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

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2004

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.

Yes ☒ No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ☒ No o

The number of shares of common stock outstanding as of the close of business on July 30, 2004:

Class	Number of Shares Outstanding
Common Stock, $0.0001 par value	25,619,590

ARENA PHARMACEUTICALS, INC.

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Arena Pharmaceuticals®, Arena® and our corporate logo are registered service marks of Arena. CART™ and BRL Screening™ are unregistered service marks of Arena.

In this report, "Arena Pharmaceuticals," "Arena," "we," "us" and "our" refer to Arena Pharmaceuticals, Inc. and/or our wholly owned subsidiary, BRL Screening, Inc., unless the context otherwise provides.

PART I. FINANCIAL INFORMATION
Item 1. Unaudited Consolidated Financial Statements

Arena Pharmaceuticals, Inc.
Condensed Consolidated Balance Sheets

	June 30, 2004 (Unaudited)	December 31, 2003 (Note)
Assets		
Current assets:		
Cash and cash equivalents	$ 27,257,594	$ 60,471,856
Short-term investments, available-for-sale	103,303,549	93,545,027
Accounts receivable	24,793	27,712
Prepaid expenses and other current assets	4,104,651	4,730,961
Total current assets	134,690,587	158,775,556
Land, property and equipment, net	54,723,154	55,729,472
Acquired technology, net	10,254,714	11,023,212
Other non-current assets	3,326,525	4,369,869
Total assets	$ 202,994,980	$ 229,898,109
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 3,195,252	$ 1,741,981
Accrued compensation	1,209,552	1,281,486
Current portion of deferred revenues	2,861,736	2,861,736
Current portion of obligations under capital leases	347	43,874
Total current liabilities	7,266,887	5,929,077
Deferred rent	935,123	933,684
Deferred revenues, less current portion	444,445	1,111,112
Financing obligation	13,129,663	13,000,000
Commitments		
Convertible preferred stock	27,438,411	25,776,104
Stockholders' equity:		
Common stock	2,874	2,867
Additional paid-in capital	315,778,717	315,861,773
Treasury stock	(23,070,000)	(23,070,000)
Accumulated other comprehensive income (loss)	(527,291)	526,580
Deferred compensation	(1,414,965)	(2,647,610)
Accumulated deficit	(136,988,884)	(107,525,478)
Total stockholders' equity	153,780,451	183,148,132
Total liabilities and stockholders' equity	$ 202,994,980	$ 229,898,109

Note: The balance sheet at December 31, 2003, has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements.

See accompanying notes to unaudited condensed consolidated financial statements.

Condensed Consolidated Statements of Operations
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Revenues:				
Total revenues	$ 1,398,334	$ 2,973,770	$ 7,181,668	$ 8,349,210
Expenses:				
Research and development	14,382,211	13,131,197	28,180,238	25,197,309
General and administrative	2,424,919	2,081,980	4,971,108	3,967,171
Amortization of deferred compensation	383,671	828,684	884,299	1,862,650
Amortization of acquired technology	405,305	405,305	810,610	810,610
Total operating expenses	17,596,106	16,447,166	34,846,255	31,837,740
Interest income and other, net	59,408	1,711,081	(163,369)	2,914,780
Net loss	(16,138,364)	(11,762,315)	(27,827,956)	(20,573,750)
Dividends on redeemable convertible preferred stock	(354,594)	—	(709,508)	—
Accretion of discount related to redeemable convertible preferred stock	(462,971)	—	(925,942)	—
Net loss allocable to common stockholders	$ (16,955,929)	$ (11,762,315)	$ (29,463,406)	$ (20,573,750)
Net loss per share allocable to common stockholders, basic and diluted	$ (0.67)	$ (0.42)	$ (1.17)	$ (0.74)
Shares used in calculating net loss per share allocable to common stockholders, basic and diluted	25,318,761	27,718,235	25,252,592	27,703,961

See accompanying notes to unaudited condensed consolidated financial statements.

Arena Pharmaceuticals, Inc.
Condensed Consolidated Cash Flow Statements
(Unaudited)

	Six months ended June 30,	
	2004	2003
Operating Activities		
Net loss	$ (27,827,956)	$ (20,573,750)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,518,749	2,735,200
Equity in losses of TaiGen	602,758	572,660
Amortization of acquired technology	810,610	810,610
Amortization of deferred compensation	884,299	1,862,650
Amortization/accretion of short-term investment premium/discount	719,955	882,337
Deferred rent	1,439	12,931
Deferred interest expense	129,663	—
Gain (loss) on disposal of equipment	(3,366)	15,543
Changes in operating assets and liabilities:		
Accounts receivable	2,919	3,478,023
Prepaid expenses and other current assets	584,198	(661,289)
Deferred revenues	(666,667)	(985,880)
Accounts payable and accrued expenses	1,408,194	(613,158)
Net cash used in operating activities	(19,835,205)	(12,464,123)
Investing Activities		
Purchases of short-term investments, available-for-sale	(61,127,028)	(74,368,090)
Proceeds from sales/maturities of short-term investments	49,594,680	68,177,580
Purchases of land, property and equipment	(2,516,680)	(11,648,920)
Proceeds from sale of equipment	7,615	11,687
Deposits, restricted cash and other assets	440,586	239,246
Net cash used in investing activities	(13,600,827)	(17,588,497)
Financing Activities		
Principal payments under capital lease obligations	(43,527)	(265,772)
Proceeds from issuance of common stock	265,297	295,046
Net cash provided by financing activities	221,770	29,274
Net decrease in cash and cash equivalents	(33,214,262)	(30,023,346)
Cash and cash equivalents at beginning of period	60,471,856	61,871,305
Cash and cash equivalents at end of period	$ 27,257,594	$ 31,847,959

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 subsidiary BRL Screening, Inc., 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, 2003, as filed with the Securities and Exchange Commission. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and in accordance 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 of operations 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. A discussion of the Company's critical accounting policies and management estimates is described in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this quarterly report on Form 10-Q.

2. Net Loss Per Share

Basic and diluted net loss per share allocable to common stockholders are presented in conformity with the Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share," for all periods presented.

In accordance with SFAS No. 128, basic and diluted loss per share has been computed for each period using the weighted-average number of shares of common stock outstanding during the period, less shares subject to repurchase or forfeiture.

The following table presents the calculation of net loss per share:

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Net loss	$ (16,138,364)	$ (11,762,315)	$ (27,827,956)	$ (20,573,750)
Net loss allocable to common stockholders	$ (16,955,929)	$ (11,762,315)	$ (29,463,406)	$ (20,573,750)
Net loss per share allocable to common stockholders, basic and diluted	$ (0.67)	$ (0.42)	$ (1.17)	$ (0.74)
Weighted-average shares used in computing net loss per share allocable to common stockholders, basic and diluted	25,318,761	27,718,235	25,252,592	27,703,961

The Company has excluded all outstanding stock options, preferred stock and warrants, and shares of common stock subject to repurchase or forfeiture from the calculation of diluted net loss per share allocable to common stockholders because all such securities are antidilutive for all periods presented. The total number of shares subject to repurchase or forfeiture excluded from the calculation of diluted net loss per share allocable to common stockholders was 374,416 for the three and six month periods ended June 30, 2004, and 839,974 for the three and six month periods ended June 30, 2003. Such securities would have been included in the computation of diluted net loss per share allocable to common stockholders if they were dilutive.

3. Comprehensive Loss

Comprehensive loss is comprised of net loss adjusted for changes in market values of available-for-sale securities and other investments. Below is a reconciliation of net loss to comprehensive loss for all periods presented.

