ARENA PHARMACEUTICALS INC
Form 10-Q
November 08, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2007

or

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

For the transition period from to

Commission File Number: 000-31161

ARENA PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**23-2908305**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6166 Nancy Ridge Drive, San Diego, CA	**92121**
(Address of principal executive offices)	(Zip Code)

858.453.7200

(Registrant s telephone number, including area code)

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

to such filing requirements for the past 90 days. x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes x No

The number of shares of common stock outstanding as of the close of business on November 7, 2007:

Class	**Number of Shares Outstanding**
Common Stock, $0.0001 par value	72,172,388

ARENA PHARMACEUTICALS, INC.

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In this report, Arena Pharmaceuticals, Arena, we, us and our refer to Arena Pharmaceuticals, Inc. and our wholly owned subsidiaries, unless context otherwise provides.

PART I. FINANCIAL INFORMATION

Item 1. Unaudited Consolidated Financial Statements.

Arena Pharmaceuticals, Inc.

Condensed Consolidated Balance Sheets

(In thousands)

	September 30, 2007 (Unaudited)	December 31, 2006 (Note)
Assets		
Current assets:		
Cash and cash equivalents	$ 303,867	$ 373,044
Short-term investments, available-for-sale	35,251	15,781
Accounts receivable	793	310
Prepaid expenses and other current assets	12,695	10,551
Total current assets	352,606	399,686
Land, property and equipment, net	58,523	56,500
Acquired technology, net	5,259	6,412
Other non-current assets	8,937	5,867
Total assets	$ 425,325	$ 468,465
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 29,071	$ 20,769
Accrued compensation	1,958	2,178
Deferred revenues	6,142	13,054
Current portion of lease financing obligations	217	
Total current liabilities	37,388	36,001
Deferred rent	812	863
Lease financing obligations, less current portion	62,115	13,678
Commitments		
Redeemable convertible preferred stock	53,382	51,808
Stockholders equity:		
Common stock	6	6
Additional paid-in capital	733,198	723,363
Treasury stock	(23,070)	(23,070)
Accumulated other comprehensive loss	19	(13)
Accumulated deficit	(438,525)	(334,171)
Total stockholders equity	271,628	366,115
Total liabilities and stockholders equity	$ 425,325	$ 468,465

Note: The balance sheet at December 31, 2006 has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements.

See accompanying notes to unaudited condensed consolidated financial statements.

Arena Pharmaceuticals, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenues:				
Total revenues	$ 5,041	$ 4,416	$ 14,763	$ 25,870
Expenses:				
Research and development	32,219	22,727	108,834	65,293
General and administrative	7,885	3,900	19,648	13,238
Amortization of acquired technology	385	385	1,153	1,153
Total operating expenses	40,489	27,012	129,635	79,684
Loss from operations	(35,448)	(22,596)	(114,872)	(53,814)
Interest and other income:				
Interest income	4,678	3,338	14,314	9,197
Interest expense	(1,560)	(459)	(2,186)	(1,379)
Non-cash warrant settlement				(4,554)
Other	52	93	(36)	191
Total interest and other income, net	3,170	2,972	12,092	3,455
Net loss	(32,278)	(19,624)	(102,780)	(50,359)
Dividends on redeemable convertible preferred stock	(535)	(514)	(1,574)	(1,511)
Net loss allocable to common stockholders	$ (32,813)	$ (20,138)	$ (104,354)	$ (51,870)
Net loss per share allocable to common stockholders, basic and diluted	$ (0.54)	$ (0.43)	$ (1.71)	$ (1.14)
Shares used in calculating net loss per share allocable to common stockholders, basic and diluted	61,007	47,242	60,887	45,620

See accompanying notes to unaudited condensed consolidated financial statements.

Arena Pharmaceuticals, Inc.

Condensed Consolidated Cash Flow Statements

(In thousands)

(Unaudited)

	Nine months ended September 30,	
	2007	**2006**
Operating Activities		
Net loss	$ (102,780)	$ (50,359)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,942	5,428
Amortization of acquired technology	1,153	1,153
Non-cash share-based compensation	6,983	3,762
Non-cash warrant settlement		4,554
Amortization/accretion of short-term investment premium/discount	(366)	(557)
Amortization of prepaid financing costs	224	
Amortization of lease financing obligations	(361)	
Deferred rent	(51)	(32)
Deferred interest expense	(677)	145
Loss on disposal of equipment	116	7
Changes in operating assets and liabilities:		
Accounts receivable	(483)	(692)
Prepaid expenses and other assets	(2,203)	(4,041)
Deferred revenues	(6,912)	(7,270)
Accounts payable, accrued expenses and accrued compensation	8,082	3,002
Net cash used in operating activities	(91,333)	(44,900)
Investing Activities		
Purchases of short-term investments, available-for-sale	(49,777)	(2,188)
Proceeds from sales/maturities of short-term investments	30,705	1,000
Purchases of land, property and equipment	(8,100)	(11,335)
Proceeds from sale of equipment	19	1
Deposits, restricted cash and other assets	(1,541)	(749)
Net cash used in investing activities	(28,694)	(13,271)
Financing Activities		
Principal payments on lease financing obligations	(457)	
Proceeds from lease financing	48,455	
Proceeds from exercise of warrants		8,298
Proceeds from issuance of common stock	2,852	171,022
Net cash provided by financing activities	50,850	179,320
Net increase (decrease) in cash and cash equivalents	(69,177)	121,149
Cash and cash equivalents at beginning of period	373,044	73,781
Cash and cash equivalents at end of period	$ 303,867	$ 194,930

See accompanying notes to unaudited condensed consolidated financial statements.

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Arena Pharmaceuticals, Inc. (together with its wholly owned subsidiaries, the Company) should be read in conjunction with the audited financial statements and notes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission, or SEC. The accompanying financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for complete financial statements. The accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements and notes thereto. The Company s critical accounting policies and estimates and assumptions are described in Management s Discussion and Analysis of Financial Condition and Results of Operations, which is included below in this quarterly report on Form 10-Q.

2. Net Loss Per Share

Basic and diluted net loss per share allocable to common stockholders is presented in conformity with Statement of Financial Accounting Standards, or SFAS, No. 128, Earnings per Share, for all periods presented. In accordance with SFAS No. 128, basic and diluted net loss per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less any shares subject to repurchase or forfeiture.

The total number of shares of common stock outstanding excluded from the calculation of basic and diluted net loss per share because they were subject to repurchase or forfeiture was 58,312 for each of the three and nine-month periods ended September 30, 2007 and 113,110 for each of the three and nine-month periods ended September 30, 2006. Had they been dilutive, such shares would have been included in the computation of diluted net loss per share. In addition, the Company has excluded all unvested restricted stock and unvested performance-based restricted stock unit awards, which are both subject to forfeiture, outstanding stock options, preferred stock and warrants from the calculation of basic and diluted net loss per share allocable to common stockholders because these securities are antidilutive for all periods presented.

3. Comprehensive Loss

In accordance with SFAS No. 130, Reporting Comprehensive Loss, all components of comprehensive loss, including net loss, are reported in the financial statements in the period in which they are recognized. Comprehensive loss is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Below is a reconciliation, in thousands, of net loss to comprehensive loss for all periods presented.

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Net loss	$ (32,278)	$ (19,624)	$ (102,780)	$ (50,359)
Unrealized gain (loss) on available-for-sale securities and other investments	19	112	32	(21)
Comprehensive loss	$ (32,259)	$ (19,512)	$ (102,748)	$ (50,380)

4. Share-based Activity

Share-based Compensation under SFAS No. 123R

The Company recognized share-based compensation expense in accordance with SFAS No. 123R, Share-Based Payment, as follows (in thousands, except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Research and development	$ 994	$ 779	$ 3,094	$ 2,162
General and administrative	1,857	622	3,889	1,600
Total share-based compensation expense and impact on net loss allocable to common stockholders	$ 2,851	$ 1,401	$ 6,983	$ 3,762
Impact on net loss per share allocable to common stockholders, basic and diluted	$ 0.05	$ 0.03	$ 0.11	$ 0.09

The Company uses a Black-Scholes option pricing model to estimate the grant-date fair value of share-based awards in determining the share-based compensation expense recognized under SFAS No. 123R. The table below sets forth the weighted-average assumptions and estimated fair value of stock options granted under the Company s equity compensation plans during the three- and nine-month periods ended September 30, 2007 and 2006:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Risk-free interest rate	4.6%	4.9%	4.6%	4.6%
Dividend yield	0%	0%	0%	0%
Expected volatility	64%	73%	64%	70%
Expected life (years)	5.39	5.22	5.39	5.19
Weighted-average estimated fair value of stock options granted	$ 7.37	$ 6.84	$ 7.98	$ 8.33

The table below sets forth the weighted-average assumptions and estimated fair value of the options to purchase stock granted under the 2001 Arena Employee Stock Purchase Plan, as amended, for multiple offering periods during the three- and nine-month periods ended September 30, 2007 and 2006:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Risk-free interest rate	3.6% - 5.1%	1.7% - 5.3%	2.8% - 5.3%	1.7% - 5.3%
Dividend yield	0%	0%	0%	0%
Expected volatility	67% - 70%	68% - 75%	66% - 72%	68% - 75%
Expected life (years)	0.25 - 2.0	0.25 - 2.0	0.25 - 2.0	0.25 - 2.0
Weighted-average estimated fair value of options granted under Employee Stock Purchase Plan	$4.44 - $4.68	$1.99 - $4.91	$2.18 - $5.46	$1.99 - $4.91

Expected volatility for awards granted after the adoption of SFAS No. 123R is based on a combination of 75% historical volatility of the Company s common stock and 25% market-based implied volatility from traded options on its common stock, with historical volatility being more heavily weighted due to the low volume of traded options on its common stock. The expected life of options granted under SFAS No. 123R is determined based on historical experience of similar awards, giving consideration to the contractual terms of the share-based awards, vesting schedules and post-vesting cancellations. The risk-free interest rates are based on the U.S. Treasury yield curve, with a remaining term approximately equal to the expected term used in the option pricing model.

SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. If actual forfeitures do vary from estimates, the Company will recognize the difference in compensation expense in the period the actual forfeitures occur or when options vest. Forfeitures of unvested options were estimated at 5.4% and 6.7% for the three and nine months ended September 30, 2007 and 2006, respectively, based on historical experience.

Tax benefits recognized and related to share-based compensation and related cash flow impacts were not material during the three and nine months ended September 30, 2007 and 2006 because the Company is in a net operating loss position.

Share-based Award Activity

The following table summarizes the Company s stock option activity during the nine months ended September 30, 2007:

	Options	Weighted-Average Exercise Price
Outstanding at January 1, 2007	4,522,381	$ 9.44
Granted	1,336,537	13.31
Exercised	(171,845)	5.83
Forfeited/cancelled/expired	(181,893)	11.06
Outstanding at September 30, 2007	5,505,180	$ 10.44

In February 2007, the Company granted 1,690,500 performance-based restricted stock unit awards under its 2006 Long-Term Incentive Plan, as amended. The awards provide employees with five years to achieve four key drug development and strategic performance goals. A fixed number of awards will be earned for each goal that is successfully achieved. Once earned, the awards will remain unvested until the five-year performance period is complete. The awards that have been earned at February 26, 2012 will vest and be settled in shares of the Company s common stock, with the holder receiving one share of common stock for each award earned and vested. Termination of employment prior to vesting will result in the forfeiture of any earned (as well as unearned) awards, except for in limited circumstances such as termination due to death, disability or a change in control. The following table summarizes activity with respect to such awards during the nine months ended September 30, 2007:

	Performance Units	Weighted-Average Grant-Date Fair Value
Outstanding at January 1, 2007		$
Granted	1,690,500	13.50
Vested		
Forfeited/cancelled	(48,600)	13.50
Outstanding at September 30, 2007	1,641,900	$ 13.50

5. Short-term Investments, Available-for-Sale

In accordance with SFAS No. 115, Accounting for Certain Debt and Equity Securities, short-term investments are classified as available-for-sale. The Company defines short-term investments as income-yielding securities that can be readily converted to cash. These securities are carried at fair value, with unrealized gains and losses reported as accumulated other comprehensive income or loss. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income. Realized gains and losses and declines in securities judged to be other than temporary are included in other income or expense. The cost of securities sold is based on the specific identification method. Interest and dividends on available-for-sale securities are included in interest income. Short-term investments held as of September 30, 2007 and 2006 consisted primarily of U.S. Treasury and Federal agency notes and U.S. corporate debt securities.

6. Concentration of Credit Risk and Major Customers

The Company s financial instruments, which potentially subject it to concentrations of credit risk, consist primarily of cash, cash equivalents and short-term investments. The Company limits its exposure to credit loss by placing its cash and investments, in accordance with the board-approved investment policy, in U.S. government and agency obligations and in debt instruments that are rated investment grade.

The Company s revenues were derived from two collaborators for all periods presented. The percentages of total revenues derived from these collaborators are as follows:

	Three months ended September 30,		Nine months ended September 30,	
Collaboration	**2007**	**2006**	**2007**	**2006**
Ortho-McNeil Pharmaceutical, Inc.	64.8%	55.4%	63.2%	61.0%
Merck & Co., Inc.	35.2%	44.6%	36.8%	39.0%
	100.0%	100.0%	100.0%	100.0%

7. Commitments

Leases

In May 2007, the Company sold to BMR-6114-6154 Nancy Ridge Drive LLC, a Delaware limited liability company, or BMR, three properties it owned and continues to occupy, and assigned to BMR an option to purchase a fourth property currently leased and primarily occupied by the Company for total consideration of $50.1 million, resulting in net proceeds to the Company of $48.5 million after financing costs. Concurrently with the closing of the transaction, the Company leased back the three properties sold to BMR under leases with 20-year terms and two consecutive options to extend such terms for five years each. In addition, subject to certain restrictions, the Company has the option to repurchase all of the properties included in the transaction on the 10th, 15th or 20th anniversary of the execution date of the leases, and earlier if the leases are terminated under certain circumstances.

