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

FORM 10-Q

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

For the quarterly period ended September 30, 2005

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

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

Yes o No ☒

The number of shares of common stock outstanding as of the close of business on October 31, 2005:

Class	Number of Shares Outstanding
Common Stock, $0.0001 par value	35,387,800

ARENA PHARMACEUTICALS, INC.

INDEX

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

	September 30, 2005 (unaudited)	December 31, 2004 (note)
Assets		
Current assets:		
Cash and cash equivalents	$ 68,226,537	$ 58,686,129
Short-term investments, available-for-sale	79,891,936	54,627,710
Accounts receivable	1,502,192	22,590,323
Prepaid expenses and other current assets	4,131,974	5,331,799
Total current assets	153,752,639	141,235,961
Land, property and equipment, net	50,457,738	52,994,209
Acquired technology, net	8,333,469	9,486,216
Other non-current assets	5,888,965	2,648,609
Total assets	$ 218,432,811	$ 206,364,995
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 8,673,754	$ 4,988,586
Accrued compensation	1,097,007	1,300,371
Current portion of deferred revenues	15,151,507	11,497,209
Redeemable convertible preferred stock	37,571,594	—
Total current liabilities	62,493,862	17,786,166
Deferred rent	913,725	931,310
Deferred revenues, less current portion	11,387,303	18,572,979
Financing obligation, including deferred interest	13,428,944	13,259,326
Commitments		
Redeemable convertible preferred stock	11,705,976	29,092,228
Stockholders' equity:		
Common stock	3,851	2,972
Additional paid-in capital	368,391,848	319,539,956
Treasury stock	(23,070,000)	(23,070,000)
Accumulated other comprehensive loss	(16,735)	(163,455)
Deferred compensation	(483,389)	(779,972)
Accumulated deficit	(226,322,574)	(168,806,515)
Total stockholders' equity	118,503,001	126,722,986
Total liabilities and stockholders' equity	$ 218,432,811	$ 206,364,995

See accompanying notes to unaudited condensed consolidated financial statements.

Note: The balance sheet at December 31, 2004, has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by U.S generally accepted accounting principles for complete financial statements.

Arena Pharmaceuticals, Inc.
Condensed Consolidated Statements of Operations
(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Revenues:				
Total revenues	$ 7,431,887	$ 4,383,332	$ 17,356,879	$ 11,565,000
Expenses:				
Research and development	20,820,915	13,874,772	58,760,870	42,055,010
General and administrative	2,558,556	2,639,117	8,210,171	7,610,225
Amortization of deferred compensation	87,515	283,079	350,824	1,167,378
Amortization of acquired technology	384,249	405,305	1,152,747	1,215,915
Total operating expenses	23,851,235	17,202,273	68,474,612	52,048,528
Loss from operations	(16,419,348)	(12,818,941)	(51,117,733)	(40,483,528)
Interest income and other, net	781,931	19,561	2,287,016	(143,808)
Net loss	(15,637,417)	(12,799,380)	(48,830,717)	(40,627,336)
Dividends on redeemable convertible preferred stock	(494,303)	(362,104)	(1,313,328)	(1,071,612)
Accretion of discount related to redeemable convertible preferred stock	—	(462,970)	(7,372,014)	(1,388,912)
Net loss allocable to common stockholders	$ (16,131,720)	$ (13,624,454)	$ (57,516,059)	$ (43,087,860)
Net loss per share allocable to common stockholders, basic and diluted	$ (0.46)	$ (0.54)	$ (1.69)	$ (1.70)
Shares used in calculating net loss per share allocable to common stockholders, basic and diluted	35,241,050	25,362,644	34,064,695	25,313,716

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Nine months ended September 30,	
	2005	2004
Operating Activities		
Net loss	$ (48,830,717)	$ (40,627,336)
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation and amortization	5,140,852	5,254,271
Equity in losses of TaiGen	—	775,600
Amortization of acquired technology	1,152,747	1,215,915
Amortization of deferred compensation	350,824	1,167,378
Amortization/accretion of short-term investment premium/discount	334,686	1,017,077
Deferred rent	(17,585)	(467)
Deferred interest expense	169,618	194,494
Loss (gain) on disposal of equipment	16,629	(3,021)
Changes in operating assets and liabilities:		
Accounts receivable	21,088,131	18,037
Prepaid expenses and other current assets	1,199,825	27,973
Deferred revenues	(7,101,780)	(1,821,741)
Accounts payable and accrued expenses	3,481,804	1,929,050
Net cash used in operating activities	(23,014,966)	(30,852,770)
Investing Activities		
Purchases of short-term investments, available-for-sale	(98,487,862)	(95,314,008)
Proceeds from sales/maturities of short-term investments	73,035,670	131,274,753
Purchases of land, property and equipment	(2,698,183)	(3,162,581)
Proceeds from sale of equipment	77,173	8,015
Deposits, restricted cash and other assets	330,047	(137,563)
Net cash provided by (used in) investing activities	(27,743,155)	32,668,616
Financing Activities		
Principal payments under capital lease obligations	—	(43,874)
Proceeds from issuance of redeemable convertible preferred stock and warrants	11,500,000	—
Proceeds from issuance of common stock	48,798,529	378,140
Net cash provided by financing activities	60,298,529	334,266