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Net loss	$ (16,138,364)	$ (11,762,315)	$ (27,827,956)	$ (20,573,750)
Unrealized loss on available-for-sale securities and other investments	(1,284,431)	(216,292)	(1,053,871)	(243,076)
Comprehensive loss	$ (17,422,795)	$ (11,978,607)	$ (28,881,827)	$ (20,816,826)

4. Stock-based Compensation

The Company accounts for stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and its related Interpretations, which state that no compensation expense is recorded for stock options or other stock-based awards to employees and directors that are granted with an exercise price equal to or above the fair value per share of the Company's common stock per share on the grant date. In the event that stock options are granted with an exercise price below the fair value of the Company's common stock on the grant date, the difference between the fair value of the Company's common stock and the exercise price of the stock option is recorded as deferred compensation. Deferred compensation is amortized to compensation expense over the vesting period of the stock option. For stock options granted to its employees and directors, the Company has adopted the disclosure-only requirements of SFAS No. 123 "Accounting for Stock-Based Compensation" and SFAS No. 148, "Accounting for Stock Based Compensation - - Transition and Disclosure - an Amendment of FASB Statement No. 123," which require compensation expense to be disclosed in the notes to the financial statements based on the fair value of the options granted at the date of the grant. Compensation expense for options granted to non-employees other than directors has been determined in accordance with SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18,

"Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services." Such expense is based on the fair value of the options issued using the Black-Scholes method and is periodically remeasured as the underlying options vest in accordance with EITF Issue No. 96-18. Deferred compensation for restricted stock granted to employees has been determined as the quoted market value on the date the restricted stock was granted. Subsequent to Biotechnology Value Fund, L.P., Biotechnology Value Fund II, L.P., BVF Investments, L.L.C., BVF Partners L.P., and BVF Inc. (collectively, "BVF") increasing their ownership in the Company's stock in October 2002, in January, March and April 2003, the Company issued an aggregate of 750,500 shares of restricted common stock to key employees. The restricted stock vests over a two or four-year period from the date of grant. For the six months ended June 30, 2004, the Company recorded amortization of deferred compensation related to equity grants of $884,000. For the six months ended June 30, 2003, the Company recorded amortization of deferred compensation related to equity grants of $1.9 million. The Company expects that charges to be recognized in future periods from amortization of deferred compensation related to equity grants will be $633,000 for the remaining six months of 2004, and $435,000, $323,000 and $27,000 for the years ending December 31, 2005, 2006 and 2007, respectively.

In 2003, the Company set up a deferred compensation plan for its executive officers, whereby executive officers may elect to defer their shares of restricted stock. At June 30, 2004, a total of 97,501 shares of restricted stock were in the plan.

The following pro forma information regarding net loss and net loss per share has been determined as if the Company had accounted for its employee and director stock options under the fair value method prescribed by SFAS No. 123. The fair value of options was estimated at the date of grant using a Black-Scholes option valuation model using the assumptions stated below.

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Net loss allocable to common stockholders, as reported	$ (16,955,929)	$ (11,762,315)	$ (29,463,406)	$ (20,573,750)
Add: Stock-based employee compensation expense included in net loss allocable to common stockholders, as reported, net of related tax effects	383,671	828,684	884,299	1,862,650
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,204,731)	(2,038,972)	(3,294,871)	(3,432,165)
Pro forma net loss allocable to common stockholders	$ (17,776,989)	$ (12,972,603)	$ (31,873,978)	$ (22,143,265)
Net loss per share allocable to common stockholders:				
Basic and diluted — as reported	$ (0.67)	$ (0.42)	$ (1.17)	$ (0.74)
Basic and diluted — pro forma	$ (0.70)	$ (0.47)	$ (1.26)	$ (0.80)
Assumptions used for Employee Stock Options:				
Risk-free interest rate	3.8%	2.5%	2.9%	2.7%
Dividend yield	0%	0%	0%	0%
Stock price volatility	77%	86%	78%	89%
Expected life (years)	5.0	5.0	5.0	5.0
Weighted-average fair value	$ 3.89	$ 4.47	$ 3.88	$ 4.24
Assumptions used for Employee Stock Purchase Plan:				
Risk-free interest rate	2.1%	1.1%	1.6%	1.1%
Dividend yield	0%	0%	0%	0%
Stock price volatility	77%	86%	78%	88%
Expected life (years)	.25	.25	.25	.25
Weighted-average fair value	$ 1.95	$ 2.19	$ 1.97	$ 2.18

The effects of applying SFAS No. 123 for providing pro forma disclosures may not be representative of the effect on reported net income (loss) for future years.

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. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Declines in values of securities judged to be other than temporary are included in interest income. For the three and six months ended June 30, 2004 and 2003, no declines in values of securities judged to be other than temporary were included in interest income. 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. Investments held as of June 30, 2004, consisted primarily of U.S. Federal agency notes, U.S. corporate debt securities and mortgage-backed securities.

6. Concentration of Credit Risk

Financial instruments, which potentially subject the Company 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 with high credit quality financial institutions and in accordance with the Company's investment policy, debt that is rated investment grade.

The percentage of total revenues from significant collaborators is as follows:

	Three months ended June 30,	Six months ended June 30,

Collaborator	2004	2003	2004	2003
Merck & Co., Inc.	98.9%	71.7%	94.2%	51.1%
Ferring Pharmaceuticals, Inc.	—	15.7%	—	11.2%
Eli Lilly and Company	—	7.8%	—	34.5%

7. Recent Accounting Pronouncement

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," which became effective on January 1, 2004. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The adoption of FIN 46 did not impact the Company's consolidated results of operations or financial position.

In March 2004, the EITF reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." EITF 03-1 provides guidance on other-than-temporary impairment models for marketable debt and equity securities accounted for under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The EITF developed a basic three-step model to evaluate whether an investment is other-than-temporarily impaired. The provisions of EITF 03-1 will be effective for the Company's third quarter of fiscal 2004 and will be applied prospectively to all current and future investments. Quantitative and qualitative disclosures for investments accounted for under SFAS No. 115 are effective for the Company's fiscal year ending 2004. The Company does not expect the adoption of EITF 03-1 to have a material effect on it's consolidated results of operations or financial position.

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, 2003, 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 and uncertainties. Such forward-looking statements include statements about our strategies, objectives, discoveries, collaborations, internal programs, and other statements that are not historical facts, including statements which may be preceded by the words "intend," "will," "plan," "expect," "anticipate," "estimate," "aim," "believe," "hope" or similar words. For such statements, we claim the protection of the Private Securities 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 date on which they are made. We undertake no obligation to update publicly or revise any forward-looking statements. 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 and developing drugs that act on an important class of drug targets called G protein-coupled receptors, or GPCRs. We focus our drug discovery efforts in four therapeutic areas: metabolic, cardiovascular, inflammatory and central nervous system diseases. We incorporated on April 14, 1997, in the state of Delaware and commenced operations in July 1997.

In addition to our internal discovery and development efforts, we have research and development collaborations with several pharmaceutical and biotechnology companies, including Merck & Co., Inc., Fujisawa Pharmaceutical Co., Ltd., Taisho

Pharmaceutical Co., Ltd., and TaiGen Biotechnology Co., Ltd.

Recent developments include:

- Completed dosing in a Phase 1a single-dose study of our lead obesity compound, APD356
- Initiated a Phase 1b multiple-dose study of APD356
- Advanced our insomnia compound, APD125, into IND-enabling toxicity studies; a Phase 1 study is scheduled for the second half of this year pending satisfactory toxicology results
- Progressed our 19AJ program for diabetes into a selection process between two lead compounds; a Phase 1 study is anticipated to begin in the second half of 2005, assuming satisfactory preclinical results are obtained for at least one of these compounds

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 June 30,		Six months ended June 30,	
Collaborator	2004	2003	2004	2003
Merck	$ 1.4	$ 2.1	$ 6.8	$ 4.3
Fujisawa	—	—	0.4	—
Ferring	—	0.5	—	0.9
Eli Lilly	—	0.2	—	2.9
Others	—	0.2	—	0.2
Total revenues	$ 1.4	$ 3.0	$ 7.2	$ 8.3

Research & development expenses	Three months ended June 30,		Six months ended June 30,	
Type of expense	2004	2003	2004	2003
Personnel costs	$ 6.0	$ 6.1	$ 12.1	$ 12.0

Research supplies	2.5	3.7	5.5	6.9
Facility and equipment costs	2.9	2.5	5.7	4.8
External preclinical and clinical study fees and expenses	2.6	0.5	4.2	1.0
Other	0.4	0.3	0.7	0.5
Total research & development expenses	$ 14.4	$ 13.1	$ 28.2	$ 25.2

General & administrative expenses	**Three months ended June 30,**		**Six months ended June 30,**	
Type of expense	**2004**	**2003**	**2004**	**2003**
Personnel costs	$ 1.2	$ 1.2	$ 2.6	$ 2.4
Legal, accounting and other professional fees	0.4	0.3	0.8	0.5
Facility and equipment costs	0.5	0.4	0.9	0.8
Other	0.3	0.2	0.7	0.3
Total general & administrative expenses	$ 2.4	$ 2.1	$ 5.0	$ 4.0

THREE MONTHS ENDED JUNE 30, 2004 AND 2003

Revenues. We recorded revenues of $1.4 million during the three months ended June 30, 2004, compared to $3.0 million in revenues during the three months ended June 30, 2003. Ninety-nine percent of our revenues during the three months ended June 30, 2004, were from our collaboration with Merck, which included research funding and technology access and development fees. Seventy-two percent of our revenues during the three months ended June 30, 2003, were from our collaboration with Merck, which included research funding and technology access and development fees. Future revenues for research or clinical milestones are dependent upon our or our collaborators achieving scientific or clinical goals. The achievement and timing of achievement of such milestones are difficult to predict, and we expect our revenues from quarter to quarter and year to year to vary significantly. Our future revenues are also dependent upon the success of APD356 and other drug candidates that we may develop. Our collaborators often pay us before we recognize the revenues and these payments are deferred until earned. As of June 30, 2004, we had deferred revenues totaling approximately $3.3 million.