The Company has accounted for this transaction in accordance with SFAS No. 66 Accounting for Sales of Real Estate and SFAS No. 98 Accounting for Leases. The Company s option to repurchase these properties in the future is considered continued involvement under SFAS No. 66, and, therefore, the Company has applied the financing method under SFAS No. 98. Under the financing method, the book value of the properties and related accumulated depreciation remain on the Company s balance sheet and no sale is recognized. Instead, the sales price of the properties is recorded as a financing obligation and a portion of each lease payment is recorded as interest expense. The Company recorded interest expense of $1.2 million and $1.9 million, respectively, in the three and nine months ended September 30, 2007 related to this transaction. At September 30, 2007, in accordance with SFAS No. 98, the total financing obligation related to this transaction was $49.8 million.

Initial base rent for the three properties (net of taxes, insurance and maintenance costs (i.e. triple net) for which the Company is responsible) that were purchased as part of this transaction is an aggregate of $4.5 million annually, subject to an annual increase of 2.5% and other specified adjustments.

8. Redeemable Convertible Preferred Stock and Warrants

In December 2003, the Company sold to two institutional investors 3,500 shares of series B-1 redeemable convertible preferred stock, or Series B-1 Preferred, together with (i) seven-year warrants to purchase up to 1,486,200 shares of common stock at an initial exercise price of $10.00 per share; and (ii) unit warrants giving such investors the right to purchase from the Company for a period of approximately 16 months from December 24, 2003, at their option, up to $11.5 million of series B-2 redeemable convertible preferred stock (or Series B-2 Preferred and collectively with the Series B-1 Preferred, Series B Preferred) and additional seven-year warrants to purchase up to 450,000 shares of common

stock at an initial exercise price of $10.00 per share. The aggregate purchase price in such transaction was $35.0 million, and the Company received $34.2 million in net cash proceeds after closing costs. On April 22, 2005, the Company s preferred stockholders exercised their unit warrants in full. The aggregate purchase price and net cash proceeds to the Company from the exercise of the unit warrants were $11.5 million.

The Series B-1 Preferred is convertible into common stock at a fixed conversion price of $7.50 per share. The holders of the Series B-1 Preferred can require the Company at any time to redeem all or some of their shares of Series B-1 Preferred at such shares stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. The stated value is the original holder s investment plus any dividends settled by increasing the stated value at the time the dividend is payable. The Company will be required to redeem any shares of the Series B-1 Preferred that remain outstanding on December 24, 2008 at a price equal to the amount of such shares then stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. The Company may be able to satisfy all or a portion of any redemption with shares of its common stock. Any redemption amount settled in equity would be computed based on the lesser of the applicable conversion price of $7.50 and 95% of the arithmetic average of the volume weighted-average prices

of common stock for the 10 consecutive trading days prior to the date of delivery of the applicable Series B-1 Preferred redemption notice. The Series B-1 Preferred, which accrues dividends at 4% annually, had an aggregate redemption price of $40.7 million at September 30, 2007.

The Series B-2 Preferred is convertible into common stock at a fixed conversion price of $7.00 per share. If not previously converted, the Company must redeem the Series B-2 Preferred on April 22, 2010, or earlier under certain circumstances, at such shares stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. The Series B-2 Preferred, which accrues dividends at 4% annually, had an aggregate redemption price of $12.7 million at September 30, 2007. The Company may be able to satisfy all or a portion of any redemption with shares of its common stock. Except as set forth in this paragraph, the Series B-2 Preferred has substantially identical terms as the Series B-1 Preferred.

On March 31, 2006, following the Company s call notice to one of the two warrant holders, Smithfield Fiduciary LLC, an affiliate of Highbridge Capital Management, LLC, such holder exercised its warrants to purchase 829,856 shares of the Company s common stock, resulting in an aggregate purchase price and net cash proceeds to the Company of $8.3 million. In connection with this exercise in full of its warrants, Smithfield claimed that it was entitled to receive exchange warrants that would include a provision that could require the Company to issue additional exchange warrants in the future. The Company disagreed with this interpretation. On June 30, 2006, the Company entered into a Settlement Agreement and Release with Smithfield. As part of the Settlement Agreement and Release, (a) Smithfield and the Company provided each other with a release of any claims relating to (i) Smithfield s demand for, and the Company s non-issuance of, exchange warrants, and (ii) any breach or default under certain of the agreements on account of the foregoing, (b) the Company issued Smithfield a seven-year warrant to purchase 829,856 shares of the Company s common stock at an initial exercise price of $15.49 per share, and (c) the Company filed a registration statement covering the sale of the shares of common stock issuable under the new warrant. The new warrant does not contain any right for the Company, or for the holder to require the Company, to call the warrant, nor does it provide the holder the right to receive any exchange warrants in the future. The Company recorded a $4.6 million non-cash charge related to the warrant settlement in the second quarter of 2006. The Company does not know whether it will have a similar dispute with its other warrant holder, Mainfield Enterprises, Inc., or, if it does, the likely outcome of the dispute. As such, the Company has not recorded any charges related to the Mainfield warrant.

Each investor has agreed that for so long as it holds Series B Preferred, it shall vote its shares of Series B Preferred and common stock on all matters in which such investor is entitled to vote and on which holders of common stock have the right to vote, in the manner recommended by the Company s board of directors to all of its stockholders unless the Company s board of directors elects to permit the investors to vote such shares in their own discretion.

9. Income Taxes

In July 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation, or FIN, No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of SFAS No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes, and prescribes recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN No. 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006.

The Company adopted the provisions of FIN No. 48 on January 1, 2007. The total amount of unrecognized tax benefits as of the date of adoption was $8.6 million. As a result of the implementation of FIN No. 48, the Company recognized a $7.2 million decrease in deferred tax assets and a corresponding decrease in the valuation allowance. There are no unrecognized tax benefits included in the condensed consolidated balance sheet

at September 30, 2007 that would, if recognized, affect the effective tax rate.

The Company s practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company did not have any accrued interest or penalties included in its condensed consolidated balance sheets at December 31, 2006 or September 30, 2007, and did not recognize any interest and/or penalties in its condensed consolidated statement of operations during the three or nine months ended September 30, 2007.

The Company is subject to income taxation in the United States at the federal and state levels. The Company s tax years for 1997 and later are subject to examination by the United States and California tax authorities due to the carryforward of unutilized net operating losses and research and development credits.

The adoption of FIN No. 48 did not impact the Company s financial condition, results of operations or cash flows. At January 1, 2007, the Company had net deferred tax assets of $129.8 million. The deferred tax assets are primarily comprised of federal and state tax net operating loss, or NOL, carryforwards and federal and state research and development, or R&D, credit carryforwards. Due to uncertainties surrounding the Company s ability to generate future taxable income to realize these assets, the Company has not recognized these assets and a full valuation allowance has been established to offset the Company s net deferred tax assets. The future utilization of the Company s NOL and R&D credit carryforwards to offset future taxable income may be subject to a substantial annual limitation as a result of ownership changes that may have occurred previously or that could occur in the future. The Company plans to complete a Section 382/383 analysis regarding ownership changes that have occurred, and the Company expects the results of such an analysis will limit the use of the NOL and R&D credits. When this analysis is completed, the Company plans to update its unrecognized tax benefits under FIN No. 48, which may result in a change in unrecognized tax benefits within 12 months of the end of the period covered by this report. At this time, however, the Company cannot estimate how much the unrecognized tax benefits may change. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in the Company s unrecognized tax benefits will not likely impact the effective tax rate.

10. Subsequent Event

In November 2007, the Company completed a public offering by selling 11,000,000 shares of its common stock at $9.91 per share and received net proceeds of approximately $103.1 million.

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

This discussion and analysis should be read in conjunction with our financial statements and notes thereto included in this quarterly report on Form 10-Q (this Quarterly Report) and the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2006 (the 2006 Annual Report), as filed with the Securities and Exchange Commission (the SEC). Operating results are not necessarily indicative of results that may occur in future periods.

This Quarterly Report includes forward-looking statements. These forward-looking statements involve a number of risks, uncertainties and assumptions. Such forward-looking statements include statements about our strategies, objectives, discoveries, collaborations, clinical or other internal or partnered programs, and other statements that are not historical facts, including statements which may be preceded by the words may, intend, will, plan, expect, anticipate, estimate, believe or similar words. For such statements, we claim the protection of the Private Sec Litigation Reform Act of 1995. Readers of this Quarterly Report are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the time this Quarterly Report was filed with the SEC. We undertake no obligation to update publicly or revise any forward-looking statements, other than as required by law. Actual events or results may differ materially from our expectations. Important factors that could cause actual results to differ materially from those stated or implied by our forward-looking statements include, but are not limited to, the risk factors identified in our SEC reports, including this Quarterly Report.

OVERVIEW AND RECENT DEVELOPMENTS

We are a clinical-stage biopharmaceutical company focused on discovering, developing and commercializing oral drugs in four major therapeutic areas: cardiovascular, central nervous system, inflammatory and metabolic diseases. Our most advanced drug candidate, lorcaserin hydrochloride, or lorcaserin, is being investigated in a Phase 3 clinical trial program for the treatment of obesity. We have a broad pipeline of novel compounds that target known and orphan G protein-coupled receptors, or GPCRs, and includes compounds being developed by our

partners, Ortho-McNeil Pharmaceutical, Inc., a Johnson & Johnson company, or Ortho-McNeil, and Merck & Co., Inc., or Merck. We incorporated on April 14, 1997 in the state of Delaware and commenced operations in July 1997.

Our recent developments include:

Completed a public offering by selling 11,000,000 shares of our common stock at $9.91 per share, resulting in net proceeds of approximately $103.1 million.

Announced positive preliminary results from our Phase 2 clinical trial of APD125 in patients with chronic insomnia. APD125 is an oral drug candidate that we discovered and believe has the potential to reduce insomnia symptoms

and improve sleep maintenance. In the Phase 2 clinical trial, APD125 significantly improved endpoints measuring improvements in sleep maintenance with no observations of next day cognitive impairment.

An independent Echocardiographic Safety Monitoring Board, or ESMB, found no reason to stop our ongoing pivotal Phase 3 lorcaserin BLOOM (Behavioral modification and Lorcaserin for Overweight and Obesity Management) trial following a scheduled review of unblinded echocardiograms performed after patients completed six months of dosing in the trial. The review confirmed that differences, if any, in the rates of U.S. Food and Drug Administration (FDA)-defined valvulopathy in patients treated with lorcaserin and in the control group did not meet predetermined stopping criteria. The review also confirmed that the rate of FDA-defined valvulopathy in the placebo group is consistent with our statistical powering assumptions used in the design of the pivotal trial program to monitor patients for any increased risk of developing valvulopathy.

Initiated dosing in a Phase 1 clinical trial evaluating APD791, our oral, internally discovered drug candidate intended for the treatment of arterial thrombo-embolic diseases. This Phase 1 trial is primarily intended to evaluate the safety and tolerability of single ascending doses of APD791 and will also evaluate the pharmacokinetics and pharmacodynamics of APD791.

RESULTS OF OPERATIONS

We are providing the following summary of our revenues and expenses to supplement the more detailed discussion below. The following tables are stated in millions.

Revenues

	Three months ended September 30,		Nine months ended September 30,	
Collaboration	**2007**	**2006**	**2007**	**2006**
Ortho-McNeil	$ 3.2	$ 2.4	$ 9.3	$ 15.8
Merck	1.8	2.0	5.5	10.1
Total revenues	$ 5.0	$ 4.4	$ 14.8	$ 25.9

Research & development expenses

	Three months ended September 30,		Nine months ended September 30,	
Type of expense	**2007**	**2006**	**2007**	**2006**
External clinical and preclinical study fees and expenses	$ 13.4	$ 7.4	$ 52.8	$ 19.7
Personnel costs	10.1	8.1	30.9	24.4

Facility and equipment costs	3.9	3.6	11.3	9.9
Research supplies	3.5	2.7	10.0	8.9
Other	1.3	0.9	3.8	2.4
Total research & development expenses	$ 32.2	$ 22.7	$ 108.8	$ 65.3

General & administrative expenses

	Three months ended September 30,		Nine months ended September 30,	
Type of expense	**2007**	**2006**	**2007**	**2006**
Personnel costs	$ 3.8	$ 2.1	$ 9.5	$ 6.1
Legal, accounting and other professional fees	2.6	0.8	6.4	4.5
Facility and equipment costs	0.8	0.7	2.2	1.7
Other	0.7	0.3	1.5	0.9
Total general & administrative expenses	$ 7.9	$ 3.9	$ 19.6	$ 13.2

THREE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006

Revenues. We recorded revenues of $5.0 million during the three months ended September 30, 2007, compared to $4.4 million during the three months ended September 30, 2006. All of our revenues recorded during the three months ended September 30, 2007 resulted from our collaborations with Ortho-McNeil and Merck, and included $2.6 million in

amortization of milestone achievements and technology access and development fees, $1.6 million in research funding, and $0.8 million for patent activities. All of our revenues recorded during the three months ended September 30, 2006 were also from our collaborations with Ortho-McNeil and Merck, and included $2.4 million in amortization of milestone achievements and technology access and development fees and $2.0 million in research funding.

In October 2004, we extended and expanded the collaboration we entered into with Merck in 2002, and Merck purchased $7.5 million of our common stock at a price of $8.00 per share, approximately a 70% premium to the then current market price. We performed an evaluation on this stock purchase and determined that $3.9 million of the $7.5 million purchase price was an upfront payment related to the collaboration extension and expansion. Accordingly, we are recognizing the $3.9 million upfront payment, as well as the remaining portion of the unamortized upfront payment at October 2004 of $1.3 million, over the extended research portion of the collaboration term of three years. Additionally, in October 2004, we achieved a $1.0 million milestone under this collaboration, and are recognizing the milestone over the extended term of the research portion of the collaboration because it was reasonably assured to be achieved at the time we extended and expanded the collaboration. In February 2007, we amended the collaboration to reduce the number of Arena research employees funded under the collaboration in exchange for Merck purchasing $1.0 million of our common stock. This equity investment, equal to the reduction in their research funding obligation, was at a price of $24.81 per share, approximately a 70% premium to the then current market price. We performed an evaluation on this stock purchase and determined that $0.5 million of the $1.0 million purchase price was an upfront payment related to the collaboration amendment. Accordingly, we recognized this upfront payment and the unamortized portion of the previously received upfront payments over the remaining term of the research portion of the collaboration. The research portion of the collaboration ended on October 21, 2007.