Net increase in cash and cash equivalents	9,540,408	2,150,112
Cash and cash equivalents at beginning of period	58,686,129	60,471,856
Cash and cash equivalents at end of period	$ 68,226,537	$ 62,621,968

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, 2004, as filed with the Securities and Exchange Commission ("SEC"). The accompanying financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for complete financial statements. The accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

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

2. Net Loss Per Share

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

The Company has excluded all outstanding stock options, preferred stock, warrants and shares subject to repurchase or forfeiture from the calculation of diluted loss per common share 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 basic and diluted net loss per share allocable to common stockholders was 215,498 for the three and nine month periods ended September 30, 2005, and 350,332 for the three and nine month periods ended September 30, 2004. 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

In accordance with SFAS 130, "Reporting Comprehensive Loss," all components of comprehensive loss, including net loss, are reported in the financial statements in the period in which they are recognized. Comprehensive loss is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Below is a reconciliation of net loss to comprehensive loss for all periods presented.

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net loss	$ (15,637,417)	$ (12,799,380)	$ (48,830,717)	$ (40,627,336)
Unrealized gain (loss) on available-for-sale securities and other investments	38,050	444,383	146,720	(609,488)
Comprehensive loss	$ (15,599,367)	$ (12,354,997)	$ (48,683,997)	$ (41,236,824)

4. Stock-based Compensation

The Company accounts for stock-based compensation in accordance with the provisions of Accounting Principles Board ("APB") 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 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 is recorded as deferred compensation. For stock options granted to its employees and directors, the Company has adopted the disclosure-only requirements of SFAS 123, "Accounting for Stock-Based Compensation," which allows 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 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 96-18.

The Company recorded amortization of deferred compensation expense of approximately $351,000 and $1.2 million during the nine months ended September 30, 2005 and 2004, respectively. The Company expects that charges to be recognized from amortization of deferred compensation related to equity grants will be $88,000 for the remaining three months of 2005.

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS 123R, "Share-Based Payment," which will become effective for the Company in January 2006. This statement replaces SFAS 123, supersedes APB 25, and amends FASB Statement No. 95, "Statement of Cash Flows." SFAS 123R eliminates the ability to account for share-based compensation using the intrinsic value method allowed under APB 25 and will require the Company to recognize share-based compensation as compensation expense in the statement of operations based on the fair values of such equity on the date of the grant. The compensation expense will be recognized over the period in which the recipient is required to provide service in exchange for the equity award. The Company has begun, but has not completed, evaluating the impact of the adoption of SFAS 123R on its results of operations.

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 September 30, 2005, a total of 134,169 shares of restricted stock were included in the plan.

The following pro forma information regarding net loss allocable to common stockholders and net loss per share allocable to common stockholders has been determined as if the Company had accounted for its employee and director stock options and stock issued under the employee stock purchase plan under the fair value method prescribed by SFAS 123. The fair value of options was estimated at the date of grant using a Black-Scholes option valuation model.

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net loss allocable to common stockholders, as reported	$ (16,131,720)	$ (13,624,454)	$ (57,516,059)	$ (43,087,860)
Add: Stock-based employee compensation expense included in net loss allocable to common stockholders, as reported, net of related tax effects	87,515	283,079	350,824	1,167,378
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(855,598)	(1,418,473)	(3,350,696)	(4,713,344)
Pro forma net loss allocable to common stockholders	$ (16,899,803)	$ (14,759,848)	$ (60,515,931)	$ (46,633,826)
Net loss per share allocable to common stockholders:				
Basic and diluted — as reported	$ (0.46)	$ (0.54)	$ (1.69)	$ (1.70)
Basic and diluted — pro forma	$ (0.48)	$ (0.58)	$ (1.78)	$ (1.84)

The effects of applying pro forma disclosure of SFAS 123 may not be representative of the effect on reported net income or loss for future years.