Research and development expenses. Research and development expenses consist primarily of costs associated with internal development of our drug candidates and other research programs and our technologies. We generally do not track our research and development costs by program until we designate a compound to move forward as a clinical candidate; rather, we track such costs by the type of cost incurred. At June 30, 2004, we had two programs for which we tracked external costs by program, APD356 and APD125. Research and development expenses increased $1.3 million to $14.4 million for the three months ended June 30, 2004, from $13.1 million for the three months ended June 30, 2003. The difference was due primarily to (i) preclinical and clinical study fees and expenses increasing by $2.1 million as we continued to develop APD356 and APD125, (ii) facility and equipment costs, including depreciation, increasing by $439,000 due to expansion of our facilities, (iii) personnel costs decreasing by $87,000 which reflects both a decrease in the number of research personnel, partially offset by an increase in the average salary of our personnel and related benefits as well as recruiting costs, and (iv) research supplies decreasing by $1.2 million due to aggressive cost saving efforts in the research supply area. Included in the $2.6 million in preclinical and clinical study fees and expenses for the three months ended June 30, 2004 is $947,000 in external costs related to our APD356 program and $1.2 million in external costs related to our APD125 program. As of June 30, 2004, all research and development costs have been expensed as incurred. Our research and development employees decreased from 296 at June 30, 2003, to 263 at June 30, 2004. We expect research and development expenses to continue to be greater in 2004 than in 2003 as we move our development candidate pipeline forward, as well as due to increased personnel costs, particularly for development personnel salaries, which generally are higher than research personnel salaries.

General and administrative expenses. General and administrative expenses increased $0.3 million to $2.4 million for the three months ended June 30, 2004, from $2.1 million for the three months ended June 30, 2003. The increase is due primarily to (i) an increase of $138,000 from increases in utilities and other facility related costs, (ii) an increase in board and consulting services of $119,000, and (iii) professional fees, including legal and accounting fees, increasing by $111,000 related to the complexity and demands of the laws and regulations applicable to public companies, and the cost of maintaining a growing and maturing portfolio of patent applications and patents. We expect general and administrative expenses to continue to be greater in 2004 than in 2003 due to increases in legal and accounting fees related to the complexity and demands of the laws and regulations applicable to public companies, and the cost of maintaining a growing and maturing portfolio of patent applications and patents.

Amortization of deferred compensation. Subsequent to Biotechnology Value Fund, L.P., Biotechnology Value Fund II, L.P., BVF Investments, L.L.C., BVF Partners L.P., BVF Inc. (collectively, “BVF”) and Investment 10, L.L.C. (collectively with BVF, the “BVF Stockholders”) increasing their ownership in our stock in October 2002, in January, March and April 2003, we issued an aggregate of 750,500 shares of restricted common stock to key employees. The restricted stock generally vests over a two or four-year period from the date of grant. For the three months ended June 30, 2004, we recorded amortization of deferred compensation of $384,000, of which $196,000 relates to research and development employees and consultants and $188,000 relates to general and administrative employees. For the three months ended June 30, 2003, we recorded amortization of deferred compensation of $829,000 of which $493,000 relates to research and development employees and consultants and $336,000 relates to general and administrative employees. At June 30, 2004, we expect that charges to be recognized in future periods from amortization of deferred compensation related to equity grants will be $633,000 for the remaining six months of 2004, and $435,000, $323,000 and $27,000 for the years ending December 31, 2005, 2006 and 2007, respectively.

Interest income and other, net. Interest income and other, net, was $59,000 for the three months ended June 30, 2004, compared to $1.7 million for the three months ended June 30, 2003. Interest income and other, net, for the three months ended June 30, 2004, was primarily comprised of interest income of $620,000, partially offset by $103,000 attributable to our share of the net loss of TaiGen, which we have accounted for by the equity method of accounting and interest expense and financing costs of $470,000, which includes lease payments accounted for in accordance with Financial Accounting Standard No. 66 “Accounting for Sales of Real Estate” on our 6138-6150 Nancy Ridge Drive facility that we sold and are leasing back. Interest income and other, net, for the three months ended June 30, 2003, was primarily comprised of interest income of $978,000 and gains on the sale of investments of $952,000, partially offset by $206,000 attributable to our share of the net loss of TaiGen.

Dividends on redeemable convertible preferred stock. We recorded a dividend expense of $355,000 related to our redeemable convertible preferred stock in the three months ended June 30, 2004. This dividend expense, payable in additional shares of redeemable convertible preferred stock or in common stock, increases the net loss allocable to common stockholders. Assuming that the redeemable convertible preferred stock is held until the mandatory redemption date and future dividends are paid in shares of our common stock, we expect to record dividends on redeemable convertible preferred stock of $724,000 for the remaining six months of 2004 and $1.4 million for each of the years ending December 31, 2005, 2006, 2007 and 2008. We did not have any outstanding redeemable convertible preferred stock during the three months ended June 30, 2003.

Accretion of discount and deemed dividend on redeemable convertible preferred stock. In accordance with Emerging Issues Task Force ("EITF") 00-27, "Application of Issue No. 98-5 for Certain Convertible Instruments," we allocated the components of the December 2003 sale of the series B convertible preferred stock between the series B-1 convertible preferred stock, the warrants and the unit warrants on the basis of the relative fair values at the date of issuance using the Black-Scholes model. The aggregate amount allocated to the warrants and unit warrants was $6.5 million. The fair value of the common shares into which the series B-1 convertible preferred stock was convertible into on the date of issuance exceeded the proceeds allocated to the series B-1 convertible preferred stock by $2.8 million, resulting in a beneficial conversion feature that was recognized as an increase to paid-in capital and as a deemed dividend to the series B-1 convertible preferred stock. We recorded as an expense accretion of discount and deemed dividend on our redeemable convertible preferred stock in the amount of $463,000 in the three months ended June 30, 2004. We will record accretion of the value of the discount and deemed dividend of $926,000 for the remaining six months of 2004, $1.9 million for each of the years ending December 31, 2005, 2006 and 2007 and $1.8 million for the year ending December 31, 2008. We did not have any outstanding redeemable convertible preferred stock during the three months ended June 30, 2003.

SIX MONTHS ENDED JUNE 30, 2004 AND 2003

Revenues. We recorded revenues of $7.2 million during the six months ended June 30, 2004, compared to $8.3 million in revenues during the six months ended June 30, 2003. Ninety-four percent of our revenues during the six months ended June 30, 2004, were from our collaboration with Merck, which included research funding, a milestone achievement of $4.0 million, and technology access and development fees. Eighty-six percent of our revenues during the six months ended June 30, 2003, were from our collaborations with Merck and Eli Lilly and Company, which included research funding, milestone achievements, and technology access and development fees.

Research and development expenses. Research and development expenses increased $3.0 million to $28.2 million for the six months ended June 30, 2004, from $25.2 million for the six months ended June 30, 2003. The difference was due primarily to (i) preclinical and clinical study fees and expenses increasing by $3.2 million as we continued to develop APD356 and APD125, (ii) facility and equipment costs, including depreciation, increasing by $963,000 due to expansion of our facilities, (iii) personnel costs increasing by $93,000 due to increases in salaries and related benefits as well as recruiting costs, partially offset by a decrease in the number of research personnel, and (iv) research supplies decreasing by $1.4 million due to aggressive cost saving efforts in the research supply area. Included in the $4.2 million in preclinical and clinical study fees and expenses for the six months ended June 30, 2004 is $1.7 million in external costs related to our APD356 program and $1.5 million in external costs related to our APD125 program.