In December 2004, we entered into our collaboration and license agreement with Ortho-McNeil. This collaboration included a $17.5 million upfront payment, as well as research funding of $2.4 million per year, initially until December 20, 2006 and subsequently extended through December 20, 2007. We are amortizing this $17.5 million upfront payment over three years. In December 2004, we achieved two milestones under our Ortho-McNeil collaboration of $2.5 million each, which we are also recognizing over three years because they were reasonably assured to be achieved at the time we entered into the collaboration.

Our collaborators often pay us before we recognize such payments as current revenues and, accordingly, these payments are recorded as deferred revenues until earned. As of September 30, 2007, we had deferred revenues totaling $6.1 million, of which $2.1 million is expected to be recognized as revenues in the fourth quarter of 2007. The research funding we received from Merck ended in October 2007, and the research funding we receive from Ortho-McNeil is scheduled to end in December 2007. Absent any new collaboration, we do not expect to record any research funding in 2008. Future revenues for research or clinical milestones that have not yet been achieved are difficult to predict, and our revenues may vary significantly from quarter to quarter and year to year. We expect that our revenues over the next several years will depend on the clinical success of our partnered programs as well as whether we partner lorcaserin, APD125, APD791 or any of our other current or future drug candidates. Ultimately, we expect our future revenues to primarily depend on the regulatory approval and commercialization of partnered or internally developed drugs.

Research and development expenses. Research and development expenses, which account for the majority of our expenses, consisted primarily of costs associated with external clinical and preclinical study fees, manufacturing costs and other related expenses, and the development of our earlier-stage programs and technologies. Our most significant research and development costs are for clinical trials (including payments to contract research organizations, or CROs), preclinical study fees, personnel costs, research supplies, and facility and equipment costs. We expense research and development costs to operations as they are incurred when these expenditures relate to our research and development efforts and have no alternative future uses. Other than partnered, clinical and preclinical programs, we generally do not track our research and development expenses by project; rather, we track such expenses by the type of cost incurred.

Research and development expenses for the three months ended September 30, 2007 increased $9.5 million to $32.2 million, from $22.7 million for the three months ended September 30, 2006. The difference was due primarily to (i) external clinical and preclinical study fees and expenses, including manufacturing costs, increasing by $6.0 million as we continued the first of our three planned Phase 3 pivotal trials of lorcaserin and our Phase 1 clinical trial of APD791 and completed a Phase 2 clinical trial of APD125, (ii) personnel costs increasing by a total of $2.0 million as we increased the number of our research and development employees from 291 at the end of September 2006 to 340 at the end of September 2007 and recorded an additional $0.2 million in non-cash share-based compensation related to the expensing of share-based compensation under Statement of Financial Accounting Standards, or SFAS, No. 123R, Share-Based Payment, and (iii) research supplies increasing by $0.8 million. Nearly all of the increase in research and development personnel related to the development of our internal programs, primarily lorcaserin, APD125 and APD791.

Included in the $13.4 million total external clinical and preclinical study fees and expenses for the three months ended September 30, 2007 was $9.3 million related to our lorcaserin program, $1.5 million related to our APD125 program and $1.4 million related to our APD791 program. Included in the $7.4 million total external clinical and preclinical study fees and expenses for the three months ended September 30, 2006 was $5.4 million related to our lorcaserin program, $0.6 million related to our APD125 program and $0.7 million related to our APD791 program. We expect to continue to incur significant research and development expenses as we continue the ongoing and planned clinical development of our later-stage internal programs and the development of our earlier-stage programs and technologies.

General and administrative expenses. General and administrative expenses increased $4.0 million to $7.9 million for the three months ended September 30, 2007, from $3.9 million for the three months ended September 30, 2006, due primarily to (i) personnel costs increasing by a total of $1.7 million as we increased our general and administrative employees from 58 at the end of September 2006 to 68 at the end of September 2007 and recorded an additional $1.3 million in non-cash share-based compensation under SFAS No. 123R and (ii) an increase of $1.4 million in patent costs related to our partnered programs and our internal programs and technologies. We expect that our general and administrative expenses will be higher in the future due primarily to increases in the number of personnel and the non-cash share-based compensation recorded in accordance with SFAS No. 123R, as well as marketing and business development expenses.

Amortization of acquired technology. We recorded $0.4 million for amortization of acquired technology for both of the three-month periods ended September 30, 2007 and 2006 related to our patented Melanophore technology, our primary screening technology, which we acquired in 2001 for $15.4 million. The Melanophore technology is being amortized over its estimated useful life of 10 years. We expect to recognize $1.5 million for the full year ending December 31, 2007 and for each of the following three years for amortization of this technology.

Interest and other income, net. We recorded interest and other income, net, of $3.2 million for the three months ended September 30, 2007, compared to $3.0 million for the three months ended September 30, 2006. Interest and other income, net, for the three months ended September 30, 2007 was primarily comprised of (i) $4.7 million in interest income and (ii) interest expense and financing costs of $1.6 million, which included lease payments accounted for in accordance with SFAS No. 66, Accounting for Sales of Real Estate and SFAS No. 98 Accounting for Leases, on our lease financing obligations. Interest and other income, net, for the three months ended September 30, 2006 was primarily comprised of (i) $3.3 million in interest income and (ii) interest expense and financing costs of $0.5 million. The increased interest income resulting from our higher cash balances between these two periods was partially offset by increased interest expense recorded in connection with our 2007 lease financing.

Dividends on redeemable convertible preferred stock. We recorded a dividend expense of $0.5 million related to our series B redeemable convertible preferred stock, or Series B Preferred, for both of the three-month periods ended September 30, 2007 and 2006. The holders of our Series B Preferred are entitled to dividends that accrue at 4% annually. This dividend expense, which may be paid in common stock or by increasing the stated value of the Series B Preferred, increases the net loss allocable to common stockholders. Assuming that the Series B Preferred is held until the applicable mandatory redemption date, we expect to record dividends on the Series B Preferred of $0.5 million for the remainder of 2007, and $2.2 million, $0.5 million and $0.2 million in the years ending December 31, 2008, 2009 and 2010, respectively.

NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006

Revenues. We recorded revenues of $14.8 million during the nine months ended September 30, 2007, compared to $25.9 million during the nine months ended September 30, 2006. All of our revenues during the nine months ended September 30, 2007 were from our collaborations with Ortho-McNeil and Merck, and included $7.7 million in amortization of milestone achievements and technology access and development fees, $5.2 million in research funding, and $1.9 million for patent activities. All of our revenues during the nine months ended September 30, 2006 were also from our collaborations with Ortho-McNeil and Merck, and included clinical milestone achievements totaling $9.0 million, $7.2 million in amortization of milestone achievements and technology access and development fees, $6.1 million in research funding and $3.6 million in additional sponsored research and patent activities.

Research and development expenses. Research and development expenses increased $43.5 million to $108.8 million for the nine months ended September 30, 2007, from $65.3 million for the nine months ended September 30, 2006. The increase was due primarily to (i) external clinical and preclinical study fees and expenses, including manufacturing costs, increasing by $33.1 million as we completed patient enrollment in our first lorcaserin Phase 3 clinical trial and completed our APD125 Phase 2 clinical trial and (ii) personnel costs increasing by a total of $6.5 million as we increased the number of our research and development employees and recorded an additional $0.9 million in non-cash share-based compensation in accordance with SFAS No. 123R. Included in the $52.8 million in external clinical and preclinical study fees and expenses for the nine

months ended September 30, 2007 was $34.6 million related to our lorcaserin program, $12.9 million related to our APD125 program and $2.9 million related to our APD791 program. Included in the $19.7 million in external clinical and preclinical study fees and expenses for the nine months ended September 30, 2006 was $12.0 million related to our lorcaserin program, $3.5 million related to our APD125 program and $2.4 million related to our APD791 program.

General and administrative expenses. General and administrative expenses increased $6.4 million to $19.6 million for the nine months ended September 30, 2007, from $13.2 million for the nine months ended September 30, 2006. This increase is due primarily to (i) personnel costs increasing by $3.4 million as we hired additional general and administrative personnel and recorded an additional $2.3 million in non-cash share-based compensation under SFAS No. 123R, and (ii) patent costs related to our partnered programs and our internal programs and technologies increasing by $1.3 million.

Amortization of acquired technology. We recorded $1.2 million for amortization of acquired technology for both of the nine-month periods ended September 30, 2007 and 2006 related to our Melanophore screening technology.

Interest and other income, net. We recorded interest and other income, net, of $12.1 million for the nine months ended September 30, 2007, compared to $3.5 million for the nine months ended September 30, 2006. Interest and other income, net, for the nine months ended September 30, 2007 was primarily comprised of (i) $14.3 million in interest income and (ii) interest expense and financing costs of $2.2 million. Interest and other income, net, for the nine months ended September 30, 2006 was primarily comprised of (i) $9.2 million in interest income, (ii) a $4.6 million non-cash charge related to a warrant issued in a settlement with one of our warrant holders, and (iii) interest expense and financing costs of $1.4 million.

Dividends on redeemable convertible preferred stock. We recorded a dividend expense of $1.6 million related to our Series B Preferred for the nine-month period ended September 30, 2007, compared to $1.5 million for the same period in 2006. The holders of our Series B Preferred are entitled to dividends that accrue at 4% annually.

LIQUIDITY AND CAPITAL RESOURCES

Short term

We anticipate that our research and development expenditures will increase as we continue our Phase 3 BLOOM trial of lorcaserin, the first of our three planned Phase 3 pivotal trials evaluating the efficacy and safety of lorcaserin for the treatment of obesity, initiate two additional planned pivotal Phase 3 lorcaserin trials in the fourth quarter of 2007, continue our Phase 1 clinical trial of APD791 for the treatment of arterial thrombo-embolic diseases and continue the development of APD125, for which we recently announced positive results from a Phase 2 clinical trial in patients with chronic insomnia. We expect that the external expenses for our Phase 3 lorcaserin program, the majority of which we expect will be expensed through the first quarter of 2009, will be substantial. A large portion of these clinical trial expenses are expected to be paid through CROs. Our contract with the primary CRO in the Phase 3 BLOOM trial can be terminated if we give five days prior written notice. In

addition to costs related to these clinical trials, we expect to incur significant manufacturing and other pre-launch costs for lorcaserin. We estimate that our Phase 3 lorcaserin program will continue into early 2009 and may take significantly longer than expected to complete. The research funding we received from our collaboration with Merck ended in October 2007, and the research funding we receive from our collaboration with Ortho-McNeil is scheduled to end in December 2007. Absent any new collaboration, we expect to have no revenues from research funding starting in 2008.

We believe we have sufficient cash to meet our objectives over at least the next year, including continuing our development programs for lorcaserin, APD125, and APD791, continuing development of our other lead internal programs, discovering and developing additional drug candidates, continuing to build our development and manufacturing capabilities, and maintaining our research discovery capabilities. We will continue to monitor and evaluate the proper level of research and development expenditures and may adjust such expenditures based upon a variety of factors, such as our month-12 ESMB and other clinical trial and preclinical results for our drug candidates, as well as our ability to generate cash through financings and collaborative activities. We expect our capital expenditures in both 2007 and 2008 will be higher than in 2006 due to planned purchases of equipment, improvements to our facilities and the $3.2 million purchase of a facility located at 6162 Nancy Ridge Drive in our research park in October 2007.

The holders of our Series B-1 Preferred can require us to redeem all or some of their outstanding shares of Series B-1 Preferred at any time. The aggregate redemption price of our Series B-1 Preferred at September 30, 2007 was $40.7 million. If required to redeem, we may be able to satisfy all or a portion of this amount with shares of our common stock. Our ability and decision whether to use cash or stock to satisfy any redemption will depend on, among other factors, the amount of cash we have, our stock price and the amount of common stock then held by our preferred stockholders.

Our sources of liquidity include our cash balances and short-term investments. As of September 30, 2007, we had $339.1 million in cash and cash equivalents and short-term investments. On November 1, 2007, we completed a public offering of 11,000,000 shares of our common stock at $9.91 per share, resulting in net proceeds of approximately $103.1 million. In addition to our cash and investments, other potential sources of near-term liquidity include (i) research funding from our collaborators through the fourth quarter of 2007, (ii) milestone payments from our collaborators, (iii) the out-licensing of our drug candidates, internal drug programs and technologies, and (iv) equity or debt financing.

In May 2007, we sold to BMR three properties that we owned and continue to occupy, and assigned to BMR an option to purchase a fourth property that we currently lease and primarily occupy for total consideration of $50.1 million, resulting in net proceeds to us of $48.5 million. Concurrently with the closing of the transaction, we leased back the three properties sold to BMR under leases with 20-year terms and two consecutive options to extend such terms for five years each. Initial base rent for these three properties (net of taxes, insurance and maintenance costs (i.e. triple net) for which we are responsible) is an aggregate of $4.5 million annually, subject to an annual increase of 2.5% and other specified adjustments. If, at our election, we complete certain improvements to the properties sold, BMR will pay us up to an additional $16.0 million and our lease payments would increase. The amount of such increase would depend on the year in which such improvements are completed, if ever, with the initial amount of such increase for 2007 set at, assuming we receive the full $16.0 million, $1.4 million per year and increasing by approximately 2.5% each year. We expect that we may receive $1.0 million of such additional amount for improvements in 2007, but that we will not receive the remaining $15.0 million for several years, if ever.

We will continue to lease a portion of the property that is subject to BMR s purchase option from the current owner through the expiration of the lease with such owner, at which time we expect that BMR will exercise the purchase option and rent will commence under a lease with BMR for a term that is concurrent with the leases for the other three properties and at an initial base rent for such property (triple net) of $0.8 million per year, which would be subject to an annual increase of 2.5%. If BMR is unable to exercise the option due to (i) an amendment to our lease with the current owner of such property that adversely affects such option and such amendment is not consented to by BMR, or (ii) any casualty loss or proceeding in eminent domain pursuant to which BMR has a right not to exercise the option in accordance with our agreement of purchase and sale, and BMR elects not to exercise the option as a consequence of the occurrence of any event described in (i) and (ii) above, we would be required to pay BMR $12.1 million. If BMR elects to not exercise the option due to (ii) above, the lease payments on the remaining three properties would be reduced. The amount of such reduction would depend on the year in which BMR elects to not exercise the option, if ever, with the initial amount of such reduction for 2007 set at $1.1 million per year and increasing by 2.5% each year. In addition, subject to certain restrictions, we will have the option to repurchase all of the properties included in the transaction on the 10th, 15th or 20th anniversary of the execution date of the leases, and earlier if the leases are terminated under certain circumstances.

