tideland Oil & Gas Corporation on November 19, 1998. The Company has ten subsidiaries which it directly and indirectly owns as follows: (1) Rio Bravo Energy LLC, (2) Arrecefe Management LLC, (3) Marea Associates, L.P. , (4) Terranova Energia, S.de R.L. de C.V., (5) Esperanza Energy LLC and (6) Sonterra Energy Corporation. We also own a 97% limited partnership interest in Reef Ventures, L.P.(7) Arrecefe Management LLC owns a 1% general partner interest in Reef Ventures, L.P. Rio Bravo Energy, LLC owns 100% of the member interest in Sonora Pipeline LLC. (8) Reef Ventures, L.P. owns 100% of the member interest in Reef International LLC(9) and Reef Marketing LLC(10).

The Company's products and services are primarily focused on development and operation of transportation, processing, distribution and storage projects for natural gas and natural gas liquids in the northeastern states of Mexico (Chihuahua, Coahuila, Nuevo Leon and Tamaulipas) and the State of Texas.

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### Reef Ventures International Pipeline

The assets of this business consist of two different pipelines: (1) an 8 mile twelve inch diameter natural gas pipeline with metering and dehydration facilities and (2) a two mile segment of six inch diameter pipeline to be used in a future LPG project. The twelve inch pipeline connects and receives natural gas from a third party pipeline for transmission to the border between Texas and Coahuila, Mexico. The pipeline is buried underneath the Rio Grande River with

3

its termination at the delivery point in Piedras Negras, Coahuila owned by CONAGAS (the local distribution company). Reef Ventures, L.P. derives its revenues from transportation fees charged to CONAGAS for delivery of natural gas. The LPG project will require the future construction of receiving terminal facilities in Texas, boring and installation of additional six inch diameter pipeline under the Rio Grande River and approximately one mile of additional pipeline in Mexico with an unloading terminal and storage facilities at its termination point.

### Tidelands Oil & Gas Storage Enterprise

In December 2003, we entered into a Memorandum of Understanding (MOU) with PEMEX to design, build and operate an underground natural gas storage facility in the vicinity of Reynosa, Tamaulipas, Mexico, in the Burgos Basin area and eventually at other regions in Mexico. The MOU provides for exclusivity in the development of the projects and the related transportation and interconnecting pipelines to and from the storage facilities.

We have completed the initial study of the Burgos facility and expect to receive permits to construct, own and operate the storage facility and the interconnecting pipelines from the Comision Reguladora de Energia (the Mexican regulatory branch of the Secretary of Energy). The capital budget for these two projects exceeds \$700 Million Dollars and is expected to be funded through issuance of additional equity of the Company, the addition of joint venture partners and/or debt financing. Marea Associates, L.P. was formed to own the majority interest in Terranova Energia, S. de R.L. de C.V., a Mexican company which will conduct all business dealings in Mexico on behalf of Tidelands. Rio Bravo Energy LLC, an existing wholly owned subsidiary owns the general partner interest in Marea Associates, L.P. and a minority interest in Terranova Energia, S. de R.L. de C.V.

### Rio Bravo Energy, LLC

Rio Bravo Energy, LLC was formed on August 10, 1998 to operate the Chittim Gas Processing Plant which was purchased in 1999 and was processing natural gas primarily from Conoco Oil's Sacatosa Field. The Sacatosa Field was primarily an oilfield which produced high BTU casinghead gas from which gas processing operations would yield valuable hydrocarbon components such as propane, butane and natural gasolines. As the field depleted lower volumes of casinghead gas were being delivered by Conoco, and other gas producers could not be contracted with for processing of additional replacement volumes of gas. Therefore, in October 2002, the plant was temporarily shut down due to the declining economics associated with low volume operation of the plant. During 2002 through the fourth quarter of 2005 management planned to reopen the plant when adequate volumes of gas from third party producers was obtained to make plant operations economically attractive. However, we have been unsuccessful in locating a locally available and adequate supply of high BTU natural gas and have elected to dispose of the gas plant assets. Accordingly, our financial statements

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reflect an impairment charge with respect to the carrying value of these assets. Rio Bravo Energy LLC continues to serve as the parent company for Sonora Pipeline LLC, as the one percent general partner of Marea Associates, L.P. and owns a less than one percent minority interest in Terranova Energia, S. de R.L. de C.V.

### Sonora Pipeline, LLC

Sonora Pipeline, LLC was formed in January 1998 to operate the Sonora pipeline network which has the capability of delivering adequate volumes of natural gas for economic operation of the Chittim Gas Processing Plant. The pipeline network consists of approximately 80 miles of gas pipeline. This pipeline network was acquired in conjunction with the Chittim Gas Processing Plant acquisition and, when operational, could generate revenue from transportation fees to be charged to third party gas producers shipping natural gas to the gas plant owned by Rio Bravo Energy LLC. As noted above, management has evaluated the carrying value of these assets and has recorded an impairment charge in our financial statements with respect to pipeline network in addition to the gas plant. These assets will also be sold at a later date. In connection with the Mexican storage and pipeline project mentioned above, Sonora Pipeline LLC is the applicant before the Federal Energy Regulatory Commission for two U.S. pipelines that will transport gas bidirectionally to/from the United States to Mexico at two different international crossing points along the Rio Grande River in South Texas. The Progreso pipeline segment will be approximately 8.7 miles long and will commence at the existing Alamo station and extend southward and parallel an existing FERC permitted pipeline route to the international crossing point near

4

the City of Progreso, Hidalgo County, Texas. The Mission pipeline segment will be approximately 24.3 miles long and will commence at the existing HPL Valero Gilmore plant in south Texas and extend southward in parallel to existing pipelines to the international crossing point near the City of Mission, Hidalgo County, Texas. Both pipeline segments are expected to be 30 inches in diameter. Draft environmental reports are in the process of submittal and review and upon completion of these activities we expect to file applications for Certificates of Public Convenience and Necessity and seek Orders allowing the construction and operation of these U.S. pipeline segments of our Burgos Hub Storage and Pipeline project.

### Sonterra Energy Corporation Business

The assets of our Sonterra Energy Corporation subsidiary consist of propane distribution systems, including gas mains, yard lines, meters and storage tanks, serving the following residential subdivisions in the Austin, Texas area. The subdivisions include:

- o Arbolago\*
- o Austin's Colony Phase II
- o Costa Bella
- o Hills of Lakeway
- o Jacarandas
- o Lake Pointe
- o La Ventana
- o Lakewinds Estates
- o Northshore on Lake Travis Phase I
- o Riverbend
- o Rob Roy Rim

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- o Senna Hills
- o Sterling Acres
- o The Point
- o The Preserve at Barton Creek

These subdivisions contain approximately 1,700 lots. At December 31, 2005, 1,067 of these lots are metered for use. There are approximately 633 unmetered future lots within the above subdivisions where propane service can be connected. As new homes are constructed on these lots our customer base will grow. An additional component of future growth will come from the establishment of propane distribution systems in other developments such as the recent agreement between Sonterra and Cordillera Ranch Development Corp. in which Sonterra is currently installing a tank site and gas mains to supply approximately 200 homes in Units 201-204 of that subdivision. Future phases of lot development at Cordillera Ranch will result in propane service being extended to approximately 300 more homes. Sonterra is in active negotiations for the installation of propane distribution systems with other developers of residential lots in the Texas Hill Country area between San Antonio and Austin, Texas

Sonterra is the exclusive seller of propane in these subdivisions and is not considered a regulated utility. The Texas Railroad Commission regulates all aspects of the production, transportation and processing of petroleum products, including propane, in the State of Texas. Sonterra purchases propane products from a number of distributors in Austin, Texas.

### Competition

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#### Reef Ventures, L.P. Eagle Pass Pipeline Crossing

Our Eagle Pass international pipeline crossing competes with a pipeline owned by West Texas Gas, Inc. pipeline crossing which is located two miles north of Eagle Pass. We believe that the West Texas Gas crossing will be able to compete with us only marginally beginning in 2006 due to a very limited transmission capability and marketing efforts currently being undertaken by Management.

5

#### Sonterra Energy Corporation Propane Distribution

Our propane distribution business is not subject to competition within the residential subdivisions served because we are the sole propane supplier. The residential subdivisions are subject to a propane supply covenant granting us the exclusive supply of propane for each subdivision. In the future, we will compete in the bidding process for new propane distribution systems as new residential subdivisions are developed. We may also be able to acquire additional existing propane distribution systems from competitors.

#### Employees

Tidelands has ten full time employees including our corporate officers. Our Sonterra Energy subsidiary, which operates the Austin propane gas distribution company, has eleven full-time employees.

#### ITEM 2. DESCRIPTION OF PROPERTIES

Reef Ventures, L.P. owns and operates the international natural gas pipeline and related facilities located in Maverick County, Texas and Coahuila, Mexico.

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Tidelands owns a 97% limited partnership interest and a 1% general partner interest (thru Arrecefe Management LLC) in this entity. We acquired these interests from Impact International, LLC. Impact financed our purchase of this system and we owe Impact \$ 4,496,768.

Rio Bravo Energy, LLC owns and operates the Chittim Gas Processing Plant which is located in Maverick, County, Texas. The plant is currently shut down. The gas plant has the capability to fractionate natural gas into commercial grade propane and butane. In the near future, we expect to sell these assets.

Sonora Pipeline, LLC owns the Sonora Pipeline network consisting of approximately 80 miles of pipeline. No significant encumbrances exist with respect to the assets of this company. The pipeline is currently inactive and could be used to transport natural gas from third party producers to supply feedstock for the Chittim Gas Processing Plant owned by Rio Bravo Energy LLC. In the near future, we expect to sell these assets. Sonora Pipeline LLC also plans to construct, own and operate approximately 33 miles of thirty inch diameter natural gas pipelines in Hidalgo County, Texas which will interconnect at the U.S.-Mexico border with the pipeline and storage assets to be constructed, owned and operated by Terranova Energia, S. de R.L. de C.V, another subsidiary of Tidelands Oil & Gas Corporation.

Sonterra Energy Corporation operates a propane distribution systems providing propane to 15 residential subdivisions in Austin, Texas. The propane distribution system is comprised of approximately 25 miles of gas main pipe, 75,000 feet of yard lines, 850 meters and storage tanks with a combined capacity of 156,000 gallons of LPG. Sonterra is currently constructing a propane distribution system for approximately 200 residential units in Cordillera Ranch, a rural subdivision located in Kendall County, Texas.

We lease our San Antonio executive office. We entered into this office lease on August 1, 2003. The term expired November 30, 2005. We held over our tenancy in the building under the month to month clause and renewed this lease on February 1, 2006 for a term until December 31, 2007. Our monthly lease payment is \$3,400. Our rent expense for 2005 was \$40,800. Sonterra Energy Corporation entered into a sublease agreement for its offices in an adjacent building for \$2,500 per month until its renewal in October 2005 at which time the rent increased to \$3,000 per month through March 31, 2006. However, on February 1, 2006, Sonterra Energy Corporation entered into a direct lease with the building owner at a rent of \$3,300 per month for a term ending December 31, 2007. Sonterra's rent expense for this office for 2005 was \$31,500.

6

### ITEM 3. LEGAL PROCEEDINGS

#### Matter No. 1:

On January 6, 2003, we were served as a third party defendant in a lawsuit titled Northern Natural Gas Company vs. Betty Lou Sheerin vs. Tidelands Oil & Gas Corporation, ZG Gathering, Ltd. and Ken Lay, in the 150th Judicial District Court, Bexar County, Texas, Cause Number 2002-C1-16421. The lawsuit was initiated by Northern Natural Gas when it sued Betty Lou Sheerin for her failure to make payments on a note she executed payable to Northern in the original principal amount of \$1,950,000. Northern's suit was filed on November 13, 2002. Sheerin answered Northern's lawsuit on January 6, 2003. Sheerin's answer generally denied Northern's claims and raised the affirmative defenses of fraudulent inducement by Northern, estoppel, waiver and the further claim that the note does not comport with the legal requirements of a negotiable

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instrument. Sheerin seeks a judicial ruling that Northern be denied any recovery on the note. Sheerin's answer included a counterclaim against Northern, ZG Gathering, and Ken Lay generally alleging, among other things, that Northern, ZG Gathering, Ltd. and Ken Lay, fraudulently induced her execution of the note. Northern has filed a general denial of Sheerin's counterclaims. Sheerin's answer included a third party cross claim against Tidelands. She alleges that Tidelands entered into an agreement to purchase the Zavala Gathering System from ZG Gathering Ltd. and that, as a part of the agreement, Tidelands agreed to satisfy all of the obligations due and owing to Northern, thereby relieving Sheerin of all obligations she had to Northern on the \$1,950,000 promissory note in question. Tidelands and Sheerin agreed to delay the Tideland's answer date in order to allow time for mediation of the case. Tidelands participated in mediation on March 11, 2003. The case was not settled at that time. Tideland's answered the Sheerin suit on March 26, 2003. Tideland's answer denies all of Sheerin's allegations.

On May 24 and June 16, 2004 respectively, Betty Lou Sheerin filed her first and second amended original answer, affirmative defenses, special exceptions and second amended original counterclaim, second amended original third party cross-actions and requests for disclosure. In these amended pleadings, she sued Michael Ward, Royis Ward, James B. Smith, Carl Hessell and Ahmed Karim in their individual capacities. Her claims against these individuals are for fraud, breach of contract, breach of the Uniform Commercial Code, breach of duty of good faith and fair dealing and conversion. Sheerin has now non-suited her claims against Michael Ward, Royis Ward, and James B. Smith.

In September 2002, as a pre-closing deposit to the purchase of the ZG pipelines, the Company executed a \$300,000 promissory note to Betty L. Sheerin, a partner of ZG Gathering, Ltd. In addition, the Company issued 1,000,000 shares of its common stock to various partners of ZG Gathering, Ltd. On December 3, 2003, Sheerin filed a separate lawsuit against Tidelands in the 150th District Court of Bexar County, Texas on this promissory note seeking a judgment against Tidelands for the principle amount of the note, plus interest. On December 29th, 2003, Tidelands answered this lawsuit denying liability on the note. On April 1, 2004, Tidelands filed a plea in abatement asking the court to dismiss or abate Sheerin's lawsuit on the \$300,000 promissory note as it was related to and its outcome was dependent on the outcome of the Sheerin third party cross action against Tidelands in Cause Number 2002-C1-16421. The company believes that the promissory note and shares of common stock should be cancelled based upon the outcome of the litigation described above. Accordingly, our financial statements reflect this belief.

On September 15, 2004 and again on October 15, 2004 respectively, Sheerin amended her pleadings to include a third and fourth amended third party cross action against Tidelands adding a claim for the \$300,000 promissory note. In these amended pleadings, Sheerin also deleted her claims against Carl Hessell and Ahmed Karim. After adding the claim on the \$300,000 promissory note to the third party claims of Sheerin against Tidelands in Cause No. 2002-C1-16421, Sheerin dismissed Cause Number 2002-C1-16421.

Tidelands won a partial summary judgment against Sheerin as to all of her tort claims pled against Tidelands, save and except only her claim for conversion of 500,000 shares of Tidelands stock.

Sheerin seeks damages against Tidelands for indemnity for any sums found to be due from her to Northern Natural Gas Company, unspecified amounts of actual damages, statutory damages, unspecified amounts of exemplary damages, attorneys fees, costs of suit, and prejudgment and post judgment interest.



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On August 5, 2005, Northern Natural Gas Company filed its Fourth Amended Original Petition which, for the first time, named Tidelands as a defendant to Northern. Northern seeks to impose liability on Tidelands for \$1,950,000 promissory note signed by McDay Energy Partners, Ltd. (the predecessor to ZG Gathering, Ltd.) and Sheerin and the \$1,700,000 promissory note signed by McDay only. Northern contends that Tidelands is alternatively liable to Northern for payment of both such promissory notes totaling \$3,709,914 plus interest because Northern is a third party beneficiary under a December 3, 2001 purchase and sale agreement between ZG and Tidelands claiming that in such agreement Tidelands agreed to assume and satisfy all indebtedness due and owing Northern by Sheerin and ZG. Northern also claims that it is entitled to foreclosure of a lien on the gas gathering system and pipeline that was the subject of the promissory notes in question.

Tidelands has won a summary judgment motion it filed against Northern and the court has now dismissed Northern's claims against Tidelands.

On November 28, 2005, ZG Gathering, Ltd. and ZG Pipeline Management ("ZG") filed its answer to Northern's Fifth Amended Petition, its counter-claim against Northern, and its answer and cross claim against Tidelands. ZG contends that the promissory notes given by ZG and Sheerin to Northern were procured by Northern's fraudulent misrepresentations and it claims unspecified amounts of damages against Northern. ZG's cross action against Tidelands claims Tidelands entered into an agreement to purchase the Zavala Gathering System from ZG and that, as part of that agreement, Tidelands agreed to satisfy the \$3,700,914 Northern indebtedness of ZG, and to defend, indemnify, and hold ZG and Sheerin harmless from such indebtedness, to pay off a Sheerin loan of \$300,000, and to issue 1 million shares of Tidelands stock, of which 500,000 was to be free trading shares. ZG claims that Tidelands breached this agreement by failing to satisfy the Northern indebtedness, failing to defend and indemnify it from such debt, failing to pay off the \$300,000 note, failing to issue the free trading shares in Tidelands, and by placing a stop transfer order on the restricted stock that was issued by Tidelands. ZG seeks specific performance of the agreement, recovery of an unspecified amount of damages, and its attorney's fees.

Much of the discovery has been completed at this time. Based on investigation, and discovery to date, Tidelands appears to have a number of potential defenses to the claims of Sheerin and Northern. Tidelands intends to aggressively defend these lawsuits. The complexity of the issues in this case and the inherent uncertainties in litigation of this kind prevent a more definitive evaluation of the extent of Tidelands' liability exposure.

Matter No. 2:

On May 4, 2005, HBH Development Company, LLC initiated legal action against Sonterra Energy Corporation in the District Court of Travis County, Texas, 98th Judicial District, Cause No. GN 501626 HBH Development Co., LLC vs. Sonterra Energy Corp. This action involves the developer of the Austin's Colony Subdivision in Travis County, Texas and the propane distribution system originally constructed by Southern Union Company. Southern Union entered into a letter agreement with HBH concerning the construction and operation of a propane distribution system in the subdivision to be owned and operated by Southern Union. Southern Union assigned the letter agreement and its interests in the propane system to Oneok, Inc., the parent company of Oneok Propane Company. Sonterra acquired its interest in the propane system from Oneok Propane Distribution Company. HBH is claiming that Sonterra has failed or refused to pay HBH rent and easement use fees under the terms of the letter agreement. HBH alleges that Sonterra's actions cause a failure of the assignment whereby it acquired rights in the propane system or alternatively, if the assignment is effective, for breach of contract. HBH seeks to have the court terminate

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Sonterra's rights in the propane distribution system, award unspecified monetary damages, cancellation of the contract and rights associated with the propane distribution system, issue to HBH a writ of possession for the property, and for attorneys fees. HBH has amended its complaint adding claims for mutual mistake and reformation as to the letter agreement and a developer's bonus under terms of the letter agreement.

8

Sonterra is defending the legal action. It believes that under the terms of the letter agreement between HBH Development Company and Southern Union Company, that the easement use fees terminated when Southern Union conveyed its interest in the propane distribution system to Oneok Propane Company.

Matter No. 3:

On May 4, 2005, Senna Hills, Ltd. initiated legal action against Sonterra Energy Corporation in the District Court of Travis County, Texas, 53rd Judicial District Cause No. GN 501625 Senna Hills, Ltd. vs Sonterra Energy Corp. This action involves the developer of the Senna Hills Subdivision in Travis County, Texas and the propane distribution system originally constructed by Southern Union Company. Southern Union entered into a letter agreement with Senna Hills concerning the construction and operation of a propane distribution system in the subdivision to be owned and operated by Southern Union. Southern Union assigned the letter agreement and its interests in the propane system to Oneok, Inc., the parent company of Oneok Propane Company. Sonterra acquired its interest in the propane system from Oneok Propane Distribution Company. Senna Hills is claiming that Sonterra has failed or refused to pay Senna Hills rent and easement use fees under the terms of the letter agreement. Senna Hills alleges that Sonterra's actions cause a failure of the assignment whereby it acquired rights in the propane system or alternatively, if the assignment is effective, for breach of contract. Senna Hills seeks to have the court terminate Sonterra's rights in the propane distribution system, award unspecified monetary damages, and cancellation of the contract and rights associated with the propane distribution system, issue to Senna Hills a writ of possession for the property, and attorneys fees.

Senna Hills sold certain undeveloped sections of Senna Hills Subdivision to a new owner. Sonterra believes that it has the right to expand its distribution system into such undeveloped sections of the subdivision. Sonterra plans to expand the distribution system into these sections under an agreement with the new owner. Senna Hills has stated that although it is not presently objecting to Sonterra's expansion of the system at this time, it is reserving its claim that Sonterra does not have the right to do so and that it intends to ask the court to cancel Sonterra's right to use and possession of the propane distribution system, including the system in the new sections of the subdivision. Senna Hills has amended its complaint adding claims for mutual mistake and reformation as to the letter agreement and a developer's bonus under terms of the letter agreement.

Sonterra is defending the legal action. It believes that under the terms of the letter agreement between Senna Hills and Southern Union Company, that the easement use fees terminated when Southern Union conveyed its interest in the propane distribution system to Oneok Propane Company.

Matter No. 4:

On April 7, 2005, Goodson Builders, Ltd. named Sonterra Energy Corporation in a legal action titled, Goodson Builders, Ltd, Plaintiff vs. Jim

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Blackwell and BNC Engineering, LLC, Defendants. The legal action is in the District Court of Travis County, Texas 345th Judicial District. This legal action arises from a claim that an underground propane storage tank and underground distribution lines is situated on the Plaintiff's lot in the Hills of Lakeway subdivision, Travis County, Texas. Plaintiff alleges that there is no recorded easement setting forth the rights and obligations of the parties for use of the propane tank and lines. However, there is reference to a "suburban propane easement" on the plat document. Plaintiff alleges that the property is being used without permission and the use constitutes an on-going trespass. Plaintiff asks the court to determine that his lot is not subject to a "suburban propane easement", declare the propane equipment the property of plaintiff, enjoin Sonterra from use of Plaintiff's land, and award damages. The Plaintiff seeks damages of \$165,000 based on a market rental rate he claims to be \$5,000 per month, \$50,000 damages for depreciation of the value of the lot, an unspecified amount of exemplary damages, and attorneys' fees. Sonterra is defending the claims.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were brought to a vote of the security holders during the quarter ended December 31, 2005.

9

## PART II

### ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

#### Market For Common Equity And Related Stockholder Matters

Our common stock is traded on the OTC Electronic Bulletin Board. The following table sets forth the high and low bid prices of our common stock for each quarter for the years 2005 and 2004. The quotations set forth below reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

#### Common Stock

Our common stock trades Over-the-Counter (OTC) on the OTC Bulletin Board under the symbol TIDE. Table 1. sets forth the high and low bid information for the past two years. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions. These quarterly trade and quote data provided by NASDAQ OTC Bulletin Board.

Table 1.

#### Bid Information

#### Fiscal Quarter Ended

	High	Low
December 31, 2005	1.01	0.76
September 30, 2005	1.39	0.80
June 30, 2005	1.77	0.95
March 31, 2005	2.59	1.74
December 31, 2004	1.36	0.60
September 30, 2004	2.18	0.73

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June 30, 2004	3.18	1.70
March 31, 2004	4.45	1.72

On December 31, 2005, the closing bid and closing ask prices for shares of our common stock in the over-the-counter market, as reported by NASD OTC BB were \$0.87 and \$0.88 per share, respectively.

We believe that there are presently 39 market makers for our common stock. When stock is traded in the public market, characteristics of depth, liquidity and orderliness of the market may depend upon the existence of market makers as well as the presence of willing buyers and sellers. We do not know if these or other market makers will continue to make a market in our common stock. Further, the trading volume in our common stock has historically been both sporadic and light.

As of December 31, 2005, we had an aggregate of 86 stockholders of record as reported by our transfer agent, Signature Stock Transfer Co., Inc. Certain shares are held in the "street" names of securities broker dealers and we estimate the number of stockholders which may be represented by such securities broker dealer accounts may exceed 5,000.

### Dividends and Dividend Policy

There are no restrictions imposed on the Company which limit its ability to declare or pay dividends on its common stock, except as limited by state corporation law. During the year ended December 31, 2005, no cash or stock dividends were declared or paid and none are expected to be paid in the foreseeable future.

10

We expect to continue to retain all earnings generated by our future operations for the development and growth of our business. The Board of Directors will determine whether or not to pay dividends in the future in light of our earnings, financial condition, capital requirements and other factors.

### Securities Authorized for Issuance under Equity Compensation Plans

The following table summarizes our equity compensation plan information as of December 31, 2005. Information is included for equity compensation plans not approved by our security holders.

Table 1.

#### Equity Compensation Plan Information

Plan Category	Number of Securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average Exercise price of outstanding options, warrants, and rights	Number of Securities remaining available for future issuance under equity compensation plans (excluding securities reflected column (a))
	(a)	(b)	(c)

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Equity Compensation Plans approved by security holders	None	None	None
Equity Compensation Plans not approved by security holders	5,000,000 (1)	\$ 0.287	-0-
	5,000,000 (2)	\$ 0.87	4,350,122
Total	10,000,000		4,350,122

(1) On May 27, 2003, the Company adopted the 2003 Non-Qualified Stock Grant and Option Plan. The Plan reserved 5,000,000 shares. The Plan is administered by our Board of Directors. Directors, officers, employees consultants, attorneys, and others who provide services to our Company are eligible participants. Participants are eligible to be granted warrants, options, common stock as compensation. We granted 210,122 shares from this plan during 2005, 200,000 for legal services, 10,000 shares to Robert Dowies under the terms of his Employment Agreement and 122 shares to James Smith as a part of his 150,000 share employee bonus. The balance of this bonus was issued from the Plan outlined in footnote 2 below.

(2) On November 2, 2004, the company adopted the 2004 Non-Qualified Stock Grant and Option Plan. The Plan reserved 5,000,000 shares. The Plan is administered by our Board of Directors. Directors, officers, employees consultants, attorneys, and others who provide services to our Company are eligible participants. Participants are eligible to be granted warrants, options, common stock as compensation. During 2005, we granted 148,878 shares to James Smith the balance of his 150,000 share employee bonus.

### Recent Sales of Unregistered Securities

All sales of unregistered securities have been previously reported in our filed periodic reports filed with the Securities & Exchange Commission on Forms 8-K and 10-QSB.

## ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

### Business Overview

Our products and services are primarily focused on development and operation of transportation, processing, distribution and storage projects for natural gas and natural gas liquids in the northeastern states of Mexico (Chihuahua, Coahuila, Nuevo Leon and Tamaulipas) and the state of Texas in the United States of America.

We derive our revenue from transportation fees from delivery of natural gas to Conagas, the local distribution company in Piedras Negras, Coahuila, through the pipeline owned by Reef Ventures, L.P. and the sale of propane gas to residential customers through the assets owned by Sonterra Energy Corporation. This company also designs and constructs residential propane delivery systems for new residential developments in Central Texas. We derive revenue from this activity in two ways, the first being from construction revenue for yard lines and meter sets installed to a homeowner's lot, and the second being the sale of LPG gas to

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customers in the residential subdivisions.

With respect to our pipeline system owned by Reef Ventures, L.P., management is has evaluated an expansion of the pipeline in Coahuila to serve new markets along the state highway No. 57 corridor to Monclova, Coahuila. We currently expect that Reef Ventures, L.P. will not be participating in the construction of additional pipeline in Mexico to reach these new markets. The required pipeline will be constructed by end users or an intermediate purchaser of the natural gas. Reef Ventures, L.P. will simply continue to transport the additional volumes of natural gas required for these markets through its existing facilities which will be interconnected in Mexico to the new pipeline that is required to reach these potential markets. Management believes the timeline for the initiation of construction for such pipeline project in Mexico is likely to be a 2007 event. The increased volume for the Reef Ventures pipeline from such an event would approximate 2-3 times the entire baseload of demand for natural gas currently taken by the local distribution company, CONAGAS. The expected end users would be a brewery and bottling operation. While these entities have begun feasibility studies for the construction and operation of their businesses, no final decision has been made concerning the building of these facilities. There is a risk that the facilities will never be built because other sites in Mexico are deemed to be more advantageous for the location of these facilities. In that event, the expected growth in volumes for the Reef Ventures pipeline will not materialize. In addition to these potential developments, management believes that increasing volumes of natural gas can be transported in its existing facilities. In 2005, which was the final year of a two year contractual nomination scheme, the Reef Ventures pipeline was carrying only half the actual baseload volume (and none of the swing volume) being transported to CONAGAS in Piedras Negras. We believe that if given adequate supplies, the Reef Ventures pipeline can transport all the current base load and the swing requirements of CONAGAS which would result in a doubling of volumes and revenues for the pipeline. Negotiations are currently underway to achieve that objective. The planned natural gas liquid line between Eagle Pass, Texas and Piedras Negras, Coahuila has been re-evaluated in light of new supply sources emerging in Texas and Mexico and the subsidy scheme for LPG and natural gas currently in use in Mexico. It appears that the project will need to be developed as a transportation fee business model instead of a merchant facility where LPG is purchased in Texas and re-sold in a direct contract with the propane importation arm of PEMEX. This determination was made in order to reduce the risk of any future cost incurred on the LPG project. Management will continue to seek a transportation contract which would support development and operation of this project.