General and administrative expenses. General and administrative expenses increased $1.0 million to $5.0 million for the six months ended June 30, 2004, from $4.0 million for the six months ended June 30, 2003. The increase is due primarily to (i) an increase in board and consulting services of $357,000, (ii) professional fees, including legal and accounting fees, increasing by $262,000 related to the complexity and demands of the laws and regulations applicable to public companies, and the cost of maintaining a growing and maturing portfolio of patent applications and patents, (iii) an increase of $148,000 from increases in utilities and other facility related costs, and (iv) an increase in personnel costs of $93,000 from increases in salaries and related benefits.

Amortization of deferred compensation. For the six months ended June 30, 2004, we recorded amortization of deferred compensation of $884,000, of which $519,000 relates to research and development employees and consultants and $365,000 relates to general and administrative employees. For the six months ended June 30, 2003, we recorded amortization of deferred compensation of $1.9 million, of which $1.1 million relates to research and development employees and consultants and $755,000 relates to general and administrative employees.

Interest income and other, net. Interest income and other, net, was a net expense of $163,000 for the six months ended June 30, 2004, compared to a net income of $2.9 million for the six months ended June 30, 2003. Interest income and other, net, for the six months ended June 30, 2004, was primarily comprised of interest income of $1.3 million and gains on sales of investments of $61,000, partially offset by interest expense and financing costs of $935,000, which includes lease payments accounted for in accordance with Financial Accounting Standard No. 66 "Accounting for Sales of Real Estate" on our 6138-6150 Nancy Ridge Drive facility that we sold and are leasing back and $603,000 attributable to our share of the net loss of TaiGen, which we have accounted for by the equity method of accounting. Interest income and other, net, for the six months ended June 30, 2003, was primarily comprised of interest income of $2.2 million, gain on sale of investments of $1.3 million and rental and other income of $95,000, partially offset by $573,000 attributable to our share of the net loss of TaiGen.

Dividends on redeemable convertible preferred stock. We recorded a dividend expense of $710,000 related to our

redeemable convertible preferred stock in the six months ended June 30, 2004. We did not have any outstanding redeemable convertible preferred stock during the six months ended June 30, 2003.

Accretion of discount and deemed dividend on redeemable convertible preferred stock. We recorded as an expense accretion of discount and deemed dividend on our redeemable convertible preferred stock in the amount of $926,000 in the six months ended June 30, 2004. We did not have any outstanding redeemable convertible preferred stock during the six months ended June 30, 2003.

LIQUIDITY AND CAPITAL RESOURCES

Short term

We believe we have sufficient cash to meet our objectives over the next year, including continuing our clinical trials on our obesity compound APD356, advancing our lead internal development projects for sleep and diabetes into clinical trials, continuing multiple internal drug research and discovery programs and building and improving our infrastructure.

In the short-term, our sources of liquidity include our cash balances and short-term investments. As of June 30, 2004, we had $130.6 million in cash and cash equivalents and short-term investments.

In addition to our cash balances and short-term investments, other potential sources of near-term liquidity are (i) the sale of additional shares of our stock, (ii) the sale of two of our facilities that we own, neither of which is mortgaged, and (iii) the license of our internal drug programs and technologies.

Ninety-four percent of our revenues for the six months ended June 30, 2004 were from one collaborator, Merck. We expect substantially all of our revenues for 2004 to be derived from our collaboration with Merck. The loss of this collaborator would significantly increase our expected operating losses.

Long term

Looking beyond 2004, we will need to raise or generate significant amounts of cash to execute our objectives of internally developing drug products, which take many years and potentially hundreds of millions of dollars to develop, and to continue our research programs. We do not currently have adequate internal liquidity to meet this long-term goal. In order to do so, we will need to successfully license one or more of our internal drug programs, raise financing from the public or private financial markets and strategic partners, if available, or curtail some of our research development activities to reduce our expenses.

In addition, if beginning in September 2005 the closing price of our common stock for any 30 consecutive trading days is less than $7.50 per share or if, under certain circumstances, we issue common stock or common stock equivalents for less than $6.72 per share, the series B preferred stockholders may require us to redeem their preferred shares at an aggregate price equal to $35.0 million plus all accrued but unpaid dividends and any applicable penalties. We may elect to redeem their preferred shares in common shares, subject to certain limitations.

Sources and Uses of Our Cash

Net cash used in operating activities was approximately $19.8 million during the six months ended June 30, 2004, and was used to fund our net loss in the period, adjusted for non-cash expenses, including $3.5 million in depreciation and amortization expense, $884,000 in amortization of deferred compensation, $811,000 in amortization of acquired technology and other purchased intangibles, $603,000 for our minority interest in TaiGen's operations, and changes in operating assets and liabilities. Net cash used in operating activities was approximately $12.5 million during the six months ended June 30, 2003. The primary use of cash for the six months ended June 30, 2003, was to fund our net loss in the period, adjusted for non-cash expenses, including $2.7 million in depreciation and amortization, $1.9 million in amortization of deferred compensation, $811,000 in amortization of acquired technology and other purchased intangibles, $573,000 for our minority interest in TaiGen's operations, and changes in operating assets and liabilities.

Net cash used in investing activities was approximately $13.6 million during the six months ended June 30, 2004, and was primarily the result of net purchases of short-term investments of $11.5 million as well as $2.5 million for the purchase of equipment, leasehold improvements to the facilities we lease and capital improvements to the facilities we own. We expect capital expenditures will be significantly less for all of 2004 as compared to 2003 due primarily to the completion of our chemical development facility. Net cash used in investing activities was approximately $17.6 million during the six months

ended June 30, 2003, and was primarily the result of the purchase of equipment, leasehold improvements to the facilities we lease and capital improvements to the facilities we own totaling $11.6 million, as well as net purchases of short-term-investments of $6.2 million.

Net cash provided by financing activities was $222,000 during the six months ended June 30, 2004, and was primarily attributable to proceeds of $265,000 from the issuance of common stock upon exercise of options, partially offset by $43,000 in principal payments on our capital leases. Net cash provided by financing activities was $29,000 during the six months ended June 30, 2003, and was primarily attributable to proceeds of $295,000 from the issuance of common stock upon exercise of options, partially offset by $266,000 in principal payments on our capital leases.

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 our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States ("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 No. 101, "Revenue Recognition in Financial Statements," which provides guidance on revenue recognition in financial statements, and are based on the interpretations and practices developed by the SEC. Many of our agreements contain multiple elements, including technology access fees, research funding, milestones and royalty obligations.

Revenue from a milestone 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 payment is recognized over the remaining minimum period of our performance obligations under the agreement. We defer non-refundable upfront fees under our collaborations and recognize them over the period the related services are provided, or over the estimated collaboration term 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, as long as the amounts received are not refundable based on the results of the research project. Advance payments we receive in excess of amounts earned are classified as deferred revenue until earned.

In November 2002, the EITF finalized its tentative consensus on EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. Our current collaborations have not been impacted by the adoption of this consensus. We will apply EITF 00-21 to any future collaborations we enter into.

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, Inc. for $15.0 million in cash and assumed $400,000 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, and we will record a future write-down of the carrying value of the technology if we determine that the technology has become impaired or we no longer use this technology internally as our primary screening technology or we will accelerate the amortization if we determine that the technology life has been shortened.

Stock-based compensation. We account for stock options granted to employees and directors using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and

its related interpretations. Pursuant to this method, we measure the intrinsic value of the option on its grant date as the difference between the exercise price of the option and the fair market value of our stock. We then expense the difference, if any, over the vesting period of the option, on an accelerated basis, in accordance with Financial Accounting Standards Board Issued Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."

We have adopted the disclosure-only requirements of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." If we had adopted SFAS No. 123 to recognize an expense for options granted to employees and directors under our stock-based compensation plans, our earnings would have been materially impacted. The impact of this method is disclosed in the notes to the consolidated financial statements included elsewhere in this Quarterly Report.

Options issued to non-employees other than directors are accounted for under the fair value method in accordance with SFAS No. 123 and EITF Issue No. 96-18, "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services." Under the fair value method, compensation cost is measured at the grant date of the option based on the value of the award using the Black-Scholes method. Compensation cost is periodically remeasured as the underlying options vest in accordance with EITF Issue No. 96-18 and is recognized over the service period.