We will continue to be opportunistic in our efforts to generate cash. We will also continue to regularly evaluate potential acquisitions and in-licensing opportunities. Any such transaction may impact our liquidity as well as affect our expenses if, for example, our operating expenses increase as a result of such license or acquisition or we use our cash to finance the license or acquisition.

Long term

We will need to raise or generate significant amounts of cash to achieve our objectives of internally developing drugs, which take many years and potentially hundreds of millions of dollars to develop, and continuing our research programs. If we decide to market lorcaserin or any other drug candidate independently or with a partner, we will need to invest heavily in associated marketing costs. Such costs will be substantial and some will need to be incurred prior to receiving marketing approval from the FDA. We do not currently have adequate internal liquidity to meet these objectives in the long term. In order to do so, we will need to continue our out-licensing activities and look to other external sources of liquidity, including the public and private financial markets and strategic partners.

The length of time that our current cash and cash equivalents, short-term investments and any available borrowings will sustain our operations will be based on, among other things, our progress in preclinical and clinical testing, the time and costs related to current and planned clinical trials and regulatory decisions, our research and development costs (including personnel costs), the progress in our collaborations, costs associated with intellectual property, our capital expenditures, and costs associated with securing in-licensing opportunities, if at all. We do not know whether adequate funding will be available to us or, if available, that such funding will be available on acceptable terms. Any significant shortfall in funding could result in the partial or full curtailment of our development and/or research efforts, which, in turn, will affect our development pipeline and ability to generate cash in the future.

In addition to the public and private financial markets, potential sources of liquidity in the long term are milestone and royalty payments from existing and future collaborators.

Sources and Uses of Our Cash

Net cash used in operating activities was $91.3 million during the nine months ended September 30, 2007, and was primarily used to fund our net losses in the period, adjusted for non-cash expenses. Non-cash expenses included $7.0 million in share-based compensation, $5.9 million in depreciation and amortization expense, and $1.2 million in amortization of acquired technology, as well as changes in operating assets and liabilities. Net cash used in operating activities during the nine months ended September 30, 2006 was $44.9 million, and was used to fund our net loss for the period, adjusted for non-cash expenses, including a $4.6 million charge related to a warrant settlement, $5.4 million in depreciation and amortization expense, $3.8 million in share-based compensation, $1.2 million in amortization of acquired technology, as well as changes in operating assets and liabilities. We expect net cash used in operating activities will increase as we continue our Phase 3 program for lorcaserin, our clinical development of APD125 and APD791, and continue to hire employees, primarily in clinical development.

Net cash used in investing activities was $28.7 million during the nine months ended September 30, 2007, and was the result of net purchases of short-term investments of $19.1 million, $8.1 million used for equipment and improvements to our facilities, and $1.5 million used for the purchases of other non-current assets. Net cash used in investing activities was $13.3 million during the nine months ended September 30, 2006, and was primarily the result of $3.6 million used for the purchase of a facility located at 6118 Nancy Ridge Drive in our research park, $7.7 million used for equipment and improvements to our facilities, net purchases of short-term investments of $1.2 million and $0.7 million used for the purchases of other long-term assets. We expect our capital expenditures in both 2007 and 2008 will be higher than in 2006 due to planned purchases of equipment, improvements to our facilities and the $3.2 million purchase of a facility located at 6162 Nancy Ridge Drive in our research park in October 2007.

Net cash of $50.9 million was provided by financing activities during the nine months ended September 30, 2007. This was attributable to net proceeds of $48.5 million we received in May 2007 from the lease financing transaction and net proceeds of $2.9 million received from option exercises, purchases under our employee stock purchase plan, and from the equity component of the $1.0 million payment we received from Merck in February 2007, which were partially offset by $0.5 million in principal payments on our lease financing obligations. Net cash provided by financing activities during the nine months ended September 30, 2006 was $179.3 million, and was primarily attributable to net proceeds of $169.0 million we received in February 2006 from a public offering of our common stock and proceeds of $8.3 million in March 2006 from the exercise of warrants to purchase our common stock.

CRITICAL ACCOUNTING POLICIES AND MANAGEMENT ESTIMATES

The SEC defines critical accounting policies as those that are, in management s view, important to the portrayal of our financial condition and results of operations and demanding of management s judgment. Our discussion and analysis of financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on experience and on various assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from those estimates.

Our critical accounting policies include:

Revenue recognition. Our revenue recognition policies are in accordance with the SEC Staff Accounting Bulletin, or SAB, No. 104, Revenue Recognition, and Emerging Issues Task Force, or EITF, 00-21, Revenue Arrangements with Multiple Deliverables, which provide guidance on revenue recognition in financial statements. Some of our agreements contain upfront technology access fees, research funding, milestone achievements and royalties.

Revenue from a milestone achievement is recognized when earned, as evidenced by acknowledgment from our collaborator, provided that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) our performance obligations after the milestone achievement will continue to be funded by our collaborator at a level

comparable to the level before the milestone achievement. If all of these criteria are not met, the milestone achievement is recognized over the remaining period of our performance obligations under the agreement. We defer non-refundable upfront fees under our collaborations and recognize them over the period in which we have significant involvement or perform services, using various factors specific to the collaboration. Amounts we receive for research funding for a specified number of full-time researchers are recognized as revenue as the services are performed. Advance payments we receive in excess of amounts earned are classified as deferred revenues until earned.

Clinical trial expenses. We accrue clinical trial expenses based on work performed. In determining the amount to accrue, we rely on estimates of total costs incurred based on the enrollment of subjects, the completion of studies and other events. We follow this method because we believe reasonably dependable estimates of the costs applicable to various stages of a clinical trial can be made. Differences between the actual clinical trial costs and the estimated clinical trial costs that we have accrued in any prior period are recorded in the subsequent period in which the actual costs become known. Historically, these differences have not been material and we have not had to make material adjustments in the amounts recorded in a subsequent period; however, material differences could occur in the future.

Intangibles. Purchase accounting requires estimates and judgments to allocate the purchase price to the fair market value of the assets received and liabilities assumed. In February 2001, we acquired Bunsen Rush Laboratories, Inc. for $15.0 million in cash and assumed $0.4 million in liabilities. We allocated $15.4 million to the patented Melanophore technology acquired in such transaction. The Melanophore technology, our primary screening technology, is being amortized over its estimated useful life of 10 years, which was determined based on an analysis, as of the acquisition date, of the conditions in, and the economic outlook for, the pharmaceutical and biotechnology industries and the patent life of the technology. As with any intangible asset, we will continue to evaluate the value of the Melanophore technology. If, in the future, we determine that the Melanophore technology has become impaired or we no longer use it internally as our primary screening technology, we may record a write-down of the carrying value or we will accelerate the amortization if we determine that its life has been shortened.

Share-based compensation. On January 1, 2006, we adopted SFAS No. 123R using the modified-prospective transition method. Under this method, prior period results are not restated. Compensation expense recognized subsequent to adoption includes: (i) compensation expense for all share-based awards granted prior to, but unvested as of, January 1, 2006, based on the grant-date fair value, estimated in accordance with the original provision of SFAS No. 123 using a Black-Scholes option pricing model, and (ii) compensation expense for all share-based awards granted subsequent to January 1, 2006, based on the grant-date fair value, estimated in accordance with the provisions of SFAS No. 123R using the Black-Scholes option pricing model.

The determination of the grant-date fair value of share-based awards using the Black-Scholes option pricing model is based on the exercise price of the award and our stock price on the date of grant, as well as assumptions for expected volatility, the expected life of options granted and the risk-free interest rate. Changes in the assumptions can have a material impact on the compensation expense we recognize. Expected volatility for awards granted after adoption of SFAS No. 123R is based on a combination of 75% historical volatility of our common stock and 25% market-based implied volatility from traded options on our common stock, with historical volatility being more heavily weighted due to the low volume of traded options on our common stock. The expected life of options granted under SFAS No. 123R is determined based on historical experience of similar awards, giving consideration to the contractual terms of the share-based awards, vesting schedules and post-vesting cancellations. The risk-free interest rates are based on the U.S. Treasury yield curve, with a remaining term approximately equal to the expected term used in the option pricing model.

SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. If actual forfeitures do vary from estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur or when options vest.

We recorded total non-cash share-based compensation expense of $7.0 million during the nine months ended September 30, 2007.

Accounting for lease financing obligations. We have accounted for our sale leaseback transactions in accordance with SFAS No. 66 Accounting for Sales of Real Estate and SFAS No. 98 Accounting for Leases. Our option to repurchase these properties in the future is considered continued involvement under SFAS No. 66 and, therefore, we have applied the financing method under SFAS No. 98. Under the financing method, the book value of the properties and related accumulated depreciation remain on our balance sheet and no sale is recognized. Instead, the sales price of the properties is recorded as a financing obligation, and a portion of each lease payment is recorded as interest expense. We estimated and apply an incremental borrowing rate to the lease payments to record interest expense.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP. See our audited consolidated financial statements and notes thereto included in our 2006 Annual Report, which contain additional accounting policies and other disclosures required by GAAP.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our management establishes and oversees the implementation of board-approved policies covering our investments. We manage our market risk in accordance with our investment guidelines which (i) emphasize preservation of principal over other portfolio considerations, (ii) require investments to be placed in U.S. government and agency obligations and in debt instruments that are rated investment grade, (iii) establish guidelines for the diversification of our investment portfolio, and (iv) require investments to be placed with maturities that maintain safety and liquidity. We target our portfolio to have an average duration of no more than four years with no one instrument having a duration exceeding five years and one month. We do not invest in derivative instruments, or any financial instruments for trading purposes. Our primary market risk exposure as it affects our cash equivalents, short-term investments, and securities available-for-sale is interest rate risk. We monitor our interest rate risk on a periodic basis and we ensure that our cash equivalents, short-term investments, and securities available-for-sale are invested in accordance with our investments guidelines. Managing credit ratings and the duration of our financial investments enhances the preservation of our capital.

We model interest rate exposure by a sensitivity analysis that assumes a hypothetical parallel shift downward in the U.S. Treasury yield curve of 100 basis points. Under these assumptions, if the yield curve were to shift lower by 100 basis points from the level existing at September 30, 2007, we would expect future interest income from our portfolio to decline by less than $3.4 million over the next 12 months.

As of December 31, 2006, this same hypothetical reduction in interest rates would have resulted in a decline in interest income of less than $3.9 million over the 12 months following December 31, 2006. The difference in these two estimates is due to the decrease in our cash and cash equivalents, short-term investments, and securities available-for-sale between these two periods.

The model we use is not intended to forecast actual losses in interest income, but is used as a risk estimation and investment management tool. These hypothetical changes and assumptions are likely to be different from what actually occurs in the future. Furthermore, the computations do not incorporate any actions our management could take if the hypothetical interest rate changes actually occur. As a result, the impact on actual earnings will likely differ from those quantified herein.

Item 4. Controls and Procedures.

Based on an evaluation carried out as of the end of the period covered by this quarterly report, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) are effective. There was no change in our internal control over financial reporting that occurred during the last quarter covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors.

RISK FACTORS

Investment in our stock involves a high degree of risk. You should consider carefully the risks described below, together with other information in this quarterly report on Form 10-Q and our other public filings, before making investment decisions regarding our stock. If any of the following events actually occur, our business, operating results, prospects or financial condition could be materially and adversely affected. This could cause the trading price of our common stock to decline and you may lose all or part of your investment. Moreover, the risks described below are not the only ones that we face. Additional risks not presently known to us or that we currently deem immaterial may also affect our business, operating results, prospects or financial condition.

The risk factors set forth below with an asterisk (*) before the title are new risk factors or risk factors containing changes, including any material changes, from the risk factors previously disclosed in Item 1A of our annual report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission. In addition, we deleted a risk factor regarding the potential financial impact of Statement of Financial Accounting Standards No. 123R, which we adopted as of January 1, 2006.

Risks Relating to Our Business

***We will need additional funds to conduct our planned research and development efforts, and we may not be able to obtain such funds.**

We had net losses allocable to common stockholders of $88.3 million for the year ended December 31, 2006 and $104.4 million for the nine months ended September 30, 2007. We had an accumulated deficit of $438.5 million from our inception in April 1997 through September 30, 2007. Our losses have resulted in large part from the significant research and development expenditures we have made in seeking to identify and validate new drug targets and develop compounds that could become marketed drugs.

We expect that our operating expenses over the next several years will be significant and that we will continue to have significant operating losses for at least the next several years, even if we or our collaborators are successful in advancing our compounds or partnered compounds.

We do not have any commercially available drugs. It takes many years and potentially hundreds of millions of dollars to successfully develop a preclinical or early clinical compound into a marketed drug, and our efforts may not result in a marketed drug. We have substantially less money than we need to develop our compounds into marketed drugs. Additional funding may not be available to us or may not be available on terms that you or we believe are favorable. If additional funding is not available, we may have to delay, reduce the scope of or eliminate one or more of our research or development programs.

In addition, provisions of our series B-1 redeemable convertible preferred stock, or Series B-1 Preferred, require us to obtain approval of the preferred stockholders, or otherwise trigger rights of first refusal or payment provisions, to (i) offer or sell new securities, other than in specified underwritten offerings or strategic partnerships or joint venture and certain other exceptions, (ii) sell or issue common stock or securities issuable into common stock below certain prices, (iii) incur debt or allow liens on our property, other than certain permitted debt and liens, (iv) amend our certificate of incorporation so as to affect adversely any rights of the preferred stockholders, (v) authorize or create a new class of stock that will be senior or equal to the Series B-1 Preferred or our series B-2 redeemable convertible preferred stock, or Series B-2 Preferred (the Series B-1 Preferred and the Series B-2 Preferred are collectively referred to as the Series B Preferred), in terms of dividends, redemption or distribution of assets, or (vi) take certain other actions. These provisions may make it more difficult for us to take certain corporate actions and could delay, discourage or prevent future financings.

***Our stock price could decline significantly based on the results and timing of clinical trials and preclinical studies of, and decisions affecting, our lead drug candidates.**

Results of clinical trials and preclinical studies (including preclinical studies conducted after initiation of clinical trials) of our lead drug candidates may not be viewed favorably by us or third parties, including investors, analysts, potential collaborators, the academic and medical community, and regulators. The same may be true of how we design the development programs of

our lead drug candidates and regulatory decisions (including by regulatory authorities) affecting those development programs. Biotechnology company stock prices have declined significantly when such results and decisions were unfavorable or perceived negatively or when a drug candidate did not otherwise meet expectations.