Sonterra Energy Corporation, a wholly owned subsidiary of Tidelands entered into the residential propane distribution business on November 1, 2004 with its acquisition of 850 existing customers located in 15 subdivisions in the vicinity of Austin, Texas. At December 31, 2005, Sonterra had increased its number of meter hookups to 1,067 and is expecting a 15% rate of increase in the number of new meter hookups in 2006. Sonterra's existing and future market area includes several central Texas locations that do not have access to natural gas as a fuel for home heating and appliance usage. Current expansion of over 600 lots within the existing subdivisions is possible. Sonterra has also entered into a new agreements with the developers of Cordillera Ranch and Northshore at Lake Travis

to expand the serviced lots by an additional 1,500 units over time. Active negotiations with developers in our trade area will likely result in additional lots becoming available for installation of residential propane delivery in the nearby central Texas vicinity. Revenue growth from propane sold was \$250,000

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higher than projected primarily due to unit growth as opposed to price increases applied to product sold. The principal risk in the growth picture for this business unit comes from a slowing in the absorption rate for developed lots due to the interest rate cycle. This in turn would slow the rate of meter hookups in the subdivisions served.

Sonora Pipeline LLC will own and operate the U.S. (Texas) pipeline segments to be constructed in connection with the Mexican pipeline, LNG regasification terminal and gas storage projects which will interconnect to the U.S. via two international pipeline crossings in Hidalgo County, Texas. Management will be filing with the Federal Energy Regulatory Commission for permission to operate these new pipelines and for the granting of presidential permits for the international crossings near Mission and Progreso, Texas for delivery of natural gas into the state of Tamaulipas and the pipelines owned by our Mexican subsidiary, Terranova Energia S. de R.L. de C.V.

The Company is focusing on the development of infrastructure projects through its Mexican entity, Terranova Energia S.de R.L. de C.V., in the nation of the United Mexican States (Mexico). Terranova Energia is focused on project development and implementation of a natural gas storage and transportation infrastructure to support the integration of Northeastern Mexico and South Texas and the related economic growth of the border regions.

Tidelands and Terranova Energia have hired project development advisors in the United States and Mexico. The Terranova Energia advisors include ALB Energia, Rich, Heather Muller, Abogados and Miriam Grunstein, Abogada. The Tidelands advisors include Netherland Sewell & Associates, CenterPoint Energy, LLC, Mayer Brown Rowe & Maw, LLP, BNC Engineering, LLC, HSBC Securities, USA, Inc. and R.W. Beck, Inc.

The Terranova Energia project was developed to serve the need to of CFE, the Mexican federal electricity commission, to manage swing and seasonal spread in its procurement and dispatch of natural gas to its combined cycle power plants in Northern Mexico. The region's forecasted growth will require additional natural gas for power generation in the region. The same need to manage swing and seasonal spread is present for the industrial users of natural gas in Northern Mexico, in particular, the industrial users located in the Monterrey, Nuevo Leon area.

Our project area is called the Burgos Hub and Storage Project. Our medium term goals, subject to a variety of factors, including, but not limited to, regulatory permitting, engineering design, financing, construction and operating agreements, are focused on the Brasil storage field and Terranova Occidente pipeline.

The pipelines proposed are (A) the Occidente Section comprised of: (1) a pipeline from the Brasil Storage field to Nuevo Progreso, proposed international pipeline crossing into the U.S., (2) a pipeline from Brasil storage to Station 19 up to Arguelles which is another proposed international pipeline crossing into U.S. and (3) a pipeline from Pemex's Station 19 south of Reynosa which will extend southward to the Monterrey Nuevo Leon area; and (B) the Oriente Section from the offshore regasification station to Norte Puerto Mezquital proceeding to the Brazil storage field. The Occidente Section will include approximately 323 kilometers of pipeline and the Oriente Section will contain approximately 149 kilometers of pipeline. Our long term goal includes the construction of the offshore LNG regasification station.

The proposed international pipeline crossings into South Texas are the Donna Station and Arguelles and VGP station. At the Donna station our potential interconnects into Texas are with TETCO, TGPL and Texas Gas Services. At the Arguelles and VGP station our potential interconnects are with HPL, Calpine and

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Kinder Morgan. The Terranova pipeline capacity is estimated at 1.2 BCFD (billion cubic feet per day).

13

The Terranova pipelines have been designed for 30 and 36 inch diameter with bi-directional flow. The pipeline from the proposed LNG regasification terminal to the Brasil field is a 36 inch diameter pipeline and from the Brasil field to Monterey and international crossings are 30 inch diameter pipelines.

We submitted the permit application for the Terranova pipeline Occidente section to the CRE, the Mexican energy regulatory entity, on March 18, 2005 and they were accepted for full review on June 14, 2005. Management understands that the average time for processing and receiving pipeline permits is 15 months, accordingly, a decision concerning this permit application is expected from the Comision Reguladora de Energia (CRE) in the second quarter of 2006.

The proposed underground natural gas storage facility will be located in the depleted reservoir at the B1 Horizon-Brasil Field and include above ground facilities. Our design proposal for the use of this depleted reservoir as a storage facility was prepared by Netherland Sewell. Netherland Sewell, after geological and mechanical modeling, reported the reservoir at the B1 horizon as suitable for natural gas storage. The design capacity of the storage field contemplates incremental increases in capacity over three seasons. The first season capacity is 25 BCF (billion cubic feet), second season capacity is 40 BCF and third season onward is 50 BCF. The design proposes that natural gas be injected into the reservoir at 350 MMCFD (million cubic feet per day) at pressures from 2,400 psi up to 3,200 psi. Extraction flows of natural gas will be kept at 500 MMCFD to maintain structural integrity of the reservoir. The storage facility plans call for 22 injection and extraction wells. The above ground facilities will include compression stations.

We submitted the storage permit to the CRE on August 5, 2005 and it was accepted for full review on October 14, 2005. Several unique questions are presented by the filing of this permit due to the proposed location and the lack of previous storage permit applications having been considered by CRE. As a result, management has no reliable estimate concerning when this permit application will be presented for decision by staff to the CRE Commissioners.

The proposed Offshore LNG Regasification Station will be based on technology developed by the Norwegian company TORP Technology. It utilizes an unmanned floating station called a HiLoad. It has a peak capacity of 1.4 BCFD (billion cubic feet per day). This technology permits any LNG carrier vessel to connect and carry out regasification operations without any vessel modifications. It utilizes LNG vaporizers of the shell and tube type, with sea water as the heating medium. The LNG station will be located no less than 40 nautical miles from the coast at a depth of 450 feet. A support station with a power generation system and central control will be located on-shore. A buoy will support the mooring of the LNG carrier vessels. Electrical power cables, control umbilicals and pipelines will connect the HiLoad to the on-shore support station.

There are significant challenges for the natural gas supply to the power generation industry in Northeastern Mexico. We believe the CFE has taken a proactive role in this region with a view to substantially improving the reliability, flexibility and pricing of the natural gas supply. Presently, there are three LNG regasification projects permitted or under construction in Mexico at Altamira, Rosarito and Manzanillo. Additionally, there new electrical generation plants and associated pipelines under construction. The CFE has



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forecasted natural gas demand growth in the region from 2004 through year 2013. The CFE forecasts gas demand will increase from 1.7 BCFD in 2004 to 4.2 BCFD in 2013. Natural gas storage facilities in northern Mexico will provide a reliable, flexible gas supplies while creating conditions for competitive natural gas pricing.

With the assistance of our financial advisory firm, we have determined that financing of the project should be possible under a commercial structure acceptable to debt providers that would involve long-term capacity reservation agreements with creditworthy counterparties for each constituent element of the project. Another essential factor that is critical for the project's ability to raise debt financing is the ability of Terranova to attract equity capital from strategic and/or financial investors in the amounts which are likely to be required by debt providers. Our financial advisory firm has assisted us in making presentations of the project to the potential strategic and financial equity investors. We have received positive feedback from several such parties. On this basis, we could conclude that the project, in its currently envisioned configuration, could attract considerable equity capital from the potential investors. Investor appetite will depend on our ability to obtain an acceptable

14

commercial structure, relevant permits and other regulatory approvals and the fulfillment of other conditions standard for non-recourse project financing.

We have undertaken a risk analysis of the project and have identified the following project specific risks:

### Construction Risks:

- Delays in completion within the budget
- Failure of the EPC contractor to meet the required contractual performance levels

### Operating Risks:

- Project performing below expected levels of efficiency
- Increased operating costs due to insufficiency of technology
- Delays due to inclement weather, breakdown or failure of equipment and third party risks

### Market risks:

- Cushion gas price exposure

### Regulatory risks:

- Inability of Terranova to obtain the necessary permits and/or rights of way
- Changes in the regulatory conditions and requirements may directly affect the profitability of the project

### Environmental risks:

- The construction and operation of the project may result in adverse environmental or social impact, which could delay completion of the construction, curtail operation and result in payments of fines or remediation.

### Inflation risks:

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- Increased operating costs adversely affecting the project's earnings

### Financial risks:

- Interest rate risk
- Foreign exchange risk

### Political risks:

- The risks of expropriation, nationalization, inability to obtain foreign exchange and transfer it outside of the project country. (Also see "Sovereign Risk" section in Risk Factors)

While the above risks are typically dealt with through contractual mechanisms in project finance and other documents, no assurance can be had that these risks will be successfully mitigated.

## RESULTS OF OPERATIONS

**REVENUES:** The Company reported revenues of \$1,861,323 for the twelve months ended December 31, 2005 as compared with revenues from continuing operations of \$1,883,838 for the twelve months ended December 31, 2004. The primary differences in year to year results occurred from the conversion of Reef Ventures, L.P. income from gas sales to transportation fees. In the year ended December 31, 2005, Reef Ventures sold no natural gas (\$0) compared to \$1,323,459 of gas sales for the twelve months ended December 31, 2004. However, Reef Ventures, L.P. increased transportation fees to \$231,077 for the twelve months ended December 31, 2005 compared to transportation fees of \$76,767 for the twelve months ended December 31, 2004, an increase of \$154,310. In addition, the mix of revenues earned by Sonterra Energy Corporation showed a significant change in terms of propane gas sales due to the reporting of a full year of operations in 2005 versus three months for the 2004 year. Propane sales for Sonterra Energy Corporation for the twelve months ended December 31, 2005 were \$1,494,679 compared to sales of \$400,637 for the twelve months ended December 31, 2004, an increase of \$1,094,042. Construction service revenues for Sonterra Energy Corporation increased to \$135,567 for the twelve months ended December 31, 2005 compared to \$82,975 for the twelve months ended December 31, 2004, an increase of \$52,592.

**TOTAL COSTS AND EXPENSES:** Total costs and expenses from continuing operations decreased from \$31,626,135 for the twelve months ended December 31, 2004 (as restated) to \$15,171,916 for the twelve months ended December 31, 2005. The most

significant decreases occurred in Beneficial Conversion Feature Interest, Sales, General and Administrative and Impairment Losses. Each of the decreases in these categories of expenses resulted primarily from results related to the matters discussed in Footnotes 1 and 2 of the financial statements for the year ended December 31, 2005 and as described in the related sections below.

**COST OF SALES:** Total Cost of Sales decreased from \$1,508,891 for the twelve months ended December 31, 2004 to \$1,003,386 for the twelve months ended December 31, 2004. Due to the conversion of Reef Ventures, L.P. to a transportation arrangement for its business versus the purchase and sale of natural gas, its cost of sales decreased from \$1,299,518 for the twelve months ended December 31, 2004 to zero (\$0) for the twelve months ended December 31, 2005. Cost of sales for Sonterra Energy Corporation rose from \$209,373 for the twelve months ended December 31, 2004 to \$1,003,386 for the twelve months ended

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December 31, 2005, an increase of \$794,013. As stated in the Revenue discussion above, this increase was primarily the result of twelve months of operations reported in 2005 versus only three months of operations reported in 2004.

**OPERATING EXPENSES:** Operating expenses from continuing operations which are expenses related to the operation of Company assets in an active business segment increased from \$99,665 for the twelve months ended December 31, 2004 to \$202,766 for the twelve months ended December 31, 2005 which is a total increase of \$103,101. This increase was primarily from the operating expenses incurred by Sonterra Energy Corporation. Depreciation expense increased from \$244,889 for the the twelve months ended December 31, 2004 to \$485,481 for the twelve months ended December 31, 2005 due to a full year of depreciation being incurred in the 2005 year versus seven months of depreciation expense in 2004 on the natural gas pipeline owned by Reef Ventures, L.P. and the depreciable assets acquired by Sonterra Energy Corporation for the operation of the residential propane distribution systems in Austin, Texas.

**INTEREST EXPENSE:** Interest expense increased from \$300,566 during the twelve months ended December 31, 2004 to \$611,363 primarily due to twelve months of carrying cost in 2005 for the debt incurred to acquire the natural gas pipeline owned by Reef Ventures, L.P. versus seven months of interest cost reported in the 2004 acquisition year for these assets. As described in Footnote 2, the Company has restated its December 31, 2004 financial statements and all subsequent quarterly financial statements to account for the cost of the embedded beneficial conversion feature inherent in the convertible notes issued to the MAG Capital, LLC investors on November 18, 2004. This beneficial conversion feature represents the difference between the conversion price for the debentures and the fair market value of the common stock at the commitment date and subsequent quarterly measurement dates. This discount was charged to interest expense because the conversion feature is at the option of the holder and can be exercised at any time. The Company has accordingly recognized interest expense in its restated December 31, 2004 financial statements in the amount of \$3,092,105 and (\$756,329) for the twelve months ended December 31, 2005. The negative figure for 2005 interest expense recognizes the fluctuation in the market price of the common stock into which the notes are converted at the quarterly measurement dates. The interest cost associated with the issuance and conversion of these debentures due to this beneficial conversion feature is limited to the relevant 2004 and 2005 years due to the completed conversion of all the debentures into common stock in the fourth quarter of 2005.

**SALES, GENERAL AND ADMINISTRATIVE:** Sales, General and Administrative expense for the restated twelve months ended December 31, 2004 was \$11,022,019. This amount includes restated amounts for stock issued for services and finance costs associated with the valuation of stock issued as part of the Impact International LLC acquisition in 2004. Sales, General & Administrative expenses for the twelve months ended December 31, 2005 was \$8,033,249 which is a decrease of \$2,988,770 as compared to the twelve months ended December 31, 2004. During 2005, the Company recognized significant decreases in consulting fees and finance costs which were offset by increased employee expenses, board of director compensation, and overhead from full year operations of Sonterra Energy Corporation in 2005.

**IMPAIRMENT LOSSES:** As described in Footnote 1, the Company has recognized impairment of goodwill recorded in connection with the Impact International LLC acquisition in the amount of \$5,200,000 and the impairment of the carrying value of the Chittim gas plant owned by Rio Bravo Energy LLC and the gas pipeline system connecting to the Chittim gas plant owned by Sonora Pipeline LLC in the amount of \$392,000 for the twelve months ended December 31, 2005.

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**GAIN ON REDUCTION OF WARRANT LIABILITY:** As part of the Impact International LLC acquisition in the year ended December 31, 2004, the Company issued warrants at a conversion price less than the fair market value of the common stock issuable upon the exercise of those warrants. Accordingly, the Company has restated its December 31, 2004 financial statements to recognize both the additional goodwill and the related warrant liability associated with that acquisition. An evaluation of the difference between the price of the common stock and the warrant exercise price on a quarterly basis was performed resulting in the Gain on Reduction of Warrant Liability amounts shown in the restated December 31, 2004 financial statements (\$15,390,000) and the amount shown in the December 31, 2005 financial statements (\$5,168,000). The warrants originally issued in connection with this acquisition have been exercised and all common stock related to their exercise has been issued as of the end of the year December 31, 2005.

**NET LOSS FROM OPERATIONS:** Net loss of (\$14,302,037) for the twelve months ended December 31, 2004 decreased to (\$7,662,904) for the twelve months ended December 31, 2005, a decrease in the amount of loss of \$6,639,133. Included in the net loss from operations is \$4,022,525 of expenses for financing costs, investor relations fees, legal fees, director fees and employee compensation paid by issuance of common stock.

**LIQUIDITY AND CAPITAL RESOURCES:** Direct capital expenditures during the twelve months ended December 31, 2005 totaled \$2,040,386 as compared with \$8,727,010 for the twelve months ended December 31, 2004. The increased capital expenditures were composed of increased office furniture, equipment and leasehold costs (\$128,271), higher pre-construction costs regarding potential international pipeline crossings and storage facilities in Mexico (\$1,529,982), machinery, equipment, trucks, autos and trailers for Sonterra Energy Corporation (\$83,078), and storage tanks and main lines for propane distribution (\$299,055). Total debt decreased from \$17,474,107 at December 31, 2004 (as restated) to \$5,722,322 at December 31, 2005. The decrease in total debt is primarily due to: (1) reduction in the acquisition indebtedness created in the acquisition of the Reef Ventures, L.P. partnership interests from Coahuila Pipeline LLC and Impact International LLC and (2) the conversion of Convertible Debentures held by the MAG Capital, LLC, formerly Mercator Advisory Group, LLC, funds, both which events are described in Note 6 and Note 8 of the Consolidated Financial Statements for the period ended December 31, 2005. Total debt as of December 31, 2005 and December 31, 2004 expressed as a percentage of the sum of total debt and shareholders' equity was 42.45% and 77.93% respectively.

Net loss for the twelve months ended December 31, 2005 was (\$7,662,904) a decrease in net loss of 46% from the net loss of (\$14,302,037) for the twelve months ended December 31, 2004 (as restated). Diluted net loss per common share decreased 59% to (\$0.11). The net loss per share calculation for the twelve months ended December 31, 2004 included an increase in actual and equivalent shares outstanding.

### FORWARD-LOOKING STATEMENTS:

We have included forward-looking statements in this report. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward looking statements. Without limiting the foregoing, words such as "may", "will", "expect", "believe", "anticipate", "estimate", "plan" or "continue" or the negative or other variations thereof or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, and actual results may differ materially depending on a variety of factors. Factors that might cause forward-looking statements to differ materially from actual results include, among other things, overall economic and business conditions, demand for the Company's products, competitive factors in the

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industries in which we compete or intend to compete, natural gas availability and cost and timing, impact and other uncertainties of our future acquisition plans.

17

### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK:

The Company does not issue or invest in financial instruments or their derivatives for trading or speculative purposes. The operations of the Company are conducted primarily in the United States, and, are not subject to material foreign currency exchange risk. Although the Company has outstanding debt and related interest expense, market risk of interest rate exposure in the United States is currently not material.

### RISK FACTORS

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In addition to the other information presented in this report, the following should be considered carefully in evaluating our business or purchasing shares of our common stock. Investing in our common stock involves a high degree of risk. This report contains various forward looking statements that involve risk and uncertainties. Our actual results may differ materially from the results discussed in the forward looking statements. Factors that might cause such a difference include, but are not limited to, those discussed below and elsewhere in this report.

### OPERATING LOSSES

We have had significant losses ever since starting business and we expect to continue losing money for some time. To date, we have incurred significant losses. For the year ended December 31, 2005, we lost \$7,662,904 and for the year ended December 31, 2004, we lost \$14,302,037. These losses were caused primarily by:

- o Financing costs in connection with acquisitions made in prior years and the issuance of convertible debentures;
- o Limited volumes of gas transported through the international pipeline crossing;
- o Pre-development and operating expenses associated with the development of additional pipeline and storage projects in Mexico;
- o Idle assets not producing revenue, such as the gas plant and associated pipeline.

### LIMITED OPERATING HISTORY.

We have a limited operating history and our financial health will be subject to all the risks inherent in the establishment of a new business enterprise. The likelihood of success of our company must be considered in the light of the problems, expenses, difficulties, complications, and delays frequently encountered in connection with the startup and growth of a new business, and the competitive environment in which we will operate. Our success is dependent upon the successful financing and development of our business plan. No assurance of success is offered. Unanticipated problems, expenses, and delays are frequently encountered in establishing a new business and marketing and developing products. These include, but are not limited to, competition, the need to develop customers and market expertise, market conditions, sales, marketing and governmental regulation. The failure of the Company to meet any of these

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conditions would have a materially adverse effect upon the Company and may force the Company to reduce or curtail operations. No assurance can be given that the Company can or will ever operate profitably.

WE DEPEND HEAVILY ON THE CONTINUED SERVICE OF OUR CHIEF EXECUTIVE OFFICER.

We place substantial reliance upon the efforts and abilities of Michael Ward, our chief executive officer. The loss of Mr. Ward's services could have a serious adverse effect on our business, operations, revenues or prospects. We maintain key man insurance on his life in the amount of One Million Dollars.

RELIANCE ON MANAGEMENT.

All decisions with respect to the management of our Company will be made by our Company's directors and officers. Accordingly, no person should purchase any shares offered by this Prospectus unless the subscriber is willing to entrust all aspects of management to the Directors and Officers of our Company. The loss of their services could have a material adverse effect on our Company's business and prospects.

18

TRADING IN OUR COMMON STOCK ON THE OTC BULLETIN BOARD MAY BE LIMITED.

Our common stock trades on the OTC Bulletin Board. The OTC Bulletin Board is not an exchange. Trading of securities on the OTC Bulletin Board is often more sporadic than the trading of securities listed on an exchange or NASDAQ. You may have difficulty reselling any of the shares that you purchase from the selling shareholders.

THERE HAS BEEN AN VOLATILE PUBLIC MARKET FOR OUR COMMON STOCK AND THE PRICE OF OUR STOCK MAY BE SUBJECT TO FLUCTUATIONS.

We cannot assure you that a liquid transparent trading market for our common stock will develop or be sustained. You may not be able to resell your shares at or above the initial offering price. The market price of our common stock is likely to be volatile and could be subject to fluctuations in response to factors such as the following, most of which are beyond our control:

- o operating results that vary from the expectations of securities analysts and investors;
- o changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- o the operations, regulatory, market and other risks discussed in this section;
- o announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- o announcements by third parties of significant claims or proceedings against us; and
- o future sales of our common stock.

In addition, the market for our stock has from time to time experienced extreme price and volume fluctuations. These broad market fluctuations may adversely affect the market price of our common stock.

OUR COMMON STOCK IS SUBJECT TO PENNY STOCK REGULATION.

Our common stock is subject to regulations of the Securities and Exchange

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Commission relating to the market for penny stocks. The Securities Enforcement and Penny Stock Reform Act of 1990 (the "Reform Act") also requires additional disclosure in connection with any trades involving a stock defined as a "penny stock" (generally, according to recent regulations adopted by the Commission, any equity security that has a market price of less than \$5.00 per share, subject to certain exceptions), including the delivery, prior to any penny stock transaction, of a disclosure schedule explaining the penny stock market and the risks associated therewith. These regulations generally require broker-dealers who sell penny stocks to persons other than established customers and accredited investors to deliver a disclosure schedule explaining the penny stock market and the risks associated with that market. These regulations also impose various sales practice requirements on broker-dealers. The regulations that apply to penny stocks may severely affect the market liquidity for our securities and that could limit your ability to sell your securities in the secondary market.

### RISKS RELATING TO LOW-PRICE STOCKS.

Because our stock is quoted on the NASD OTC Electronic Bulletin Board and subject to the Penny Stock Regulations, an investor may find it difficult to dispose of, or to obtain accurate quotations as to the market value of, our Company's securities. The regulations governing low-priced or penny stocks could limit the ability of broker-dealers to sell the Company's securities and thus the ability of the purchasers of this Offering to sell their securities in the secondary market.

### WE MAY NOT HAVE ENOUGH FUNDING TO COMPLETE OUR BUSINESS PLAN.

We will need additional financing to fully implement our business plan. We cannot give any assurance that this additional financing could be obtained on attractive terms or at all. In addition, our ability to raise additional funds through a private placement may be restricted by SEC rules which limit a company's ability to sell securities similar to those being sold in a registered

19

offering before the time that offering is completed or otherwise terminated. Additionally, we may not have a sufficient quantity of common stock capital if all of the warrants are exercised and debentures converted. We would have to amend our articles of incorporation and increase our authorized common stock capital. Lack of funding could force us to curtail substantially or cease our operations.

### FUTURE CAPITAL NEEDS COULD RESULT IN DILUTION TO INVESTORS; ADDITIONAL FINANCING COULD BE UNAVAILABLE OR HAVE UNFAVORABLE TERMS.

Our Company's future capital requirements will depend on many factors, including cash flow from operations, progress in its gas operations, competing market developments, and the Company's ability to market its proposed products successfully. Although the Company currently has specific plans and arrangements for financing its working capital is presently insufficient to fund the Company's activities. It may be necessary to raise additional funds through equity or debt financings. Any equity financings could result in dilution to our Company's then-existing stockholders. Sources of debt financing may result in higher interest expense. Any financing, if available, may be on terms unfavorable to the Company. If adequate funds are not obtained, the Company may be required to reduce or curtail operations. The Company anticipates that its existing capital resources, together with the net proceeds of this Offering, will be adequate to satisfy its operating expenses and capital requirements for at least 6 months after the date of this Prospectus. However, such estimates may prove to be inaccurate.

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### SUBSTANTIAL CAPITAL REQUIREMENTS

We may make substantial capital expenditures for the development, acquisition and production of natural gas pipeline, processing systems and, or storage facilities. We believe that the Company will have sufficient cash provided by operating activities and equity financing to fund planned capital expenditures in the near future. If revenues or the Company's equity financing decrease as a result of lower natural gas prices, operating difficulties, the Company may have limited ability to expend the capital necessary to undertake or complete proposed plans and opportunities. There can be no assurance that additional debt or equity financing or cash generated by operations will be available to meet these requirements.

WE CAN GIVE NO ASSURANCE REGARDING THE AMOUNTS OF CASH THAT WE WILL GENERATE.

The actual amounts of cash we generate will depend upon numerous factors relating to our business which may be beyond our control, including:

- o the demand for natural gas;
- o profitability of operations;
- o required principal and interest payments on any debt we may incur;
- o the cost of acquisitions;
- o our issuance of equity securities;
- o fluctuations in working capital;
- o capital expenditures;
- o continued development of gas transportation network systems;
- o prevailing economic conditions;
- o government regulations.

WE DO NOT EXPECT TO PAY DIVIDENDS FOR SOME TIME, IF AT ALL.

No cash dividends have been paid on the Common Stock. We expect that any income received from operations will be devoted to our future operations and growth. We do not expect to pay cash dividends in the near future. Payment of dividends would depend upon our profitability at the time, cash available for those dividends, and other factors.

20

### COMPETITION

Our Company will be competing with other established businesses that market similar products. Many of these companies have greater capital, marketing and other resources than we do. There can be no assurance that these or other companies will not develop new or enhanced products that have greater market acceptance than any that may be marketed by the Company. There can be no assurance that our Company will successfully differentiate itself from its competitors or that the market will consider our products to be superior or to or more appealing than those of our competitors. Market entry by any significant competitor may have an adverse effect on our sales and profitability. See "Competition."

WE OPERATE IN HIGHLY COMPETITIVE MARKETS IN COMPETITION WITH A NUMBER OF DIFFERENT COMPANIES.

We face strong competition in our geographic areas of operations. Our competitors include major integrated oil companies, interstate and intrastate



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pipelines. We compete with integrated companies that have greater access to raw natural gas supply and are less susceptible to fluctuations in price or volume, and some of our competitors that have greater financial resources may have an advantage in competing for acquisitions or other new business opportunities.

GROWING OUR BUSINESS BY CONSTRUCTING NEW PIPELINES AND PROCESSING FACILITIES SUBJECTS US TO CONSTRUCTION RISKS AND RISKS THAT RAW NATURAL GAS SUPPLIES WILL NOT BE AVAILABLE UPON COMPLETION OF THE FACILITIES.

One of the ways we intend to grow our business is through the construction of additions to our existing gathering systems, modification of our existing gas processing plant and construction of new processing facilities. The construction of gathering and processing facilities requires the expenditure of significant amounts of capital, which may exceed our expectations. Generally, we may have only limited raw natural gas supplies committed to these facilities prior to their construction. Moreover, we may construct facilities to capture anticipated future growth in production in a region in which anticipated production growth does not materialize. As a result, there is the risk that new facilities may not be able to attract enough raw natural gas to achieve our expected investment return, which could adversely affect our results of operations and financial condition.

A SIGNIFICANT COMPONENT OF OUR GROWTH STRATEGY WILL BE ACQUISITIONS AND WE MAY NOT BE ABLE TO COMPLETE FUTURE ACQUISITIONS SUCCESSFULLY.

Our business strategy will emphasize growth through strategic acquisitions, but we cannot assure you that we will be able to identify attractive or willing acquisition candidates or that we will be able to acquire these candidates on economically acceptable terms. Competition for acquisition opportunities in our industry exists and may increase. Any increase in the level of competition for acquisitions may increase the cost of, or cause us to refrain from, completing acquisitions.

Our strategy of acquisitions is dependent upon, among other things, our ability to obtain debt and equity financing and possible regulatory approvals. Our ability to pursue our growth strategy may be hindered if we are not able to obtain financing or regulatory approvals, including those under federal and state antitrust laws. Our ability to grow through acquisitions and manage such growth will require us to invest in operational, financial and management information systems and to attract, retain, motivate and effectively manage our employees. The inability to manage the integration of acquisitions effectively could have a material adverse effect on our financial condition, results of operations and business. Pursuit of our acquisition strategy may cause our financial position and results of operations to fluctuate significantly from period to period.

IF WE ARE UNABLE TO MAKE ACQUISITIONS ON ECONOMICALLY AND OPERATIONALLY ACCEPTABLE TERMS, OUR FUTURE FINANCIAL PERFORMANCE MAY BE LIMITED.

There can be no assurance that:

21

- o we will identify attractive acquisition candidates in the future;
- o we will be able to acquire assets on economically acceptable terms;
- o any acquisitions will not be dilutive to earnings and operating surplus; or

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- o any debt incurred to finance an acquisition will not affect our ability to make distributions to you.

If we are unable to make acquisitions on economically and operationally acceptable terms, our future financial performance will be limited to the performance of our present gas gathering network.