Valuation of our series B convertible preferred stock, and related warrants and unit warrants. In accordance with EITF 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," we allocated the total proceeds received in our financing among the series B convertible preferred stock, the warrants and the unit warrants. We estimated the value of the warrants and unit warrants at $6.5 million using the Black-Scholes method. The fair value of the common shares into which the series B-1 convertible preferred stock was convertible into on the date of issuance exceeded the proceeds allocated to the series B convertible preferred stock by $2.8 million, resulting in a beneficial conversion feature that was recognized as an increase to paid-in-capital and as a deemed dividend to the series B convertible preferred stock. We will record amortization of the value of the warrants, unit warrants and deemed dividend over five years, which will increase the losses allocable to our common stockholders.

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 the 2003 Annual Report which contains accounting policies and other disclosures required by GAAP.

AVAILABLE INFORMATION

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Section 16 reports and our other filings with the SEC, and any amendments to such reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge on our website (www.arenapharm.com) as soon as reasonably practicable after they are filed with, or furnished to, the SEC.

RISK FACTORS

An investment in our stock involves a high degree of risk. Investors evaluating us should carefully consider the factors described below and all other information contained in this prospectus and in our other public filings before making investment decisions regarding our stock. Any of the following factors could materially harm our business, operating results and financial condition. Additional factors and uncertainties not currently known to us or that we currently consider immaterial could also harm our business, operating results and financial condition. Investors could lose all or part of their investment as a result of these factors.

If APD356 fails in clinical trials, we may significantly curtail some of our activities

We initiated our multiple-dose Phase 1 safety study on our internally discovered compound APD356 in July 2004. If APD356 is found to be unsafe in, or not tolerated by, the people we test in our clinical trials, we may not be able to raise new financing or generate significant partnering revenue in the short term. Without such funding, we would need to re-evaluate our strategy of moving multiple drug 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 the breadth of our pipeline would reduce our opportunity for success.

We have a history of losses and expect our losses to continue

We had losses of $29.5 million for the six months ended June 30, 2004, and we had an accumulated deficit of $137.0 million from our inception in April 1997 through June 30, 2004. 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 compounds that could become marketed drugs.

We expect our operating expenses over the next several years will be significant and that we will continue to have significant operating losses in the near-term, even if we or our collaborators are successful in advancing compounds discovered using our technologies.

We will need additional funds in the future for our research and development, and we may not be able to obtain such funds

We cannot sustain our current operating plan for more than approximately two years unless we obtain additional financing from collaborators or investors. In addition, it takes many years and potentially hundreds of millions of dollars to successfully develop a preclinical or early clinical compound into a marketed drug. We currently have substantially less money than we would need to successfully develop such a compound into a marketed drug. Financing may not be available to us or may not be available on terms that you or we believe are favorable.

We do not know whether we can currently license our programs or technologies on terms that would significantly reduce the need for us to obtain additional financing from investors. Our strategy is to continue developing these programs and move them towards or into clinical development so that we can achieve acceptable financial terms with a collaborator or in the capital markets. If our research and development efforts are not successful in the next one or two years, and if we do not receive new financing from investors, we may need to license our programs on financial terms that are unfavorable to us.

Our stock has not performed as well as the stock of many of our peers for some time, and we presently are aware of only a small number of securities analysts covering our stock, which means limited third-party information is available to investors. We believe that institutional and other investors value third-party information in making investment decisions regarding our stock. These factors, and many others, may affect our ability to access capital markets.

If adequate funds are not available to us, we will be required to significantly curtail or eliminate one or more of our drug discovery or development programs, or to completely discontinue our operations.

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. In addition, we believe that the average number of shares of our stock that trade each day is low. As a result, 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.

All of our programs are in the early stage of drug discovery and development, and if problems arise in the testing or approval process, our drug development efforts may be delayed or may not be successful

We are transitioning from primarily a research company to a research and development company. The research and development of new medicines is highly uncertain and subject to significant risks. Our most advanced program, APD356, is in the early stages of drug development. We do not expect any drugs resulting from our research to be commercially available for many years, if ever.

It typically takes many years to conduct preclinical and clinical trials and failure often occurs. Interim results of trials do not assure final results, and acceptable results in early trials may not be repeated in later trials.

In the course of our discovery, preclinical testing and clinical trials, we will rely on third parties, including laboratories, investigators and manufacturers, to perform critical services for us. For example, we are relying on contract clinical sites to conduct our clinical trials. Clinical research organizations will be responsible for many aspects of the trials, including finding and enrolling subjects for testing and administering the testing. These third parties may not be available when we need them or, if they are available, may not perform their services in a timely or acceptable manner. 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 expect any drugs resulting from our collaborators' research and development efforts to be commercially available for many years, if ever.

If we are unable to obtain regulatory approval to develop and market products in the United States and foreign jurisdictions, we will not be able to commercialize products resulting from our research; we may encounter difficulties during our clinical trials

Governmental authorities in the U.S. heavily regulate the testing, development, manufacturing, approval and marketing of drugs. Any compound we are testing may not prove to be safe or effective or meet all of the applicable regulatory requirements. We may elect to, or a regulatory agency may require us to, discontinue development of a compound at any time for scientific, regulatory, commercial or other reasons. These regulations are complex and change from time to time.

Governments in other countries have similar requirements for the testing, development, manufacturing, approval and marketing of drugs, and, as in the U.S., the requirements are complex and change from time to time.

We have filed an investigational new drug application (an "IND") with the FDA, and are conducting our Phase 1b multi-dose clinical trial for APD356 in the U.S.

Completion of clinical trials may take several years and failure may occur at any stage of testing. The length of time required varies substantially according to the type, complexity and intended use of the product candidate. Interim results of a preclinical study or clinical trial do not necessarily predict final results, and acceptable results in early trials may not be repeated in later trials. For example, a drug candidate that is successful at the preclinical level may cause harmful or dangerous side effects when tested at the clinical level. Our rate of commencement and completion of clinical trials may be delayed by many factors, including:

- our inability to manufacture sufficient quantities of materials for use in clinical trials;
- variability in the number and types of subjects available for each study;
- difficulty in maintaining contact with subjects after treatment, resulting in incomplete data;

- unforeseen safety issues or side effects;
- poor or unanticipated lack of effectiveness of products during the clinical trials; or

- regulatory delays.

Data obtained from the clinical trials are susceptible to varying interpretation, which may delay, limit or prevent regulatory approval. A number of companies in the pharmaceutical industry, including biotechnology companies, have suffered significant setbacks in advanced clinical trials, even after achieving promising results in earlier trials. In addition, regulatory authorities may refuse or delay approval as a result of other factors, such as changes in regulatory policy during the period of product development and regulatory agency review.

Satisfaction of regulatory requirements for marketing approval typically takes many years. To obtain regulatory approval, we must first show that our drug products are safe and effective for target indications through preclinical studies and clinical trials. Preclinical testing and clinical development are long, expensive and uncertain processes, and we do not know whether the FDA or its foreign counterparts will allow us to undertake clinical trials of any potential drug products.

Because, in part, of the early stage of our drug candidate research and development process, we cannot predict whether or not regulatory approval will be obtained for any product we develop. At the present time, only one of our drug candidates, APD356, is undergoing clinical trials. Compounds developed by us, alone or with other parties, may not prove to be safe and effective in clinical trials and may not meet all of the applicable regulatory requirements needed to receive marketing approval. If regulatory approval of a product is granted, this approval will be limited to those disease states and conditions for which the product is demonstrated through clinical trials to be safe and effective. Failure to obtain regulatory approval would delay or prevent us from commercializing products.

These risks also apply to the development activities of our collaborators, and we do not expect any drugs resulting from our collaborators' research and development efforts to be commercially available for many years, if ever.

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 and Chief Executive Officer, 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 is planning on leaving, retiring or otherwise disassociating with us in the near future.

Our revenues are contingent upon the actions of our existing and potential collaborators

Our revenues depend on our ability to enter into new collaborative and license agreements and the success of our existing collaborations. We will receive little revenue under our existing agreements if our own or our collaborators' research, development or, ultimately, marketing efforts are unsuccessful, or if our agreements are terminated early. Typically, our collaborators (and not us) control the development of compounds into drugs after we have met early preclinical scientific milestones, and we are not entitled to the more significant milestone payments under our agreements until our collaborators have advanced compounds into clinical testing, which may not occur for many years, if ever.