We have several drug programs that are currently in clinical trials. In addition to successfully completing clinical trials, in order to conduct long-term clinical trials and gain regulatory approval to commercialize drug candidates, regulatory authorities require that all drug candidates complete long-term toxicology and carcinogenicity preclinical studies. These studies in animals are required to help determine the potential risk that drug candidates may be toxic or cause cancer in humans. The preclinical assessment of carcinogenic potential includes short-term in vitro and in vivo studies to look for chromosomal damage. These short-term studies have been completed for our clinical stage programs. Carcinogenic potential is also assessed in long-term toxicology and carcinogenicity studies in animals. The long-term carcinogenicity studies are lifetime assessments conducted in two species, typically rodents. A common challenge in assessing carcinogenic potential in the selected species is separating out any potential drug effects from the natural lifetime incidence of cancers in the selected species. To date, we have only competed long-term preclinical toxicology studies for lorcaserin, and we have not completed carcinogenicity studies for lorcaserin or any of our other clinical-stage programs. The results of our clinical trials and preclinical studies are uncertain, and the design of these trials and studies (which may change significantly and be more expensive than currently anticipated depending on our results and regulatory decisions) may also be viewed negatively by third parties. We may not be successful in advancing our programs on our projected timetable, if at all. Failure to initiate or delays in the development programs for any of our drug candidates, or unfavorable results or decisions or negative perceptions regarding any of such programs, could cause our stock price to decline significantly. This is particularly the case with respect to our most advanced drug candidate, lorcaserin, for which we plan to initiate two additional Phase 3 pivotal trials by the end of 2007 and expect a month-12 ESMB review to occur during the first quarter of 2008.

***Our development of lorcaserin may be adversely impacted by cardiovascular side effects previously associated with fenfluramine and dexfenfluramine.**

We have developed lorcaserin to more selectively stimulate the 5-HT2C serotonin receptor because we believe this may avoid the cardiovascular side effects associated with fenfluramine and dexfenfluramine (often used in combination with phentermine, the combination of which was commonly referred to as fen-phen), two serotonin-releasing agents and non-selective serotonin receptor agonists, both of which were withdrawn from the market in 1997 after reported incidences of heart valve disease and pulmonary hypertension associated with their usage. We may not be correct in this belief, however, or lorcaserin s selectivity profile may not avoid these undesired side effects. Moreover, the potential relationship between the activity of lorcaserin and the activity of fenfluramine and dexfenfluramine may result in increased United States Food and Drug Administration, or FDA, regulatory scrutiny of the safety of lorcaserin and may raise potential adverse publicity in the marketplace, which could affect clinical enrollment or ultimately sales if lorcaserin is approved for sale.

***The development programs for our drug candidates are expensive, time consuming, uncertain and susceptible to change, interruption, delay or termination.**

Drug development programs are very expensive, time consuming and difficult to design and implement. Our drug candidates are in various stages of development and are prone to the risks of failure inherent in drug development. We will need to complete additional clinical trials before we can demonstrate that our drug candidates are safe and effective to the satisfaction of the FDA and similar non-U.S. regulatory authorities. Clinical trials are expensive and uncertain processes that take years to complete. Failure can occur at any stage of the process, and successful early clinical trials do not ensure that later clinical trials will be successful. In addition, the commencement of our planned clinical trials could be substantially delayed or prevented by several factors, including:

limited number of, and competition for, suitable patients required for enrollment in our clinical trials;

limited number of, and competition for, suitable sites to conduct our clinical trials;

delay or failure to obtain FDA approval or agreement to commence a clinical trial;

delay or failure to obtain sufficient supplies of our drug candidates for our clinical trials;

delay or failure to reach agreement on acceptable clinical trial agreement terms or clinical trial protocols with prospective sites or investigators; and

delay or failure to obtain institutional review board, or IRB, approval to conduct a clinical trial at a prospective site.

Even if the results of our development programs are favorable, the development programs of our most advanced drug candidates, including those being developed by our collaborators, may take significantly longer than expected to complete. In addition, the FDA, other regulatory authorities, our collaborators, or we may suspend, delay or terminate our development programs at any time for various reasons, including:

lack of effectiveness of any drug candidate during clinical trials;

side effects experienced by study participants or other safety issues;

slower than expected rates of patient recruitment and enrollment or lower than expected patient retention rates;

delays or inability to manufacture or obtain sufficient quantities of materials for use in clinical trials;

inadequacy of or changes in our manufacturing process or compound formulation;

delays in obtaining regulatory approvals to commence a study, or clinical holds, or delays requiring suspension or termination of a study by a regulatory authority, such as the FDA, after a study is commenced;

changes in applicable regulatory policies and regulations;

delays in identifying and reaching agreement on acceptable terms with prospective clinical trial sites;

uncertainty regarding proper dosing;

unfavorable results from ongoing clinical trials and preclinical studies;

failure of our clinical research organizations to comply with all regulatory and contractual requirements or otherwise perform their services in a timely or acceptable manner;

scheduling conflicts with participating clinicians and clinical institutions;

failure to construct appropriate clinical trial protocols;

insufficient data to support regulatory approval;

termination of clinical trials by one or more clinical trial sites;

inability or unwillingness of medical investigators to follow our clinical protocols;

difficulty in maintaining contact with subjects during or after treatment, which may result in incomplete data; or

lack of sufficient funding to continue clinical trials and preclinical studies.

There is typically a high rate of attrition from the failure of drug candidates proceeding through clinical trials, and many companies have experienced significant setbacks in advanced development programs even after promising results in earlier studies or trials. We may experience similar setbacks in our development programs. If we or our collaborators abandon or are delayed in our development efforts related to lorcaserin, APD125, APD668, APD791 or any other drug candidate, we may not be able to generate sufficient revenues to continue our operations at the current level or become profitable, our reputation in the industry and in the investment community would likely be significantly damaged, additional funding may not be available to us or may not be available on terms you or we believe are favorable, and our stock price would likely decrease significantly.

***Our drug candidates are subject to extensive regulation, and we may not receive required regulatory approvals for any of our drug candidates.**

The clinical development, manufacturing, labeling, packaging, storage, record-keeping, advertising, promotion, export, marketing and distribution, and other possible activities relating to our drug candidates are, and any resulting drugs will be,

subject to extensive regulation by the FDA and other regulatory agencies in the United States. Neither our collaborators nor we are permitted to market our drug candidates in the United States until we receive regulatory approval from the FDA. Neither our collaborators nor we have received marketing approval for any of our drug candidates. Specific preclinical data, chemistry, manufacturing and controls data, a proposed clinical study protocol and other information must be submitted to the FDA as part of an investigational new drug, or IND, application, and clinical trials may commence only after the IND application becomes effective. To market a new drug in the United States, we must submit to the FDA and obtain FDA approval of a New Drug Application, or NDA. An NDA must be supported by extensive clinical and preclinical data, as well as extensive information regarding chemistry, manufacturing and controls to demonstrate the safety and effectiveness of the drug candidate.

Obtaining approval of an NDA can be a lengthy, expensive and uncertain process. In addition, failure to comply with FDA and other applicable regulatory requirements may, either before or after product approval, if any, subject our company to administrative or judicially imposed sanctions, including:

warning letters;

civil and criminal penalties;

injunctions;

withdrawal of approved products;

product seizure or detention;

product recalls;

total or partial suspension of production;

imposition of restrictions on operations, including costly new manufacturing requirements; and

refusal to approve pending NDAs or supplements to approved NDAs.

Regulatory approval of an NDA or NDA supplement is not guaranteed. Despite the time and expense exerted, failure can occur at any stage, and we could encounter problems that cause us to abandon clinical trials or to repeat or perform additional preclinical studies and clinical trials. The number of preclinical studies and clinical trials that will be required for FDA approval varies depending on the drug candidate, the disease or condition that the drug candidate is designed to target, and the regulations applicable to any particular drug candidate. The FDA can delay, limit or deny approval of a drug candidate for many reasons, including:

a drug candidate may not be deemed safe or effective;

FDA officials may not find the data from preclinical studies and clinical trials sufficient;

the FDA may not approve our third-party manufacturer s processes or facilities; or

the FDA may change its approval policies or adopt new regulations.

We do not expect any drugs resulting from our research and development efforts to be commercially available until 2010 or later. Our most advanced drug candidates, including lorcaserin and APD125, have not completed all preclinical studies and the large, pivotal Phase 3 clinical trials for efficacy and safety that are required for FDA approval. Also, we have not previously filed NDAs with the FDA, nor have we previously conducted Phase 3 clinical trials, which are significantly larger and more complex than earlier-stage trials. This lack of corporate experience may impede our ability to successfully complete these trials and obtain FDA approval in a timely manner, if at all, for our drug candidates for which development and commercialization is our responsibility. Even if we believe that data collected from our preclinical studies and clinical trials of our drug candidates are promising and that our information and procedures regarding chemistry, manufacturing, and controls are sufficient, our data may not be sufficient to support approval by the FDA or any other United States or foreign regulatory authority. As a result, we cannot predict when or whether regulatory approval will be obtained for any drug we develop. Even if approved, drug candidates may not be approved for all indications requested and such approval may be

subject to limitations on the indicated uses for which the drug may be marketed. Our business and reputation may be harmed by any failure or significant delay in receiving regulatory approval for the sale of any drugs resulting from our drug candidates.

In order to market any drugs outside of the United States, we and our collaborators must comply with numerous and varying regulatory requirements of other countries. Approval procedures vary among countries and can involve additional product testing and additional administrative review periods. The time required to obtain approval in other countries might differ from that required to obtain FDA approval. The regulatory approval process in other countries may include all of the risks associated with FDA approval as well as additional, presently unanticipated, risks. Regulatory approval in one country does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one country may negatively impact the regulatory process in others. Failure to obtain regulatory approval in other countries or any delay or setback in obtaining such approval could have the same adverse effects associated with regulatory approval in the United States, including the risk that our drug candidates may not be approved for all indications requested and that such approval may be subject to limitations on the indicated uses for which the drug may be marketed.

The results of preclinical studies and completed clinical trials are not necessarily predictive of future results, and our current drug candidates may not have favorable results in later studies or trials.

Preclinical studies and Phase 1 and Phase 2 clinical trials are not primarily designed to test the efficacy of a drug candidate, but rather to test safety, to study pharmacokinetics and pharmacodynamics, and to understand the drug candidate s side effects at various doses and schedules. To date, long-term safety and efficacy have not yet been demonstrated in clinical trials for any of our drug candidates. Favorable results in our early studies or trials may not be repeated in later studies or trials, including continuing preclinical studies and large-scale clinical trials, and our drug candidates in later-stage trials may fail to show desired safety and efficacy despite having progressed through earlier-stage trials. In particular, preclinical data and the limited clinical results that we have obtained for lorcaserin and APD125 may not predict results from studies in larger numbers of subjects drawn from more diverse populations treated for longer periods of time. They also may not predict the ability of lorcaserin or APD125 to achieve or sustain the desired effects in the intended population or to do so safely. Unfavorable results from ongoing preclinical studies or clinical trials could result in delays, modifications or abandonment of ongoing or future clinical trials. Preclinical and clinical results are frequently susceptible to varying interpretations that may delay, limit or prevent regulatory approvals or commercialization. Negative or inconclusive results or adverse medical events during a clinical trial could cause a clinical trial to be delayed, repeated or terminated. In addition, we may report top-line data from time to time, which is based on a preliminary analysis of key efficacy and safety data, and is subject to change following a more comprehensive review of the data related to the applicable clinical trial.

***Many of our research and development programs are in early stages of development, and may not result in the commencement of clinical trials.**

Many of our research and development programs are in the discovery or preclinical stage of development. The process of discovering compounds with therapeutic potential is expensive, time consuming and unpredictable. Similarly, the process of conducting preclinical studies of compounds that we discover requires the commitment of a substantial amount of our technical and financial resources and personnel. We may not discover additional compounds with therapeutic potential, and any of the compounds for which we are conducting preclinical studies may not result in the commencement of clinical trials. We cannot be certain that results sufficiently favorable to justify commencement of Phase 1 clinical trials will be obtained in these preclinical investigations. If we are unable to identify and develop new drug candidates, we may not be able to maintain a clinical development pipeline or generate revenues.

The technologies on which we rely may not result in the discovery or development of commercially viable drugs or could become obsolete.

Our GPCR technologies include technologies that allow us to discover drug-like compounds that act on receptor subtypes of known GPCRs and novel GPCRs where the native ligands have not been identified. These methods of identifying, prioritizing and screening molecular targets are unproven, and may not result in the regulatory approval and commercialization of any therapeutic products. We do not believe that there are any drugs on the market that have been discovered or developed using our proprietary technologies. If we are unable to identify additional drug candidates using our proprietary drug discovery technologies, we may not be able to maintain a clinical development pipeline or generate revenues.

Another company, organization or individual could have, or could develop, a technology targeting GPCRs to discover and develop compounds into drugs more effectively or efficiently than our screening and other technologies. Such a technology

could render our technologies, in particular our constitutively activated receptor technology, or CART, and Melanophore technology, obsolete or noncompetitive.

***Drug discovery and development is intensely competitive in the therapeutic areas on which we focus. If our competitors develop treatments that are approved faster, marketed better or demonstrated to be more effective or safer than our drug candidates, our commercial opportunities will be reduced or eliminated.**

We focus our efforts on GPCRs. Because GPCRs are an important target class for drug discovery efforts, we believe that many pharmaceutical and biotechnology companies and other organizations have internal drug discovery programs focused on GPCRs. Many of the drugs that our collaborators or we are attempting to discover and develop would compete with existing therapies. In addition, many companies are pursuing the development of new drugs that target the same diseases and conditions that we target. Many of our competitors, particularly large pharmaceutical companies, have substantially greater research, development and marketing capabilities and greater financial, scientific and human resources than we do. Companies that complete clinical trials, obtain required regulatory agency approvals and commence commercial sale of their drugs before we do for the same indication may achieve a significant competitive advantage, including certain patent and FDA marketing exclusivity rights. In addition, our competitors may develop drugs with fewer side effects, more desirable characteristics (such as route of administration or frequency of dosing) or greater efficacy than our drug candidates or drugs, if any, for the same indication. Any results from our research and development efforts, or from our joint efforts with our existing or any future collaborators, may not compete successfully with existing or newly discovered products or therapies.