Our acquisition strategy involves many risks, including:

- o difficulties inherent in the integration of operations and systems;
- o the diversion of management's attention from other business concerns; and
- o the potential loss of key employees of acquired businesses.

In addition, future acquisitions may involve significant expenditures. Depending upon the nature, size and timing of future acquisitions, we may be required to secure financing. We cannot assure you that additional financing will be available to us on acceptable terms.

OUR BUSINESS IS DEPENDENT UPON PRICES AND MARKET DEMAND FOR NATURAL GAS AND PROPANE, WHICH ARE BEYOND OUR CONTROL AND HAVE BEEN EXTREMELY VOLATILE.

We are subject to significant risks due to fluctuations in commodity prices, primarily with respect to the prices of gas that we may own as a result of our processing and distribution activities.

The markets and prices for residue gas depend upon factors beyond our control. These factors include demand for oil, and natural gas, which fluctuate with changes in market and economic conditions and other factors, including:

- o the impact of weather on the demand for oil and natural gas;
- o the level of domestic oil and natural gas production;
- o the availability of imported oil and natural gas;
- o the availability of local, intrastate and interstate transportation systems;
- o the availability and marketing of competitive fuels;
- o the impact of energy conservation efforts; and
- o the extent of governmental regulation and taxation.

WE GENERALLY DO NOT OWN THE LAND ON WHICH OUR PIPELINES ARE CONSTRUCTED AND WE ARE SUBJECT TO THE POSSIBILITY OF INCREASED COSTS FOR THE LOSS OF LAND USE.

We generally do not own the land on which our pipelines are constructed. Instead, we obtain the right to construct and operate the pipelines on other people's land for a period of time. If we were to lose these rights, our business could be affected negatively.

### RISKS RELATED TO THE RETAIL PROPANE AND ASSOCIATED BUSINESSES

- o Decreases in the demand for propane because of warmer weather may adversely affect our financial condition and results of operations.
- o Weather conditions have a significant impact on the demand for propane for heating purposes. All of our propane customers rely heavily on propane as a heating fuel. The volume of propane sold is at its highest during the six-month peak heating season of October through March and is directly affected by the severity of the winter weather. We estimate

that approximately two-thirds of our annual retail propane volume will be sold during these months. Actual weather conditions can vary substantially from quarter to quarter and year to year, significantly affecting our financial performance. Furthermore, warmer than normal temperatures in our service area can significantly decrease the total volume of propane we sell. Consequently, our operating results may vary significantly due to actual changes in temperature. Weather conditions in any quarter or year may have a material adverse effect on our operations.

- o Sudden and sharp propane price increases that cannot be passed on to customers may adversely affect our profits, income, and cash flow.
- o Energy efficiency and technology may reduce the demand for propane and our revenues.
- o The national trend toward increased conservation and technological advances, including installation of improved insulation and the development of more efficient furnaces and other heating devices, has adversely affected the demand for propane by retail customers. Future conservation and efficiency measures or technological advances in heating, conservation, energy generation, or other devices might reduce demand for propane and our revenues.
- o The propane business is highly regulated. New or stricter environmental, health, or safety regulations may increase our operating costs and reduce our net income.
- o The propane business is subject to a wide range of federal, state, and local environmental, transportation, health and safety laws and regulations governing the storage, distribution, and transportation of propane. We may have increased costs in the future due to new or stricter safety, health, transportation, and environmental regulations or liabilities resulting from non compliance with operating or other regulatory permits. The increase in any such costs may reduce our net income.
- o We will be subject to all operating hazards and risks normally associated with handling, storing, transporting, and delivering combustible liquids such as propane for use by consumers. As a result, we may be a defendant in various legal proceedings and litigation arising in the ordinary course of business. Our insurance may not be adequate to protect us from all material expenses related to potential future claims for personal injury and property damage or that insurance will be available in the future at economical prices. In addition, the occurrence of a serious accident, whether or not we are involved, may have an adverse effect on the public's desire to use our products.

#### GOVERNMENT REGULATION AND ENVIRONMENTAL MATTERS

Our business is regulated by certain local, state and federal laws and regulations relating to the exploration for, and the development, production,

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marketing, pricing, transportation and storage of, natural gas and oil. We are also subject to extensive and changing environmental and safety laws and regulations governing plugging and abandonment, the discharge of materials into the environment or otherwise relating to environmental protection. In addition, we are subject to changing and extensive tax laws, and the effect of newly enacted tax laws cannot be predicted. The implementation of new, or the modification of existing, laws or regulations, including regulations which may be promulgated under the Oil Pollution Act of 1990, could have a material adverse effect on the Company.

FEDERAL, STATE OR LOCAL REGULATORY MEASURES COULD ADVERSELY AFFECT OUR BUSINESS.

While the Federal Energy Regulatory Commission, or FERC, does not directly regulate the major portions of our operations, federal regulation, directly or indirectly, influences certain aspects of our business and the market for our products. As a raw natural gas gatherer and not an operator of interstate transmission pipelines, we generally are exempt from FERC regulation under the

23

Natural Gas Act of 1938, but FERC regulation still significantly affects our business. In recent years, FERC has pursued pro-competition policies in its regulation of interstate natural gas pipelines. However, we cannot assure you that FERC will continue this approach as it considers proposals by pipelines to allow negotiated rates not limited by rate ceilings, pipeline rate case proposals and revisions to rules and policies that may affect rights of access to natural gas transportation capacity.

While state public utility commissions do not regulate our business, state and local regulations do affect our business. We are subject to ratable take and common purchaser statutes in the states where we operate. Ratable take statutes generally require gatherers to take, without undue discrimination, natural gas production that may be tendered to the gatherer for handling. Similarly, common purchaser statutes generally require gatherers to purchase without undue discrimination as to source of supply or producer. These statutes are designed to prohibit discrimination in favor of one producer over another producer or one source of supply over another source of supply. These statutes also have the effect of restricting our right as an owner of gathering facilities to decide with whom we contract to purchase or transport natural gas. Federal law leaves any economic regulation of raw natural gas gathering to the states, and some of the states in which we operate have adopted complaint-based or other limited economic regulation of raw natural gas gathering activities. States in which we operate that have adopted some form of complaint-based regulation, like Oklahoma, Kansas and Texas, generally allow natural gas producers and shippers to file complaints with state regulators in an effort to resolve grievances relating to natural gas gathering access and rate discrimination. The states in which we conduct operations administer federal pipeline safety standards under the Pipeline Safety Act of 1968, and the "rural gathering exemption" under that statute that our gathering facilities currently enjoy may be restricted in the future. The "rural gathering exemption" under the Natural Gas Pipeline Safety Act of 1968 presently exempts substantial portions of our gathering facilities from jurisdiction under that statute, including those portions located outside of cities, towns, or any area designated as residential or commercial, such as a subdivision or shopping center.

OUR BUSINESS INVOLVES HAZARDOUS SUBSTANCES AND MAY BE ADVERSELY AFFECTED BY ENVIRONMENTAL REGULATION.

Many of the operations and activities of our gathering systems, plants and other

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facilities are subject to significant federal, state and local environmental laws and regulations. These include, for example, laws and regulations that impose obligations related to air emissions and discharge of wastes from our facilities and the cleanup of hazardous substances that may have been released at properties currently or previously owned or operated by us or locations to which we have sent wastes for disposal. Various governmental authorities have the power to enforce compliance with these regulations and the permits issued under them, and violators are subject to administrative, civil and criminal penalties, including civil fines, injunctions or both. Liability may be incurred without regard to fault for the remediation of contaminated areas. Private parties, including the owners of properties through which our gathering systems pass, may also have the right to pursue legal actions to enforce compliance as well as to seek damages for non-compliance with environmental laws and regulations or for personal injury or property damage.

There is inherent risk of the incurrence of environmental costs and liabilities in our business due to our handling of natural gas and other petroleum products, air emissions related to our operations, historical industry operations, waste disposal practices and the prior use of natural gas flow meters containing mercury. In addition, the possibility exists that stricter laws, regulations or enforcement policies could significantly increase our compliance costs and the cost of any remediation that may become necessary. We cannot assure you that we will not incur material environmental costs and liabilities. Furthermore, we cannot assure you that our insurance will provide sufficient coverage in the event an environmental claim is made against us.

Our business may be adversely affected by increased costs due to stricter pollution control requirements or liabilities resulting from non-compliance with required operating or other regulatory permits. New environmental regulations might adversely affect our products and activities, including processing, storage and transportation, as well as waste management and air emissions. Federal and state agencies also could impose additional safety requirements, any of which could affect our profitability.

24

### RISK OF ADDITIONAL COSTS AND LIABILITIES RELATED TO ENVIRONMENTAL AND SAFETY REGULATIONS AND CLAIMS

Our pipeline operations are subject to various federal, state and local environmental, safety, health and other laws, which can increase the cost of planning, designing, installing and operating such facilities. There can be no assurance that costs and liabilities relating to compliance will not be incurred in the future. Moreover, it is possible that other developments, such as increasingly strict environmental and safety laws, regulations and enforcement policies thereunder, and claims for damages to property or persons resulting from our operations, could result in additional costs to and liabilities for us.

### GOVERNMENTAL REGULATION OF OUR PIPELINES COULD INCREASE OUR OPERATING COSTS

Currently our operations involving the gathering of natural gas from wells are exempt from regulation under the Natural Gas Act. Section 1(b) of the Natural Gas Act provides that the provisions of the Act shall not apply to facilities used for the production or gathering of natural gas. Our physical dimensions and operations support the conclusion that our facilities perform primarily a gathering function. We should not, therefore, be subject to Natural Gas Act regulation. There, however, can be no assurance that this will remain the case. The Federal Energy Regulatory Commission's oversight of entities subject to the Natural Gas Act includes the regulation of rates, entry and exit of service,

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acquisition, construction and abandonment of transmission facilities, and accounting for regulatory purposes. The implementation of new laws or policies that would subject us to regulation by the Federal Energy Regulatory Commission under the Natural Gas Act could have a material adverse effect on our financial condition and operations. Similarly, changes in the method or circumstances of operation, or in the configuration of facilities, could result in changes in our regulatory status.

Our gas gathering operations are subject to regulation at the state level, which increases the costs of operating our pipeline facilities. Matters subject to regulation include rates, service and safety. We have been granted an exemption from regulation as a public utility in Texas. Presently, our rates are not regulated in Texas. Changes in state regulations, or our status under these regulations due to configuration changes in our operating facilities, that subject us to further regulation could have a material adverse effect on our financial condition. Litigation or governmental regulation relating to environmental protection and operational safety may result in substantial costs and liabilities.

Our operations are subject to federal and state environmental laws under which owners of natural gas pipelines can be liable for clean-up costs and fines in connection with any pollution caused by the pipelines. We can also be liable for clean-up costs resulting from pollution which occurred before our acquisition of the gathering systems. In addition, we are subject to federal and state safety laws that dictate the type of pipeline, quality of pipe protection, depth, methods of welding and other construction-related standards. While we believe that the gathering systems comply in all material respects with applicable laws, we cannot assure you that future events will not occur for which we may be liable. Possible future developments, including stricter laws or enforcement policies, or claims for personal or property damages resulting from our operations could result in substantial costs and liabilities to us.

### SOVEREIGN RISK

The Company is focusing on the development of infrastructure projects through its Mexican entity, Terranova Energia S.de R.L. de C.V., in the nation of the United Mexican States (Mexico). The risk of indirect or regulatory actions by local, state or federal authorities in Mexico which may inhibit, delay, hinder or block projects under development in Mexico is very high given the history of operations conducted by past businesses other than the Company in Mexico. There is a substantial risk that a set of actions taken by commission or omission by the various actors in the public, private, nongovernmental and/or social sectors could negatively impact a project or investment in Mexico. The legal system

25

employed in Mexico is dramatically different in its structure and method of operation compared to the common law foundation present in the United States of America. The level of legal protection afforded investors by the North American Free Trade Agreement has not materially improved from a foreign investor's viewpoint.

There can be no assurance that a commercially viable project will be completed due to the above factors which could result in commercial competitors trying to circumvent the market system through the exploitation of undocumented, extraofficial channels of influence that constitute unfair competition. Federal, state and local authorities are not well coordinated in their legal protections and improper influence and competition may arise from any level of government to disrupt or destroy the commercial viability of investments by foreign investors.

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While the Company has taken precautions to limit its investments to prudent levels, there is a continuing risk of adverse activities arising from the above sources that could impair or result in the entire loss of investment in otherwise commercially viable projects initiated by the Company in Mexico.

### PIPELINE SYSTEM OPERATIONS ARE SUBJECT TO OPERATIONAL HAZARDS AND UNFORESEEN INTERRUPTIONS

The operations of our pipeline systems are subject to hazards and unforeseen interruptions, including natural disasters, adverse weather, accidents or other events, beyond our control. A casualty occurrence might result in injury and extensive property or environmental damage. Although we intend to maintain customary insurance coverages for gathering systems of similar capacity, we can offer no assurance that these coverages will be sufficient for any casualty loss we may incur.

### OPERATING RISKS OF NATURAL GAS OPERATIONS

The natural gas business involves certain operating hazards. The availability of a ready market for our natural gas products also depends on the proximity of reserves to, and the capacity of, natural gas gathering systems, pipelines and trucking or terminal facilities. As a result, substantial liabilities to third parties or governmental entities may be incurred, the payment of which could reduce or eliminate the funds available for exploration, development or acquisitions or result in the loss of the Company's properties. In accordance with customary industry practices, the Company maintains insurance against some, but not all, of such risks and losses. The Company does not carry business interruption insurance. The occurrence of such an event not fully covered by insurance could have a material adverse effect on the financial condition and results of operations of the Company.

### OUR BUSINESS INVOLVES MANY HAZARDS AND OPERATIONAL RISKS, SOME OF WHICH MAY NOT BE COVERED BY INSURANCE.

Our operations are subject to the many hazards inherent in the gathering, compressing, treating and processing of raw natural gas and NGLs and storage of residue gas, including ruptures, leaks and fires. These risks could result in substantial losses due to personal injury and/or loss of life, severe damage to and destruction of property and equipment and pollution or other environmental damage and may result in curtailment or suspension of our related operations. We are not fully insured against all risks incident to our business. If a significant accident or event occurs that is not fully insured, it could adversely affect our operations and financial condition.

### INSURANCE

Companies engaged in the petroleum products distribution and storage business may be sued for substantial damages in the event of an actual or alleged accident or environmental contamination. The Company maintains \$2,000,000 of liability insurance. There can be no assurance that we will be able to continue to maintain liability insurance at a reasonable cost in the future, or that a potential liability will not exceed the coverage limits. Nor can there be any assurance that the amount of insurance carried by us will enable it to satisfy any claims for which it might be held liable resulting from the conduct of its business operations.

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### ITEM 7. FINANCIAL STATEMENTS

#### Index to Financial Statements

Independent Accountant's Report.....	
Financial Statements	
Balance Sheets.....	
Statements of Operations.....	
Statements of Stockholder's Equity.....	
Statements of Cash Flows.....	
Notes to Financial Statements.....	

### ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

### ITEM 8A. CONTROLS AND PROCEDURES.

#### CONTROLS AND PROCEDURES

##### (a) Evaluation Of Disclosure Controls And Procedures.

Item 308(a)(3) of Regulation S-B states that "Management is not permitted to conclude that the small business issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the small business issuer's internal control over financial reporting." As a result of the restatements to our December 31, 2004 financial statements and our quarterly reports for the periods ending March 31, June 30 and September 30, 2006, as disclosed in our Current Report on Form 8-K and described under Footnote 2 to our December 31, 2005 financial statements contained herein, our Chief Executive Officer and Principal Accounting Officer, can no longer conclude that after evaluating the effectiveness of our "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Report on Form 10-KSB, that our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

However, the Company believes that its restatement to its December 31, 2004 financial statements and restatements to quarterly reports for March 31, June 30 and September 30, 2005 financial statements, will be a one time occurrence and that moving forward our Controls and Procedures will once again be effective as the embedded derivative accounting matters contained in the December 31, 2004, March 30, June 30 and September 30, 2005 financial statements involved a highly complex transaction involving an "unconventional" warrants and convertible debt instruments, and the Company does not anticipate entering into any additional complex financing transactions involving derivatives in the future. The Company is utilizing the guidelines communicated to it by the SEC after various communications regarding accounting for derivatives.

##### (b) Changes In Internal Control Over Financial Reporting.

There were no significant changes in our internal control over financial reporting during the last fiscal year and/or up to and including the date of this filing (except as disclosed in (a) above) that we believe materially affected, or are reasonably likely to materially affect, our internal



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control over financial reporting.

27

### (c) Limitations.

Our management, including our Principal Executive Officer and Principal Financial Officer, does not expect that our disclosure controls or internal controls over financial reporting will prevent all errors or all instances of fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitation of a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

ITEM 8B. OTHER INFORMATION: None

### PART III

#### ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS, AND CONTROL PERSONS: COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

Name	Age	Position	Date became director or officer
Michael Ward	50	Director, President, CEO	October 21, 1998
James B. Smith, C.P.A.	52	Director, CFO, Sr. V.P.	August 16, 2003
Ahmed Karim	33	Director, Vice President	October 21, 1998
Robert Dowies	55	V.P.	October 18, 2004
Carl Hessel	42	Director	January 28, 2004

MICHAEL WARD: Mr. Ward is the President, Chief Executive Officer and Chairman of our Board of Directors. Michael Ward has served in his present capacities since October 21, 1998. He is Vice President and Chief Executive Officer of Tidelands Gas Corporation. He is a Manager and Vice President of Development of Rio Bravo Energy, LLC. Mr. Ward has more than 25 years of diversified experience as an oil and gas professional. He was educated in business management and administration at Southwest Texas State University and the University of Texas. He has wide experience in the capacity in which he successfully served in operating oil and gas companies in the United States. During the past 20 years, he has been associated with Century Energy Corporation where his duties and responsibilities were production and drilling superintendent and supervised 300 re-completions and new drills in Duval County, Texas. In association with Omega Minerals, Inc.,

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where he was vice president and part owner, he operated 65 wells in 23 counties in South and West Texas: 17 wells in Seminole and Osage Counties, Oklahoma, 44 wells in Neosho and Wilson Counties, Kansas and 125 wells in Brown, Pike, Schuyler and Scott Counties, Illinois. He was president and owner of Major Petroleum Company. He drilled, completed and produced 42 wells in South and West Texas counties. The company was sold. With Tidelands Oil Corporation, his duties included supervising and performing remedial well work, work-overs and economic evaluation of the corporate properties. The primary area of interest was in Maverick County, Texas. He has performed project financing analysis and consulting of refinery acquisitions for the Yemen government.

28

JAMES B. SMITH: On August 16, 2003, we employed James B. Smith to act as a Senior Vice President and Chief Financial Officer. Mr. Smith received a Bachelor of Science from Texas A&M University and a Master of Professional accounting degree from the McCombs School of Business at the University of Texas, Austin. He is licensed as a Certified Public Accountant in Texas and Colorado. From 1996 through 2001, he directed the financial affairs and tax planning for several closely held corporations engaged in land development in Colorado. From 2000 through 2003, he served as Chief Financial Officer for Starr Produce Company, a major produce company with significant subsidiaries in real estate development and agri-business.

AHMED KARIM: Mr. Karim Vice President and director of the Company. He is a graduate of Simon Fraser University. He holds a degree in Business Administration, specializing in marketing and international business. Since 1995 his business experience includes work with Quest Investments Group and Interworld Trade and Finance where his responsibilities included marketing, finance and investor relations.

ROBERT W. DOWIES: On October 18, 2004, we employed Robert W. Dowies as our Vice President of Gas Markets and Supply. Mr. Dowies has 30 years experience in the energy marketing. Ten years as the owner of a natural gas trading company and 20 years with a public utility. Until his employment with Tidelands Oil & Gas Corporation, since 1998, Mr. Dowies worked for Trebor Energy Resources, Inc. in Houston, Texas. His principal responsibilities were the development of financial alliances with various energy merchants and producers providing a \$50 million dollar credit support for gas marketing activities, financial trading accounts, pipeline transportation agreements, storage strategies and capital projects. He developed and implemented marketing strategies which resulted in \$40 million dollars of annual revenue. He designed and coordinated the construction and implementation of a natural gas gathering system. We entered into a three year employment contract paying him an annual salary of \$100,000 which includes an annual stock grant of 100,000 shares.

CARL HESSEL: On January 28, 2004, Mr. Hessel joined our board of directors. Mr. Hessel founded Margaux Investment Management Group, S.A. which is located in Geneva, Switzerland in 2001. Prior to 2001, he served as Vice President of Merrill Lynch where he was responsible for creating global high net worth management platform. He began his career at Goldman Sachs and help build the Scandinavian ultra-high net worth market. Mr. Hessel received his M.B.A. from Wharton Business School and a degree in Finance and Management from the University of Pennsylvania. He was awarded the Marcus Wallenberg Foundation's Scholarship.

Compliance with Section 16(a) of the Securities Exchange Act of 1934

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's

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directors and executive officers, and persons who own more than 10% of the Company's Common Stock, to file with the Securities and Exchange Commission initial reports of beneficial ownership and reports of changes in beneficial ownership of Common Stock of the Company. Officers, directors and greater than 10% shareholders are required by the Securities and Exchange Commission to furnish the Company with copies of all section 16(a) reports they file. Based solely on copies of such forms furnished as provided above, or written representations that no Forms 5 were required, the Company believes that during the fiscal year ended December 31, 2005 all Section 16(a) filing requirements applicable to its executive officers, directors and beneficial owners of more than 10% of its Common Stock were complied with, except as follows:

1. Michael Ward, Ahmed Karim, Carl Hessel and Robert Dowies did not file Forms 5 during 2005.
2. James Smith filed on late Form 4 on November 11, 2005 for a June 27, 2005 transaction.

### ITEM 10. EXECUTIVE COMPENSATION

The following sets forth the compensation of the officers of the Company in the year ended December 31, 2005.

29

#### Summary Compensation.

The following table sets forth the compensation paid by the Company during fiscal year 2005 to its officers. This information includes the dollar value of base salaries, bonus awards and number of stock options granted, and certain other compensation, if any.

Table 1.

Name and Position	Year	Salary	Bonus	Stock Underlying Options	Stock Grants
Michael Ward, Pres.(1)	2005	\$252,000	\$10,500	-0-	1,150,000
James Smith, V.P.,CFO(2)	2005	\$168,000	\$19,500	-0-	650,000
Ahmed Karim, V.P.(3)	2005	-0-	-0-	-0-	150,000
Robert Dowies (4)	2005	\$100,000	\$ 4,167	-0-	100,000(3)

(1) Mr. Ward received a stock grant of 1,000,000 common shares under the terms of his employment agreement. He also received 150,000 common shares as director fees.

(2) Mr. Smith received a stock grant of 500,000 common shares under the terms of his employment agreement and a bonus stock grant of 150,000 shares. Mr. Smith joined the board of directors on June 27, 2005.

(3) Mr. Karim received \$36,000 compensation as a director including a stock grant of 150,000 common shares. Mr. Karim resigned his position as Vice President on June 27, 2005.

(4) Mr. Dowies received a stock grant of 100,000 common shares under the terms of his employment agreement.

#### Executive Officer Compensation

During 2005, the Company had four executive officers, Michael Ward, James B. Smith, Ahmed Karim and Robert Dowies. Michael Ward's was paid \$252,000 salary

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and a bonus of \$10,500. James B. Smith was paid \$168,000, plus an \$19,500 bonus. Messrs. Ward and Smith have new and different employment agreements for 2004 discussed below in the Employment Agreement paragraph. During 2005, Michael Ward received 1,000,000 shares of common stock as his annual stock grant under the terms of his employment agreement and 150,000 common shares as directors fees. Mr. Smith received 500,000 common shares as his annual stock grant under the terms of his employment agreement and 150,000 shares as a stock grant bonus.

During 2005, we paid Mr. Dowies \$104,,167 which consisted of his annual salary of \$100,000, a \$4,167 dollar bonus and his annual stock grant of 100,000 shares. Mr. Dowies employment agreement stock grant vested on April 18, 2005.

Mr. Karim did not receive any officer salary during 2005. Mr. Karim resigned as a Vice President on June 27, 2005. We paid Mr. Karim \$36,000 and granted 150,000 common shares as director compensation for 2005.

### Director Compensation

On April 11, 2001, the Company agreed to compensate Ahmed Karim, a director, for services provided at the rate of \$5,000 per month until June 30, 2003 and \$3,000 per month thereafter. For the year ended December 31, 2005, we incurred \$36,000 for cash director compensation and issued a total of 450,000 common shares to three directors, Michael Ward, Ahmed Karim and Carl Hessel. We plan to compensate directors with an annual stock grant of 150,000 shares each.

### Committees of the Board of Directors

Tidelands does not have a Compensation committee. The Board of Directors acts as the Compensation Committee. Tidelands has no compensation written policies outlining factors and criteria underlying awards or payments in relation to executive officers.

30

### Employment and Consulting Agreements with Management

The Company has entered into employment agreements with the following officers:

**MICHAEL WARD** - Under the terms of Mr. Ward's employment agreement, commencing January 1, 2004, he was employed as the Company's President and Chief Executive Officer for a term of five (5) years. His base annual salary is \$252,000. The annual salary may be increased from year to year, as determined by our board of directors acting as the Compensation Committee, by at least the Consumer Price Index. As additional compensation, Mr. Ward will be entitled to an annual stock grant of One Million (1,000,000) shares. Stock grant dates are June 30 and December 31 each year. As incentive compensation, Mr. Ward will be entitled to additional compensation equal to two percent of our net profits and one percent of the increase in sales over a previous year's sales, effective with the fiscal year ending 2004. Mr. Ward is entitled to all employee benefits as provided by the Company. He is entitled to four weeks paid vacation and an annual automobile allowance of \$12,000.