For the six months ended June 30, 2004, revenues recognized under our collaboration with Merck represented approximately 94% of our total revenues. Absent any new collaborations, we expect substantially all of our revenues for the remaining six months of 2004 will be derived from our collaboration with Merck. Our revenues will be materially impacted if:

- Merck terminates its agreement with us;
- Our collaborators do not devote their time and financial resources to develop compounds identified with our technologies;
- Our collaborators dispute whether we have achieved a milestone, rights to a particular receptor or compound, or other terms of our agreements;
- Collaborators and potential collaborators use alternative technologies to our technologies and compete with us in developing drugs; and
- Our collaborators experience failures in the discovery or development of compounds identified with our technologies

or in the clinic or marketplace with other drugs that cause them to discontinue or slow down progress under our collaboration.

The term of the collaborative research program with Merck is three years from October 21, 2002. Merck can terminate this program for any of the following reasons: (i) without cause, at any time on or after October 21, 2004, by giving notice at least 90 days prior to such termination date, if certain milestones have been achieved and paid; (ii) without cause, at any time after October 21, 2004, by giving 180 days prior notice; (iii) for certain technical grounds (including if the GPCRs that the subject of the collaboration are scientifically shown to be unsuitable targets for drug development or valid third-party patent rights block the achievement of significant program goals) by giving 30 days prior notice; and (iv) in the event of a change in control of Arena, by giving 30 days prior notice. Merck can also terminate the agreement without any reason at any time after October 21, 2005. Either party can terminate the agreement at any time for cause if the other party breaches its material obligations under the agreement by causes and reasons within its control, has not cured such breach and there is no dispute as to whether such breach has occurred. Additionally, in lieu of terminating the agreement, Merck can terminate certain aspects of the agreement

by giving 90 days prior notice if we materially breach our obligations at any time during the period from October 21, 2002, to October 21, 2005 (or such earlier date of termination) and fail to cure such breach, if such default can be cured but not within a certain period, or if we do not commence and diligently continue good faith efforts to cure such default during such period. In the event of any such termination, our revenues would be materially adversely affected.

Consolidation in our industry and our or our collaborator's inability to obtain acceptable prices for drugs could make partnering more difficult and diminish our revenues

Consolidation in the pharmaceutical and biotechnology industry and setbacks caused by competition from generic drugs and litigation may have an adverse effect on us. In addition to the number of potential partners being reduced, pharmaceutical companies may be less willing to enter into a new collaboration with us during a time they are integrating a new operation as a result of a merger or acquisition, their therapeutic areas of focus may change following a merger, or they may have reduced research budgets as a result of some financial setback.

In addition, our and our collaborators' ability to commercialize future drugs will depend in part on government regulation and the reimbursement policies of government authorities, private health insurers and other third party payors. Government and third party payors are increasingly attempting to contain healthcare costs by limiting coverage and reimbursement levels for new drugs. These efforts may limit our commercial opportunity now by reducing the amount a potential collaborator is willing to pay to license our programs and in the future by reducing the revenues that we and our collaborators could generate from drug sales.

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 success depends, in part, on our ability to operate 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 our drug discovery and development programs that could be determined to be similar, identical or superior to ours or our licensors or collaborators. Our activities, or those of our licensors or collaborators, could be determined to infringe these patents.

Although the government sponsored project to sequence the human genome has made genomics information freely available to the public, other organizations, companies and individuals are seeking proprietary positions on genomics information that overlap with the government sponsored project. 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 be significant litigation and other administrative proceedings in our industry regarding patent and other intellectual property rights. Any legal 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 products, 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.

Others contact us from time to time notifying us regarding their intellectual property rights, sometime asserting that we may need a license to use their technologies. No person is pursuing infringement proceedings against us that we believe will have a material adverse impact on our activities.

In addition, third parties 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 third parties.

Drug discovery and development is an intensely competitive business that could render our technologies obsolete or noncompetitive

The main focus of our efforts are G protein-coupled receptors, or GPCRs. Because GPCRs are an important target class for drug discovery efforts, we believe that most pharmaceutical companies and many biotechnology companies and other organizations, have internal drug discovery programs focused on GPCRs. Another company, organization or individual could have, or could develop, a technology using GPCRs to discover and develop compounds into drugs more effectively or more 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.

Many of the drugs that we or our collaborators are attempting to discover and develop would compete with existing therapies. In addition, many companies are pursuing the development of drugs that target the same diseases and conditions that we are targeting such as metabolic diseases, cardiovascular diseases, central nervous system disorders and inflammatory diseases. Our competitors, or even our collaborators, may use discovery technologies and techniques to develop compounds into drugs more efficiently or successfully than we or our collaborators are able to do with our technologies. Many of our competitors, particularly large pharmaceutical companies, have substantially greater research and development 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 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 products or therapies.

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

A patent gives the patent owner the exclusive right to exclude others from making, using, importing, selling and offering for sale the patented invention. Our success will depend on our own and on our collaborators' abilities to obtain, secure and defend patents. In particular, the patents directed to compounds discovered using our technologies are important to commercializing drugs. We have numerous United States and foreign patent applications pending for our technologies, including patent applications on drug lead discovery techniques using CART, genetically altered GPCRs, GPCRs that we have discovered, new uses for previously discovered GPCRs, compounds discovered using CART and Melanophore and other technologies. 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 legal issues. Consequently, we expect that the analysis of our patent applications will be complex and time consuming. Therefore, our patent position is very uncertain and we do not know when, or if, we will obtain additional patents for our technologies.

In March 2003, we became aware that the Japanese Patent Office had issued a Notification of Reasons for Revocation of our Japanese patent on our Melanophore technology based on the alleged obviousness and lack of enablement. In subsequent proceedings, the Japanese Patent Office has dropped its lack of enablement argument and has focused on obviousness. We are currently defending the non-obviousness of this patent. If we were to lose our opposition before the Japanese Patent Office, it might adversely affect our ability to enter into new drug discovery partnerships with Japanese companies that focus on the Melanophore technology.

As of July 23, 2004, we own, in part or in whole, or have exclusively licensed the following patents: 13 in the United States, 11 in European countries, six in Australia, and three in New Zealand. In addition, as of July 23, 2004, we have approximately

203 patent applications before the United States Patent and Trademark Office, foreign patent offices and international patent authorities. These patents and patent applications are divided into 59 distinct families of related patents that are directed to CART, Melanophore technology, other novel screening methods, chemical compositions of matter, methods of treatment using chemical compositions, or GPCR genes. One of our patent families was exclusively in-licensed and contains a single issued patent. Eight of our patent families containing a total of six patents and 27 patent applications were the subject of joint inventions by our employees and the employees of other entities. The remaining 50 patent families containing a total of 26 patents and 176 patent applications were invented solely by our employees. There is no assurance that any of these patent applications will issue, or that any of the patents will be enforceable or will cover a drug product or other commercially significant product or method. Our most advanced compounds, including APD356, are the subject of patent applications and not patents.

Except for the United States patents relating to our Melanophore technology, the term of all of our other current patents commenced, and our future patents, if any, will commence, on the date of issuance and terminate 20 years from the earliest effective filing date of the patent application. Since our United States Melanophore patents were issued under now superceded rules that provided a patent term of 17 years from the date of issuance, the term of these patents are scheduled to end in 2012, more than 21 years after their earliest filing date. Because the time from filing to issuance of biotechnology patent applications is often more than three years, the resulting term of our pending patent applications, if any, on our products and technologies may be substantially less than 20 years. In the United States, patent term extensions are available for certain delays in patent office proceedings and United States Food and Drug Administration ("FDA") approval. However, due to the specific requirements for obtaining these extensions, there is no assurance that our patents will be afforded extensions even if we encounter significant delays in patent office proceedings or FDA approval.

Our rights in our federally registered marks, including "Arena Pharmaceuticals," "Arena" and our corporate logo, can last indefinitely if we continue to use the mark on or in connection with the goods and/or services in the registration and file all necessary documentation in the United States Patent and Trademark Office at the appropriate times. Our rights in our other marks, such as "CART" and "BRL Screening", can last indefinitely under state law.