***If we do not partner one or more unpartnered programs or raise additional funds, we may have to curtail some of our activities.**

Without additional capital or funding from partners, we would need to re-evaluate our strategy of moving multiple drug discovery and development programs forward while at the same time maintaining our research and discovery capabilities. Based on such evaluation, we may need to significantly curtail some of our current and planned programs and expenditures. We do not know what programs, if any, we would need to curtail, but we believe narrowing our pipeline would reduce our opportunities for success.

***Our revenues depend upon the actions of our existing and potential collaborators.**

We expect that, for at least the next few years, our revenues will depend upon the success of our existing collaborations and on our ability to enter into new collaborations. Our revenues of $30.6 million for the year ended December 31, 2006, and of $14.8 million for the nine months ended September 30, 2007, were derived exclusively from our collaborations with Merck and Ortho-McNeil. Absent any new collaborator, we expect all of our revenues for 2007 to be derived from our collaborations with Merck and Ortho-McNeil. In 2008 and beyond, due to the fact that the research programs under these collaborations from which we have derived research funding revenues in the past are scheduled to end in the fourth quarter of 2007, our revenues from these collaborations will depend on, in addition to patent reimbursements, milestone and royalty payments, if any. Thus, we will receive little additional revenues from our existing collaborators if our own or our collaborators research, development or, ultimately, marketing efforts are unsuccessful.

Typically, our collaborators (and not us) control the development of compounds into drugs after we have met early preclinical scientific milestones. In addition, we may not have complete access to information about the results and status of our collaborators clinical trials and regulatory programs and strategies. We are not entitled to the more significant milestone payments under our agreements until our collaborators have advanced compounds in clinical testing. Our partners may not devote adequate resources to the development of our compounds and may not develop or implement a successful clinical or regulatory strategy. Only two of our partners, Merck and Ortho-McNeil, have advanced our

drug candidates into clinical testing and paid us the applicable milestone payments. We cannot guarantee that any other development, approval or sales milestones in our existing or future collaborations will be achieved, or that we will receive any payments for the achievement of any future milestones.

In addition, our existing collaborations may be terminated early in certain circumstances, in which case we would not receive future milestone or royalty payments or patent reimbursements. Pursuant to our agreement with Merck, Merck or we can terminate our collaboration if the other party breaches its material obligations under the agreement by causes and reasons within its control, has not cured such breach within 90 days of receiving a letter requesting such cure, and there is no dispute as to whether such breach has occurred. Pursuant to our agreement with Ortho-McNeil, we and Ortho-McNeil each have the right to terminate the agreement early if the other party commits an uncured material breach of its obligations. At any time after the end of the research program, Ortho-McNeil may terminate the agreement by providing us at least 60 days prior written notice. Our revenues will be materially impacted if:

our agreement with either Merck or Ortho-McNeil is terminated;

our collaborators do not devote their time and financial resources to develop compounds under our collaborations;

our collaborators dispute whether we have achieved a milestone, rights to a particular receptor or compound, or other terms of our agreements;

our collaborators use alternative technologies to our technologies and compete with us in developing drugs; or

our collaborators experience failures in the discovery or development of compounds identified with our technologies or in the clinic or marketplace with other products that cause them to discontinue or slow down our collaboration.

Moreover, our ability to enter into new collaborations depends on the outcomes of our preclinical and clinical testing. We do not control these outcomes. In addition, even if our testing is successful, pharmaceutical companies may not partner with us on terms that we believe are acceptable until we have advanced our drug candidates into the clinic and, possibly, through later-stage clinical trials, if at all.

We may have conflicts with our prospective, current or past collaborators that could delay or prevent the development or commercialization of our drug candidates.

We may have conflicts with our prospective, current or past collaborators, such as conflicts concerning the interpretation of preclinical or clinical data, the achievement of milestones, or the ownership of intellectual property. If any conflicts arise with Ortho-McNeil, Merck or any other prospective, current or past collaborator, such collaborator may act in a manner that is adverse to our interests. Any such disagreement could result in one or more of the following, each of which could delay or prevent the development or commercialization of our drug candidates, and in turn prevent us from generating revenues:

unwillingness on the part of a collaborator to pay us research funding, milestone payments or royalties that we believe are due to us under a collaboration;

uncertainty regarding ownership of intellectual property rights arising from our collaborative activities, which could prevent us from entering into additional collaborations;

unwillingness on the part of a collaborator to keep us informed regarding the progress of its development and commercialization activities or to permit public disclosure of the results of those activities; or

slowing or cessation of a collaborator s development or commercialization efforts with respect to our drug candidates.

***Setbacks and consolidation in the pharmaceutical and biotechnology industries, and our or our collaborators inability to obtain third-party coverage and adequate reimbursement, could make partnering more difficult and diminish our revenues.**

Setbacks in the pharmaceutical and biotechnology industries, such as those caused by safety concerns relating to high-profile drugs like Avandia, Vioxx and Celebrex, or drug candidates such as rimonabant and torcetrapib, as well as competition from generic drugs, litigation, and industry consolidation, may have an adverse effect on us. For example, pharmaceutical companies may be less willing to enter into new collaborations or continue existing collaborations if they are integrating a new operation as a result of a merger or acquisition or if their therapeutic areas of focus change following a merger. Moreover, our and our collaborators ability to commercialize future drugs will depend in part on government regulation and the availability of coverage and adequate reimbursement from third-party payers, including government payers, such as the Medicaid and Medicare programs, increases in government-run, single-payer health insurance plans and compulsory licenses of drugs. Government and third-party payers are increasingly attempting to contain healthcare costs by limiting coverage and reimbursement levels for new drugs. These efforts may limit our commercial opportunities by reducing the amount a potential collaborator is willing to pay to license our programs or drug candidates in the future due to a reduction in the potential revenues from drug sales.

***We rely on third parties to conduct our clinical trials and many of our preclinical studies. If those parties do not successfully carry out their contractual duties or meet expected deadlines, our drug candidates may not advance in a timely manner or at all.**

In the course of our discovery, preclinical testing and clinical trials, we rely on third parties, including laboratories, investigators, clinical research organizations and manufacturers, to perform critical services for us. For example, we rely on third parties to conduct our clinical trials and many of our preclinical studies. Clinical research organizations are responsible for many aspects of the trials, including finding and enrolling subjects for testing and administering the trials. Although we rely on these third parties to conduct our clinical trials, we are responsible for ensuring that each of our clinical trials is conducted in accordance with its investigational plan and protocol. Moreover, FDA and foreign regulatory authorities require us to comply with regulations and standards, commonly referred to as good clinical practices, or GCPs, for conducting, monitoring, recording and reporting the results of clinical trials to ensure that the data and results are scientifically credible and accurate and that the trial subjects are adequately informed of the potential risks of participating in clinical trials. Our reliance on third parties does not relieve us of these responsibilities and requirements. These third parties may not be available when we need them or, if they are available, may not comply with all regulatory and contractual requirements or may not otherwise perform their services in a timely or acceptable manner, and we may need to enter into new arrangements with alternative third parties and our clinical trials may be extended, delayed or terminated. These independent third parties may also have relationships with other commercial entities, some of which may compete with us. In addition, if such third parties fail to perform their obligations in compliance with our clinical trial protocols or GCPs, our clinical trials may not meet regulatory requirements or may need to be repeated. Furthermore, we may not be able to obtain regulatory approval to commercialize the drug candidate being tested in such trials. As a result of our dependence on third parties, we may face delays or failures outside of our direct control. These risks also apply to the development activities of our collaborators, and we do not control our collaborators research and development, clinical trials or regulatory activities. We do not expect any drugs resulting from our collaborators research and development efforts to be commercially available for many years, if ever.

***We or a third-party manufacturer may encounter failures or difficulties that could delay the clinical development or regulatory approval of our drug candidates, or their ultimate commercial production if approved.**

We and third parties manufacture our drug candidates. Should we obtain FDA approval for any of our drug candidates, we expect to rely, in whole or in part, on third-party manufacturers for commercial production. Any performance failure on the part of us or a third-party manufacturer could delay clinical development or regulatory approval of our drug candidates. We or third-party manufacturers may encounter difficulties involving production yields, regulatory compliance, quality control and quality assurance, as well as shortages of qualified personnel. Approval of our drug candidates could be delayed, limited or denied if the FDA does not approve our or a third-party manufacturer s processes or facilities. Manufacturers are subject to ongoing periodic unannounced inspection by the FDA, the Drug Enforcement Administration of the United States Department of Justice, or DEA, and corresponding state and foreign authorities to ensure strict compliance with current Good Manufacturing Practices, or cGMPs, and other applicable government regulations and corresponding foreign standards. We do not have control over a third-party manufacturer s compliance with these regulations and standards. If we or one of our manufacturers fails to maintain compliance, we or they could be subject to civil or criminal penalties, the production of our drug candidates could be interrupted or suspended, or our product could be recalled or withdrawn, resulting in delays, additional costs and potentially lost revenues.

In addition, we or our third-party manufacturers may encounter delays and problems in manufacturing our drug candidates for a variety of reasons, including accidents during operation, failure of equipment, delays in receiving materials, natural or other disasters, or other factors inherent in operating complex manufacturing facilities. We or our third-party manufacturers may not be able to operate our respective manufacturing facilities in a cost-effective manner or in a time frame that is consistent with our expected future manufacturing needs. If this were to occur, we would need to seek alternative means to fulfill our manufacturing needs, which could delay progress on our programs.

***We may engage in strategic transactions that could impact our liquidity, increase our expenses and present significant distractions to our management.**

From time to time we consider strategic transactions, such as acquisitions of companies, asset purchases and out-licensing or in-licensing of compounds or technologies. Additional potential transactions we may consider include a variety of different business arrangements, including spin-offs, strategic partnerships, joint ventures, restructurings, divestitures, business combinations and investments. Any such transaction may require us to incur non-recurring or other charges, may increase our near and long-term expenditures and may pose significant integration challenges, require additional expertise or disrupt our management or business, which could harm our operations and financial results.

***Our efforts will be seriously jeopardized if we are unable to retain and attract key employees.**

Our success depends on the continued contributions of our principal management, development and scientific personnel, and the ability to hire and retain key personnel, particularly in the clinical development area as we transition more of our programs from research into drug development. We face intense competition for such personnel. The loss of services of any principal member of our management or scientific staff, particularly Jack Lief, our President, Chief Executive Officer and Chairman, and Dominic P. Behan, Ph.D., our Senior Vice President and Chief Scientific Officer, could adversely impact our operations and ability to raise additional capital. To our knowledge, neither Mr. Lief nor Dr. Behan plans to leave, retire or otherwise disassociate with us in the near future.

We use biological materials, hazardous materials, chemicals and radioactive compounds.

Our research and development activities involve the use of potentially harmful biological materials as well as materials, chemicals and various radioactive compounds that could be hazardous to human health and safety or the environment. These materials and various wastes resulting from their use are stored at our facility pending ultimate use and disposal. We cannot completely eliminate the risk of contamination, which could cause:

interruption of our research and development efforts;

injury to our employees and others;

environmental damage resulting in costly clean up; and

liabilities under federal, state and local laws and regulations governing the use, storage, handling and disposal of these materials and specified waste products.

In such an event, we may be held liable for any resulting damages, and any such liability could exceed our resources. Although we carry insurance in amounts and type that we consider commercially reasonable, we cannot be certain that the coverage or coverage limits of our insurance policies will be adequate and we do not have insurance coverage for losses relating to an interruption of our research and development efforts caused by contamination.

We may incur substantial liabilities from any product liability claims if our insurance coverage for those claims is inadequate.

We face an inherent risk of product liability exposure related to the testing of our drug candidates in clinical trials, and will face an even greater risk if we sell drugs commercially. An individual may bring a liability claim against us if one of our drug candidates or drugs causes, or merely appears to have caused, an injury. If we cannot successfully defend ourselves against a product liability claim, we will incur substantial liabilities. Regardless of merit or eventual outcome, liability claims may result in:

decreased demand for our drug;

injury to our reputation;

withdrawal of clinical trial subjects;

costs of related litigation;

substantial monetary awards to subjects or other claimants;

loss of revenues; and

the inability to commercialize our drug candidates.

We have limited product liability insurance that covers our clinical trials. We intend to expand our insurance coverage to include the sale of drugs if marketing approval is obtained for any of our drug candidates. However, insurance coverage is

increasingly expensive. We may not be able to maintain insurance coverage at a reasonable cost, and we may not have insurance coverage that will be adequate to satisfy any liability that may arise.

Our operations might be interrupted by the occurrence of a natural disaster or other catastrophic event.

Our laboratories, offices and chemical development facility are located in the same business park in San Diego. We depend on our facilities and on our collaborators, contractors and vendors for the continued operation of our business. Natural disasters or other catastrophic events, including terrorist attacks, power interruptions, wildfires and other fires, actions of animal rights activists, earthquakes and wars could disrupt our operations or those of our collaborators, contractors and vendors. Even though we believe we carry commercially reasonable business interruption and liability insurance, and our contractors may carry liability insurance that protect us in certain events, we might suffer losses as a result of business interruptions that exceed the coverage available under our and our contractors insurance policies or for which we or our contractors do not have coverage. For example, we are not insured against a terrorist attack. Any natural disaster or catastrophic event could have a significant negative impact on our operations and financial results. Moreover, any such event could delay our research and development programs.

***Even if any of our drug candidates receives regulatory approval, our drug candidates will still be subject to extensive post-marketing regulation.**

If we or our collaborators receive regulatory approval for our drug candidates, we will also be subject to ongoing FDA obligations and continued regulatory review, such as continued adverse event reporting requirements. We may also be subject to additional FDA post-marketing obligations, all of which may result in significant expense and limit our ability to commercialize such drugs.