**JAMES B. SMITH:** Under the terms of Mr. Smith's employment agreement, commencing October 1, 2004, he was employed as the Company's Senior Vice President and Chief Financial Officer for a term of four (4) years. His base annual salary is \$168,000. The annual salary may be increased from year to year, as determined by our board of directors acting as the Compensation Committee, by at least the Consumer Price Index. As additional compensation, Mr. Smith will be entitled to an annual stock grant of Five Hundred (500,000) shares. Stock grant dates are

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October 1 during the four year term. The first year stock grant was paid October 1, 2004. As incentive compensation, Mr. Smith will be entitled to additional compensation equal to two percent of our net profits and one percent of the increase in sales over a previous year's sales, effective October 1, 2004. Mr. Smith is entitled to all employee benefits as provided by the Company. He is entitled to four weeks paid vacation and an annual automobile allowance of \$12,000. Mr. Smith joined our board of directors

General Motors Financial Co., Inc., 6.75%, 2018

20,000

22,650

General Motors Financial Co., Inc., 4.25%, 2023 (n)

35,000

33,600

Goodyear Tire & Rubber Co., 6.5%, 2021

140,000

148,050

Goodyear Tire & Rubber Co., 7%, 2022

40,000

43,000

Jaguar Land Rover PLC, 8.125%, 2021 (n)

300,000

340,500

Lear Corp., 8.125%, 2020

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32,000

35,680

Lear Corp., 4.75%, 2023 (n)

25,000

24,188

LKQ Corp., 4.75%, 2023 (n)

10,000

9,525

\$

1,114,669

**Table of Contents***Portfolio of Investments continued*

<b>Issuer</b>	<b>Shares/Par</b>	<b>Value (\$)</b>
<b>Bonds - continued</b>		
<b>Broadcasting - 3.2%</b>		
AMC Networks, Inc., 7.75%, 2021	\$ 116,000	\$ 130,500
Clear Channel Communications, Inc., 9%, 2021	202,000	203,515
Clear Channel Worldwide Holdings, Inc., 6.5%, 2022	85,000	89,250
Clear Channel Worldwide Holdings, Inc., 6.5%, 2022	25,000	26,000
Clear Channel Worldwide Holdings, Inc., A, 7.625%, 2020	5,000	5,288
Clear Channel Worldwide Holdings, Inc., B, 7.625%, 2020	35,000	37,363
Hughes Network Systems LLC, 7.625%, 2021	70,000	76,650
IAC/InterActive Corp., 4.75%, 2022	55,000	52,113
Intelsat Jackson Holdings S.A., 6.625%, 2022 (n)	75,000	76,500
Intelsat Jackson Holdings S.A., 6.625%, 2022	105,000	107,100
Intelsat S.A., 8.125%, 2023 (n)	135,000	142,763
LBI Media Holdings, Inc., 11%, 2017 (p)	24,000	2,400
LBI Media, Inc., 13.5%, 2020	68,000	31,450
LBI Media, Inc., 13.5% to 2015, 11.5% to 2020 (p)(z)	58,977	27,277
Liberty Media Corp., 8.5%, 2029	110,000	117,425
Liberty Media Corp., 8.25%, 2030	35,000	37,275
Netflix, Inc., 5.375%, 2021 (n)	70,000	71,575
Nexstar Broadcasting Group, Inc., 6.875%, 2020 (n)	80,000	83,600
SIRIUS XM Radio, Inc., 5.875%, 2020 (n)	10,000	10,350
SIRIUS XM Radio, Inc., 5.25%, 2022 (n)	15,000	15,225
Univision Communications, Inc., 6.875%, 2019 (n)	25,000	26,938
Univision Communications, Inc., 7.875%, 2020 (n)	80,000	88,800
Univision Communications, Inc., 8.5%, 2021 (n)	130,000	143,975
		\$ 1,603,332
<b>Brokerage &amp; Asset Managers - 0.4%</b>		
E*TRADE Financial Corp., 6.375%, 2019	\$ 195,000	\$ 208,650
<b>Building - 2.1%</b>		
Allegion U.S. Holding Co., Inc., 5.75%, 2021 (n)	\$ 50,000	\$ 51,875
Boise Cascade Co., 6.375%, 2020	65,000	67,925
Building Materials Holding Corp., 7%, 2020 (n)	45,000	48,375
CEMEX Espana S.A., 9.25%, 2020 (n)	75,000	81,750
CEMEX S.A.B. de C.V., 9.25%, 2020	130,000	141,700
HD Supply, Inc., 8.125%, 2019	45,000	50,297
HD Supply, Inc., 7.5%, 2020 (n)	30,000	31,650
HD Supply, Inc., 11.5%, 2020	105,000	126,656
Nortek, Inc., 8.5%, 2021	150,000	164,438
Roofing Supply Group LLC/Roofing Supply Finance, Inc., 10%, 2020 (n)	64,000	72,320
USG Corp., 6.3%, 2016	105,000	112,350
USG Corp., 7.875%, 2020 (n)	45,000	49,500
USG Corp., 5.875%, 2021 (n)	20,000	20,400
		\$ 1,019,236

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
<b>Business Services - 1.5%</b>		
Equinix, Inc., 4.875%, 2020	\$ 55,000	\$ 55,206
Equinix, Inc., 5.375%, 2023	35,000	34,738
Fidelity National Information Services, Inc., 5%, 2022	75,000	77,155
First Data Corp., 10.625%, 2021 (n)	115,000	123,481
iGATE Corp., 9%, 2016	165,000	177,375
Iron Mountain, Inc., 8.375%, 2021	11,000	11,880
Lender Processing Services, Inc., 5.75%, 2023	35,000	36,488
NeuStar, Inc., 4.5%, 2023	35,000	31,850
Rolta LLC, 10.75%, 2018 (n)	200,000	185,000
		\$ 733,173
<b>Cable TV - 2.1%</b>		
CCO Holdings LLC, 8.125%, 2020	\$ 95,000	\$ 104,025
CCO Holdings LLC, 6.5%, 2021	25,000	26,000
CCO Holdings LLC/CCO Capital Corp., 5.75%, 2024	40,000	37,900
Cequel Communications Holdings, 6.375%, 2020 (n)	25,000	25,938
Cequel Communications Holdings I LLC, 5.125%, 2021 (n)	25,000	24,250
DISH DBS Corp., 6.75%, 2021	60,000	64,950
DISH DBS Corp., 5%, 2023	60,000	57,375
Nara Cable Funding Ltd., 8.875%, 2018 (z)	200,000	213,500
Telenet Finance Luxembourg, 6.375%, 2020 (n)	EUR 100,000	144,337
Time Warner Cable, Inc., 4.5%, 2042	\$ 85,000	63,710
UPC Holding B.V., 9.875%, 2018 (n)	100,000	108,250
Ziggo Bond Co. B.V., 8%, 2018 (n)	EUR 100,000	144,600
		\$ 1,014,835
<b>Chemicals - 1.1%</b>		
Celanese U.S. Holdings LLC, 6.625%, 2018	\$ 50,000	\$ 53,938
Celanese U.S. Holdings LLC, 5.875%, 2021	8,000	8,560
Celanese U.S. Holdings LLC, 4.625%, 2022	20,000	19,650
Hexion U.S. Finance Corp., 6.625%, 2020	40,000	40,600
Hexion U.S. Finance Corp./Hexion Nova Scotia Finance, 8.875%, 2018	95,000	97,850
Huntsman International LLC, 8.625%, 2021	140,000	157,150
Polypore International, Inc., 7.5%, 2017	50,000	52,875
Tronox Finance LLC, 6.375%, 2020	100,000	102,000
		\$ 532,623
<b>Computer Software - 0.5%</b>		
Infor U.S., Inc., 11.5%, 2018	\$ 80,000	\$ 92,800
Syniverse Holdings, Inc., 9.125%, 2019	135,000	146,138
VeriSign, Inc., 4.625%, 2023	35,000	34,081
		\$ 273,019



**Table of Contents***Portfolio of Investments continued*

<b>Issuer</b>	<b>Shares/Par</b>	<b>Value (\$)</b>
<b>Bonds - continued</b>		
<b>Computer Software - Systems - 0.5%</b>		
Audatex North America, Inc., 6.75%, 2018	\$ 40,000	\$ 42,772
Audatex North America, Inc., 6%, 2021 (n)	45,000	46,463
Audatex North America, Inc., 6.125%, 2023 (z)	15,000	15,225
CDW LLC/CDW Finance Corp., 12.535%, 2017	10,000	10,400
CDW LLC/CDW Finance Corp., 8.5%, 2019	110,000	121,825
		\$ 236,685
<b>Conglomerates - 1.6%</b>		
Amsted Industries, Inc., 8.125%, 2018 (n)	\$ 185,000	\$ 195,869
BC Mountain LLC, 7%, 2021 (n)	70,000	70,875
Dynacast International LLC, 9.25%, 2019	75,000	82,500
Griffon Corp., 7.125%, 2018	150,000	160,313
Renaissance Acquisition, 6.875%, 2021 (n)	145,000	147,538
Silver II Borrower, 7.75%, 2020 (n)	150,000	157,125
		\$ 814,220
<b>Construction - 0.2%</b>		
Empresas ICA S.A.B. de C.V., 8.9%, 2021	\$ 80,000	\$ 78,000
<b>Consumer Products - 0.5%</b>		
Elizabeth Arden, Inc., 7.375%, 2021	\$ 100,000	\$ 108,750
Prestige Brands, Inc., 8.125%, 2020	30,000	33,300
Spectrum Brands Escrow Corp., 6.375%, 2020 (n)	85,000	90,313
		\$ 232,363
<b>Consumer Services - 0.7%</b>		
ADT Corp., 6.25%, 2021 (n)	\$ 55,000	\$ 58,369
Monitronics International, Inc., 9.125%, 2020 (z)	55,000	58,300
QVC, Inc., 7.375%, 2020 (n)	50,000	54,495
Service Corp. International, 7%, 2019	145,000	155,875
		\$ 327,039
<b>Containers - 1.5%</b>		
Ardagh Packaging Finance PLC, 9.125%, 2020 (n)	\$ 200,000	\$ 214,500
Berry Plastics Group, Inc., 9.5%, 2018	30,000	32,550
Berry Plastics Group, Inc., 9.75%, 2021	55,000	64,625
Crown Americas LLC, 4.5%, 2023 (n)	70,000	65,625
Reynolds Group, 7.125%, 2019	175,000	186,813
Reynolds Group, 5.75%, 2020	50,000	51,625
Reynolds Group, 8.25%, 2021	115,000	119,600
		\$ 735,338
<b>Defense Electronics - 0.2%</b>		
Ducommun, Inc., 9.75%, 2018	\$ 98,000	\$ 109,515

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
Electrical Equipment - 0.2%		
Avaya, Inc., 9.75%, 2015	\$ 70,000	\$ 69,300
Avaya, Inc., 7%, 2019 (n)	25,000	23,875
		\$ 93,175
Electronics - 0.7%		
Freescale Semiconductor, Inc., 9.25%, 2018 (n)	\$ 122,000	\$ 131,913
Nokia Corp., 5.375%, 2019	80,000	82,500
Nokia Corp., 6.625%, 2039	25,000	24,625
Sensata Technologies B.V., 6.5%, 2019 (n)	105,000	113,400
		\$ 352,438
Emerging Market Quasi-Sovereign - 0.6%		
Banco de la Provincia de Buenos Aires, 11.75%, 2015 (n)	\$ 124,000	\$ 122,140
Petroleos de Venezuela S.A., 5.25%, 2017	250,000	200,625
		\$ 322,765
Emerging Market Sovereign - 0.3%		
Republic of Venezuela, 12.75%, 2022	\$ 25,000	\$ 25,188
Republic of Venezuela, 7%, 2038	160,000	107,040
		\$ 132,228
Energy - Independent - 5.0%		
Afren PLC, 11.5%, 2016 (n)	\$ 200,000	\$ 228,250
Antero Resources Finance Corp., 6%, 2020	50,000	52,750
Antero Resources Finance Corp., 5.375%, 2021 (n)	45,000	45,731
BreitBurn Energy Partners LP, 8.625%, 2020	50,000	53,125
BreitBurn Energy Partners LP, 7.875%, 2022	100,000	101,000
Carrizo Oil & Gas, Inc., 8.625%, 2018	45,000	49,275
Carrizo Oil & Gas, Inc., 7.5%, 2020	45,000	49,050
Chaparral Energy, Inc., 7.625%, 2022	110,000	118,800
Concho Resources, Inc., 5.5%, 2023	20,000	20,750
Denbury Resources, Inc., 8.25%, 2020	135,000	148,500
Energy XXI Gulf Coast, Inc., 9.25%, 2017	165,000	183,975
Energy XXI Gulf Coast, Inc., 7.5%, 2021 (n)	65,000	67,925
EP Energy LLC, 9.375%, 2020	145,000	167,475
EP Energy LLC, 7.75%, 2022	130,000	146,250
EPL Oil & Gas, Inc., 8.25%, 2018	90,000	96,525
Halcon Resources Corp., 8.875%, 2021	155,000	161,394
Harvest Operations Corp., 6.875%, 2017	30,000	32,213
Hilcorp Energy I/Hilcorp Finance Co., 8%, 2020 (n)	40,000	43,400
Laredo Petroleum, Inc., 9.5%, 2019	65,000	72,638
LINN Energy LLC, 8.625%, 2020	5,000	5,325
LINN Energy LLC, 7.75%, 2021	20,000	20,650
MEG Energy Corp., 6.5%, 2021 (n)	55,000	57,406
MEG Energy Corp., 7%, 2024 (n)	40,000	40,900

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
Energy - Independent - continued		
Oasis Petroleum, Inc., 6.875%, 2022 (n)	\$ 45,000	\$ 48,600
QEP Resources, Inc., 6.875%, 2021	80,000	85,600
Samson Investment Co., 10.25%, 2020 (n)	75,000	81,000
SandRidge Energy, Inc., 8.125%, 2022	145,000	154,425
SM Energy Co., 6.5%, 2021	80,000	86,800
Whiting Petroleum Corp., 6.5%, 2018	20,000	21,300
Whiting Petroleum Corp., 5%, 2019	40,000	41,600
		\$ 2,482,632
Engineering - Construction - 0.2%		
BakerCorp International, Inc., 8.25%, 2019	\$ 85,000	\$ 82,556
Entertainment - 1.0%		
Activision Blizzard, Inc., 6.125%, 2023 (n)	\$ 60,000	\$ 62,700
AMC Entertainment, Inc., 8.75%, 2019	180,000	193,725
Cedar Fair LP, 5.25%, 2021 (n)	80,000	78,800
Cinemark USA, Inc., 5.125%, 2022	50,000	48,875
Six Flags Entertainment Corp., 5.25%, 2021 (n)	90,000	88,425
		\$ 472,525
Financial Institutions - 3.2%		
Aviation Capital Group, 4.625%, 2018 (n)	\$ 55,000	\$ 56,086
Aviation Capital Group, 6.75%, 2021 (n)	25,000	26,938
CIT Group, Inc., 5.25%, 2018	40,000	43,250
CIT Group, Inc., 6.625%, 2018 (n)	119,000	134,916
CIT Group, Inc., 5.5%, 2019 (n)	118,000	127,735
CIT Group, Inc., 5%, 2022	35,000	35,438
Credit Acceptance Corp., 9.125%, 2017	105,000	110,775
Icahn Enterprises LP, 8%, 2018	112,000	117,460
International Lease Finance Corp., 7.125%, 2018 (n)	137,000	157,721
Nationstar Mortgage LLC/Capital Corp., 10.875%, 2015	60,000	62,063
Nationstar Mortgage LLC/Capital Corp., 6.5%, 2018	45,000	46,575
Nationstar Mortgage LLC/Capital Corp., 7.875%, 2020	290,000	309,938
PHH Corp., 7.375%, 2019	40,000	42,300
PHH Corp., 6.375%, 2021	60,000	59,400
SLM Corp., 8.45%, 2018	25,000	29,188
SLM Corp., 8%, 2020	165,000	188,513
SLM Corp., 7.25%, 2022	40,000	42,800
		\$ 1,591,096
Food & Beverages - 1.1%		
Constellation Brands, Inc., 3.75%, 2021	\$ 10,000	\$ 9,588
Constellation Brands, Inc., 4.25%, 2023	95,000	91,081
Hawk Acquisition Sub, Inc., 4.25%, 2020 (n)	70,000	67,725

**Table of Contents***Portfolio of Investments continued*

<b>Issuer</b>	<b>Shares/Par</b>	<b>Value (\$)</b>
<b>Bonds - continued</b>		
<b>Food &amp; Beverages - continued</b>		
Marfrig Holding Europe B.V., 9.875%, 2017 (n)	\$ 200,000	\$ 199,750
Sun Merger Sub, Inc., 5.875%, 2021 (n)	85,000	88,825
TreeHouse Foods, Inc., 7.75%, 2018	80,000	84,600
		\$ 541,569
<b>Forest &amp; Paper Products - 0.7%</b>		
Boise, Inc., 8%, 2020	\$ 105,000	\$ 118,965
Graphic Packaging Holding Co., 7.875%, 2018	65,000	70,688
Smurfit Kappa Group PLC, 7.75%, 2019 (n)	EUR 50,000	73,943
Tembec Industries, Inc., 11.25%, 2018	\$ 55,000	60,088
		\$ 323,684
<b>Gaming &amp; Lodging - 1.9%</b>		
Caesars Entertainment Operating Co., Inc., 8.5%, 2020	\$ 50,000	\$ 46,188
Chester Downs & Marina LLC, 9.25%, 2020 (n)	45,000	45,675
CityCenter Holdings LLC, 10.75%, 2017 (p)	40,000	42,880
Fontainebleau Las Vegas Holdings LLC, 10.25%, 2015 (a)(d)(n)	290,000	181
Hilton Worldwide Finance Co., 5.625%, 2021 (n)	65,000	66,788
Isle of Capri Casinos, Inc., 8.875%, 2020	70,000	74,550
Isle of Capri Casinos, Inc., 5.875%, 2021	20,000	19,625
MGM Resorts International, 11.375%, 2018	110,000	141,075
MGM Resorts International, 6.625%, 2021	90,000	96,188
Pinnacle Entertainment, Inc., 8.75%, 2020	70,000	77,350
PNK Finance Corp., 6.375%, 2021 (n)	55,000	57,750
Ryman Hospitality Properties, Inc., REIT, 5%, 2021 (n)	35,000	33,863
Seven Seas Cruises S. DE R.L., 9.125%, 2019	130,000	142,838
Wynn Las Vegas LLC, 7.75%, 2020	95,000	107,113
		\$ 952,064
<b>Industrial - 1.1%</b>		
Dematic S.A., 7.75%, 2020 (n)	\$ 105,000	\$ 111,038
Howard Hughes Corp., 6.875%, 2021 (n)	75,000	77,625
Hyva Global B.V., 8.625%, 2016 (n)	200,000	199,000
Mueller Water Products, Inc., 8.75%, 2020	66,000	73,920
SPL Logistics Escrow LLC, 8.875%, 2020 (n)	90,000	96,525
		\$ 558,108
<b>Insurance - Property &amp; Casualty - 0.3%</b>		
XL Group PLC, 6.5% to 2017, FRN to 2049	\$ 175,000	\$ 171,675
<b>International Market Quasi-Sovereign - 0.2%</b>		
Eksportfinans A.S.A., 5.5%, 2016	\$ 35,000	\$ 36,645
Eksportfinans A.S.A., 5.5%, 2017	40,000	41,920
		\$ 78,565

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
Machinery & Tools - 1.4%		
Case New Holland, Inc., 7.875%, 2017	\$ 95,000	\$ 112,456
CNH America LLC, 7.25%, 2016	50,000	55,125
H&E Equipment Services Co., 7%, 2022	90,000	98,100
NESCO LLC/NESCO Holdings Corp., 11.75%, 2017 (n)	150,000	168,750
RSC Equipment Rental, Inc., 8.25%, 2021	140,000	158,550
United Rentals North America, Inc., 5.75%, 2018	45,000	48,263
United Rentals North America, Inc., 7.625%, 2022	48,000	53,760
		\$ 695,004
Major Banks - 1.5%		
Bank of America Corp., FRN, 5.2%, 2049	\$ 107,000	\$ 97,103
Barclays Bank PLC, 7.625%, 2022	200,000	206,300
JPMorgan Chase & Co., 6%, 2049	100,000	96,750
RBS Capital Trust II, 6.425% to 2034, FRN to 2049	95,000	89,300
Royal Bank of Scotland Group PLC, 6.99% to 2017, FRN to 2049 (n)	100,000	104,750
Royal Bank of Scotland Group PLC, 7.648% to 2031, FRN to 2049	150,000	156,000
		\$ 750,203
Medical & Health Technology & Services - 3.1%		
AmSurg Corp., 5.625%, 2020	\$ 75,000	\$ 75,375
Davita, Inc., 6.625%, 2020	290,000	309,213
Fresenius Medical Care AG & Co. KGaA, 9%, 2015 (n)	120,000	133,800
Fresenius Medical Care Capital Trust III, 5.875%, 2022 (n)	15,000	15,900
HCA, Inc., 8.5%, 2019	100,000	107,375
HCA, Inc., 7.5%, 2022	150,000	168,563
HCA, Inc., 5.875%, 2022	45,000	47,363
HealthSouth Corp., 8.125%, 2020	175,000	192,719
IASIS Healthcare LLC/IASIS Capital Corp., 8.375%, 2019	90,000	95,400
Kinetic Concepts, Inc., 12.5%, 2019	40,000	43,100
Tenet Healthcare Corp., 8%, 2020	120,000	130,650
Tenet Healthcare Corp., 4.5%, 2021	15,000	14,550
Tenet Healthcare Corp., 8.125%, 2022 (n)	30,000	32,850
Universal Health Services, Inc., 7%, 2018	30,000	32,025
Universal Health Services, Inc., 7.625%, 2020	105,000	110,250
		\$ 1,509,133
Medical Equipment - 0.4%		
Biomet, Inc., 6.5%, 2020	\$ 90,000	\$ 95,625
Physio-Control International, Inc., 9.875%, 2019 (n)	62,000	69,130
Teleflex, Inc., 6.875%, 2019	50,000	52,250
		\$ 217,005

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
<b>Metals &amp; Mining - 2.1%</b>		
ArcelorMittal S.A., 6.75%, 2022	\$ 30,000	\$ 32,625
ArcelorMittal S.A., 7.25%, 2041	55,000	52,938
Arch Coal, Inc., 7.25%, 2020	70,000	53,288
Century Aluminum Co., 7.5%, 2021 (n)	85,000	79,900
Commercial Metals Co., 4.875%, 2023	55,000	52,250
Consol Energy, Inc., 8%, 2017	75,000	79,500
Consol Energy, Inc., 8.25%, 2020	70,000	76,563
First Quantum Minerals Ltd., 7.25%, 2019 (n)	200,000	187,500
Fortescue Metals Group Ltd., 8.25%, 2019 (n)	90,000	99,900
Plains Exploration & Production Co., 6.125%, 2019	85,000	92,916
Plains Exploration & Production Co., 6.5%, 2020	35,000	38,560
TMS International Corp., 7.625%, 2021 (z)	70,000	73,150
Walter Energy, Inc., 9.5%, 2019 (n)	30,000	31,650
Walter Energy, Inc., 8.5%, 2021 (n)	95,000	80,513
		\$ 1,031,253
<b>Municipals - 0.1%</b>		
New Jersey Tobacco Settlement Financing Corp., 1-A, 4.5%, 2023	\$ 50,000	\$ 46,633
<b>Natural Gas - Distribution - 0.4%</b>		
AmeriGas Finance LLC, 6.75%, 2020	\$ 90,000	\$ 98,100
Ferrellgas LP/Ferrellgas Finance Corp., 6.5%, 2021	60,000	60,750
Ferrellgas LP/Ferrellgas Finance Corp., 6.75%, 2022 (z)	20,000	20,400
		\$ 179,250
<b>Natural Gas - Pipeline - 2.1%</b>		
Access Midstream Partners Co., 4.875%, 2023	\$ 165,000	\$ 164,175
Atlas Pipeline Partners LP, 4.75%, 2021 (n)	25,000	23,500
Atlas Pipeline Partners LP, 5.875%, 2023 (n)	50,000	49,125
Crestwood Midstream Partners LP, 6.125%, 2022 (z)	20,000	20,450
Crosstex Energy, Inc., 8.875%, 2018	110,000	117,150
Crosstex Energy, Inc., 7.125%, 2022	10,000	11,475
El Paso Corp., 7%, 2017	75,000	84,668
El Paso Corp., 7.75%, 2032	150,000	155,694
Energy Transfer Equity LP, 7.5%, 2020	135,000	155,925
Enterprise Products Partners LP, 7.034% to 2018, FRN to 2068	40,000	44,200
Inergy Midstream LP, 6%, 2020 (n)	80,000	81,800
MarkWest Energy Partners LP, 5.5%, 2023	65,000	67,275
Summit Midstream Holdings LLC, 7.5%, 2021 (n)	65,000	68,413
		\$ 1,043,850
<b>Network &amp; Telecom - 0.8%</b>		
Centurylink, Inc., 7.65%, 2042	\$ 95,000	\$ 88,113
Citizens Communications Co., 9%, 2031	65,000	67,275

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
<b>Network &amp; Telecom - continued</b>		
Frontier Communications Corp., 8.125%, 2018	\$ 30,000	\$ 34,575
TW Telecom Holdings, Inc., 5.375%, 2022 (n)	25,000	24,938
TW Telecom Holdings, Inc., 5.375%, 2022	55,000	54,863
Windstream Corp., 8.125%, 2018	20,000	21,650
Windstream Corp., 7.75%, 2020	80,000	85,800
Windstream Corp., 7.75%, 2021	40,000	42,700
		\$ 419,914
<b>Oil Services - 0.9%</b>		
Bristow Group, Inc., 6.25%, 2022	\$ 75,000	\$ 78,750
Dresser-Rand Group, Inc., 6.5%, 2021	45,000	47,813
Edgen Murray Corp., 8.75%, 2020 (n)	105,000	121,275
Shale-Inland Holdings LLC/Finance Co., 8.75%, 2019 (n)	115,000	117,875
Unit Corp., 6.625%, 2021	100,000	104,500
		\$ 470,213
<b>Other Banks &amp; Diversified Financials - 1.1%</b>		
Ally Financial, Inc., 5.5%, 2017	\$ 80,000	\$ 86,400
Groupe BPCE S.A., 12.5% to 2019, FRN to 2049 (n)	200,000	255,750
LBG Capital No. 1 PLC, 7.875%, 2020 (n)	200,000	214,500
		\$ 556,650
<b>Pharmaceuticals - 0.9%</b>		
Capsugel FinanceCo. SCA, 9.875%, 2019 (n)	EUR 100,000	\$ 151,898
Capsugel S.A., 7%, 2019 (p)(z)	\$ 25,000	25,000
Endo Health Solutions, Inc., 7.25%, 2022	65,000	69,225
Valeant Pharmaceuticals International, Inc., 7%, 2020 (n)	100,000	107,750
Valeant Pharmaceuticals International, Inc., 7.25%, 2022 (n)	55,000	59,813
Vantage Point Imaging, 7.5%, 2021 (n)	45,000	49,950
		\$ 463,636
<b>Pollution Control - 0.1%</b>		
Heckmann Corp., 9.875%, 2018	\$ 45,000	\$ 45,788
<b>Precious Metals &amp; Minerals - 0.4%</b>		
Eldorado Gold Corp., 6.125%, 2020 (n)	\$ 80,000	\$ 79,600
IAMGOLD Corp., 6.75%, 2020 (n)	120,000	107,100
		\$ 186,700
<b>Printing &amp; Publishing - 0.4%</b>		
American Media, Inc., 13.5%, 2018 (z)	\$ 23,764	\$ 25,071
Gannett Co., Inc., 6.375%, 2023 (z)	60,000	63,300
Lamar Media Corp., 5%, 2023	70,000	66,675
Nielsen Finance LLC, 7.75%, 2018	45,000	49,050
		\$ 204,096

**Table of Contents***Portfolio of Investments continued*

<b>Issuer</b>	<b>Shares/Par</b>	<b>Value (\$)</b>
<b>Bonds - continued</b>		
Railroad & Shipping - 0.1%		
Watco Cos. LLC, 6.375%, 2023 (n)	\$ 60,000	\$ 59,400
Real Estate - 1.2%		
Aviv Healthcare Properties LP, 6%, 2021 (z)	\$ 40,000	\$ 41,000
CNL Lifestyle Properties, Inc., REIT, 7.25%, 2019	50,000	52,000
DuPont Fabros Technology, Inc., REIT, 5.875%, 2021 (n)	135,000	138,375
ERP Properties, REIT, 5.75%, 2022	65,000	67,466
Felcor Lodging LP, REIT, 5.625%, 2023	50,000	49,250
GLP Capital LP/GLP Financing II, Inc., 4.375%, 2018 (n)	80,000	81,600
MPT Operating Partnership LP, REIT, 6.375%, 2022	160,000	165,200
		\$ 594,891
Retailers - 1.3%		
Academy Ltd., 9.25%, 2019 (n)	\$ 55,000	\$ 60,981
Burlington Coat Factory Warehouse Corp., 10%, 2019	100,000	112,000
CST Brands, Inc., 5%, 2023 (n)	5,000	4,838
J. Crew Group, Inc., 8.125%, 2019	85,000	89,781
Jo-Ann Stores Holdings, Inc., 9.75%, 2019 (n)(p)	80,000	83,000
Limited Brands, Inc., 6.9%, 2017	55,000	62,838
Limited Brands, Inc., 6.95%, 2033	40,000	39,800
Rite Aid Corp., 9.25%, 2020	110,000	127,050
Sally Beauty Holdings, Inc., 6.875%, 2019	45,000	49,725
		\$ 630,013
Specialty Chemicals - 0.2%		
Chemtura Corp., 5.75%, 2021	\$ 45,000	\$ 45,563
Koppers, Inc., 7.875%, 2019	40,000	43,400
		\$ 88,963
Specialty Stores - 0.7%		
Michaels Stores, Inc., 11.375%, 2016	\$ 81,000	\$ 83,026
Michaels Stores, Inc., 7.75%, 2018	50,000	53,938
Office Depot De Mexico, S.A. de C.V., 6.875%, 2020 (n)	200,000	204,500
		\$ 341,464
Telecommunications - Wireless - 3.9%		
Altice Financing S.A., 7.875%, 2019 (n)	\$ 200,000	\$ 216,600
Crown Castle International Corp., 7.125%, 2019	50,000	54,000
Digicel Group Ltd., 10.5%, 2018 (n)	265,000	286,200
Eileme 2 AB, 11.625%, 2020 (n)	200,000	233,500
MetroPCS Wireless, Inc., 7.875%, 2018	75,000	81,000
MetroPCS Wireless, Inc., 6.25%, 2021 (n)	65,000	68,006
Sprint Capital Corp., 6.875%, 2028	105,000	99,750
Sprint Corp., 7.875%, 2023 (n)	145,000	157,325



**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
<b>Telecommunications - Wireless - continued</b>		
Sprint Nextel Corp., 8.375%, 2017	\$ 140,000	\$ 162,050
Sprint Nextel Corp., 9%, 2018 (n)	25,000	30,313
Sprint Nextel Corp., 6%, 2022	110,000	108,350
T-Mobile USA, Inc., 6.633%, 2021	15,000	15,863
Wind Acquisition Finance S.A., 12.25%, 2017 (n)(p)	200,000	196,014
Wind Acquisition Finance S.A., 7.25%, 2018 (n)	200,000	210,500
		\$ 1,919,471
<b>Telephone Services - 0.3%</b>		
Cogent Communications Group, Inc., 8.375%, 2018 (n)	\$ 45,000	\$ 49,275
Level 3 Financing, Inc., 9.375%, 2019	65,000	72,638
Level 3 Financing, Inc., 8.625%, 2020	45,000	50,963
		\$ 172,876
<b>Transportation - 0.4%</b>		
Far Eastern Shipping Co., 8%, 2018 (n)	\$ 200,000	\$ 181,000
<b>Transportation - Services - 2.6%</b>		
Aguila American Resources Ltd., 7.875%, 2018 (n)	\$ 150,000	\$ 159,938
Avis Budget Car Rental LLC, 8.25%, 2019	65,000	70,850
Avis Budget Car Rental LLC, 9.75%, 2020	40,000	46,800
CEVA Group PLC, 8.375%, 2017 (n)	235,000	243,225
Jack Cooper Finance Co., 9.25%, 2020 (z)	65,000	69,550
Navios Maritime Acquisition Corp., 8.625%, 2017	165,000	173,003
Navios Maritime Acquisition Corp., 8.125%, 2021 (z)	70,000	70,700
Navios Maritime Holdings, Inc., 8.875%, 2017	35,000	36,619
Navios South American Logistics, Inc., 9.25%, 2019	112,000	121,240
Swift Services Holdings, Inc., 10%, 2018	190,000	212,800
Ultrapetrol (Bahamas) Ltd., 8.875%, 2021 (n)	42,000	44,940
Ultrapetrol (Bahamas) Ltd., 8.875%, 2021 (n)	14,000	14,980
		\$ 1,264,645
<b>Utilities - Electric Power - 2.7%</b>		
AES Corp., 8%, 2017	\$ 13,000	\$ 15,308
AES Corp., 7.375%, 2021	40,000	45,300
Calpine Corp., 7.875%, 2020 (n)	108,000	117,990
Calpine Corp., 6%, 2022 (z)	10,000	10,375
Covanta Holding Corp., 7.25%, 2020	95,000	102,768
EDP Finance B.V., 6%, 2018 (n)	145,000	153,338
Energy Future Holdings Corp., 10%, 2020	183,000	192,150
Energy Future Holdings Corp., 10%, 2020 (n)	145,000	151,525
InterGen N.V., 7%, 2023 (n)	200,000	206,500
NRG Energy, Inc., 8.25%, 2020	195,000	217,425