In 2000, the United States Patent and Trademark Office began issuing broad patent claims that could allow patent holders to control the use of all drug products that modulate a particular drug target or GPCR, regardless of whether the infringing drug product bears any structural resemblance to a chemical compound known to the patent holder at the time of patent filing. The question of whether these new patent claims are valid and if so under what circumstances is highly controversial and the subject of intense litigation. Whether we or our competitors are able to obtain and enforce such patent claims particularly as they apply to the GPCRs that are the subject of our drug development activities may have a large impact on our profits from any drugs that we are able to develop. Moreover, the uncertainty surrounding the validity of these patent claims may make it significantly more difficult to predict future profits and to raise additional financing.

More consistent policies regarding the breadth of claims allowed in biotechnology patents have begun to emerge in the last few years. For example, on January 5, 2001, the United States Patent and Trademark Office issued finalized Utility Examination Guidelines to its patent examiners that focus on what can be patented under United States patent law. These guidelines are beginning to be implemented in a more consistent fashion and primarily impact the procedures that are used in determining the types of inventions that can be patented and the minimum threshold of information necessary to patent inventions in the fields of biotechnology and chemistry. We still do not completely know to what extent these guidelines will ultimately affect our patents or those of our competitors and collaborators.

We also rely on trade secrets to protect our technologies. However, trade secrets are difficult to protect. We require all of our employees to contractually agree not to improperly use our trade secrets or disclose them to others, but we may be unable to determine if our employees have conformed or will conform with their legal obligations under these agreements. We also require collaborators and consultants to enter into confidentiality agreements, 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.

Technology licensed to us by others, or in-licensed technology, is important to some aspects of our business. With a few exceptions, we generally do not control the patent prosecution, maintenance or enforcement of in-licensed technology. Accordingly, we are unable to exercise the same degree of control over in-licensed technology as we do over our internally developed technologies. Moreover, some of our academic institution licensors, research collaborators and scientific advisors have rights to publish data and information to which we have rights. If we cannot maintain the confidentiality of our

technologies and other confidential information in connection with our collaborations, then our ability to receive patent protection or protect our proprietary information will be impaired.

We have entered into collaborations with several commercial and academic entities, and 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. As a general matter, all of our consulting agreements require consultants to maintain the secrecy of our confidential information.

We cannot protect our intellectual property rights throughout the world

Filing patents on all of our drug discovery technologies throughout the world would be prohibitively expensive. Competitors may use our technologies in jurisdictions where we have not obtained patent protection to develop their own drug products. These products may compete with our products and may not be covered by any of our patent claims or other intellectual property rights.

Patent law outside the United States is also uncertain and in many countries is currently undergoing review and revision, particularly with respect to biotechnology-related and pharmaceutical inventions. The laws of some countries do not protect our intellectual property rights to the same extent as United States laws. It may be necessary or useful for us to participate in proceedings to determine the validity of our, or our competitors', foreign patents, which could result in substantial cost and divert our efforts and attention from other aspects of our business.

We may encounter significant delays or problems with our new chemical development facility

We have a chemical development facility that we are using for process research, the scale-up and production of intermediates and other compounds for research and development purposes, and the production of active pharmaceutical ingredients.

We are completing the activities in our chemical development facility to manufacture Active Pharmaceutical Ingredients ("API") in accordance with U.S. current good manufacturing practices ("cGMP"), European and other regulatory requirements. In addition, drug-manufacturing facilities in the state of California must be inspected and licensed by the California Department of Health and Human Services in compliance with state regulatory requirements. California law prohibits the shipment of product from a manufacturing facility for any clinical testing or commercial use prior to satisfaction of licensing requirements. There is no assurance that we will obtain a license, or obtain it in a timely manner.

We may encounter delays and problems in operating our chemical development facility due to:

- governmental approvals, permits and regulation of the facility;
- accidents during operation of the facility;
- installation of equipment for the facility;
- delays in receiving raw materials from suppliers;
- natural or other disasters; or
- other factors inherent in operating a complex manufacturing facility.

Even if we are able to successfully commence full operation of our chemical development facility, we may not be able to do so in a cost-effective manner or in a time frame that is consistent with our expected future manufacturing needs. In addition, our future manufacturing needs may not be sufficient to allow the facility to be fully operational.

Our quarterly operating results may fluctuate and may cause our stock price to decline

Our revenues and results of operations may fluctuate significantly from quarter to quarter, depending on a variety of factors, including:

- our success or failure in clinical trials;

- the timing of the discovery of drug leads and the development of drug candidates, if any;
- entering into a new collaboration or modifying or terminating an existing collaboration;
- the timing and receipt by us of milestone and royalty payments, if any;
- changes in the research and development budgets of our existing collaborators or potential collaborators;
- others introducing new drug discovery techniques or new drugs that target the same diseases and conditions that we or our collaborators target;
- regulatory actions;
- changes in accounting principles generally accepted in the United States; and

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

We are not able to control all of these factors. Period-to-period comparisons of our financial results are not necessarily indicative of our future performance. If our revenues or results of operations in a particular period do not meet stockholders' or analysts' expectations, our stock price may decline and such decline could be significant.

Our stock price has fluctuated historically. From January 1, 2002, through December 31, 2003, the market price of our stock was as low as $5.20 per share and as high as $12.79 per share. From January 1, 2004, to July 31, 2004, the market price of our stock was as low as $3.83 per share and as high as $7.10 per share.

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

There were 25,593,274 shares of our common stock outstanding as of June 30, 2004. The outstanding shares of our Series B-1 Convertible Preferred Stock are convertible into up to 4,764,849 shares of common stock at $7.50 per share of common stock. Holders of the Series B-1 Convertible Preferred Stock will 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-1 Convertible Preferred Stock. In addition, our Series B-1 Convertible Preferred Stock owners hold warrants to acquire common stock and unit warrants to acquire Series B-2 Convertible Preferred Stock and additional warrants to acquire common stock, which, if exercised and converted, would obligate us to issue up to 3,579,057 additional shares of common stock at a weighted average exercise price of $8.62 per share. In addition, as of June 30, 2004, there were 2,852,841 common stock options issued and outstanding under our equity compensation plans at a weighted average exercise price of $9.14, 1,502,941 additional shares of common stock issuable under our equity compensation plans, 744,515 shares of common stock reserved for issuance under our 2001 Employee Stock Purchase Plan and 97,501 shares issuable under a 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 fall 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 result in the market price of our common stock declining.

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.

Provisions of our Series B Convertible Preferred Stock may prevent or make it more difficult for us to raise funds or

take certain other actions

In December 2003, we completed the private placement to two institutional investors of (i) an aggregate of 3,500 shares of our Series B-1 Convertible Preferred Stock, (ii) seven-year warrants to purchase up to an aggregate of 1,486,200 shares of our common stock at an exercise price of $10.00 per share and (iii) unit warrants to purchase for a period of approximately 16 months up to $11,500,000 of our Series B-2 Convertible Preferred Stock and additional seven-year warrants to purchase up to 450,000 shares of our common stock at an exercise price of $10.00 per share. Provisions of the Series B Convertible Preferred Stock may 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 underwritten offerings, licensing transactions 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 Convertible Preferred Stock in terms of dividends, redemption or distribution of assets, (vi) use more than $25 million in cash for acquisitions or (vii) 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.

Holders of our Series B Convertible Preferred Stock may require us to redeem their Series B Convertible Preferred Stock, and we will be required to redeem any shares of Series B Convertible Preferred Stock that remain outstanding on the fifth anniversary of their issuance

If (i) following the 21st month anniversary of the original issue date of the applicable series of Series B Convertible Preferred Stock, the closing price of our common stock for any 30 consecutive trading days is below the applicable conversion price for the Series B Convertible Preferred Stock or (ii) we issue common stock or common stock equivalents (excluding, among other things, certain common stock and common stock equivalents issued or issuable (a) to our officers, directors, employees or consultants, (b) in connection with certain strategic partnerships or joint ventures, (c) pursuant to certain underwritten public offerings with gross proceeds of greater than $35.0 million, and (d) in connection with certain mergers and acquisitions) for less than $6.72, in the case of the Series B-1 Convertible Preferred Stock, or a price to be determined based on a formula, in the case of Series B-2 Convertible Preferred Stock, then in each case the holders of the Series B Convertible Preferred Stock may require us to redeem their shares of the applicable series of Series B Convertible Preferred Stock at a price equal to the amount of the original holder's original investment, plus all accrued but unpaid dividends thereon to the date of payment and any applicable penalties. In addition, we will be required to redeem any shares of the Series B Convertible Preferred Stock that remain outstanding on the fifth anniversary of their issuance at a price equal to the amount of the original holder's original investment, plus all accrued but unpaid dividends thereon to the date of such payment. We can elect to pay the redemption price in shares of our common stock if (i) we have sufficient number of shares of common stock available for issuance, (ii) the shares of common stock to be issued are registered under an effective registration statement, (iii) our common stock is listed on NASDAQ or other eligible market, (iv) the shares to be issued can be issued without violating the rules of NASDAQ or any applicable trading market or a provision of our agreement with the holders, (v) no bankruptcy event has occurred, and (vi) certain other enumerated conditions.