If any of our drug candidates receive United States regulatory approval, the FDA may still impose significant restrictions on the indicated uses for which such drugs may be marketed or impose ongoing requirements for potentially costly post-approval studies. If the FDA approves any of our drug candidates, the labeling, packaging, adverse event reporting, storage, advertising and promotion for the drug will be subject to extensive regulatory requirements. We and the manufacturers of our products are also required to comply with cGMP regulations, which include requirements relating to quality control and quality assurance as well as the corresponding maintenance of records and documentation. Further, regulatory agencies must approve these manufacturing facilities before they can be used to manufacture our products, and these facilities are subject to ongoing regulatory inspections. In addition, regulatory agencies subject a drug, its manufacturer and the manufacturer s facilities to continual review and inspections. The subsequent discovery of previously unknown problems with a drug, including adverse events of unanticipated severity or frequency, or problems with the facility where the drug is manufactured, may result in restrictions on the marketing of that drug, up to and including withdrawal of the drug from the market. The DEA and comparable state-level agencies also heavily regulate the manufacturing, holding, processing, security record keeping and distribution of drugs that are considered controlled substances. If any of our drug candidates are scheduled by the DEA as controlled substances (due to abuse potential), we will become subject to DEA s regulations. The DEA periodically inspects facilities for compliance with its rules and regulations. If our manufacturing facilities or those of our suppliers fail to comply with applicable regulatory requirements, it could result in regulatory action and additional costs to us. Failure to comply with applicable FDA and other regulatory requirements may, either before or after product approval, if any, subject our company to administrative or judicially imposed sanctions, including:

- issuance of warning letters by the FDA;

imposition of fines and other civil penalties;

criminal prosecutions;

injunctions, suspensions or revocations of regulatory approvals;

suspension of any ongoing clinical trials;

total or partial suspension of manufacturing;

delays in commercialization;

refusal by the FDA to approve pending applications or supplements to approved applications filed by us or our collaborators;

refusals to permit drugs to be imported to or exported from the United States;

restrictions on operations, including costly new manufacturing requirements; and

product recalls or seizures.

The FDA s policies may change and additional government regulations may be enacted that could prevent or delay regulatory approval of our drug candidates or further restrict or regulate post-approval activities. We cannot predict the likelihood, nature or extent of adverse government regulation that may arise from future legislation or administrative action, either in the United States or abroad. If we are not able to maintain regulatory compliance, we might not be permitted to market our drugs and our business could suffer.

***Even if we receive regulatory approval to market our drug candidates, our ability to generate revenues from any resulting products will be subject to a variety of risks, many of which are out of our control.**

Even if our drug candidates obtain regulatory approval, resulting products may not gain market acceptance among physicians, patients, healthcare payors and/or the medical community. We believe that the degree of market acceptance and our ability to generate revenues from such products will depend on a number of factors, including:

timing of market introduction of competitive drugs;

efficacy of our drug candidates;

prevalence and severity of any side effects;

potential advantages or disadvantages over alternative treatments;

strength of sales, marketing and distribution support;

price of our future products, both in absolute terms and relative to alternative treatments;

the effect of current and future healthcare laws on our drug candidates; and

availability of coverage and reimbursement from government and other third-party payors.

If our approved drugs, if any, fail to achieve market acceptance, we may not be able to generate significant revenue to achieve or sustain profitability.

Laws, rules and regulations relating to public companies may be costly and impact our ability to attract and retain directors and executive officers.

Laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted by the Securities and Exchange Commission, or SEC, and by the Nasdaq Global Market, may result in increased costs to us. These laws, rules and regulations could make it more difficult or costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers. We cannot predict or estimate the amount or timing of additional costs we may incur to respond to these laws, rules and regulations.

Risks Relating to Our Intellectual Property

***Our success is dependent on intellectual property rights held by us and third parties and our interest in these rights is complex and uncertain.**

Our success will depend on our own and on our collaborators abilities to obtain, secure and defend patents. In particular, the patents directed to our most advanced drug candidates and other compounds discovered using our technologies or that are otherwise part of our collaborations are important to commercializing drugs. We have numerous United States and foreign patent applications pending for our technologies. There is no assurance that any of our patent applications will issue, or that any of the patents will be enforceable or will cover a drug or other commercially significant technology or method, or that the patents will be held to be valid for their expected terms.

The procedures for obtaining a patent in the United States and in most foreign countries are complex. These procedures require an analysis of the scientific technology related to the invention and many sophisticated legal issues. Obtaining patent rights outside the United States often requires the translation of highly technical documents and an improper translation may lead to the loss of, or otherwise jeopardize, the patent protection of our inventions. Ensuring adequate quality of translators and foreign patent attorneys is often very challenging. Consequently, the process for having our pending patent applications issue as patents will be difficult, complex and time consuming. Our patent position is very uncertain and we do not know when, or if, we will obtain additional patents for our technologies, or if the scope of the patents obtained will be sufficient to protect our drugs.

In addition, other entities may challenge the validity or enforceability of our patents and patent applications in litigation or administrative proceedings. Even the issuance of a patent is not conclusive as to its validity or enforceability. We cannot make assurances as to how much protection, if any, will be given to our patents if we attempt to enforce them or they are challenged. It is possible that a competitor or a generic pharmaceutical provider may successfully challenge our patents and those challenges may result in reduction or elimination of our patents coverage.

We also rely on confidentiality agreements and trade secrets to protect our technologies. However, such information is difficult to protect. We require our employees to contractually agree not to improperly use our confidential information or disclose it to others, but we may be unable to determine if our employees have conformed or will conform to their legal obligations under these agreements. We also enter into confidentiality agreements with prospective collaborators, collaborators, service providers and consultants, but we may not be able to adequately protect our trade secrets or other proprietary information in the event of any unauthorized use or disclosure or the lawful development by others of this information. Many of our employees and consultants were, and many of them may currently be, parties to confidentiality agreements with other pharmaceutical and biotechnology companies, and the use of our technologies could violate these agreements. In addition, third parties may independently discover our trade secrets or proprietary information.

Some of our academic institution licensors, research collaborators and scientific advisors have rights to publish data and information to which we have rights. We generally seek to prevent our partners from disclosing scientific discoveries before we have the opportunity to file patent applications on such discoveries. In some of our collaborations, we do not have control over our partners ability to disclose their own discoveries under the collaboration and in some of our academic collaborations we are limited to relatively short periods to review a proposed publication and file a patent application. If we cannot maintain the confidentiality of our technologies and other confidential information in connection with our collaborations, our ability to receive patent protection or protect our proprietary information will be impaired.

The United States Patent and Trademark Office has recently enacted and/or proposed changes in the rules governing (i) the duties of patent applicants to disclose information that relates to their applications, (ii) the ability of patent applicants to file unlimited numbers of patent applications and patent claims that concern closely related inventions and/or different aspects of the same invention, and (iii) the manner in which the United States Patent and Trademark Office will decide whether to require patent applicants to separate closely related inventions into separate patent applications. In addition, the United States Congress is considering a change to the federal laws dealing with patents on several issues including, but not limited to: (i) what types of information can be used to determine whether an invention is not new and, therefore, not patentable, (ii) the limits on the independent administrative rulemaking authority of the United States Patent and Trademark Office, (iii) the duties of patent applicants to disclose information that relates to their applications, (iv) whether, under what circumstances, and how many times a third party will have an opportunity to challenge an issued United States patent before the United States Patent and Trademark Office, (v) whether and under what circumstances patent applicants can lose their ability to enforce their patents in the United States based on their failure to disclose certain information relating to their inventions, and (vi) how damages for patent infringement may be limited and apportioned based on a number of factors including the similarity of a patented invention to pre-existing technologies.

The United States is by far the largest single market for pharmaceuticals in the world, responsible for between 40 and 50 percent of all such sales. Because of the critical nature of patent rights to the pharmaceutical industry, changes in United States patent rules and laws could have a profound effect on our future profits. Several of the patent rule and law changes that are being considered or have been recently enacted could significantly weaken patent protections in the United States in general. They may also have a disproportionately large negative impact on the biotechnology and pharmaceutical industries in particular, as well as tilt the balance of market control and distribution of profits between the manufacturers of patented pharmaceutical products and the manufacturers of generic pharmaceutical products towards the generics manufacturers. At present there is considerable uncertainty as to which patent rules and laws will be changed and whether changes to the patent rules will ultimately be enforced or struck down by the courts.

A dispute regarding the infringement or misappropriation of our proprietary rights or the proprietary rights of others could be costly and result in delays in our research and development activities.

Our commercial success also depends upon our ability to develop and manufacture our drug candidates and market and sell drugs, if any, and conduct our research and development activities without infringing or misappropriating the proprietary rights of others. There are many patents and patent applications filed, and that may be filed, by others relating to drug discovery and development programs that could be determined to be similar, identical or superior to ours or our licensors or collaborators. We may be exposed to future litigation by others based on claims that our drug candidates, technologies or activities infringe the intellectual property rights of others. Numerous United States and foreign issued patents and pending patent applications owned by others exist in the area of GPCRs, including some which purport to allow the patent holder to control the use of all drugs that modulate a particular drug target or GPCR, regardless of whether the infringing drug bears any structural resemblance to a chemical compound known to the patent holder at the time of patent filing. Numerous United States and foreign issued patents and pending patent applications owned by others also exist in the therapeutic areas in, and for the therapeutic targets for, which we are developing drugs. These could materially affect our ability to develop our drug candidates or sell drugs, and our activities, or those of our licensors or collaborators, could be determined to infringe these patents. Because patent applications can take many years to issue, there may be currently pending applications, unknown to us, which may later result in issued patents that our drug candidates or technologies may infringe. There also may be existing patents, of which we are not aware, that our drug candidates or technologies may infringe. Further, there may be issued patents and pending patent applications in fields relevant to our business, of which we are or may become aware, that we believe we do not infringe or that we believe are invalid or relate to immaterial portions of our overall drug discovery and development efforts. We cannot assure you that others holding any of these patents or patent applications will not assert infringement claims against us for damages or seeking to enjoin our activities. We also cannot assure you that, in the event of litigation, we will be able to successfully assert any belief we may have as to non-infringement, invalidity or immateriality, or that any infringement claims will be resolved in our favor.

In addition, others may infringe or misappropriate our proprietary rights, and we may have to institute costly legal action to protect our intellectual property rights. We may not be able to afford the costs of enforcing or defending our intellectual property rights against others.

Other organizations, companies and individuals are seeking proprietary positions on genomics information that overlap with the government-sponsored project to sequence the human genome. Our activities, or those of our licensors or collaborators, could be affected by conflicting positions that may exist between any overlapping genomics information made available publicly as a result of the government-sponsored project and genomics information that other organizations, companies or individuals consider to be proprietary. There could also be significant litigation and other administrative proceedings in our industry that affect us regarding patent and other intellectual property rights. Any legal action or administrative action against us, or our collaborators, claiming damages or seeking to enjoin commercial

activities relating to our drug discovery and development programs could:

require us, or our collaborators, to obtain a license to continue to use, manufacture or market the affected drugs, methods or processes, which may not be available on commercially reasonable terms, if at all;

prevent us from importing, making, using, selling or offering to sell the subject matter claimed in patents held by others and subject us to potential liability for damages;

consume a substantial portion of our managerial, scientific and financial resources; or

be costly, regardless of the outcome.

Furthermore, because of the substantial amount of pre-trial document and witness discovery required in connection with intellectual property litigation, there is risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments. If securities analysts or investors perceive these results to be negative, it could have a substantial adverse effect on the trading price of our common stock.

We have been contacted from time to time by third parties regarding their intellectual property rights, sometimes asserting that we may need a license to use their technologies. If we fail to obtain any required licenses or make any necessary changes to our technologies, we may be unable to develop or commercialize some or all of our drug candidates.

We cannot protect our intellectual property rights throughout the world.

Filing, prosecuting and defending patents on all of our drug discovery technologies and all of our potential drug candidates throughout the world would be prohibitively expensive. Competitors may use our technologies to develop their own drugs in jurisdictions where we have not obtained patent protection. These drugs may compete with our drugs, if any, and may not be covered by any of our patent claims or other intellectual property rights. The laws of some foreign countries do not protect intellectual property rights to the same extent as the laws of the United States, and many companies have encountered significant problems in protecting and defending such rights in foreign jurisdictions. Many countries, including certain countries in Europe, have compulsory licensing laws under which a patent owner may be compelled to grant licenses to third parties (for example, the patent owner has failed to work the invention in that country or the third party has patented improvements). In addition, many countries limit the enforceability of patents against government agencies or government contractors. In these countries, the patent owner may have limited remedies, which could materially diminish the value of the patent. Compulsory licensing of life-saving drugs is also becoming increasingly popular in developing countries either through direct legislation or international initiatives. Such compulsory licenses could be extended to include some of our drug candidates, which could limit our potential revenue opportunities. Moreover, the legal systems of certain countries, particularly certain developing countries, do not favor the aggressive enforcement of patents and other intellectual property protection, particularly those relating to biotechnology and/or pharmaceuticals, which makes it difficult for us to stop the infringement of our patents. Proceedings to enforce our patent rights in foreign jurisdictions could result in substantial cost and divert our efforts and attention from other aspects of our business.

Risks Relating to Our Securities

***Our stock price will likely be volatile, and your investment in our stock could decline in value.**

Our stock price has fluctuated historically. From January 1, 2005 to September 30, 2007, the market price of our stock was as low as $4.85 per share and as high as $20.68 per share.

Very few drug candidates being tested will ultimately receive FDA approval, and biotechnology or biopharmaceutical companies may experience a significant drop in stock price based on a clinical trial result or regulatory action. Our stock price may fluctuate significantly depending on a variety of factors, including:

the success or failure of our clinical-stage development programs, or other results or decisions affecting, the development of our drug candidates;

the timing of the discovery of drug leads and the development of our drug candidates;

the entrance into a new collaboration or the modification or termination of an existing collaboration;

the timing and receipt by us of milestone and royalty payments or failing to achieve and receive the same;

changes in our research and development budget or the research and development budgets of our existing or potential collaborators;

the introduction of new drug discovery techniques or the introduction or withdrawal of drugs by others that target the same diseases and conditions that we or our collaborators target;

regulatory actions;

expenses related to, and the results of, litigation and other proceedings relating to intellectual property rights or other matters;

financing strategy or decisions; and

accounting changes.

We are not able to control all of these factors. If our financial or scientific results in a particular period do not meet stockholders or analysts expectations, our stock price may decline and such decline could be significant.