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Bonds - continued</b>		
<b>Utilities - Electric Power - continued</b>		
NRG Energy, Inc., 6.625%, 2023	\$ 45,000	\$ 46,519
Texas Competitive Electric Holdings Co. LLC, 11.5%, 2020 (n)	125,000	89,063
		\$ 1,348,261
<b>Total Bonds (Identified Cost, \$31,929,413)</b>		<b>\$ 32,654,272</b>
<b>Common Stocks - 29.8%</b>		
<b>Aerospace - 2.2%</b>		
Lockheed Martin Corp.	4,150	\$ 553,361
United Technologies Corp.	5,140	546,125
		\$ 1,099,486
<b>Alcoholic Beverages - 0.9%</b>		
Diageo PLC, ADR	3,400	\$ 433,806
<b>Automotive - 0.0%</b>		
Accuride Corp. (a)	2,414	\$ 10,863
<b>Broadcasting - 0.9%</b>		
Viacom, Inc., B	5,300	\$ 441,437
<b>Brokerage &amp; Asset Managers - 0.9%</b>		
BlackRock, Inc.	1,494	\$ 449,410
<b>Business Services - 0.7%</b>		
Accenture PLC, A	5,050	\$ 371,175
<b>Chemicals - 1.8%</b>		
3M Co.	2,820	\$ 354,897
PPG Industries, Inc.	3,035	554,130
		\$ 909,027
<b>Computer Software - 0.7%</b>		
Oracle Corp.	10,060	\$ 337,010
<b>Computer Software - Systems - 1.2%</b>		
International Business Machines Corp.	3,254	\$ 583,149
<b>Electrical Equipment - 2.1%</b>		
Danaher Corp.	7,080	\$ 510,397
Tyco International Ltd.	14,110	515,721
		\$ 1,026,118

**Table of Contents***Portfolio of Investments continued*

<b>Issuer</b>	<b>Shares/Par</b>	<b>Value (\$)</b>
<b>Common Stocks - continued</b>		
<b>Energy - Independent - 1.2%</b>		
Occidental Petroleum Corp.	6,430	\$ 617,794
<b>Food &amp; Beverages - 1.9%</b>		
General Mills, Inc.	8,030	\$ 404,873
Nestle S.A., ADR	7,640	553,212
		\$ 958,085
<b>Food &amp; Drug Stores - 1.1%</b>		
CVS Caremark Corp.	8,440	\$ 525,474
<b>General Merchandise - 0.7%</b>		
Target Corp.	5,570	\$ 360,880
<b>Insurance - 2.0%</b>		
MetLife, Inc.	8,070	\$ 381,792
Travelers Cos., Inc.	6,950	599,785
		\$ 981,577
<b>Major Banks - 2.0%</b>		
Bank of New York Mellon Corp.	12,690	\$ 403,542
JPMorgan Chase & Co.	11,220	578,279
		\$ 981,821
<b>Medical Equipment - 2.9%</b>		
Abbott Laboratories	13,160	\$ 480,998
St. Jude Medical, Inc.	7,180	412,060
Thermo Fisher Scientific, Inc.	5,730	560,279
		\$ 1,453,337
<b>Pharmaceuticals - 2.5%</b>		
Johnson & Johnson	6,970	\$ 645,492
Pfizer, Inc.	18,450	566,046
		\$ 1,211,538
<b>Printing &amp; Publishing - 0.1%</b>		
American Media Operations, Inc. (a)	6,090	\$ 30,328
<b>Restaurants - 0.8%</b>		
McDonald's Corp.	3,916	\$ 377,972
<b>Telephone Services - 1.9%</b>		
AT&T, Inc.	11,080	\$ 401,096
Verizon Communications, Inc.	10,200	515,202
		\$ 916,298

**Table of Contents***Portfolio of Investments continued*

Issuer	Shares/Par	Value (\$)
<b>Common Stocks - continued</b>		
Tobacco - 1.3%		
Philip Morris International, Inc.	7,230	\$ 644,338
<b>Total Common Stocks (Identified Cost, \$11,350,508)</b>		<b>\$ 14,720,923</b>
<b>Floating Rate Loans (g)(r) - 1.0%</b>		
Aerospace - 0.1%		
TransDigm, Inc., Term Loan C, 3.75%, 2020	\$ 52,382	\$ 52,382
Conglomerates - 0.1%		
Silver II U.S. Holdings LLC, Term Loan, 4%, 2019	\$ 51,938	\$ 51,816
Consumer Services - 0.1%		
Realogy Corp., Term Loan, 4.5%, 2020	\$ 34,284	\$ 34,570
Energy - Independent - 0.1%		
MEG Energy Corp., Term Loan, 3.75%, 2020	\$ 46,074	\$ 46,276
Entertainment - 0.1%		
Cedar Fair LP, Term Loan B, 3.25%, 2020	\$ 43,957	\$ 44,012
Food & Beverages - 0.1%		
Aramark Corp., Term Loan D, 4%, 2019	\$ 52,938	\$ 53,057
Retailers - 0.1%		
Toys R Us Property Co. I LLC, Term Loan B, 6%, 2019	\$ 56,598	\$ 55,239
Transportation - Services - 0.3%		
Commercial Barge Line Co., Term Loan, 7.5%, 2019	\$ 165,372	\$ 162,891
<b>Total Floating Rate Loans (Identified Cost, \$501,686)</b>		<b>\$ 500,243</b>
<b>Preferred Stocks - 0.3%</b>		
Other Banks & Diversified Financials - 0.3%		
Ally Financial, Inc., 7% (z)	60	\$ 57,609
GMAC Capital Trust I, 8.125%	3,325	89,310
<b>Total Preferred Stocks (Identified Cost, \$140,693)</b>		<b>\$ 146,919</b>
<b>Convertible Bonds - 0.2%</b>		
Network & Telecom - 0.2%		
Nortel Networks Corp., 2.125%, 2014 (Identified Cost, \$68,906) (a)(d)	\$ 70,000	\$ 69,038

**Table of Contents***Portfolio of Investments continued***Money Market Funds - 2.6%**

<b>Issuer</b>	<b>Shares/Par</b>	<b>Value (\$)</b>
MFS Institutional Money Market Portfolio, 0.1%, at Cost and Net Asset Value (v)	1,299,694	\$ 1,299,694
<b>Total Investments (Identified Cost, \$45,290,900)</b>		<b>\$ 49,391,089</b>
<b>Other Assets, Less Liabilities - 0.0%</b>		<b>10,755</b>
<b>Net Assets - 100.0%</b>		<b>\$ 49,401,844</b>

- (a) Non-income producing security.
- (c) The rate shown represents a current effective yield, not a coupon rate.
- (d) In default. Interest and/or scheduled principal payment(s) have been missed.
- (g) The rate shown represents a weighted average coupon rate on settled positions at period end, unless otherwise indicated.
- (i) Interest only security for which the fund receives interest on notional principal (Par amount). Par amount shown is the notional principal and does not reflect the cost of the security.
- (n) Securities exempt from registration under Rule 144A of the Securities Act of 1933. These securities may be sold in the ordinary course of business in transactions exempt from registration, normally to qualified institutional buyers. At period end, the aggregate value of these securities was \$12,490,298, representing 25.3% of net assets.
- (p) Payment-in-kind security.
- (r) Remaining maturities of floating rate loans may be less than stated maturities shown as a result of contractual or optional prepayments by the borrower. Such prepayments cannot be predicted with certainty. These loans may be subject to restrictions on resale. Floating rate loans generally have rates of interest which are determined periodically by reference to a base lending rate plus a premium.
- (v) Underlying affiliated fund that is available only to investment companies managed by MFS. The rate quoted for the MFS Institutional Money Market Portfolio is the annualized seven-day yield of the fund at period end.
- (z) Restricted securities are not registered under the Securities Act of 1933 and are subject to legal restrictions on resale. These securities generally may be resold in transactions exempt from registration or to the public if the securities are subsequently registered. Disposal of these securities may involve time-consuming negotiations and prompt sale at an acceptable price may be difficult. The fund holds the following restricted securities:

<b>Restricted Securities</b>	<b>Acquisition Date</b>	<b>Cost</b>	<b>Value</b>
Ally Financial, Inc., 7%	4/13/11-4/14/11	\$56,250	\$57,609
American Media, Inc., 13.5%, 2018	12/22/10	24,040	25,071
Audatex North America, Inc., 6.125%, 2023	10/17/13	15,000	15,225
Aviv Healthcare Properties LP, 6%, 2021	10/10/13-10/15/13	40,374	41,000
Banc of America Commercial Mortgage, Inc., FRN, 6.249%, 2051	6/19/08	241,910	133,876
Calpine Corp., 6%, 2022	10/17/13	9,919	10,375
Capsugel S.A., 7%, 2019	10/31/13	25,000	25,000
Crestwood Midstream Partners LP, 6.125%, 2022	10/22/13	20,000	20,450
Falcon Franchise Loan LLC, FRN, 12.161%, 2025	1/29/03	3,122	6,014
Ferrellgas LP/Ferrellgas Finance Corp., 6.75%, 2022	10/21/13	20,000	20,400
Gannett Co., Inc., 6.375%, 2023	9/26/13-10/8/13	60,001	63,300

**Table of Contents***Portfolio of Investments continued*

<b>Restricted Securities - continued</b>	<b>Acquisition Date</b>	<b>Cost</b>	<b>Value</b>
Jack Cooper Finance Co., 9.25%, 2020	10/24/13	\$68,413	\$69,550
LBI Media, Inc., 13.5% to 2015, 11.5% to 2020	12/26/12-5/15/13	30,178	27,277
Monitronics International, Inc., 9.125%, 2020	10/21/13-10/23/13	58,756	58,300
Morgan Stanley Capital I, Inc., FRN, 1.385%, 2039	7/20/04	2,796	3,364
Nara Cable Funding Ltd., 8.875%, 2018	1/26/12	195,090	213,500
Navios Maritime Acquisition Corp., 8.125%, 2021	10/29/13	70,000	70,700
Preferred Term Securities XII Ltd., CDO, 0%, 2033	1/07/05	127,734	2
Preferred Term Securities XVI Ltd., CDO, 0%, 2035	12/08/04	187,576	0
Preferred Term Securities XVII Ltd., CDO, 0%, 2035	3/09/05	114,513	0
TMS International Corp., 7.625%, 2021	10/4/13-10/22/13	71,807	73,150
<b>Total Restricted Securities</b>			<b>\$934,163</b>
% of Net assets			1.9%

The following abbreviations are used in this report and are defined:

ADR American Depositary Receipt  
CDO Collateralized Debt Obligation  
FRN Floating Rate Note. Interest rate resets periodically and may not be the rate reported at period end.  
PLC Public Limited Company  
REIT Real Estate Investment Trust

Abbreviations indicate amounts shown in currencies other than the U.S. dollar. All amounts are stated in U.S. dollars unless otherwise indicated. A list of abbreviations is shown below:

EUR Euro

**Derivative Contracts at 10/31/13****Forward Foreign Currency Exchange Contracts at 10/31/13**

Type	Currency	Counter-party	Contracts to Deliver/Receive	Settlement Date	In Exchange for	Contracts at Value	Net Unrealized Appreciation (Depreciation)
<b>Liability Derivatives</b>							
BUY	EUR	Citibank NA	102,222	1/17/14	\$140,904	\$138,807	\$(2,097)
SELL	EUR	Deutsche Bank AG London	242,978	1/17/14	328,004	329,939	(1,935)
SELL	EUR	JPMorgan Chase Bank	242,978	1/17/14	328,004	329,939	(1,935)
							\$(5,967)

See Notes to Financial Statements

**Table of Contents***Financial Statements***STATEMENT OF ASSETS AND LIABILITIES**

At 10/31/13

This statement represents your fund's balance sheet, which details the assets and liabilities comprising the total value of the fund.

<b>Assets</b>	
Investments-	
Non-affiliated issuers, at value (identified cost, \$43,991,206)	\$48,091,395
Underlying affiliated funds, at cost and value	1,299,694
Total investments, at value (identified cost, \$45,290,900)	\$49,391,089
Cash	101,121
Receivables for	
Investments sold	226,079
Interest and dividends	653,779
Other assets	3,977
Total assets	\$50,376,045
<b>Liabilities</b>	
Payables for	
Forward foreign currency exchange contracts	\$5,967
Investments purchased	807,953
Payable to affiliates	
Investment adviser	2,231
Transfer agent and dividend disbursing costs	507
Payable for independent Trustees' compensation	67,703
Accrued expenses and other liabilities	89,840
Total liabilities	\$974,201
Net assets	\$49,401,844
<b>Net assets consist of</b>	
Paid-in capital	\$59,909,979
Unrealized appreciation (depreciation) on investments and translation of assets and liabilities in foreign currencies	4,094,512
Accumulated net realized gain (loss) on investments and foreign currency	(14,493,938)
Accumulated distributions in excess of net investment income	(108,709)
Net assets	\$49,401,844
Shares of beneficial interest outstanding	7,008,009
Net asset value per share (net assets of \$49,401,844 / 7,008,009 shares of beneficial interest outstanding)	\$7.05

**See Notes to Financial Statements**

**Table of Contents***Financial Statements***STATEMENT OF OPERATIONS**

Year ended 10/31/13

This statement describes how much your fund earned in investment income and accrued in expenses. It also describes any gains and/or losses generated by fund operations.

<b>Net investment income</b>	
Income	
Interest	\$2,629,417
Dividends	348,281
Dividends from underlying affiliated funds	2,025
Foreign taxes withheld	(124)
Total investment income	\$2,979,599
Expenses	
Management fee	\$434,638
Transfer agent and dividend disbursing costs	15,279
Administrative services fee	17,500
Independent Trustees compensation	13,740
Stock exchange fee	23,732
Custodian fee	15,163
Shareholder communications	65,694
Audit and tax fees	71,160
Legal fees	494
Miscellaneous	20,626
Total expenses	\$678,026
Fees paid indirectly	(47)
Reduction of expenses by investment adviser	(126)
Net expenses	\$677,853
Net investment income	\$2,301,746
<b>Realized and unrealized gain (loss) on investments and foreign currency</b>	
Realized gain (loss) (identified cost basis)	
Investments	\$1,601,251
Foreign currency	(24,766)
Net realized gain (loss) on investments and foreign currency	\$1,576,485
Change in unrealized appreciation (depreciation)	
Investments	\$2,420,312
Translation of assets and liabilities in foreign currencies	(3,153)
Net unrealized gain (loss) on investments and foreign currency translation	\$2,417,159
Net realized and unrealized gain (loss) on investments and foreign currency	\$3,993,644
Change in net assets from operations	\$6,295,390

**See Notes to Financial Statements**



**Table of Contents***Financial Statements***STATEMENTS OF CHANGES IN NET ASSETS**

These statements describe the increases and/or decreases in net assets resulting from operations, any distributions, and any shareholder transactions.

	<b>Years ended 10/31</b>	
	<b>2013</b>	<b>2012</b>
<b>Change in net assets</b>		
<b>From operations</b>		
Net investment income	\$2,301,746	\$2,683,676
Net realized gain (loss) on investments and foreign currency	1,576,485	(422,577)
Net unrealized gain (loss) on investments and foreign currency translation	2,417,159	3,194,743
Change in net assets from operations	\$6,295,390	\$5,455,842
<b>Distributions declared to shareholders</b>		
From net investment income	\$(2,737,377)	\$(2,828,436)
From tax return of capital	(2,128,348)	(1,831,057)
Total distributions declared to shareholders	\$(4,865,725)	\$(4,659,493)
Change in net assets from fund share transactions	\$376,605	\$361,678
Total change in net assets	\$1,806,270	\$1,158,027
<b>Net assets</b>		
At beginning of period	47,595,574	46,437,547
At end of period (including accumulated distributions in excess of net investment income of \$108,709 and \$113,997, respectively)	\$49,401,844	\$47,595,574
<b>See Notes to Financial Statements</b>		

**Table of Contents***Financial Statements***FINANCIAL HIGHLIGHTS**

The financial highlights table is intended to help you understand the fund's financial performance for the past 5 years. Certain information reflects financial results for a single fund share. The total returns in the table represent the rate by which an investor would have earned (or lost) on an investment in the fund share class (assuming reinvestment of all distributions) held for the entire period.

	Years ended 10/31				
	2013	2012	2011	2010	2009
Net asset value, beginning of period	\$6.84	\$6.73	\$7.23	\$6.71	\$5.36
<b>Income (loss) from investment operations</b>					
Net investment income (d)	\$0.33	\$0.39	\$0.40	\$0.44	\$0.56
Net realized and unrealized gain (loss) on investments and foreign currency	0.58	0.39	(0.18)	0.77	1.32
Total from investment operations	\$0.91	\$0.78	\$0.22	\$1.21	\$1.88
<b>Less distributions declared to shareholders</b>					
From net investment income	\$(0.39)	\$(0.41)	\$(0.42)	\$(0.51)	\$(0.54)
From tax return of capital	(0.31)	(0.26)	(0.30)	(0.18)	
Total distributions declared to shareholders	\$(0.70)	\$(0.67)	\$(0.72)	\$(0.69)	\$(0.54)
Net increase from repurchase of capital shares	\$	\$	\$	\$	\$0.01
Net asset value, end of period (x)	\$7.05	\$6.84	\$6.73	\$7.23	\$6.71
Market value, end of period	\$7.29	\$7.46	\$6.86	\$7.95	\$6.23
Total return at market value (%)	7.94	19.99	(4.67)	40.46	46.76
Total return at net asset value (%) (j)(r)(s)(x)	13.85	12.15	2.81	18.63	40.08
<b>Ratios (%) (to average net assets) and Supplemental data:</b>					
Expenses before expense reductions (f)	1.39	1.49	1.42	1.53	1.64
Expenses after expense reductions (f)	1.39	1.45	1.39	1.47	1.64
Net investment income	4.73	5.73	5.65	6.36	10.17
Portfolio turnover	40	49	53	55	78
Net assets at end of period (000 omitted)	\$49,402	\$47,596	\$46,438	\$49,461	\$45,646

(d) Per share data is based on average shares outstanding.

(f) Ratios do not reflect reductions from fees paid indirectly, if applicable.

(j) Total return at net asset value is calculated using the net asset value of the fund, not the publicly traded price and therefore may be different than the total return at market value.

(r) Certain expenses have been reduced without which performance would have been lower.

(s) From time to time the fund may receive proceeds from litigation settlements, without which performance would be lower.

(x) The net asset values per share and total returns at net asset value per share have been calculated on net assets which include adjustments made in accordance with U.S. generally accepted accounting principles required at period end for financial reporting purposes.

**See Notes to Financial Statements**

**Table of Contents**

**NOTES TO FINANCIAL STATEMENTS**

**(1) Business and Organization**

MFS Special Value Trust (the fund) is organized as a Massachusetts business trust and is registered under the Investment Company Act of 1940, as amended, as a closed-end management investment company.

**(2) Significant Accounting Policies**

**General** The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of increases and decreases in net assets from operations during the reporting period. Actual results could differ from those estimates. In the preparation of these financial statements, management has evaluated subsequent events occurring after the date of the fund's Statement of Assets and Liabilities through the date that the financial statements were issued. The fund invests in high-yield securities rated below investment grade. Investments in high-yield securities involve greater degrees of credit and market risk than investments in higher-rated securities and tend to be more sensitive to economic conditions. The fund invests in foreign securities. Investments in foreign securities are vulnerable to the effects of changes in the relative values of the local currency and the U.S. dollar and to the effects of changes in each country's legal, political, and economic environment.

In January 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2013-01 (ASU 2013-01) entitled Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities which is intended to clarify the scope of Accounting Standards Update 2011-11 (ASU 2011-11), Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. Consistent with the effective date for ASU 2011-11, ASU 2013-01 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. ASU 2013-01 limits the scope of ASU 2011-11's disclosure requirements on offsetting to financial assets and financial liabilities related to derivatives, repurchase and reverse repurchase agreements, and securities lending and securities borrowing transactions. Although still evaluating the potential impact of these two ASUs to the fund, management expects that the impact of the fund's adoption will be limited to additional financial statement disclosures.

In June 2013, FASB issued Accounting Standards Update 2013-08 Financial Services—Investment Companies (Topic 946) Amendments to the Scope, Measurement, and Disclosure Requirements (ASU 2013-08) which is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. ASU 2013-08 sets forth a methodology for determining whether an entity should be characterized as an investment company and prescribes fair value accounting for an investment company's non-controlling ownership interest in another investment company. FASB has determined that a fund registered under the Investment Company Act of 1940 automatically meets ASU 2013-08's criteria for an investment company. Although still evaluating the potential impacts of ASU 2013-08 to the fund, management expects that the impact of the fund's adoption will be limited to additional financial statement disclosures.

**Table of Contents**

*Notes to Financial Statements continued*

**Investment Valuations** Equity securities, including restricted equity securities, are generally valued at the last sale or official closing price as provided by a third-party pricing service on the market or exchange on which they are primarily traded. Equity securities, for which there were no sales reported that day, are generally valued at the last quoted daily bid quotation as provided by a third-party pricing service on the market or exchange on which such securities are primarily traded. Debt instruments and floating rate loans (other than short-term instruments), including restricted debt instruments, are generally valued at an evaluated or composite bid as provided by a third-party pricing service. Short-term instruments with a maturity at issuance of 60 days or less generally are valued at amortized cost, which approximates market value. Forward foreign currency exchange contracts are generally valued at the mean of bid and asked prices for the time period interpolated from rates provided by a third-party pricing service for proximate time periods. Open-end investment companies are generally valued at net asset value per share. Securities and other assets generally valued on the basis of information from a third-party pricing service may also be valued at a broker/dealer bid quotation. Values obtained from third-party pricing services can utilize both transaction data and market information such as yield, quality, coupon rate, maturity, type of issue, trading characteristics, and other market data. The values of foreign securities and other assets and liabilities expressed in foreign currencies are converted to U.S. dollars using the mean of bid and asked prices for rates provided by a third-party pricing service.

The Board of Trustees has delegated primary responsibility for determining or causing to be determined the value of the fund's investments (including any fair valuation) to the adviser pursuant to valuation policies and procedures approved by the Board. If the adviser determines that reliable market quotations are not readily available, investments are valued at fair value as determined in good faith by the adviser in accordance with such procedures under the oversight of the Board of Trustees. Under the fund's valuation policies and procedures, market quotations are not considered to be readily available for most types of debt instruments and floating rate loans and many types of derivatives. These investments are generally valued at fair value based on information from third-party pricing services. In addition, investments may be valued at fair value if the adviser determines that an investment's value has been materially affected by events occurring after the close of the exchange or market on which the investment is principally traded (such as foreign exchange or market) and prior to the determination of the fund's net asset value, or after the halting of trading of a specific security where trading does not resume prior to the close of the exchange or market on which the security is principally traded. Events that occur on a frequent basis after foreign markets close (such as developments in foreign markets and significant movements in the U.S. markets) and prior to the determination of the fund's net asset value may be deemed to have a material effect on the value of securities traded in foreign markets. Accordingly, the fund's foreign equity securities may often be valued at fair value. The adviser generally relies on third-party pricing services or other information (such as the correlation with price movements of similar securities in the same or other markets; the type, cost and investment characteristics of the security; the business and financial condition of the issuer; and trading and other market data) to assist in determining whether to fair value and at what value to fair value an investment. The value of an investment for purposes of calculating the fund's net asset value can differ depending

**Table of Contents***Notes to Financial Statements continued*

on the source and method used to determine value. When fair valuation is used, the value of an investment used to determine the fund's net asset value may differ from quoted or published prices for the same investment. There can be no assurance that the fund could obtain the fair value assigned to an investment if it were to sell the investment at the same time at which the fund determines its net asset value per share.

Various inputs are used in determining the value of the fund's assets or liabilities. These inputs are categorized into three broad levels. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an investment's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The fund's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the investment. Level 1 includes unadjusted quoted prices in active markets for identical assets or liabilities. Level 2 includes other significant observable market-based inputs (including quoted prices for similar securities, interest rates, prepayment speed, and credit risk). Level 3 includes unobservable inputs, which may include the adviser's own assumptions in determining the fair value of investments. Other financial instruments are derivative instruments not reflected in total investments, such as forward foreign currency exchange contracts. The following is a summary of the levels used as of October 31, 2013 in valuing the fund's assets or liabilities:

<b>Investments at Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Equity Securities:</b>				
United States	\$13,792,888	\$57,608	\$30,328	\$13,880,824
Switzerland	553,212			553,212
United Kingdom	433,806			433,806
<b>Non-U.S. Sovereign Debt</b>		533,558		533,558
Municipal Bonds		46,633		46,633
U.S. Corporate Bonds		24,327,319		24,327,319
Commercial Mortgage-Backed Securities		220,727		220,727
Asset-Backed Securities (including CDOs)		2		2
Foreign Bonds		7,595,071		7,595,071
Floating Rate Loans		500,243		500,243
Mutual Funds	1,299,694			1,299,694
<b>Total Investments</b>	<b>\$16,079,600</b>	<b>\$33,281,161</b>	<b>\$30,328</b>	<b>\$49,391,089</b>
<b>Other Financial Instruments</b>				
Forward Foreign Currency Exchange Contracts	\$	\$(5,967)	\$	\$(5,967)

For further information regarding security characteristics, see the Portfolio of Investments.

**Table of Contents**

*Notes to Financial Statements continued*

The following is a reconciliation of level 3 assets for which significant unobservable inputs were used to determine fair value. The fund's policy is to recognize transfers between the levels as of the end of the period. The table presents the activity of level 3 securities held at the beginning and the end of the period.

	Equity Securities	Asset-Backed Securities	Total
Balance as of 10/31/12	\$32,216	\$	\$32,216
Change in unrealized appreciation (depreciation)	(1,888)		(1,888)
Transfers into Level 3		0	0
Balance as of 10/31/13	\$30,328	\$0	\$30,328

The net change in unrealized appreciation (depreciation) from investments still held as level 3 at October 31, 2013 is \$(1,888).

**Foreign Currency Translation** Purchases and sales of foreign investments, income, and expenses are converted into U.S. dollars based upon currency exchange rates prevailing on the respective dates of such transactions or on the reporting date for foreign denominated receivables and payables. Gains and losses attributable to foreign currency exchange rates on sales of securities are recorded for financial statement purposes as net realized gains and losses on investments. Gains and losses attributable to foreign exchange rate movements on receivables, payables, income and expenses are recorded for financial statement purposes as foreign currency transaction gains and losses. That portion of both realized and unrealized gains and losses on investments that results from fluctuations in foreign currency exchange rates is not separately disclosed.

**Derivatives** The fund uses derivatives for different purposes, primarily to increase or decrease exposure to a particular market or segment of the market, or security, to increase or decrease interest rate or currency exposure, or as alternatives to direct investments. Derivatives are used for hedging or non-hedging purposes. While hedging can reduce or eliminate losses, it can also reduce or eliminate gains. When the fund uses derivatives as an investment to increase market exposure, or for hedging purposes, gains and losses from derivative instruments may be substantially greater than the derivative's original cost.

The derivative instruments used by the fund were forward foreign currency exchange contracts. The fund's period end derivatives, as presented in the Portfolio of Investments and the associated Derivative Contract tables, generally are indicative of the volume of its derivative activity during the period.

The following table presents, by major type of derivative contract, the fair value, on a gross basis, of the asset and liability components of derivatives held by the fund at October 31, 2013 as reported in the Statement of Assets and Liabilities:

Risk	Derivative Contracts	Fair Value Liability Derivatives
Foreign Exchange	Forward Foreign Currency Exchange	\$(5,967)

**Table of Contents**

*Notes to Financial Statements continued*

The following table presents, by major type of derivative contract, the realized gain (loss) on derivatives held by the fund for the year ended October 31, 2013 as reported in the Statement of Operations:

<b>Risk</b>	<b>Foreign Currency</b>
Foreign Exchange	\$(25,062)

The following table presents, by major type of derivative contract, the change in unrealized appreciation (depreciation) on derivatives held by the fund for the year ended October 31, 2013 as reported in the Statement of Operations:

<b>Risk</b>	<b>Translation of Assets and Liabilities in Foreign Currencies</b>
Foreign Exchange	\$(3,040)

Derivative counterparty credit risk is managed through formal evaluation of the creditworthiness of all potential counterparties. On certain, but not all, over-the-counter derivatives, the fund attempts to reduce its exposure to counterparty credit risk whenever possible by entering into an International Swaps and Derivatives Association (ISDA) Master Agreement on a bilateral basis with each of the counterparties with whom it undertakes a significant volume of transactions. The ISDA Master Agreement gives each party to the agreement the right to terminate all transactions traded under such agreement if there is a certain deterioration in the credit quality of the other party. Upon an event of default or a termination of the ISDA Master Agreement, the non-defaulting party has the right to close out all transactions traded under such agreement and to net amounts owed under each transaction to one net amount payable by one party to the other. This right to close out and net payments across all transactions traded under the ISDA Master Agreement could result in a reduction of the fund's credit risk to such counterparty equal to any amounts payable by the fund under the applicable transactions, if any.

Collateral and margin requirements differ by type of derivative. Margin requirements are set by the broker or clearing house for cleared derivatives (i.e., futures contracts, cleared swaps, and exchange-traded options) while collateral terms are contract specific for over-the-counter traded derivatives (i.e., forward foreign currency exchange contracts, uncleared swap agreements, and over-the-counter options). For derivatives traded under an ISDA Master Agreement, the collateral requirements are netted across all transactions traded under such agreement and one amount is posted from one party to the other to collateralize such obligations. Cash that has been segregated to cover the fund's collateral or margin obligations under derivative contracts, if any, will be reported separately in the Statement of Assets and Liabilities as restricted cash. Securities pledged as collateral or margin for the same purpose, if any, are noted in the Portfolio of Investments.