There can be no assurance that we will not have to redeem the Series B Convertible Preferred Stock, or, if we do have to redeem the stock, that we will be able to pay the redemption price using shares of our common stock. If we use common stock to redeem the Series B Convertible Preferred Stock, your ownership interest may be significantly diluted. If we are required or elect to redeem shares of the Series B Convertible Preferred Stock 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 would likely 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.

We may engage in strategic transactions that could impact our liquidity

From time to time we consider strategic transactions, such as acquisitions of companies, asset purchases and out-licensing or in-licensing compounds developed by us or others. These additional potential transactions may include a variety of different business arrangements, including spin-offs, acquisitions, 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 or disrupt our management or business, which could harm our operations and financial results.

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 plan, dated as of October 30, 2002, between us and Computershare Trust Company, Inc., as Rights Agent, as amended on December 24, 2003 (the "Rights Agreement"). The Rights Agreement is not intended to prevent an acquisition of us at a full and fair price. Rather, it is intended to deter an attempt to acquire us in a manner or on terms not approved by our board of directors, and will cause substantial dilution to any person who attempts to acquire us in a manner or on terms not so approved.

The Certificate of Designations for the Series B Convertible Preferred Stock provides that the Series B Convertible Preferred Stock holders are entitled to receive a premium in the event of a change of control. The Series B Convertible Preferred Stock holders have also agreed to vote as recommended by our board of directors on all matters in which the common stockholders have the right to vote.

The Rights Agreement and Certificate of Designations for the Series B Convertible Preferred Stock, as well as other provisions in our certificate of incorporation and by-laws 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. 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.

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 hazardous materials, chemicals and various radioactive compounds that could be hazardous to human health, 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:

- an interruption of our research and development efforts;
- injury to our employees and others resulting in the payment of damages;
- environmental damage resulting in costly clean up; or
- 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 could be held liable for any resulting damages, and any such liability could exceed our resources. Although we believe that we carry insurance in amounts and type that we consider commercially reasonable, we do not have insurance coverage for losses relating to an interruption of our research and development efforts caused by contamination and we cannot be certain that the coverage or coverage limits of our insurance policies will be adequate.

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

We depend on our collaborators, contractors and vendors and on our laboratories and other facilities 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 reasonably adequate 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.

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 with high credit quality institutions, (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 approximately three years with no one instrument having a duration exceeding five years. 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 held 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 held 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 downwards 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 June 30, 2004, we would expect future interest income from our portfolio to decline by less than $1.3 million over the next 12 months. As of December 31, 2003, our estimate for the effect of this same hypothetical reduction in interest rates was a decline in interest income of less than $1.5 million.

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. The hypothetical changes and assumptions are likely to be different from what actually occurs in the future. Furthermore, the computations do not incorporate actions our management could take if the hypothetical interest rate changes actually occur. As a result, actual earnings consequences will likely differ from those quantified herein.

Item 4. Controls and Procedures

Evaluation of Disclosure 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 (“CEO”) and Vice President, Finance (“VP, Finance”), our CEO and VP, Finance have concluded that, as of the end of such period, our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders

The annual meeting of our stockholders was held on June 11, 2004, for the purpose of (i) electing directors to hold office until the next annual meeting of stockholders or until their respective successors have been elected or appointed and (ii) ratifying the appointment of Ernst & Young LLP as our independent registered public accounting firm. Proxies for the meeting were solicited pursuant to Section 14(a) of the Securities Exchange Act of 1934 and there was no solicitation in opposition to the director nominees. Jack Lief, Dominic P. Behan, Ph.D., Donald D. Belcher, Scott H. Bice, Duke K. Bristow, Ph.D., J. Clayburn La Force, Jr., Ph.D., and Robert L. Toms, Sr. were elected as directors to our Board of Directors. Derek T. Chalmers, Ph.D. did not stand for reelection. The votes cast by proxy or in person with respect to the election of directors, as determined by the final report of the inspectors, are set forth below. There were no broker non-votes with respect to any director nominee.

Director Nominee	“FOR”	“WITHHELD”
Jack Lief	23,560,862	2,960,250
Dominic P. Behan, Ph.D.	23,630,239	2,890,873
Donald D. Belcher	23,590,232	2,930,880
Scott H. Bice	23,545,488	2,975,624
Duke K. Bristow, Ph.D.	23,555,372	2,965,740
J. Clayburn La Force, Jr., Ph.D.	23,592,346	2,928,766
Robert L. Toms, Sr.	23,550,082	2,971,030

Stockholders ratified the selection of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2004, and the voting results, as determined by the final report of the inspectors, are set forth below.

23,613,053	Votes for approval
2,906,106	Votes against approval
1,953	Abstensions

There were no broker non-votes with respect to this matter.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

EXHIBIT	DESCRIPTION

NO.	
3.1	Fifth Amended and Restated Certificate of Incorporation of Arena Pharmaceuticals, Inc. (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	Amended and Restated By-Laws of Arena (incorporated by reference to Exhibit 3.2 to Arena's report on Form 8-K filed with the Securities and Exchange Commission on January 21, 2003, Commission File No. 000-31161)
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 September 30, 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 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
31.1	Section 302 Certification by Arena's chief executive officer
31.2	Section 302 Certification by Arena's principal financial officer
32.1	Section 906 Certification by Arena's chief executive officer and principal financial officer

(b) Reports on Form 8-K

On April 21, 2004, we filed a Current Report on Form 8-K under Item 7 - Financial Statements and Exhibits and Item 12 - Results of Operations and Financial Condition, reporting that, on April 20, 2004, we issued a press release announcing our financial results for the first quarter of 2004. A copy of the press release is attached as Exhibit 99.1 to the Form 8-K.

On June 8, 2004, we filed a Current Report on Form 8-K under Item 5 - Other Events, reporting that Nigel R.A. Beeley, Ph.D. resigned as our Vice President and head of medicinal chemistry to join Senomyx, Inc., a San Diego based biotechnology company, as Vice President, Discovery.

On June 14, 2004, we filed a Current Report on Form 8-K under Item 5 - Other Events, reporting that Jack Lief, Dominic P. Behan, Ph.D., Donald D. Belcher, Scott H. Bice, Duke K. Bristow, Ph.D., J. Clayburn La Force, Jr., Ph.D., and Robert L. Toms, Sr. were elected as directors to our Board of Directors at our 2004 Annual Meeting of Stockholders on June 11, 2004; Derek T. Chalmers, Ph.D. decided to not stand for reelection to focus his attention on his new venture as the chief executive officer of a start-up biotechnology company; and that the stockholders ratified the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending 2004.

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: August 5, 2004

ARENA PHARMACEUTICALS, INC.

By: /s/ Jack Lief
Jack Lief
President and Chief Executive Officer

By: /s/ Robert E. Hoffman
Robert E. Hoffman, CPA
Vice President, Finance and Chief Accounting Officer

EXHIBIT INDEX

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32.1	Section 906 certification by Arena's chief executive officer and principal financial officer

Exhibit 31.1

CERTIFICATION

I, Jack Lief, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arena Pharmaceuticals, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and

   c) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2004

/s/ Jack Lief
Jack Lief
President and Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Robert E. Hoffman, CPA, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arena Pharmaceuticals, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and

   c) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2004

/s/ Robert E. Hoffman
Robert E. Hoffman, CPA
VP, Finance and Chief Accounting Officer

Exhibit 32.1

CERTIFICATION OF CEO AND CFO PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Arena Pharmaceuticals, Inc. (the "Company") for the period ended June 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Jack Lief, as President and Chief Executive Officer of the Company, and Robert E. Hoffman, as Vice President, Finance and principal financial and accounting officer of the Company, each hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Jack Lief	/s/ Robert E. Hoffman
Jack Lief	Robert E. Hoffman
President and Chief Executive Officer	VP, Finance (principal financial and accounting officer)
Date: August 5, 2004	Date: August 5, 2004