***Holders of our Series B Preferred can require us to redeem their Series B Preferred.**

On December 24, 2003, we completed a private placement of (i) 3,500 shares of our Series B-1 Preferred, (ii) seven-year warrants to purchase 1,486,200 shares of our common stock at an exercise price of $10.00 per share (subject to weighted-average adjustment in certain circumstances) and (iii) unit warrants to purchase $11.5 million of our Series B-2 Preferred and additional seven-year warrants to purchase 450,000 shares of our common stock at an exercise price of $10.00 per share (subject to weighted-average adjustment in certain circumstances). On April 22, 2005, the investors exercised their unit warrants in full.

The holders of our Series B-1 Preferred can require us at any time to redeem all or some of their shares of Series B-1 Preferred at such shares stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. The stated value is the original holder s investment plus any dividends settled by increasing the stated value at the time the dividend is payable. The Series B-1 Preferred, which accrues dividends at 4% annually, had an aggregate redemption price of $40.7 million at September 30, 2007.

The holders of our Series B-2 Preferred will be entitled to require us to redeem their shares of Series B-2 Preferred at such shares stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties if, in the future, the average of the closing prices of our common stock for any 30 consecutive trading days is below $7.00 per share, which is the conversion price for the Series B-2 Preferred. The Series B-2 Preferred, which accrues dividends at 4% annually, had an aggregate redemption price of $12.7 million at September 30, 2007.

Also, the holders of the Series B-2 Preferred may require us to redeem their shares if we issue common stock or common stock equivalents for an effective net price to us per share less than approximately $5.33 (excluding, among other things, certain common stock and common stock equivalents issued or issuable (i) to our officers, directors, employees or consultants, (ii) in connection with certain strategic partnerships or joint ventures, and (iii) in connection with certain mergers and acquisitions). Effective net price is not defined in the Certificate of Designations governing our Series B-2 Preferred. The holders of our Series B-2 Preferred may assert that effective net price should be calculated as the amount we receive after paying any discounts and other expenses related to any such issuance.

At the option of any holder of any Series B Preferred, any Series B Preferred held by such holder may be converted into common stock based on the applicable conversion price then in effect for such shares of Series B Preferred.

In addition to the foregoing redemption rights, at any time following the occurrence of a Triggering Event, a holder of the Series B Preferred may require us to repurchase all or any portion of the Series B Preferred then held by such holder at a price per share equal to the greater of 115% of the stated value or the market value (as calculated under the Certificate of Designations for the Series B-1 Preferred and the Series B-2 Preferred) of such shares of Series B Preferred plus all accrued but unpaid dividends thereon to the date of payment. Triggering Event is specifically defined in the Certificate of Designations for the Series B-1 Preferred and the Series B-2 Preferred, and includes any of the following events (i) immediately prior to a bankruptcy event; (ii) we fail for any reason to timely deliver a certificate evidencing any securities to a purchaser or the exercise or conversion rights of the holders are otherwise suspended for other than a permissible reason; (iii) any of certain events of default (as set forth in the Registration Rights Agreement with the Series B Preferred holders) occur and remain uncured for 60 days; (iv) we fail to make any cash payment required under the Series B Preferred transaction documents and such failure is not timely cured; (v) the issuance of a going concern opinion by our independent registered public accounting firm that is not timely cured; (vi) we breach a section of the Series B Preferred purchase agreement relating to indebtedness and subordination; or (vii) we default in the timely performance of any other obligation under the Series B Preferred transaction documents and such default is not timely cured.

We will also be required to redeem any shares of the Series B Preferred that remain outstanding on the fifth anniversary of their issuance at a price equal to the amount of such shares then stated value, plus all accrued but unpaid dividends thereon to the date of payment and any applicable penalties.

If we are required to redeem all or some of the currently outstanding shares of our Series B Preferred, we may be able to pay all or a portion of the redemption price using shares of our common stock if certain enumerated conditions are satisfied, including:

we have sufficient number of shares of common stock available for issuance;

the shares of common stock to be issued are registered under an effective registration statement or are otherwise available for sale under Rule 144(k) under the Securities Act of 1933, as amended, or Securities Act;

our common stock is listed on the Nasdaq Global Market or other eligible market;

the shares to be issued can be issued without violating the rules of the Nasdaq Global Market or any applicable trading market or a provision of our Certificate of Designations for the Series B Preferred; and

no bankruptcy event has occurred.

If we are permitted to satisfy all or a portion of a redemption by using shares of our common stock, and if we elect to do so, the number of shares to be issued to holders of Series B Preferred will be determined by dividing their cash redemption price by the lesser of the conversion price or 95% of the average of the volume weighted-average price of our common stock for either 10 or 15 trading days.

There can be no assurance that if we have to redeem our Series B Preferred, that we will be able to pay a portion of the redemption price using shares of our common stock. If we use common stock to redeem a portion of the Series B Preferred, the ownership interests of the current holders of our common stock may be significantly diluted. If we are required or elect to redeem shares of the Series B Preferred using cash, we may not have sufficient cash to redeem these shares or to continue our planned research and discovery activities. In such event we may try to raise additional capital by issuing new stock, but there can be no assurance that capital will be available on acceptable terms or at all.

***There are a substantial number of shares of our common stock eligible for future sale in the public market, and the sale of these shares could cause the market price of our common stock to fall.**

There were 61,151,538 shares of our common stock outstanding as of September 30, 2007. The outstanding shares of our Series B-1 Preferred are convertible into up to 5,426,753 shares of common stock at $7.50 per share of common stock. The outstanding shares of our Series B-2 Preferred are convertible into up to 1,811,553 shares of common stock at $7.00 per share of common stock. Holders of Series B Preferred are entitled to receive a 4% annual dividend that is payable by issuing common stock or by increasing the amount of common stock that is issuable upon conversion of the Series B Preferred. In connection with the Series B Preferred financing, we issued warrants to acquire 1,936,200 shares of common stock at an exercise price of $10.00 per share to the two purchasers in our Series B Preferred financing. As of September 30, 2007, 1,106,344 of such warrants are outstanding. Such warrants provide that if the closing price of our common stock is equal to or above $14.00 per share for 30 consecutive trading days, upon 10 trading days prior written notice, we will have the right to, and the warrant holders will have the right to require us to, call and cancel any unexercised portion of the warrants (subject to certain conditions). Following such a call notice, we would be obligated to issue to the warrant holder an exchange warrant entitling the holder to purchase shares of our common stock equal to the Call Amount (as such term is defined in the warrants). This exchange warrant would contain the same terms and conditions as the original warrant, except that the maturity date would be seven years from the date of issuance of such exchange warrant and the exercise price would be equal to 130% of the average of the volume weighted-average price of our common stock for the five trading days preceding the original warrant cancellation date.

On March 31, 2006, following our call notice to one of our two warrant holders, Smithfield Fiduciary LLC, such holder exercised its warrants to purchase 829,856 shares of our common stock. In connection with this exercise in full of its warrants, Smithfield claimed that it was entitled to receive exchange warrants that would include a provision that could require us to issue additional exchange warrants in the future. We disagreed with this interpretation and, on June 30, 2006, we entered into a Settlement Agreement and Release with Smithfield. As part of the Settlement Agreement and Release, (a) Smithfield and we provided each other with a release of any claims relating to (i) Smithfield s demand for, and our non-issuance of, exchange warrants, and (ii) any breach or default under certain of our agreements on account of the foregoing,

(b) we issued Smithfield a seven-year warrant to purchase 829,856 shares of our common stock at an initial exercise price of $15.49 per share, and (c) we filed a registration statement covering the sale of the shares of common stock issuable under the new warrant. The new warrant does not contain any right for us, or for the holder to require us, to call the warrant, nor does it provide the holder the right to receive any exchange warrants in the future.

In addition, as of September 30, 2007, there were options to purchase 5,505,180 shares of our common stock issued and outstanding under our equity incentive plans at a weighted-average exercise price of $10.44, 1,641,900 performance-based restricted stock unit awards outstanding under our 2006 Long-Term Incentive Plan, as amended, 2,648,106 additional shares of common stock issuable under our 2006 Long-Term Incentive Plan, as amended, 523,584 shares of common stock issuable under our 2001 Employee Stock Purchase Plan, as amended, and 107,919 shares of common stock issuable under our Deferred Compensation Plan. A substantial number of the shares described above, when issued upon exercise, will be available for immediate resale in the public market. The market price of our common stock could decline as a result of such resales due to the increased number of shares available for sale in the market.

Any future equity or debt issuances by us may have dilutive or adverse effects on our existing stockholders.

We have financed our operations, and we expect to continue to finance our operations, primarily by issuing and selling our common stock or securities convertible into or exercisable for shares of our common stock. In light of our need for additional financing, we may issue additional shares of common stock or additional convertible securities that could dilute your ownership in our company and may include terms that give new investors rights that are superior to yours. Moreover, any issuances by us of equity securities may be at or below the prevailing market price of our common stock and in any event may have a dilutive impact on your ownership interest, which could cause the market price of our common stock to decline. The terms of our Series B Preferred limit our ability to engage in certain equity issuances.

We may also raise additional funds through the incurrence of debt, and the holders of any debt we may issue would have rights superior to your rights in the event we are not successful and are forced to seek the protection of bankruptcy laws. The terms of our Series B Preferred limit our ability to incur debt.

Our largest stockholders may take actions that are contrary to your interests, including selling their stock.

A small number of our stockholders hold a significant amount of our outstanding stock. These stockholders may support competing transactions and have interests that are different from yours. Sales of a large number of shares of our stock by these large stockholders or other stockholders within a short period of time could adversely affect our stock price.

We may have disagreements with our warrant holders.

We previously had a disagreement with one of our two warrant holders regarding whether such holder was entitled to receive exchange warrants following the exercise of its warrants in full. Although we entered into a Settlement Agreement and Release with this holder, we may have a similar dispute with the other warrant holder. Moreover, we may be involved with other disagreements with our warrant holders in the future. Such disagreements may lead to litigation which may be expensive and consume management s time, or involve settlements, the terms of which may not be favorable to us.

Our rights agreement and certain provisions in our charter documents and Delaware law could delay or prevent a change in management or a takeover attempt that you may consider to be in your best interest.

We have adopted certain anti-takeover provisions, including a stockholders rights agreement, dated as of October 30, 2002, between us and Computershare Trust Company, Inc., as Rights Agent, as amended. The rights agreement will cause substantial dilution to any person who attempts to acquire us in a manner or on terms not approved by our board of directors.

The rights agreement and Certificate of Designations for the Series B Preferred, as well as other provisions in our certificate of incorporation and bylaws and under Delaware law, could delay or prevent the removal of directors and other management and could make more difficult a merger, tender offer or proxy contest involving us that you may consider to be in your best interest. For example, these provisions:

allow our board of directors to issue preferred stock without stockholder approval;

limit who can call a special meeting of stockholders;

eliminate stockholder action by written consent; and

establish advance notice requirements for nomination for election to the board of directors or for proposing matters to be acted upon at stockholders meetings.

Item 6. Exhibits.

EXHIBIT NO.	DESCRIPTION
3.1	Fifth Amended and Restated Certificate of Incorporation of Arena (incorporated by reference to Exhibit 3.1 to Arena s quarterly report on Form 10-Q for the period ended June 30, 2002, filed with the Securities and Exchange Commission on August 14, 2002, Commission File No. 000-31161)
3.2	Certificate of Amendment of the Fifth Amended and Restated Certificate of Incorporation of Arena (incorporated by reference to Exhibit 4.2 to Arena s registration statement on Form S-8, filed with the Securities and Exchange Commission on June 28, 2006, Commission File No. 333-135398)
3.3	Certificate of Designations of Series A Junior Participating Preferred Stock of Arena, dated November 4, 2002 (incorporated by reference to Exhibit 3.3 to Arena s quarterly report on Form 10-Q for the period ended September 30, 2002, filed with the Securities and Exchange Commission on November 14, 2002, Commission File No. 000-31161)
3.4	Certificate of Designations of Series B-1 Convertible Preferred Stock and Series B-2 Convertible Preferred Stock of Arena, dated December 24, 2003 (incorporated by reference to Exhibit 3.1 to Arena s current report on Form 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
3.5	Amended and Restated Bylaws of Arena (incorporated by reference to Exhibit 3.1 to Arena s current report on Form 8-K filed with the Securities and Exchange Commission on October 4, 2007, Commission File No. 000-31161)
4.1	Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena s current report on Form 8-K filed with the Securities and Exchange Commission on November 1, 2002, Commission File No. 000-31161)
4.2	Amendment No. 1, dated December 24, 2003, to Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena s current report on Form 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
4.3	Amendment No. 2, dated November 16, 2006, to Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.3 to Amendment No. 2 to Arena s Registration Statement on Form 8-A filed with the Securities and Exchange Commission on November 16, 2006, Commission File No. 000-31161)
4.4	Form of common stock certificates (incorporated by reference to Exhibit 4.2 to Arena s registration statement on Form S-1, as amended, filed with the Securities and Exchange Commission on July 19, 2000, Commission File No. 333-3594)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(B) promulgated under the Securities Exchange Act of 1934

SIGNATURES

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

Date: November 8, 2007

ARENA PHARMACEUTICALS, INC.

By: /s/ Jack Lief
Jack Lief
President and Chief Executive Officer (principal executive officer authorized to sign on behalf of the registrant)

By: /s/ Robert E. Hoffman
Robert E. Hoffman, CPA
Vice President, Finance and Chief Financial Officer (principal financial and chief accounting officer authorized to sign on behalf of the registrant)

EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
3.1	Fifth Amended and Restated Certificate of Incorporation of Arena (incorporated by reference to Exhibit 3.1 to Arena s quarterly report on Form 10-Q for the period ended June 30, 2002, filed with the Securities and Exchange Commission on August 14, 2002, Commission File No. 000-31161)
3.2	Certificate of Amendment of the Fifth Amended and Restated Certificate of Incorporation of Arena (incorporated by reference to Exhibit 4.2 to Arena s registration statement on Form S-8, filed with the Securities and Exchange Commission on June 28, 2006, Commission File No. 333-135398)
3.3	Certificate of Designations of Series A Junior Participating Preferred Stock of Arena, dated November 4, 2002 (incorporated by reference to Exhibit 3.3 to Arena s quarterly report on Form 10-Q for the period ended September 30, 2002, filed with the Securities and Exchange Commission on November 14, 2002, Commission File No. 000-31161)
3.4	Certificate of Designations of Series B-1 Convertible Preferred Stock and Series B-2 Convertible Preferred Stock of Arena, dated December 24, 2003 (incorporated by reference to Exhibit 3.1 to Arena s current report on Form 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
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