The fund's accounting policy with respect to balance sheet offsetting is that, absent an event of default by the counterparty or a termination of the agreement, the ISDA Master Agreement does not result in an offset of reported amounts of financial assets

**Table of Contents**

*Notes to Financial Statements continued*

and financial liabilities in the Statement of Assets and Liabilities across transactions between the fund and the applicable counterparty.

**Forward Foreign Currency Exchange Contracts** The fund entered into forward foreign currency exchange contracts for the purchase or sale of a specific foreign currency at a fixed price on a future date. These contracts may be used to hedge the fund's currency risk or for non-hedging purposes. For hedging purposes, the fund may enter into contracts to deliver or receive foreign currency that the fund will receive from or use in its normal investment activities. The fund may also use contracts to hedge against declines in the value of foreign currency denominated securities due to unfavorable exchange rate movements. For non-hedging purposes, the fund may enter into contracts with the intent of changing the relative exposure of the fund's portfolio of securities to different currencies to take advantage of anticipated exchange rate changes.

Forward foreign currency exchange contracts are adjusted by the daily exchange rate of the underlying currency and any unrealized gains or losses are recorded as a receivable or payable for forward foreign currency exchange contracts until the contract settlement date. On contract settlement date, any gain or loss on the contract is recorded as realized gains or losses on foreign currency.

Risks may arise upon entering into these contracts from unanticipated movements in the value of the contract and from the potential inability of counterparties to meet the terms of their contracts. Generally, the fund's maximum risk due to counterparty credit risk is the unrealized gain on the contract due to the use of Continuous Linked Settlement, an industry accepted settlement system. This risk is mitigated in cases where there is an ISDA Master Agreement between the fund and the counterparty providing for netting as described above and for posting of collateral by the counterparty to the fund to cover the fund's exposure to the counterparty under such ISDA Master Agreement.

**Loans and Other Direct Debt Instruments** The fund invests in loans and loan participations or other receivables. These investments may include standby financing commitments, including revolving credit facilities, which obligate the fund to supply additional cash to the borrower on demand. Loan participations involve a risk of insolvency of the lending bank or other financial intermediary.

**Indemnifications** Under the fund's organizational documents, its officers and Trustees may be indemnified against certain liabilities and expenses arising out of the performance of their duties to the fund. Additionally, in the normal course of business, the fund enters into agreements with service providers that may contain indemnification clauses. The fund's maximum exposure under these agreements is unknown as this would involve future claims that may be made against the fund that have not yet occurred.

**Investment Transactions and Income** Investment transactions are recorded on the trade date. Interest income is recorded on the accrual basis. All premium and discount is amortized or accreted for financial statement purposes in accordance with U.S. generally accepted accounting principles. The fund earns certain fees in connection with its floating rate loan purchasing activities. These fees are in addition to interest payments earned and may include amendment fees, commitment fees, facility fees, consent fees, and prepayment fees. Commitment fees are recorded on an accrual basis



**Table of Contents**

*Notes to Financial Statements continued*

as income in the accompanying financial statements. Dividends received in cash are recorded on the ex-dividend date. Certain dividends from foreign securities will be recorded when the fund is informed of the dividend if such information is obtained subsequent to the ex-dividend date. Dividend and interest payments received in additional securities are recorded on the ex-dividend or ex-interest date in an amount equal to the value of the security on such date. Debt obligations may be placed on non-accrual status or set to accrue at a rate of interest less than the contractual coupon when the collection of all or a portion of interest has become doubtful. Interest income for those debt obligations may be further reduced by the write-off of the related interest receivables when deemed uncollectible.

The fund may receive proceeds from litigation settlements. Any proceeds received from litigation involving portfolio holdings are reflected in the Statement of Operations in realized gain/loss if the security has been disposed of by the fund or in unrealized gain/loss if the security is still held by the fund. Any other proceeds from litigation not related to portfolio holdings are reflected as other income in the Statement of Operations.

**Fees Paid Indirectly** The fund's custody fee may be reduced according to an arrangement that measures the value of cash deposited with the custodian by the fund. This amount, for the year ended October 31, 2013, is shown as a reduction of total expenses in the Statement of Operations.

**Tax Matters and Distributions** The fund intends to qualify as a regulated investment company, as defined under Subchapter M of the Internal Revenue Code, and to distribute all of its taxable income, including realized capital gains. As a result, no provision for federal income tax is required. The fund's federal tax returns, when filed, will remain subject to examination by the Internal Revenue Service for a three year period. Foreign taxes, if any, have been accrued by the fund in the accompanying financial statements in accordance with the applicable foreign tax law. Foreign income taxes may be withheld by certain countries in which the fund invests. Additionally, capital gains realized by the fund on securities issued in or by certain foreign countries may be subject to capital gains tax imposed by those countries.

Distributions to shareholders are recorded on the ex-dividend date. The fund seeks to pay monthly distributions based on an annual rate of 10% of the fund's average monthly net asset value. As a result, distributions may exceed actual earnings which may result in a tax return of capital or, to the extent the fund has long-term gains, distributions of current year long-term gains may be recharacterized as ordinary income. Income and capital gain distributions are determined in accordance with income tax regulations, which may differ from U.S. generally accepted accounting principles. Certain capital accounts in the financial statements are periodically adjusted for permanent differences in order to reflect their tax character. These adjustments have no impact on net assets or net asset value per share. Temporary differences which arise from recognizing certain items of income, expense, gain or loss in different periods for financial statement and tax purposes will reverse at some time in the future. Distributions from other sources, in excess of net investment income or net realized gains are temporary overdistributions for financial statement purposes resulting from differences in the recognition or classification of income or distributions for financial statement and tax purposes.

**Table of Contents***Notes to Financial Statements continued*

Book/tax differences primarily relate to amortization and accretion of debt securities and deferred trustee compensation.

The tax character of distributions declared to shareholders for the last two fiscal years is as follows:

	10/31/13	10/31/12
Ordinary income (including any short-term capital gains) (a)	\$2,737,377	\$2,828,436
Tax return of capital (b)	2,128,348	1,831,057
Total distributions	\$4,865,725	\$4,659,493

(a) Included in the fund's distributions from ordinary income for the year ended October 31, 2013 is \$403,310, in excess of investment company taxable income which, in accordance with applicable U.S. tax law, is taxable to shareholders as ordinary income distributions.

(b) Distributions in excess of tax basis earnings and profits are reported in the financial statements as a tax return of capital.

The federal tax cost and the tax basis components of distributable earnings were as follows:

As of 10/31/13	
Cost of investments	\$45,661,965
Gross appreciation	5,240,139
Gross depreciation	(1,511,015)
Net unrealized appreciation (depreciation)	\$3,729,124
Capital loss carryforwards	(14,122,873)
Other temporary differences	(114,386)

Under the Regulated Investment Company Modernization Act of 2010 (the Act), net capital losses recognized for fund fiscal years beginning after October 31, 2011 may be carried forward indefinitely, and their character is retained as short-term and/or long-term losses (post-enactment losses). Previously, net capital losses were carried forward for eight years and treated as short-term (pre-enactment losses). As a transition rule, the Act requires that all post-enactment net capital losses be used before pre-enactment net capital losses.

As of October 31, 2013, the fund had capital loss carryforwards available to offset future realized gains. Such pre-enactment losses expire as follows:

10/31/16	\$(9,321,635)
10/31/17	(4,711,246)
10/31/18	(89,992)
Total	\$(14,122,873)

**(3) Transactions with Affiliates**

**Investment Adviser** The fund has an investment advisory agreement with MFS to provide overall investment management and related administrative services and facilities to the fund. The management fee is computed daily and paid monthly at an annual rate of 0.68% of the fund's average daily net assets and 3.40% of gross income. Gross income is calculated based on tax elections that generally include the

**Table of Contents**

*Notes to Financial Statements continued*

accretion of discount and exclude the amortization of premium, which may differ from investment income reported in the Statement of Operations. MFS has agreed to reduce its management fee to the lesser of the contractual management fee as set forth above or 0.90% of the average daily net assets. This written agreement will continue until modified by the fund's Board of Trustees, but such an agreement will continue at least until October 31, 2014. For the year ended October 31, 2013, the fund's average daily net assets and gross income did not meet the thresholds required to waive the management fee under this agreement. The management fee, from net assets and gross income, incurred for the year ended October 31, 2013 was equivalent to an annual effective rate of 0.89% of the fund's average daily net assets.

**Transfer Agent** The fund engages Computershare Trust Company, N.A. (Computershare) as the sole transfer agent for the fund. MFS Service Center, Inc. (MFSC) monitors and supervises the activities of Computershare for an agreed upon fee approved by the Board of Trustees. For the year ended October 31, 2013, these fees paid to MFSC amounted to \$2,444.

**Administrator** MFS provides certain financial, legal, shareholder communications, compliance, and other administrative services to the fund. Under an administrative services agreement, the fund partially reimburses MFS the costs incurred to provide these services. The fund is charged an annual fixed amount of \$17,500 plus a fee based on average daily net assets. The administrative services fee incurred for the year ended October 31, 2013 was equivalent to an annual effective rate of 0.0359% of the fund's average daily net assets.

**Trustees and Officers Compensation** The fund pays compensation to independent Trustees in the form of a retainer, attendance fees, and additional compensation to Board and Committee chairpersons. The fund does not pay compensation directly to Trustees or officers of the fund who are also officers of the investment adviser, all of whom receive remuneration for their services to the fund from MFS. Certain officers and Trustees of the fund are officers or directors of MFS and MFSC.

Prior to December 31, 2001, the fund had an unfunded defined benefit plan (DB plan) for independent Trustees. As of December 31, 2001, the Board took action to terminate the DB plan with respect to then-current and any future independent Trustees, such that the DB plan covers only certain of those former independent Trustees who retired on or before December 31, 2001. Effective January 1, 2002, accrued benefits under the DB plan for then-current independent Trustees who continued were credited to an unfunded retirement deferral plan (the Retirement Deferral plan), which was established for and exists solely with respect to these credited amounts, and is not available for other deferrals by these or other independent Trustees. Although the Retirement Deferral plan is unfunded, amounts deferred under the plan are periodically adjusted for investment experience as if they had been invested in shares of the fund. The DB plan resulted in a pension expense of \$531 and the Retirement Deferral plan resulted in an expense of \$4,369. Both amounts are included in independent Trustees' compensation for the year ended October 31, 2013. The liability for deferred retirement benefits payable to certain independent Trustees under both plans amounted to \$67,688 at October 31, 2013, and is included in Payable for independent Trustees' compensation in the Statement of Assets and Liabilities.

**Table of Contents***Notes to Financial Statements continued*

**Other** This fund and certain other funds managed by MFS (the funds) have entered into services agreements (the Agreements) which provide for payment of fees by the funds to Tarantino LLC and Griffin Compliance LLC in return for the provision of services of an Independent Chief Compliance Officer (ICCO) and Assistant ICCO, respectively, for the funds. The ICCO and Assistant ICCO are officers of the funds and the sole members of Tarantino LLC and Griffin Compliance LLC, respectively. The funds can terminate the Agreements with Tarantino LLC and Griffin Compliance LLC at any time under the terms of the Agreements. For the year ended October 31, 2013, the aggregate fees paid by the fund to Tarantino LLC and Griffin Compliance LLC were \$326 and are included in Miscellaneous expense in the Statement of Operations. MFS has agreed to reimburse the fund for a portion of the payments made by the fund in the amount of \$126, which is shown as a reduction of total expenses in the Statement of Operations. Additionally, MFS has agreed to bear all expenses associated with office space, other administrative support, and supplies provided to the ICCO and Assistant ICCO.

The fund invests in the MFS Institutional Money Market Portfolio which is managed by MFS and seeks current income consistent with preservation of capital and liquidity. Income earned on this investment is included in Dividends from underlying affiliated funds in the Statement of Operations. This money market fund does not pay a management fee to MFS.

**(4) Portfolio Securities**

Purchases and sales of investments, other than short-term obligations, aggregated \$18,871,634 and \$20,052,287, respectively.

**(5) Shares of Beneficial Interest**

The fund's Declaration of Trust permits the Trustees to issue an unlimited number of full and fractional shares of beneficial interest. The Trustees have authorized the repurchase by the fund of up to 10% annually of its own shares of beneficial interest. During the years ended October 31, 2013 and October 31, 2012, the fund did not repurchase any shares. Other transactions in fund shares were as follows:

	Year ended 10/31/13		Year ended 10/31/12	
	Shares	Amount	Shares	Amount
Shares issued to shareholders in reinvestment of distributions	53,968	\$376,605	52,911	\$361,678

**(6) Line of Credit**

The fund and certain other funds managed by MFS participate in a \$1.1 billion unsecured committed line of credit, subject to a \$1 billion sublimit, provided by a syndication of banks under a credit agreement. Borrowings may be made for temporary financing needs. Interest is charged to each fund, based on its borrowings, generally at a rate equal to the higher of the Federal Reserve funds rate or one month LIBOR plus an agreed upon spread. A commitment fee, based on the average daily, unused portion of the committed line of credit, is allocated among the participating funds at the end of each calendar quarter. In addition, the fund and other funds managed by MFS have established unsecured uncommitted borrowing arrangements with certain banks for temporary financing needs. Interest is charged to each fund,

**Table of Contents***Notes to Financial Statements continued*

based on its borrowings, at a rate equal to the Federal Reserve funds rate plus an agreed upon spread. For the year ended October 31, 2013, the fund's commitment fee and interest expense were \$242 and \$0, respectively, and are included in Miscellaneous expense in the Statement of Operations.

**(7) Transactions in Underlying Affiliated Funds-Affiliated Issuers**

An affiliated issuer may be considered one in which the fund owns 5% or more of the outstanding voting securities, or a company which is under common control. For the purposes of this report, the fund assumes the following to be an affiliated issuer:

<b>Underlying Affiliated Fund</b>	<b>Beginning Shares/Par Amount</b>	<b>Acquisitions Shares/Par Amount</b>	<b>Dispositions Shares/Par Amount</b>	<b>Ending Shares/Par Amount</b>
MFS Institutional Money Market Portfolio	1,578,168	11,402,092	(11,680,566)	1,299,694
<b>Underlying Affiliated Fund</b>	<b>Realized Gain (Loss)</b>	<b>Capital Gain Distributions</b>	<b>Dividend Income</b>	<b>Ending Value</b>
MFS Institutional Money Market Portfolio	\$	\$	\$2,025	\$1,299,694

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Trustees and Shareholders of MFS Special Value Trust:

We have audited the accompanying statement of assets and liabilities of MFS Special Value Trust (the Fund), including the portfolio of investments, as of October 31, 2013, and the related statement of operations for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the 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 and financial highlights are free of material misstatement. We were not engaged to perform an audit of the Fund's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and financial highlights, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our procedures included confirmation of securities owned as of October 31, 2013, by correspondence with the custodian and others or by other appropriate auditing procedures where replies from others were not received. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of MFS Special Value Trust at October 31, 2013, the results of its operations for the year then ended, the changes in its net assets for each of the two years in the period then ended, and its financial highlights for each of the five years in the period then ended, in conformity with U.S. generally accepted accounting principles.

Boston, Massachusetts

December 16, 2013

**Table of Contents**

**RESULTS OF SHAREHOLDER MEETING**

(unaudited)

At the annual meeting of shareholders of MFS Special Value Trust, which was held on October 3, 2013, the following actions were taken:

**Item 1:** To elect the following individuals as Trustees:

<b>Nominee</b>	<b>For</b>	<b>Number of Shares</b>	<b>Withheld Authority</b>
Maureen R. Goldfarb	5,443,701.803		364,177.397
Robert J. Manning	5,441,492.803		366,386.397
Laurie J. Thomsen	5,437,267.803		370,611.397

**Table of Contents****TRUSTEES AND OFFICERS IDENTIFICATION AND BACKGROUND**

The Trustees and Officers of the Trust, as of December 1, 2013, are listed below, together with their principal occupations during the past five years. (Their titles may have varied during that period.) The address of each Trustee and Officer is 111 Huntington Avenue, Boston, Massachusetts 02199-7618.

Name, Age	Position(s)		Term	Principal Occupations During the Past Five Years	Other Directorships <sup>(i)</sup>
	Held with Fund	Trustee/Officer Since <sup>(h)</sup>			
<b>INTERESTED TRUSTEES</b>					
Robert J. Manning <sup>(k)</sup> (age 50)	Trustee	February 2004	2016	Massachusetts Financial Services Company, Chairman, Chief Executive Officer and Director; President (until 2009); Chief Investment Officer (until 2010)	N/A
<b>INDEPENDENT TRUSTEES</b>					
David H. Gunning (age 71)	Trustee and Chair of Trustees	January 2004	2015	Private investor	Lincoln Electric Holdings, Inc. (welding equipment manufacturer), Director; Development Alternatives, Inc. (consulting), Director/Non-Executive Chairman; Portman Limited (mining), Director (until 2008)
Robert E. Butler (age 72)	Trustee	January 2006	2015	Consultant investment company industry regulatory and compliance matters	N/A
Maureen R. Goldfarb (age 58)	Trustee	January 2009	2016	Private investor	N/A
William R. Gutow (age 72)	Trustee	December 1993	2014	Private investor and real estate consultant; Capitol Entertainment Management Company (video franchise), Vice Chairman	Texas Donuts (donut franchise), Vice Chairman (until 2010)



**Table of Contents***Trustees and Officers continued*

Name, Age	Position(s)		Term	Principal Occupations During the Past Five Years	Other
	Held with Fund	Trustee/Officer Since <sup>(h)</sup>			
Michael Hegarty (age 68)	Trustee	December 2004	2014	Private investor	Brookfield Office Properties, Inc. (real estate), Director; Rouse Properties Inc. (real estate), Director; Capmark Financial Group Inc. (real estate), Director
John P. Kavanaugh (age 59)	Trustee	January 2009	2014	Private investor	N/A
J. Dale Sherratt (age 75)	Trustee	June 1989	2015	Insight Resources, Inc. (acquisition planning specialists), President; Wellfleet Investments (investor in health care companies), Managing General Partner	N/A
Laurie J. Thomsen (age 56)	Trustee	March 2005	2016	Private investor; New Profit, Inc. (venture philanthropy), Executive Partner (until 2010)	The Travelers Companies (insurance), Director
Robert W. Uek (age 72)	Trustee	January 2006	2014	Consultant to investment company industry	N/A
<b>OFFICERS</b> John M. Corcoran <sup>(k)</sup> (age 48)	President	October 2008	N/A	Massachusetts Financial Services Company, Senior Vice President (since October 2008); State Street Bank and Trust (financial services provider), Senior Vice President, (until 2008)	N/A
Christopher R. Bohane <sup>(k)</sup> (age 39)	Assistant Secretary and Assistant Clerk	July 2005	N/A	Massachusetts Financial Services Company, Vice President and Assistant General Counsel	N/A
Kino Clark <sup>(k)</sup> (age 45)	Assistant  Treasurer	January 2012	N/A	Massachusetts Financial Services Company, Vice President	N/A

**Table of Contents***Trustees and Officers continued*

Name, Age	Position(s)		Term	Principal Occupations During the Past Five Years	Other
	Held with Fund	Trustee/Officer Since <sup>(h)</sup>			
Thomas H. Connors <sup>(k)</sup>  (age 54)	Assistant  Secretary and Assistant Clerk	September 2012	N/A	Massachusetts Financial Services Company, Vice President and Senior Counsel; Deutsche Investment Management Americas Inc. (financial service provider), Director and Senior Counsel (until 2012)	N/A
Ethan D. Corey <sup>(k)</sup> (age -50)	Assistant Secretary and Assistant Clerk	July 2005	N/A	Massachusetts Financial Services Company, Senior Vice President and Associate General Counsel	N/A
David L. DiLorenzo <sup>(k)</sup> (age 45)	Treasurer	July 2005	N/A	Massachusetts Financial Services Company, Senior Vice President	N/A
Robyn L. Griffin (age 38)	Assistant Independent Chief Compliance Officer	August 2008	N/A	Griffin Compliance LLC (provider of compliance services), Principal (since August 2008); State Street Corporation (financial services provider), Mutual Fund Administration Assistant Vice President (until 2008)	N/A
Brian E. Langenfeld <sup>(k)</sup>  (age 40)	Assistant Secretary and Assistant Clerk	June 2006	N/A	Massachusetts Financial Services Company, Vice President and Senior Counsel	N/A
Susan S. Newton <sup>(k)</sup>  (age 63)	Assistant Secretary and Assistant Clerk	May 2005	N/A	Massachusetts Financial Services Company, Senior Vice President and Associate General Counsel	N/A
Susan A. Pereira <sup>(k)</sup> (age 43)	Assistant Secretary and Assistant Clerk	July 2005	N/A	Massachusetts Financial Services Company, Vice President and Senior Counsel	N/A

**Table of Contents***Trustees and Officers continued*

Name, Age	Position(s)			Principal Occupations During the Past Five Years	Other Directorships <sup>(j)</sup>
	Held with Fund	Trustee/Officer Since <sup>(h)</sup>	Term Expiring		
Kasey L. Phillips <sup>(k)</sup> (age 42)	Assistant Treasurer	September 2012	N/A	Massachusetts Financial Services Company, Vice President; Wells Fargo Funds Management, LLC, Senior Vice President, Fund Treasurer (until 2012)	N/A
Mark N. Polebaum <sup>(k)</sup> (age 61)	Secretary and Clerk	January 2006	N/A	Massachusetts Financial Services Company, Executive Vice President, General Counsel and Secretary	N/A
Frank L. Tarantino (age 69)	Independent Chief Compliance Officer	June 2004	N/A	Tarantino LLC (provider of compliance services), Principal	N/A
Richard S. Weitzel <sup>(k)</sup> (age 43)	Assistant Secretary and Assistant Clerk	October 2007	N/A	Massachusetts Financial Services Company, Senior Vice President and Associate General Counsel	N/A
James O. Yost <sup>(k)</sup> (age 53)	Deputy Treasurer	September 1990	N/A	Massachusetts Financial Services Company, Senior Vice President	N/A

(h) Date first appointed to serve as Trustee/officer of an MFS Fund. Each Trustee has served continuously since appointment unless indicated otherwise. For the period from December 15, 2004 until February 22, 2005, Mr. Manning served as Advisory Trustee. For the period October 2008, until January 2012, Mr. Corcoran served as Treasurer of the Funds. Prior to January 2012, Messrs. DiLorenzo and Yost served as Assistant Treasurers of the Funds.

(j) Directorships or trusteeships of companies required to report to the Securities and Exchange Commission (i.e., public companies).

(k) Interested person of the Trust within the meaning of the Investment Company Act of 1940 (referred to as the 1940 Act), which is the principal federal law governing investment companies like the fund, as a result of position with MFS. The address of MFS is 111 Huntington Avenue, Boston, Massachusetts 02199-7618.

The Trust holds annual shareholder meetings for the purpose of electing Trustees, and Trustees are elected for fixed terms. The Board of Trustees is currently divided into three classes, each having a term of three years which term expires on the date of the third annual meeting following the election to office of the Trustee's class. Each year the term of one class expires. Each Trustee and officer will serve until next elected or his or her earlier death, resignation, retirement or removal.

**Table of Contents**

*Trustees and Officers continued*

Messrs. Butler, Kavanaugh, and Uek and Ms. Thomsen are members of the Fund's Audit Committee.

Each of the Fund's Trustees and officers holds comparable positions with certain other funds of which MFS or a subsidiary is the investment adviser or distributor, and, in the case of the officers, with certain affiliates of MFS. As of January 1, 2013, the Trustees served as board members of 143 funds within the MFS Family of Funds.

The Statement of Additional Information for the Fund includes further information about the Trustees and is available without charge upon request by calling 1-800-225-2606.

**Investment Adviser**

Massachusetts Financial Services Company  
111 Huntington Avenue  
Boston, MA 02199-7618

**Portfolio Managers**

William Adams  
Ward Brown  
Nevin Chitkara  
David Cole  
Matthew Ryan

**Custodian**

State Street Bank and Trust Company  
1 Lincoln Street  
Boston, MA 02111-2900

**Independent Registered Public Accounting Firm**

Ernst & Young LLP  
200 Clarendon Street  
Boston, MA 02116

**Table of Contents**

**BOARD REVIEW OF INVESTMENT ADVISORY AGREEMENT**

The Investment Company Act of 1940 requires that both the full Board of Trustees and a majority of the non-interested ( independent ) Trustees, voting separately, annually approve the continuation of the Fund s investment advisory agreement with MFS. The Trustees consider matters bearing on the Fund and its advisory arrangements at their meetings throughout the year, including a review of performance data at each regular meeting. In addition, the independent Trustees met several times over the course of three months beginning in May and ending in July, 2013 ( contract review meetings ) for the specific purpose of considering whether to approve the continuation of the investment advisory agreement for the Fund and the other investment companies that the Board oversees (the MFS Funds ). The independent Trustees were assisted in their evaluation of the Fund s investment advisory agreement by independent legal counsel, from whom they received separate legal advice and with whom they met separately from MFS during various contract review meetings. The independent Trustees were also assisted in this process by the MFS Funds Independent Chief Compliance Officer, a full-time senior officer appointed by and reporting to the independent Trustees.

In connection with their deliberations regarding the continuation of the investment advisory agreement, the Trustees, including the independent Trustees, considered such information and factors as they believed, in light of the legal advice furnished to them and their own business judgment, to be relevant. The investment advisory agreement for the Fund was considered separately, although the Trustees also took into account the common interests of all MFS Funds in their review. As described below, the Trustees considered the nature, quality, and extent of the various investment advisory, administrative, and shareholder services performed by MFS under the existing investment advisory agreement and other arrangements with the Fund.

In connection with their contract review meetings, the Trustees received and relied upon materials that included, among other items: (i) information provided by Lipper Inc., an independent third party, on the investment performance (based on net asset value) of the Fund for various time periods ended December 31, 2012 and the investment performance (based on net asset value) of a group of funds with substantially similar investment classifications/objectives (the Lipper performance universe ), (ii) information provided by Lipper Inc. on the Fund s advisory fees and other expenses and the advisory fees and other expenses of comparable funds identified by Lipper Inc. (the Lipper expense group ), (iii) information provided by MFS on the advisory fees of comparable portfolios of other clients of MFS, including institutional separate accounts and other clients, (iv) information as to whether and to what extent applicable expense waivers, reimbursements or fee breakpoints are observed for the Fund, (v) information regarding MFS financial results and financial condition, including MFS and certain of its affiliates estimated profitability from services performed for the Fund and the MFS Funds as a whole, and compared to MFS institutional business, (vi) MFS views regarding the outlook for the mutual fund industry and the strategic business plans of MFS, (vii) descriptions of various functions performed by MFS for the Funds, such as compliance monitoring and portfolio trading practices, and (viii) information regarding the overall organization of MFS, including information about MFS senior management and other personnel providing investment

**Table of Contents**

*Board Review of Investment Advisory Agreement continued*

advisory, administrative and other services to the Fund and the other MFS Funds. The comparative performance, fee and expense information prepared and provided by Lipper Inc. was not independently verified and the independent Trustees did not independently verify any information provided to them by MFS.

The Trustees' conclusion as to the continuation of the investment advisory agreement was based on a comprehensive consideration of all information provided to the Trustees and not the result of any single factor. Some of the factors that figured particularly in the Trustees' deliberations are described below, although individual Trustees may have evaluated the information presented differently from one another, giving different weights to various factors. It is also important to recognize that the fee arrangements for the Fund and other MFS Funds are the result of years of review and discussion between the independent Trustees and MFS, that certain aspects of such arrangements may receive greater scrutiny in some years than in others, and that the Trustees' conclusions may be based, in part, on their consideration of these same arrangements during the course of the year and in prior years.

Based on information provided by Lipper Inc. and MFS, the Trustees reviewed the Fund's total return investment performance as well as the performance of peer groups of funds over various time periods. The Trustees placed particular emphasis on the total return performance of the Fund's common shares in comparison to the performance of funds in its Lipper performance universe over the three-year period ended December 31, 2012, which the Trustees believed was a long enough period to reflect differing market conditions. The total return performance of the Fund's common shares ranked 5th out of a total of 5 funds in the Lipper performance universe for this three-year period (a ranking of first place out of the total number of funds in the performance universe indicating the best performer and a ranking of last place out of the total number of funds in the performance universe indicating the worst performer). The total return performance of the Fund's common shares ranked 6th out of a total of 7 funds for the one-year period and 5th out of a total of 5 funds for the five-year period ended December 31, 2012. Given the size of the Lipper performance universe and information previously provided by MFS regarding differences between the Fund and other funds in its Lipper performance universe, the Trustees also reviewed the Fund's performance in comparison to a custom benchmark developed by MFS. The Fund under-performed its custom benchmark for each of the one-, three- and five-year periods ended December 31, 2012 (one-year: 15.1% total return for the Fund versus 16.7% total return for the benchmark; three-year: 10.5% total return for the Fund versus 11.7% total return for the benchmark; five-year: 6.1% total return for the Fund versus 7.2% total return for the benchmark). Because of the passage of time, these performance results may differ from the performance results for more recent periods, including those shown elsewhere in this report.

The Trustees expressed concern to MFS about the substandard investment performance of the Fund. In the course of their deliberations, the Trustees took into account information provided by MFS in connection with the contract review meetings, as well as during investment review meetings conducted with portfolio management personnel during the course of the year, as to MFS' efforts to improve the Fund's performance, including assigning three new portfolio managers for the Fund in 2012. In addition, the Trustees requested that they receive a separate update on the Fund's

**Table of Contents**

*Board Review of Investment Advisory Agreement continued*

performance at each of their regular meetings. After reviewing these and related factors, the Trustees concluded, within the context of their overall conclusions regarding the investment advisory agreement, that MFS' responses and efforts and plans to improve investment performance were sufficient to support approval of the continuance of the investment advisory agreement for an additional one-year period, but that they would continue to closely monitor the performance of the Fund.

In assessing the reasonableness of the Fund's advisory fee, the Trustees considered, among other information, the Fund's advisory fee and the total expense ratio of the Fund's common shares as a percentage of average daily net assets and the advisory fee and total expense ratios of peer groups of funds based on information provided by Lipper Inc. The Trustees considered that MFS has agreed in writing to reduce its advisory fee, which may not be changed without the Trustees' approval. The Trustees also considered that, according to the Lipper data (which takes into account any fee reductions or expense limitations that were in effect during the Fund's last fiscal year), the Fund's effective advisory fee rate and total expense ratio were each higher than the Lipper expense group median.

The Trustees also considered the advisory fees charged by MFS to any comparable institutional accounts. In comparing these fees, the Trustees considered information provided by MFS as to the generally broader scope of services provided by MFS to the Fund in comparison to institutional accounts and the impact on MFS and expenses associated with the more extensive regulatory regime to which the Fund is subject in comparison to institutional accounts.

The Trustees considered that, as a closed-end fund, the Fund is unlikely to experience meaningful asset growth. As a result, the Trustees did not view the potential for realization of economies of scale as the Fund's assets grow to be a material factor in their deliberations. The Trustees noted that they would consider economies of scale in the future in the event the Fund experiences significant asset growth, such as through an offering of preferred shares (which is not currently contemplated) or a material increase in the market value of the Fund's portfolio securities.

The Trustees also considered information prepared by MFS relating to MFS' costs and profits with respect to the Fund, the MFS Funds considered as a group, and other investment companies and accounts advised by MFS, as well as MFS' methodologies used to determine and allocate its costs to the MFS Funds, the Fund and other accounts and products for purposes of estimating profitability.

After reviewing these and other factors described herein, the Trustees concluded, within the context of their overall conclusions regarding the investment advisory agreement, that the advisory fees charged to the Fund represent reasonable compensation in light of the services being provided by MFS to the Fund.

In addition, the Trustees considered MFS' resources and related efforts to continue to retain, attract and motivate capable personnel to serve the Fund. The Trustees also considered current and developing conditions in the financial services industry, including the presence of large and well-capitalized companies which are spending, and appear to be prepared to continue to spend, substantial sums to engage personnel and to provide services to competing investment companies. In this regard, the Trustees also considered the financial resources of MFS and its ultimate parent, Sun Life

**Table of Contents**

*Board Review of Investment Advisory Agreement continued*

Financial Inc. The Trustees also considered the advantages and possible disadvantages to the Fund of having an adviser that also serves other investment companies as well as other accounts.

The Trustees also considered the nature, quality, cost, and extent of administrative services provided to the Fund by MFS under agreements other than the investment advisory agreement. The Trustees also considered the nature, extent and quality of certain other services MFS performs or arranges for on the Fund's behalf, which may include securities lending programs, directed expense payment programs, class action recovery programs, and MFS' interaction with third-party service providers, principally custodians and sub-custodians. The Trustees concluded that the various non-advisory services provided by MFS and its affiliates on behalf of the Fund were satisfactory.

The Trustees also considered benefits to MFS from the use of the Fund's portfolio brokerage commissions, if applicable, to pay for investment research and various other factors. Additionally, the Trustees considered so-called "fall-out benefits" to MFS such as reputational value derived from serving as investment manager to the Fund.

Based on their evaluation of factors that they deemed to be material, including those factors described above, the Board of Trustees, including the independent Trustees, concluded that the Fund's investment advisory agreement with MFS should be continued for an additional one-year period, commencing August 1, 2013.

A discussion regarding the Board's most recent review and renewal of the fund's Investment Advisory Agreement with MFS is available by clicking on the fund's name under "Closed End Funds" in the "Products" section of the MFS Web site ([mfs.com](http://mfs.com)).



## **Table of Contents**

### **PROXY VOTING POLICIES AND INFORMATION**

A general description of the MFS funds' proxy voting policies and procedures is available without charge, upon request, by calling 1-800-225-2606, by visiting the Proxy Voting section of *mfs.com* or by visiting the SEC's Web site at <http://www.sec.gov>.

Information regarding how the fund voted proxies relating to portfolio securities during the most recent twelve-month period ended June 30 is available without charge by visiting the Proxy Voting section of *mfs.com* or by visiting the SEC's Web site at <http://www.sec.gov>.

### **QUARTERLY PORTFOLIO DISCLOSURE**

The fund will file a complete schedule of portfolio holdings with the Securities and Exchange Commission (the Commission) for the first and third quarters of each fiscal year on Form N-Q. A shareholder can obtain the quarterly portfolio holdings report at *mfs.com*. The fund's Form N-Q is also available on the EDGAR database on the Commission's Internet Web site at <http://www.sec.gov>, and may be reviewed and copied at the:

Public Reference Room

Securities and Exchange Commission

100 F Street, NE, Room 1580

Washington, D.C. 20549

Information on the operation of the Public Reference Room may be obtained by calling the Commission at 1-800-SEC-0330. Copies of the Fund's Form N-Q also may be obtained, upon payment of a duplicating fee, by electronic request at the following e-mail address: [publicinfo@sec.gov](mailto:publicinfo@sec.gov) or by writing the Public Reference Section at the above address.

### **FURTHER INFORMATION**

From time to time, MFS may post important information about the fund or the MFS funds on the MFS web site (*mfs.com*). This information is available by visiting the News & Commentary section of *mfs.com* or by clicking on the fund's name under Closed End Funds in the Products section of *mfs.com*.

### **FEDERAL TAX INFORMATION (unaudited)**

The fund will notify shareholders of amounts for use in preparing 2013 income tax forms in January 2014. The following information is provided pursuant to provisions of the Internal Revenue Code.

The fund designates the maximum amount allowable as qualified dividend income eligible for the 15% tax rate.

For corporate shareholders, 13.22% of the ordinary income dividends paid during the fiscal year qualify for the corporate dividends received deduction.

**Table of Contents**

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**FACTS**

**WHAT DOES MFS DO WITH YOUR PERSONAL INFORMATION?**

**Why?**

Financial companies choose how they share your personal information. Federal law gives consumers the right to limit some but not all sharing. Federal law also requires us to tell you how we collect, share, and protect your personal information. Please read this notice carefully to understand what we do.

**What?**

The types of personal information we collect and share depend on the product or service you have with us. This information can include:

- Social Security number and account balances
- Account transactions and transaction history
- Checking account information and wire transfer instructions

When you are *no longer* our customer, we continue to share your information as described in this notice.

**How?**

All financial companies need to share customers' personal information to run their everyday business. In the section below, we list the reasons financial companies can share their customers' personal information; the reasons MFS chooses to share; and whether you can limit this sharing.

Reasons we can share your personal information	Does MFS share?	Can you limit this sharing?
<b>For our everyday business purposes</b> such as to process your transactions, maintain your account(s), respond to court orders and legal investigations, or report to credit bureaus	Yes	No
<b>For our marketing purposes</b> to offer our products and services to you	No	We don't share
<b>For joint marketing with other financial companies</b>	No	We don't share
<b>For our affiliates' everyday business purposes</b> information about your transactions and experiences	No	We don't share
<b>For our affiliates' everyday business purposes</b> information about your creditworthiness	No	We don't share

For nonaffiliates to market to you

No

We don't share

**Questions?**

Call **800-225-2606** or go to **mfs.com**.

**Table of Contents**

Page 2

**Who we are**

**Who is providing this notice?**

MFS Funds, MFS Investment Management, MFS Institutional Advisors, Inc., MFS Fund Distributors, Inc., MFS Heritage Trust Company, and MFS Service Center, Inc.

**What we do**

**How does MFS protect my personal information?**

To protect your personal information from unauthorized access and use, we use security measures that comply with federal law. These measures include procedural, electronic, and physical safeguards for the protection of the personal information we collect about you.

**How does MFS collect my personal information?**

We collect your personal information, for example, when you

open an account or provide account information

direct us to buy securities or direct us to sell your securities

make a wire transfer

We also collect your personal information from others, such as credit bureaus, affiliates and other companies.

**Why can't I limit all sharing?**

Federal law gives you the right to limit only

sharing for affiliates everyday business purposes information about your creditworthiness

affiliates from using your information to market to you

sharing for nonaffiliates to market to you

State laws and individual companies may give you additional rights to limit sharing.

**Definitions**

**Affiliates**

Companies related by common ownership or control. They can be financial and nonfinancial companies.

**Nonaffiliates**

*MFS does not share personal information with affiliates, except for everyday business purposes as described on page one of this notice.*

Companies not related by common ownership or control. They can be financial and nonfinancial companies.

**Joint Marketing**

*MFS does not share with nonaffiliates so they can market to you.*

A formal agreement between nonaffiliated financial companies that together market financial products or services to you.

*MFS doesn't jointly market.*

**Other important information**

If you own an MFS product or receive an MFS service in the name of a third party such as a bank or broker-dealer, their privacy policy may apply to you instead of ours.

**Table of Contents**

**CONTACT US**

**TRANSFER AGENT, REGISTRAR, AND**

**DIVIDEND DISBURSING AGENT**

**CALL**

1-800-637-2304

9 a.m. to 5 p.m. Eastern time

**WRITE**

Computershare Trust Company, N.A.

P.O. Box 43078

Providence, RI 02940-3078

New York Stock Exchange Symbol: **MFV**

**Table of Contents**

**ITEM 2. CODE OF ETHICS.**

The Registrant has adopted a Code of Ethics pursuant to Section 406 of the Sarbanes-Oxley Act and as defined in Form N-CSR that applies to the Registrant's principal executive officer and principal financial and accounting officer. During the period covered by this report, the Registrant has not amended any provision in its Code of Ethics (the "Code") that relates to an element of the Code's definitions enumerated in paragraph (b) of Item 2 of this Form N-CSR. During the period covered by this report, the Registrant did not grant a waiver, including an implicit waiver, from any provision of the Code.

A copy of the Code of Ethics is filed as an exhibit to this Form N-CSR.

**ITEM 3. AUDIT COMMITTEE FINANCIAL EXPERT.**

Messrs. Robert E. Butler, John P. Kavanaugh and Robert W. Uek and Ms. Laurie J. Thomsen, members of the Audit Committee, have been determined by the Board of Trustees in their reasonable business judgment to meet the definition of "audit committee financial expert" as such term is defined in Form N-CSR. In addition, Messrs. Butler, Kavanaugh and Uek and Ms. Thomsen are "independent" members of the Audit Committee (as such term has been defined by the Securities and Exchange Commission in regulations implementing Section 407 of the Sarbanes-Oxley Act of 2002). The Securities and Exchange Commission has stated that the designation of a person as an audit committee financial expert pursuant to this Item 3 on the Form N-CSR does not impose on such a person any duties, obligations or liability that are greater than the duties, obligations or liability imposed on such person as a member of the Audit Committee and the Board of Trustees in the absence of such designation or identification.

**ITEM 4. PRINCIPAL ACCOUNTANT FEES AND SERVICES.**

**Items 4(a) through 4(d) and 4(g):**

The Board of Trustees has appointed Ernst & Young LLP ("E&Y") to serve as independent accountants to the Registrant (hereinafter the "Registrant" or the "Fund"). The tables below set forth the audit fees billed to the Fund as well as fees for non-audit services provided to the Fund and/or to the Fund's investment adviser, Massachusetts Financial Services Company ("MFS") and to various entities either controlling, controlled by, or under common control with MFS that provide ongoing services to the Fund ("MFS Related Entities").

For the fiscal years ended October 31, 2013 and 2012, audit fees billed to the Fund by E&Y were as follows:

	<b>Audit Fees</b>	
	<b>2013</b>	<b>2012</b>
<b>Fees billed by E&amp;Y:</b>		
MFS Special Value Trust	48,260	44,879

**Table of Contents**

For the fiscal years ended October 31, 2013 and 2012, fees billed by E&Y for audit-related, tax and other services provided to the Fund and for audit-related, tax and other services provided to MFS and MFS Related Entities were as follows:

	Audit-Related Fees <sup>1</sup>		Tax Fees <sup>2</sup>		All Other Fees <sup>3</sup>	
	2013	2012	2013	2012	2013	2012
<b>Fees billed by E&amp;Y:</b>						
To MFS Special Value Trust	10,714	10,504	9,267	9,170	0	0
<b>Fees billed by E&amp;Y:</b>						
To MFS and MFS Related Entities of MFS Special Value Trust <sup>*</sup>	0	0	0	0	0	0
<b>Aggregate Fees for Non-audit</b>						
			<b>Services</b>			
			<b>2013</b>	<b>2012</b>		
<b>Fees Billed by E&amp;Y:</b>						
To MFS Special Value Trust, MFS and MFS Related Entities <sup>#</sup>			77,981	59,674		

<sup>\*</sup> This amount reflects the fees billed to MFS and MFS Related Entities for non-audit services relating directly to the operations and financial reporting of the Fund (portions of which services also related to the operations and financial reporting of other funds within the MFS Funds complex).

<sup>#</sup> This amount reflects the aggregate fees billed by E&Y for non-audit services rendered to the Fund and for non-audit services rendered to MFS and the MFS Related Entities.

<sup>1</sup> The fees included under **Audit-Related Fees** are fees related to assurance and related services that are reasonably related to the performance of the audit or review of financial statements, but not reported under **Audit Fees**, including accounting consultations, agreed-upon procedure reports, attestation reports, comfort letters and internal control reviews.

<sup>2</sup> The fees included under **Tax Fees** are fees associated with tax compliance, tax advice and tax planning, including services relating to the filing or amendment of federal, state or local income tax returns, regulated investment company qualification reviews and tax distribution and analysis.

<sup>3</sup> The fees under **All Other Fees** are fees for products and services provided by E&Y other than those reported under **Audit Fees**, **Audit-Related Fees** and **Tax Fees**.

**Item 4(e)(1):**

Set forth below are the policies and procedures established by the Audit Committee of the Board of Trustees relating to the pre-approval of audit and non-audit related services:

To the extent required by applicable law, pre-approval by the Audit Committee of the Board is needed for all audit and permissible non-audit services rendered to the Fund and all permissible non-audit services rendered to MFS or MFS Related Entities if the services relate directly to the operations and financial reporting of the Registrant. Pre-approval is currently on an engagement-by-engagement basis. In the event pre-approval of such services is necessary between regular meetings of the Audit Committee and it is not practical to wait to seek pre-approval at the next regular meeting of the Audit Committee, pre-approval of such services may be referred to the Chair of the Audit Committee for approval; provided that the Chair may not pre-approve any individual engagement for such



**Table of Contents**

services exceeding \$50,000 or multiple engagements for such services in the aggregate exceeding \$100,000 between such regular meetings of the Audit Committee. Any engagement pre-approved by the Chair between regular meetings of the Audit Committee shall be presented for ratification by the entire Audit Committee at its next regularly scheduled meeting.

**Item 4(e)(2):**

None, or 0%, of the services relating to the Audit-Related Fees, Tax Fees and All Other Fees paid by the Fund and MFS and MFS Related Entities relating directly to the operations and financial reporting of the Registrant disclosed above were approved by the audit committee pursuant to paragraphs (c)(7)(i)(C) of Rule 2-01 of Regulation S-X (which permits audit committee approval after the start of the engagement with respect to services other than audit, review or attest services, if certain conditions are satisfied).

**Item 4(f):** Not applicable.

**Item 4(h):** The Registrant's Audit Committee has considered whether the provision by a Registrant's independent registered public accounting firm of non-audit services to MFS and MFS Related Entities that were not pre-approved by the Committee (because such services were provided prior to the effectiveness of SEC rules requiring pre-approval or because such services did not relate directly to the operations and financial reporting of the Registrant) was compatible with maintaining the independence of the independent registered public accounting firm as the Registrant's principal auditors.

**ITEM 5. AUDIT COMMITTEE OF LISTED REGISTRANTS.**

The Registrant has an Audit Committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934. The members of the Audit Committee are Messrs. Robert E. Butler, John P. Kavanaugh, and Robert W. Uek and Ms. Laurie J. Thomsen.

**ITEM 6. SCHEDULE OF INVESTMENTS**

A schedule of investments of the Registrant is included as part of the report to shareholders of the Registrant under Item 1 of this Form N-CSR.

**ITEM 7. DISCLOSURE OF PROXY VOTING POLICIES AND PROCEDURES FOR CLOSED-END MANAGEMENT INVESTMENT COMPANIES.**

**MASSACHUSETTS FINANCIAL SERVICES COMPANY**

**PROXY VOTING POLICIES AND PROCEDURES**

**February 1, 2013**

Massachusetts Financial Services Company, MFS Institutional Advisors, Inc., MFS International (UK) Limited, MFS Heritage Trust Company, McLean Budden Limited and MFS' other subsidiaries that perform discretionary investment management activities (collectively, MFS ) have adopted proxy voting policies

## **Table of Contents**

and procedures, as set forth below ( MFS Proxy Voting Policies and Procedures ), with respect to securities owned by the clients for which MFS serves as investment adviser and has the power to vote proxies, including the pooled investment vehicles sponsored by MFS (the MFS Funds ). References to clients in these policies and procedures include the MFS Funds and other clients of MFS, such as funds organized offshore, sub-advised funds and separate account clients, to the extent these clients have delegated to MFS the responsibility to vote proxies on their behalf under the MFS Proxy Voting Policies and Procedures.

The MFS Proxy Voting Policies and Procedures include:

- A. Voting Guidelines;
- B. Administrative Procedures;
- C. Records Retention; and
- D. Reports.

### **A. VOTING GUIDELINES**

#### **1. General Policy: Potential Conflicts of Interest**

MFS policy is that proxy voting decisions are made in what MFS believes to be the best long-term economic interests of MFS clients, and not in the interests of any other party or in MFS corporate interests, including interests such as the distribution of MFS Fund shares and institutional client relationships.

MFS reviews corporate governance issues and proxy voting matters that are presented for shareholder vote by either management or shareholders of public companies. Based on the overall principle that all votes cast by MFS on behalf of its clients must be in what MFS believes to be the best long-term economic interests of such clients, MFS has adopted proxy voting guidelines, set forth below, that govern how MFS generally will vote on specific matters presented for shareholder vote.

As a general matter, MFS votes consistently on similar proxy proposals across all shareholder meetings. However, some proxy proposals, such as certain excessive executive compensation, environmental, social and governance matters, are analyzed on a case-by-case basis in light of all the relevant facts and circumstances of the proposal. Therefore, MFS may vote similar proposals differently at different shareholder meetings based on the specific facts and circumstances of the issuer or the terms of the proposal. In addition, MFS also reserves the right to override the guidelines with respect to a particular proxy proposal when such an override is, in MFS best judgment, consistent with the overall principle of voting proxies in the best long-term economic interests of MFS clients.

## **Table of Contents**

MFS also generally votes consistently on the same matter when securities of an issuer are held by multiple client accounts, unless MFS has received explicit voting instructions to vote differently from a client for its own account. From time to time, MFS may also receive comments on the MFS Proxy Voting Policies and Procedures from its clients. These comments are carefully considered by MFS when it reviews these guidelines and revises them as appropriate.

These policies and procedures are intended to address any potential material conflicts of interest on the part of MFS or its subsidiaries that are likely to arise in connection with the voting of proxies on behalf of MFS clients. If such potential material conflicts of interest do arise, MFS will analyze, document and report on such potential material conflicts of interest (see Sections B.2 and D below), and shall ultimately vote the relevant proxies in what MFS believes to be the best long-term economic interests of its clients. The MFS Proxy Voting Committee is responsible for monitoring and reporting with respect to such potential material conflicts of interest.

MFS is also a signatory to the United Nations Principles for Responsible Investment. In developing these guidelines, MFS considered environmental, social and corporate governance issues in light of MFS fiduciary obligation to vote proxies in the best long-term economic interest of its clients.

## **2. MFS Policy on Specific Issues** **Election of Directors**

MFS believes that good governance should be based on a board with at least a simple majority of directors who are independent of management, and whose key committees (e.g., compensation, nominating, and audit committees) consist entirely of independent directors. While MFS generally supports the board's nominees in uncontested or non-contentious elections, we will not support a nominee to a board of a U.S. issuer (or issuer listed on a U.S. exchange) if, as a result of such nominee being elected to the board, the board would consist of a simple majority of members who are not independent or, alternatively, the compensation, nominating (including instances in which the full board serves as the compensation or nominating committee) or audit committees would include members who are not independent.

MFS will also not support a nominee to a board if we can determine that he or she attended less than 75% of the board and/or relevant committee meetings in the previous year without a valid reason stated in the proxy materials or other company communications. In addition, MFS may not support some or all nominees standing for re-election to a board if we can determine: (1) the board or its compensation committee has re-priced or exchanged underwater stock options

## **Table of Contents**

since the last annual meeting of shareholders and without shareholder approval; (2) the board or relevant committee has not taken adequately responsive action to an issue that received majority support or opposition from shareholders; (3) the board has implemented a poison pill without shareholder approval since the last annual meeting and such poison pill is not on the subsequent shareholder meeting's agenda, (including those related to net-operating loss carryforwards); or (4) there are governance concerns with a director or issuer.

MFS may not support certain board nominees of U.S. issuers under certain circumstances where MFS deems compensation to be egregious due to pay-for-performance issues and/or poor pay practices. Please see the section below titled "MFS Policy on Specific Issues: Advisory Votes on Executive Compensation" for further details.

MFS evaluates a contested or contentious election of directors on a case-by-case basis considering the long-term financial performance of the company relative to its industry, management's track record, the qualifications of all nominees, and an evaluation of what each side is offering shareholders.

### **Majority Voting and Director Elections**

MFS votes for reasonably crafted proposals calling for directors to be elected with an affirmative majority of votes cast and/or the elimination of the plurality standard for electing directors (including binding resolutions requesting that the board amend the company's bylaws), provided the proposal includes a carve-out for a plurality voting standard when there are more director nominees than board seats (*e.g.*, contested elections) ("Majority Vote Proposals").

### **Classified Boards**

MFS generally supports proposals to declassify a board (*i.e.*; a board in which only one-third of board members is elected each year) for all issuers other than for certain closed-end investment companies. MFS generally opposes proposals to classify a board for issuers other than for certain closed-end investment companies.

### **Proxy Access**

MFS believes that the ability of qualifying shareholders to nominate a certain number of directors on the company's proxy statement ("Proxy Access") may have corporate governance benefits. However, such potential benefits must be balanced by its potential misuse by shareholders. Therefore, we support Proxy Access proposals at U.S. issuers that establish an ownership criteria of 3% of the company held continuously for a period of 3 years. MFS analyzes all other proposals seeking Proxy Access on a case-by-case basis. In its analysis, MFS will consider the proposed ownership criteria for qualifying shareholders (such as ownership threshold and holding period) as well as the proponent's rationale for seeking Proxy Access.

## **Table of Contents**

### **Stock Plans**

MFS opposes stock option programs and restricted stock plans that provide unduly generous compensation for officers, directors or employees, or that could result in excessive dilution to other shareholders. As a general guideline, MFS votes against restricted stock, stock option, non-employee director, omnibus stock plans and any other stock plan if all such plans for a particular company involve potential dilution, in the aggregate, of more than 15%. However, MFS will also vote against stock plans that involve potential dilution, in aggregate, of more than 10% at U.S. issuers that are listed in the Standard and Poor's 100 index as of December 31 of the previous year. In the cases where a stock plan amendment is seeking qualitative changes and not additional shares, MFS will vote its shares on a case-by-case basis.

MFS also opposes stock option programs that allow the board or the compensation committee to re-price underwater options or to automatically replenish shares without shareholder approval. MFS also votes against stock option programs for officers, employees or non-employee directors that do not require an investment by the optionee, that give "free rides" on the stock price, or that permit grants of stock options with an exercise price below fair market value on the date the options are granted. MFS will consider proposals to exchange existing options for newly issued options, restricted stock or cash on a case-by-case basis, taking into account certain factors, including, but not limited to, whether there is a reasonable value-for-value exchange and whether senior executives are excluded from participating in the exchange.

MFS supports the use of a broad-based employee stock purchase plans to increase company stock ownership by employees, provided that shares purchased under the plan are acquired for no less than 85% of their market value and do not result in excessive dilution.

### **Shareholder Proposals on Executive Compensation**

MFS believes that competitive compensation packages are necessary to attract, motivate and retain executives. However, MFS also recognizes that certain executive compensation practices can be excessive and not in the best, long-term economic interest of a company's shareholders. We believe that the election of an issuer's board of directors (as outlined above), votes on stock plans (as outlined above) and advisory votes on pay (as outlined below) are typically the most effective mechanisms to express our view on a company's compensation practices.

MFS generally opposes shareholder proposals that seek to set rigid restrictions on executive compensation as MFS believes that compensation committees should retain some flexibility to determine the appropriate pay package for executives. Although we support linking executive stock option grants to a

## **Table of Contents**

company's performance, MFS also opposes shareholder proposals that mandate a link of performance-based pay to a specific metric. MFS generally supports reasonably crafted shareholder proposals that (i) require the issuer to adopt a policy to recover the portion of performance-based bonuses and awards paid to senior executives that were not earned based upon a significant negative restatement of earnings unless the company already has adopted a satisfactory policy on the matter, or (ii) expressly prohibit the backdating of stock options.

### **Advisory Votes on Executive Compensation**

MFS will analyze advisory votes on executive compensation on a case-by-case basis. MFS will vote against an advisory vote on executive compensation if MFS determines that the issuer has adopted excessive executive compensation practices and will vote in favor of an advisory vote on executive compensation if MFS has not determined that the issuer has adopted excessive executive compensation practices. Examples of excessive executive compensation practices may include, but are not limited to, a pay-for-performance disconnect, employment contract terms such as guaranteed bonus provisions, unwarranted pension payouts, backdated stock options, overly generous hiring bonuses for chief executive officers, unnecessary perquisites, or the potential reimbursement of excise taxes to an executive in regards to a severance package. In cases where MFS (i) votes against consecutive advisory pay votes, or (ii) determines that a particularly egregious excessive executive compensation practice has occurred, then MFS may also vote against certain or all board nominees. MFS may also vote against certain or all board nominees if an advisory pay vote for a U.S. issuer is not on the agenda, or the company has not implemented the advisory vote frequency supported by a plurality/ majority of shareholders.

MFS generally supports proposals to include an advisory shareholder vote on an issuer's executive compensation practices on an annual basis.

### **Golden Parachutes**

From time to time, MFS may evaluate a separate, advisory vote on severance packages or "golden parachutes" to certain executives at the same time as a vote on a proposed merger or acquisition. MFS will support an advisory vote on a severance package on a case-by-case basis, and MFS may vote against the severance package regardless of whether MFS supports the proposed merger or acquisition.

Shareholders of companies may also submit proxy proposals that would require shareholder approval of severance packages for executive officers that exceed certain predetermined thresholds. MFS votes in favor of such shareholder proposals when they would require shareholder approval of any severance package for an executive officer that exceeds a certain multiple of such officer's annual compensation that is not determined in MFS' judgment to be excessive.

## **Table of Contents**

### **Anti-Takeover Measures**

In general, MFS votes against any measure that inhibits capital appreciation in a stock, including proposals that protect management from action by shareholders. These types of proposals take many forms, ranging from poison pills and shark repellents to super-majority requirements.

MFS generally votes for proposals to rescind existing poison pills and proposals that would require shareholder approval to adopt prospective poison pills, unless the company already has adopted a clearly satisfactory policy on the matter. MFS may consider the adoption of a prospective poison pill or the continuation of an existing poison pill if we can determine that the following two conditions are met: (1) the poison pill allows MFS clients to hold an aggregate position of up to 15% of a company's total voting securities (and of any class of voting securities); and (2) either (a) the poison pill has a term of not longer than five years, provided that MFS will consider voting in favor of the poison pill if the term does not exceed seven years and the poison pill is linked to a business strategy or purpose that MFS believes is likely to result in greater value for shareholders; or (b) the terms of the poison pill allow MFS clients the opportunity to accept a fairly structured and attractively priced tender offer (e.g. a chewable poison pill that automatically dissolves in the event of an all cash, all shares tender offer at a premium price). MFS will also consider on a case-by-case basis proposals designed to prevent tenders which are disadvantageous to shareholders such as tenders at below market prices and tenders for substantially less than all shares of an issuer.

MFS will consider any poison pills designed to protect a company's net-operating loss carryforwards on a case-by-case basis, weighing the accounting and tax benefits of such a pill against the risk of deterring future acquisition candidates.

### **Reincorporation and Reorganization Proposals**

When presented with a proposal to reincorporate a company under the laws of a different state, or to effect some other type of corporate reorganization, MFS considers the underlying purpose and ultimate effect of such a proposal in determining whether or not to support such a measure. MFS generally votes with management in regards to these types of proposals, however, if MFS believes the proposal is in the best long-term economic interests of its clients, then MFS may vote against management (e.g. the intent or effect would be to create additional inappropriate impediments to possible acquisitions or takeovers).

### **Issuance of Stock**

There are many legitimate reasons for the issuance of stock. Nevertheless, as noted above under Stock Plans, when a stock option plan (either individually or when aggregated with other plans of the same company) would substantially dilute the existing equity (e.g. by approximately 10-15% as described above), MFS

## **Table of Contents**

generally votes against the plan. In addition, MFS typically votes against proposals where management is asking for authorization to issue common or preferred stock with no reason stated (a blank check ) because the unexplained authorization could work as a potential anti-takeover device. MFS may also vote against the authorization or issuance of common or preferred stock if MFS determines that the requested authorization is excessive or not warranted.

### **Repurchase Programs**

MFS supports proposals to institute share repurchase plans in which all shareholders have the opportunity to participate on an equal basis. Such plans may include a company acquiring its own shares on the open market, or a company making a tender offer to its own shareholders.

### **Cumulative Voting**

MFS opposes proposals that seek to introduce cumulative voting and for proposals that seek to eliminate cumulative voting. In either case, MFS will consider whether cumulative voting is likely to enhance the interests of MFS clients as minority shareholders.

### **Written Consent and Special Meetings**

The right to call a special meeting or act by written consent can be a powerful tool for shareholders. As such, MFS supports proposals requesting the right for shareholders who hold at least 10% of the issuer's outstanding stock to call a special meeting. MFS also supports proposals requesting the right for shareholders to act by written consent.

### **Independent Auditors**

MFS believes that the appointment of auditors for U.S. issuers is best left to the board of directors of the company and therefore supports the ratification of the board's selection of an auditor for the company. Some shareholder groups have submitted proposals to limit the non-audit activities of a company's audit firm or prohibit any non-audit services by a company's auditors to that company. MFS opposes proposals recommending the prohibition or limitation of the performance of non-audit services by an auditor, and proposals recommending the removal of a company's auditor due to the performance of non-audit work for the company by its auditor. MFS believes that the board, or its audit committee, should have the discretion to hire the company's auditor for specific pieces of non-audit work in the limited situations permitted under current law.

### **Other Business**

MFS generally votes against other business proposals as the content of any such matter is not known at the time of our vote.



## **Table of Contents**

### **Adjourn Shareholder Meeting**

MFS generally supports proposals to adjourn a shareholder meeting if we support the other ballot items on the meeting's agenda. MFS generally votes against proposals to adjourn a meeting if we do not support the other ballot items on the meeting's agenda.

### **Environmental, Social and Governance ( ESG ) Issues**

MFS believes that a company's ESG practices may have an impact on the company's long-term economic financial performance and will generally support proposals relating to ESG issues that MFS believes are in the best long-term economic interest of the company's shareholders. For those ESG proposals for which a specific policy has not been adopted, MFS considers such ESG proposals on a case-by-case basis. As a result, it may vote similar proposals differently at various shareholder meetings based on the specific facts and circumstances of such proposal.

MFS generally supports proposals that seek to remove governance structures that insulate management from shareholders (*i.e.*, anti-takeover measures) or that seek to enhance shareholder rights. Many of these governance-related issues, including compensation issues, are outlined within the context of the above guidelines. In addition, MFS typically supports proposals that require an issuer to reimburse successful dissident shareholders (who are not seeking control of the company) for reasonable expenses that such dissident incurred in soliciting an alternative slate of director candidates. MFS also generally supports reasonably crafted shareholder proposals requesting increased disclosure around the company's use of collateral in derivatives trading. MFS typically does not support proposals to separate the chairman and CEO positions as we believe that the most beneficial leadership structure of a company should be determined by the company's board of directors. However, we will generally support such proposals if we determine there to be governance concerns at the issuer. For any governance-related proposal for which an explicit guideline is not provided above, MFS will consider such proposals on a case-by-case basis and will support such proposals if MFS believes that it is in the best long-term economic interest of the company's shareholders.

MFS generally supports proposals that request disclosure on the impact of environmental issues on the company's operations, sales, and capital investments. However, MFS may not support such proposals based on the facts and circumstances surrounding a specific proposal, including, but not limited to, whether (i) the proposal is unduly costly, restrictive, or burdensome, (ii) the company already provides publicly-available information that is sufficient to enable shareholders to evaluate the potential opportunities and risks that environmental matters pose to the company's operations, sales and capital investments, or (iii) the proposal seeks a level of disclosure that exceeds that provided by the company's industry peers. MFS will analyze all other environmental proposals on a case-by-case basis and will support such proposals if MFS believes such proposal is in the best long-term economic interest of the company's shareholders.

## **Table of Contents**

MFS will analyze social proposals on a case-by-case basis. MFS will support such proposals if MFS believes that such proposal is in the best long-term economic interest of the company's shareholders. Generally, MFS will support shareholder proposals that (i) seek to amend a company's equal employment opportunity policy to prohibit discrimination based on sexual orientation and gender identity; and (ii) request additional disclosure regarding a company's political contributions (including trade organizations and lobbying activity) (unless the company already provides publicly-available information that is sufficient to enable shareholders to evaluate the potential opportunities and risks that such contributions pose to the company's operations, sales and capital investments).

The laws of various states or countries may regulate how the interests of certain clients subject to those laws (e.g. state pension plans) are voted with respect to social issues. Thus, it may be necessary to cast ballots differently for certain clients than MFS might normally do for other clients.

## **Foreign Issuers**

MFS generally supports the election of a director nominee standing for re-election in uncontested or non-contentious elections unless it can be determined that (1) he or she failed to attend at least 75% of the board and/or relevant committee meetings in the previous year without a valid reason given in the proxy materials; (2) since the last annual meeting of shareholders and without shareholder approval, the board or its compensation committee has re-priced underwater stock options; or (3) since the last annual meeting, the board has either implemented a poison pill without shareholder approval or has not taken responsive action to a majority shareholder approved resolution recommending that the poison pill be rescinded. Also, certain markets outside of the U.S. have adopted best practice guidelines relating to corporate governance matters (e.g. the United Kingdom's Corporate Governance Code). Many of these guidelines operate on a "comply or explain" basis. As such, MFS will evaluate any explanations by companies relating to their compliance with a particular corporate governance guideline on a case-by-case basis and may vote against the board nominees or other relevant ballot item if such explanation is not satisfactory.

MFS generally supports the election of auditors, but may determine to vote against the election of a statutory auditor in certain markets if MFS reasonably believes that the statutory auditor is not truly independent.

Some international markets have also adopted mandatory requirements for all companies to hold shareholder votes on executive compensation. MFS will not support such proposals if MFS determines that a company's executive compensation practices are excessive, considering such factors as the specific market's best practices that seek to maintain appropriate pay-for-performance alignment and to create long-term shareholder value.

## **Table of Contents**

Many other items on foreign proxies involve repetitive, non-controversial matters that are mandated by local law. Accordingly, the items that are generally deemed routine and which do not require the exercise of judgment under these guidelines (and therefore voted with management) for foreign issuers include, but are not limited to, the following: (i) receiving financial statements or other reports from the board; (ii) approval of declarations of dividends; (iii) appointment of shareholders to sign board meeting minutes; (iv) discharge of management and supervisory boards; and (v) approval of share repurchase programs (absent any anti-takeover or other concerns). MFS will evaluate all other items on proxies for foreign companies in the context of the guidelines described above, but will generally vote against an item if there is not sufficient information disclosed in order to make an informed voting decision.

In accordance with local law or business practices, some foreign companies or custodians prevent the sales of shares that have been voted for a certain period beginning prior to the shareholder meeting and ending on the day following the meeting ( share blocking ). Depending on the country in which a company is domiciled, the blocking period may begin a stated number of days prior or subsequent to the meeting (e.g. one, three or five days) or on a date established by the company. While practices vary, in many countries the block period can be continued for a longer period if the shareholder meeting is adjourned and postponed to a later date. Similarly, practices vary widely as to the ability of a shareholder to have the block restriction lifted early (e.g. in some countries shares generally can be unblocked up to two days prior to the meeting whereas in other countries the removal of the block appears to be discretionary with the issuer's transfer agent). Due to these restrictions, MFS must balance the benefits to its clients of voting proxies against the potentially serious portfolio management consequences of a reduced flexibility to sell the underlying shares at the most advantageous time. For companies in countries with share blocking periods or in markets where some custodians may block shares, the disadvantage of being unable to sell the stock regardless of changing conditions generally outweighs the advantages of voting at the shareholder meeting for routine items. Accordingly, MFS will not vote those proxies in the absence of an unusual, significant vote that outweighs the disadvantage of being unable to sell the stock.

In limited circumstances, other market specific impediments to voting shares may limit our ability to cast votes, including, but not limited to, late delivery of proxy materials, untimely vote cut-off dates, power of attorney and share re-registration requirements, or any other unusual voting requirements. In these limited instances, MFS votes securities on a best efforts basis in the context of the guidelines described above.

## **Table of Contents**

### **B. ADMINISTRATIVE PROCEDURES**

#### **1. MFS Proxy Voting Committee**

The administration of these MFS Proxy Voting Policies and Procedures is overseen by the MFS Proxy Voting Committee, which includes senior personnel from the MFS Legal and Global Investment Support Departments. The Proxy Voting Committee does not include individuals whose primary duties relate to client relationship management, marketing, or sales. The MFS Proxy Voting Committee:

- a. Reviews these MFS Proxy Voting Policies and Procedures at least annually and recommends any amendments considered to be necessary or advisable;
- b. Determines whether any potential material conflict of interest exists with respect to instances in which MFS (i) seeks to override these MFS Proxy Voting Policies and Procedures; (ii) votes on ballot items not governed by these MFS Proxy Voting Policies and Procedures; (iii) evaluates an excessive executive compensation issue in relation to the election of directors; or (iv) requests a vote recommendation from an MFS portfolio manager or investment analyst (e.g. mergers and acquisitions); and
- c. Considers special proxy issues as they may arise from time to time.

#### **2. Potential Conflicts of Interest**

The MFS Proxy Voting Committee is responsible for monitoring potential material conflicts of interest on the part of MFS or its subsidiaries that could arise in connection with the voting of proxies on behalf of MFS clients. Due to the client focus of our investment management business, we believe that the potential for actual material conflict of interest issues is small. Nonetheless, we have developed precautions to assure that all proxy votes are cast in the best long-term economic interest of shareholders.<sup>1</sup> Other MFS internal policies require all MFS employees to avoid actual and potential conflicts of interests between personal activities and MFS client activities. If an employee (including investment professionals) identifies an actual or potential conflict of interest with respect to any voting decision (including the ownership of securities in their individual portfolio), then that employee must recuse himself/herself from participating in the voting process. Any significant attempt by an employee of MFS or its subsidiaries to unduly influence MFS voting on a particular proxy matter should also be reported to the MFS Proxy Voting Committee.

In cases where proxies are voted in accordance with these MFS Proxy Voting Policies and Procedures, no material conflict of interest will be deemed to exist. In cases where (i) MFS is considering overriding these MFS Proxy Voting Policies and Procedures, (ii) matters presented for vote are not governed by these MFS Proxy Voting Policies and Procedures, (iii) MFS evaluates a potentially excessive executive compensation issue

<sup>1</sup> For clarification purposes, note that MFS votes in what we believe to be the best, long-term economic interest of our clients entitled to vote at the shareholder meeting, regardless of whether other MFS clients hold short positions in the same issuer.

**Table of Contents**

in relation to the election of directors or advisory pay or severance package vote, (iv) a vote recommendation is requested from an MFS portfolio manager or investment analyst (e.g. mergers and acquisitions); or (v) MFS evaluates a director nominee who also serves as a director of the MFS Funds (collectively, Non-Standard Votes ); the MFS Proxy Voting Committee will follow these procedures:

- a. Compare the name of the issuer of such proxy against a list of significant current (i) distributors of MFS Fund shares, and (ii) MFS institutional clients (the MFS Significant Client List );
- b. If the name of the issuer does not appear on the MFS Significant Client List, then no material conflict of interest will be deemed to exist, and the proxy will be voted as otherwise determined by the MFS Proxy Voting Committee;
- c. If the name of the issuer appears on the MFS Significant Client List, then the MFS Proxy Voting Committee will be apprised of that fact and each member of the MFS Proxy Voting Committee will carefully evaluate the proposed vote in order to ensure that the proxy ultimately is voted in what MFS believes to be the best long-term economic interests of MFS clients, and not in MFS corporate interests; and
- d. For all potential material conflicts of interest identified under clause (c) above, the MFS Proxy Voting Committee will document: the name of the issuer, the issuer's relationship to MFS, the analysis of the matters submitted for proxy vote, the votes as to be cast and the reasons why the MFS Proxy Voting Committee determined that the votes were cast in the best long-term economic interests of MFS clients, and not in MFS corporate interests. A copy of the foregoing documentation will be provided to MFS Conflicts Officer.

The members of the MFS Proxy Voting Committee are responsible for creating and maintaining the MFS Significant Client List, in consultation with MFS distribution and institutional business units. The MFS Significant Client List will be reviewed and updated periodically, as appropriate.

If an MFS client has the right to vote on a matter submitted to shareholders by Sun Life Financial, Inc. or any of its affiliates (collectively Sun Life ), MFS will cast a vote on behalf of such MFS client pursuant to the recommendations of Institutional Shareholder Services, Inc. ( ISS ) benchmark policy, or as required by law.

Except as described in the MFS Funds prospectus, from time to time, certain MFS Funds (the top tier fund ) may own shares of other MFS Funds (the underlying fund ). If an underlying fund submits a matter to a shareholder vote, the top tier fund

## **Table of Contents**

will generally vote its shares in the same proportion as the other shareholders of the underlying fund. If there are no other shareholders in the underlying fund, the top tier fund will vote in what MFS believes to be in the top tier fund's best long-term economic interest. If an MFS client has the right to vote on a matter submitted to shareholders by a pooled investment vehicle advised by MFS, MFS will cast a vote on behalf of such MFS client in the same proportion as the other shareholders of the pooled investment vehicle.

### **3. Gathering Proxies**

Most proxies received by MFS and its clients originate at Broadridge Financial Solutions, Inc. ( Broadridge ). Broadridge and other service providers, on behalf of custodians, send proxy related material to the record holders of the shares beneficially owned by MFS clients, usually to the client's proxy voting administrator or, less commonly, to the client itself. This material will include proxy ballots reflecting the shareholdings of Funds and of clients on the record dates for such shareholder meetings, as well as proxy materials with the issuer's explanation of the items to be voted upon.

MFS, on behalf of itself and certain of its clients (including the MFS Funds) has entered into an agreement with an independent proxy administration firm pursuant to which the proxy administration firm performs various proxy vote related administrative services such as vote processing and recordkeeping functions. Except as noted below, the proxy administration firm for MFS and its clients, including the MFS Funds, is ISS. The proxy administration firm for MFS Development Funds, LLC is Glass, Lewis & Co., Inc. ( Glass Lewis ); Glass Lewis and ISS are each hereinafter referred to as the Proxy Administrator ).

The Proxy Administrator receives proxy statements and proxy ballots directly or indirectly from various custodians, logs these materials into its database and matches upcoming meetings with MFS Fund and client portfolio holdings, which are input into the Proxy Administrator's system by an MFS holdings data-feed. Through the use of the Proxy Administrator system, ballots and proxy material summaries for all upcoming shareholders' meetings are available on-line to certain MFS employees and members of the MFS Proxy Voting Committee.

It is the responsibility of the Proxy Administrator and MFS to monitor the receipt of ballots. When proxy ballots and materials for clients are received by the Proxy Administrator, they are input into the Proxy Administrator's on-line system. The Proxy Administrator then reconciles a list of all MFS accounts that hold shares of a company's stock and the number of shares held on the record date by these accounts with the Proxy Administrator's list of any upcoming shareholder's meeting of that company. If a proxy ballot has not been received, the Proxy Administrator contacts the custodian requesting the reason as to why a ballot has not been received.

## **Table of Contents**

### **4. Analyzing Proxies**

Proxies are voted in accordance with these MFS Proxy Voting Policies and Procedures. The Proxy Administrator, at the prior direction of MFS, automatically votes all proxy matters that do not require the particular exercise of discretion or judgment with respect to these MFS Proxy Voting Policies and Procedures as determined by MFS. With respect to proxy matters that require the particular exercise of discretion or judgment, the MFS Proxy Voting Committee considers and votes on those proxy matters. MFS also receives research and recommendations from the Proxy Administrator which it may take into account in deciding how to vote. MFS uses the research of ISS to identify (i) circumstances in which a board may have approved excessive executive compensation, (ii) environmental and social proposals that warrant consideration or (iii) circumstances in which a non-U.S. company is not in compliance with local governance or compensation best practices. In those situations where the only MFS fund that is eligible to vote at a shareholder meeting has Glass Lewis as its Proxy Administrator, then we will rely on research from Glass Lewis to identify such issues. Representatives of the MFS Proxy Voting Committee review, as appropriate, votes cast to ensure conformity with these MFS Proxy Voting Policies and Procedures.

As a general matter, portfolio managers and investment analysts have little involvement in most votes taken by MFS. This is designed to promote consistency in the application of MFS voting guidelines, to promote consistency in voting on the same or similar issues (for the same or for multiple issuers) across all client accounts, and to minimize the potential that proxy solicitors, issuers, or third parties might attempt to exert inappropriate influence on the vote. In limited types of votes (e.g. mergers and acquisitions, capitalization matters, potentially excessive executive compensation issues, or shareholder proposals relating to environmental and social issues), a representative of MFS Proxy Voting Committee may consult with or seek recommendations from MFS portfolio managers or investment analysts.<sup>2</sup> However, the MFS Proxy Voting Committee would ultimately determine the manner in which all proxies are voted.

As noted above, MFS reserves the right to override the guidelines when such an override is, in MFS best judgment, consistent with the overall principle of voting proxies in the best long-term economic interests of MFS clients. Any such override of the guidelines shall be analyzed, documented and reported in accordance with the procedures set forth in these policies.

### **5. Voting Proxies**

In accordance with its contract with MFS, the Proxy Administrator also generates a variety of reports for the MFS Proxy Voting Committee, and makes available on-line various other types of information so that the MFS Proxy Voting Committee or proxy team may review and monitor the votes cast by the Proxy Administrator on behalf of MFS clients.

<sup>2</sup> From time to time, due to travel schedules and other commitments, an appropriate portfolio manager or research analyst may not be available to provide a vote recommendation. If such a recommendation cannot be obtained within a reasonable time prior to the cut-off date of the shareholder meeting, the MFS Proxy Voting Committee may determine to abstain from voting.

## **Table of Contents**

### **6. Securities Lending**

From time to time, the MFS Funds or other pooled investment vehicles sponsored by MFS may participate in a securities lending program. In the event MFS or its agent receives timely notice of a shareholder meeting for a U.S. security, MFS and its agent will attempt to recall any securities on loan before the meeting's record date so that MFS will be entitled to vote these shares. However, there may be instances in which MFS is unable to timely recall securities on loan for a U.S. security, in which cases MFS will not be able to vote these shares. MFS will report to the appropriate board of the MFS Funds those instances in which MFS is not able to timely recall the loaned securities. MFS generally does not recall non-U.S. securities on loan because there may be insufficient advance notice of proxy materials, record dates, or vote cut-off dates to allow MFS to timely recall the shares in certain markets on an automated basis. As a result, non-U.S. securities that are on loan will not generally be voted. If MFS receives timely notice of what MFS determines to be an unusual, significant vote for a non-U.S. security whereas MFS shares are on loan, and determines that voting is in the best long-term economic interest of shareholders, then MFS will attempt to timely recall the loaned shares.

### **7. Engagement**

The MFS Proxy Voting Policies and Procedures are available on [www.mfs.com](http://www.mfs.com) and may be accessed by both MFS clients and the companies in which MFS clients invest. From time to time, MFS may determine that it is appropriate and beneficial for representatives from the MFS Proxy Voting Committee to engage in a dialogue or written communication with a company or other shareholders regarding certain matters on the company's proxy statement that are of concern to shareholders, including environmental, social and governance matters. A company or shareholder may also seek to engage with representatives of the MFS Proxy Voting Committee in advance of the company's formal proxy solicitation to review issues more generally or gauge support for certain contemplated proposals.

### **C. RECORDS RETENTION**

MFS will retain copies of these MFS Proxy Voting Policies and Procedures in effect from time to time and will retain all proxy voting reports submitted to the Board of Trustees of the MFS Funds for the period required by applicable law. Proxy solicitation materials, including electronic versions of the proxy ballots completed by representatives of the MFS Proxy Voting Committee, together with their respective notes and comments, are maintained in an electronic format by the Proxy Administrator and are accessible on-line by the MFS Proxy Voting Committee. All proxy voting materials and supporting documentation, including records generated by the Proxy Administrator's system as to proxies processed, including the dates when proxy ballots were received and submitted, and the votes on each company's proxy issues, are retained as required by applicable law.



**Table of Contents**

**D. REPORTS**

**MFS Funds**

MFS publicly discloses the proxy voting records of the MFS Funds on an annual basis, as required by law. MFS will also report the results of its voting to the Board of Trustees of the MFS Funds. These reports will include: (i) a summary of how votes were cast (including advisory votes on pay and golden parachutes); (ii) a summary of votes against management's recommendation; (iii) a review of situations where MFS did not vote in accordance with the guidelines and the rationale therefore; (iv) a review of the procedures used by MFS to identify material conflicts of interest and any matters identified as a material conflict of interest; (v) a review of these policies and the guidelines; (vi) a review of our proxy engagement activity; (vii) a report and impact assessment of instances in which the recall of loaned securities of a U.S. issuer was unsuccessful; and (viii) as necessary or appropriate, any proposed modifications thereto to reflect new developments in corporate governance and other issues. Based on these reviews, the Trustees and Managers of the MFS Funds will consider possible modifications to these policies to the extent necessary or advisable.

**All MFS Advisory Clients**

MFS may publicly disclose the proxy voting records of certain clients or the votes it casts with respect to certain matters as required by law. At any time, a report can also be printed by MFS for each client who has requested that MFS furnish a record of votes cast. The report specifies the proxy issues which have been voted for the client during the year and the position taken with respect to each issue and, upon request, may identify situations where MFS did not vote in accordance with the MFS Proxy Voting Policies and Procedures.

Except as described above, MFS generally will not divulge actual voting practices to any party other than the client or its representatives because we consider that information to be confidential and proprietary to the client. However, as noted above, MFS may determine that it is appropriate and beneficial to engage in a dialogue with a company regarding certain matters. During such dialogue with the company, MFS may disclose the vote it intends to cast in order to potentially effect positive change at a company in regards to environmental, social or governance issues.

**Table of Contents****ITEM 8. PORTFOLIO MANAGERS OF CLOSED-END MANAGEMENT INVESTMENT COMPANIES.****Portfolio Manager(s)**

Information regarding the portfolio manager(s) of the MFS Special Value Trust (the Fund) is set forth below. Each portfolio manager is primarily responsible for the day-to-day management of the Fund.

<b>Portfolio Manager</b>	<b>Primary Role</b>	<b>Since</b>	<b>Title and Five Year History</b>
William J. Adams	Lower Quality Debt Instruments Portfolio Manager	2011	Investment Officer of MFS; employed in the investment are of MFS since 2009; Credit Analyst at MFS from 1997 to 2005.
Ward Brown	Emerging Markets Debt Instruments Portfolio Manager	2012	Investment Officer of MFS; employed in the investment are of MFS since 2005
Nevin P. Chitkara	Equity Securities Portfolio Manager	2012	Investment Officer of MFS; employed in the investment are of MFS since 1997
David P. Cole	Lower Quality Debt Instruments Portfolio Manager	2006	Investment Officer of MFS; employed in the investment are of MFS since 2004
Matthew W. Ryan	Emerging Markets Debt Instruments Portfolio Manager	2012	Investment Officer of MFS; employed in the investment are of MFS since 1997

**Compensation**

Portfolio manager compensation is reviewed annually. As of December 31, 2012, portfolio manager total cash compensation is a combination of base salary and performance bonus:

*Base Salary* Base salary represents a smaller percentage of portfolio manager total cash compensation than performance bonus.

*Performance Bonus* Generally, the performance bonus represents more than a majority of portfolio manager total cash compensation.

The performance bonus is based on a combination of quantitative and qualitative factors, generally with more weight given to the former and less weight given to the latter.

The quantitative portion is based on the pre-tax performance of assets managed by the portfolio manager over one-, three-, and five-year periods relative to peer group universes and/or indices (benchmarks). As of December 31, 2012, the following benchmarks were used to measure the following portfolio manager's performance for the following Fund:

<b>Fund</b>	<b>Portfolio Manager</b>	<b>Benchmark(s)</b>
MFS Special Value Trust	William J. Adams	Barclays U.S. High-Yield Corporate Bond Index
		JP Morgan Emerging Markets Bond Index Global
		Russell 1000 Value Index
	Ward Brown	JP Morgan Emerging Markets Board Index Global
	Nevin P. Chitkara	Russell 1000 Value Index
	David P. Cole	Barclays U.S. High-Yield Corporate Bond Index
		JP Morgan Emerging Markets Bond Index Global
		Russell 1000 Value Index

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Matthew W. Ryan      JP Morgan Emerging Markets Board Index Global

Additional or different benchmarks, including versions of indices, custom indices, and linked indices that combine performance of different indices for different portions of the time period, may also be used. Primary weight is given to portfolio performance over a three-year time period with lesser consideration given to portfolio performance over one- and five-year periods (adjusted as appropriate if the portfolio manager has served for less than five years).

The qualitative portion is based on the results of an annual internal peer review process (conducted by other portfolio managers, analysts, and traders) and management's assessment of overall portfolio manager contributions to investor relations and the investment process (distinct from fund and other account performance). This performance bonus may be in the form of cash and/or a deferred cash award, at the discretion of management. A deferred cash award is issued for a cash value and becomes payable over a three-year vesting period if the

**Table of Contents**

portfolio manager remains in the continuous employ of MFS or its affiliates. During the vesting period, the value of the unfunded deferred cash award will fluctuate as though the portfolio manager had invested the cash value of the award in an MFS Fund(s) selected by the portfolio manager. A selected fund may be, but is not required to be, a fund that is managed by the portfolio manager.

Portfolio managers also typically benefit from the opportunity to participate in the MFS Equity Plan. Equity interests and/or options to acquire equity interests in MFS or its parent company are awarded by management, on a discretionary basis, taking into account tenure at MFS, contribution to the investment process, and other factors.

Finally, portfolio managers also participate in benefit plans (including a defined contribution plan and health and other insurance plans) and programs available generally to other employees of MFS. The percentage such benefits represent of any portfolio manager's compensation depends upon the length of the individual's tenure at MFS and salary level, as well as other factors.

**Ownership of Fund Shares**

The following table shows the dollar range of equity securities of the Fund beneficially owned by the Fund's portfolio manager(s) as of the Fund's fiscal year ended October 31, 2013. The following dollar ranges apply:

- N. None
- A. \$1 - \$10,000
- B. \$10,001 - \$50,000
- C. \$50,001 - \$100,000
- D. \$100,001 - \$500,000
- E. \$500,001 - \$1,000,000
- F. Over \$1,000,000

Name of Portfolio Manager	Dollar Range of Equity Securities in Fund
William J. Adams	N
Ward Brown	N
Nevin P. Chitkara	N
David P. Cole	N
Matthew W. Ryan	N

**Other Accounts**

In addition to the Fund, each portfolio manager of the Fund is named as a portfolio manager of certain other accounts managed or subadvised by MFS or an affiliate. The number and assets of these accounts were as follows as of October 31, 2013:

Name	Registered Investment Companies*		Other Pooled Investment Vehicles		Other Accounts	
	Number of Accounts	Total Assets	Number of Accounts	Total Assets	Number of Accounts	Total Assets
William J. Adams	12	\$7.5 billion	3	\$1.3 billion	1	\$102 million
Ward Brown	12	\$12.1 billion	8	\$4.1 billion	6	\$3.4 billion
Nevin P. Chitkara	19	\$56.0 billion	6	\$4.7 billion	39	\$14.9 billion
David P. Cole	12	\$7.5 billion	1	\$918 million	1	\$102 million

Matthew W. Ryan	14	\$12.9 billion	8	\$4.1 billion	6	\$3.4 billion
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\* Includes the Fund.

**Table of Contents**

Advisory fees are not based upon performance of any of the accounts identified in the table above.

**Potential Conflicts of Interest**

The Adviser seeks to identify potential conflicts of interest resulting from a portfolio manager's management of both the Fund and other accounts, and has adopted policies and procedures designed to address such potential conflicts.

The management of multiple funds and accounts (including proprietary accounts) gives rise to potential conflicts of interest if the funds and accounts have different objectives and strategies, benchmarks, time horizons and fees as a portfolio manager must allocate his or her time and investment ideas across multiple funds and accounts. In certain instances there are securities which are suitable for the Fund's portfolio as well as for accounts of the Adviser or its subsidiaries with similar investment objectives. The Fund's trade allocation policies may give rise to conflicts of interest if the Fund's orders do not get fully executed or are delayed in getting executed due to being aggregated with those of other accounts of the Adviser or its subsidiaries. A portfolio manager may execute transactions for another fund or account that may adversely affect the value of the Fund's investments. Investments selected for funds or accounts other than the Fund may outperform investments selected for the Fund.

When two or more clients are simultaneously engaged in the purchase or sale of the same security, the securities are allocated among clients in a manner believed by the Adviser to be fair and equitable to each. It is recognized that in some cases this system could have a detrimental effect on the price or volume of the security as far as the Fund is concerned. In most cases, however, the Adviser believes that the Fund's ability to participate in volume transactions will produce better executions for the Fund.

The Adviser and/or a portfolio manager may have a financial incentive to allocate favorable or limited opportunity investments or structure the timing of investments to favor accounts other than the Fund, for instance, those that pay a higher advisory fee and/or have a performance adjustment and/or include an investment by the portfolio manager.

**ITEM 9. PURCHASES OF EQUITY SECURITIES BY CLOSED-END MANAGEMENT INVESTMENT COMPANY AND AFFILIATED PURCHASERS.****MFS Special Value Trust**

Period	(a) Total number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased under the Plans or Programs
11/01/12-11/30/12	0	N/A	0	691,094
12/01/12-12/31/12	0	N/A	0	691,094
1/01/13-1/31/13	0	N/A	0	691,094
2/01/13-2/28/13	0	N/A	0	691,094
3/01/13-3/31/13	0	N/A	0	696,770
4/01/13-4/30/13	0	N/A	0	696,770
5/01/13-5/31/13	0	N/A	0	696,770
6/01/13-6/30/13	0	N/A	0	696,770
7/01/13-7/31/13	0	N/A	0	696,770
8/01/13-8/31/13	0	N/A	0	696,770
9/01/13-9/30/13	0	N/A	0	696,770
10/01/13-10/31/13	0	N/A	0	696,770

<i>Total</i>	<i>0</i>	<i>0</i>
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