The Black-Scholes option pricing model is widely used to estimate the value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models such as Black-Scholes require the input of highly subjective assumptions, including the expected stock price volatility and expected life of the stock option. The Company is responsible for determining the assumptions for the expected stock volatility and expected life of its stock options used in estimating the fair value of those options. Because the Company's employee stock options have characteristics significantly different from those of traded options and changes in the subjective input assumptions can materially affect the estimated value, in management's opinion, the Black-Scholes pricing model may not provide a reliable measure of the fair value of the Company's employee stock options. The Company is currently evaluating other valuation methods.

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

In accordance with SFAS 115, "Accounting for Certain Debt and Equity Securities," short-term investments are classified as available-for-sale. The Company defines short-term investments as income-yielding securities that can be readily converted to cash. These securities are carried at fair value, with unrealized gains and losses reported as accumulated other comprehensive income or loss. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income. Realized gains and losses and declines in securities judged to be other than temporary are included in other income or expense. The cost of securities sold is based on the specific identification method. Interest and dividends on available-for-sale securities are included in interest income. Investments held as of September 30, 2005, consist primarily of U.S. Federal agency notes and U.S. corporate debt 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 quality financial institutions and, in accordance with the Company's investment policy, in debt instruments that are rated investment grade.

The Company's revenues were derived from one or two collaborators for the periods presented. The percentages of total revenues from each of the Company's significant collaborations are as follows:

	Three months ended September 30,		Nine months ended September 30,	
Collaborations	2005	2004	2005	2004
Merck & Co., Inc.	53.2%	100.0%	45.3%	96.4%
Ortho-McNeil Pharmaceutical, Inc.	46.8%	—%	54.7%	—%

7. Redeemable Convertible Preferred Stock

The holders of the Company's Series B-1 Convertible Preferred Stock (the "Series B-1 Preferred") can require the Company to redeem all or some of their shares of the Series B-1 Preferred at such shares' stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. The stated value is the original holder's investment plus any dividends settled by increasing the stated value at the time the dividend is payable. The aggregate redemption price of the Series B-1 Preferred at September 30, 2005, was approximately $37.6 million, and accrues interest at a rate of 4.0% annually. The Company may be able to satisfy a portion of any redemption with shares of its common stock. The Company is unable to accurately estimate how much it would be able to satisfy any redemption of the Series B-1 Preferred in common stock, and, therefore, classified the entire Series B-1 Preferred value of $37.6 million at September 30, 2005, as a current liability. Due to the Series B-1 Preferred becoming redeemable in the first quarter of 2005, the Company recorded a charge of $7.4 million to accrete the discount and deemed dividend on redeemable convertible preferred stock in that quarter. Any redemption amount

settled in equity would be computed based on the lesser of the applicable conversion price of $7.50 and 95% of the arithmetic average of the volume weighted average prices of common stock for the 10 consecutive trading days prior to the date of delivery of the applicable Series B-1 Preferred redemption notice.

On April 22, 2005, the Company's preferred stockholders exercised their Unit Warrants and received (i) an aggregate of 1,150 shares of the Company's Series B-2 Convertible Preferred Stock (the "Series B-2 Preferred") and (ii) seven-year Warrants to purchase an aggregate of 450,000 shares of common stock at an exercise price of $10.00 per share (subject to weighted-average adjustment in certain circumstances). The aggregate gross proceeds to the Company from the exercise of the Unit Warrants were $11.5 million.

If not previously converted, the Company must redeem the Series B-2 Preferred in five years from April 22, 2005, or earlier under certain circumstances, at such shares' stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. Any such redemption may be made by the Company in cash or, subject to certain conditions, in shares of common stock. The Series B-2 Preferred is convertible into common stock at a fixed conversion price of $7.00 per share. Otherwise, the Series B-2 Preferred has substantially identical terms as the Series B-1 Preferred.

8. Effect of New Accounting Standards

In December 2004, the FASB issued SFAS 123R, "Share-Based Payment." This statement replaces SFAS 123, supersedes APB 25, and amends FASB Statement No. 95, "Statement of Cash Flows." SFAS 123R eliminates the ability to account for share-based compensation using the intrinsic value method allowed under APB 25 and will require the Company to recognize share-based compensation as compensation expense in the statement of operations based on the fair values of such equity on the date of the grant. The compensation expense will be recognized over the period in which the recipient is required to provide service in exchange for the equity award. This statement will also require the Company to adopt a fair value-based method for measuring the compensation expense related to share-based compensation. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. In accordance with the new rule, the expense provisions of SFAS 123R will be effective for the Company beginning in January 2006.

SFAS 123R permits public companies to choose between the following two adoption methods:

- A "modified prospective" method in which compensation cost is recognized beginning with the effective date based on (i) the requirements of SFAS 123R for all share-based payments granted after the effective date and (ii) the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date, or

- A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits companies to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (i) all prior periods presented or (ii) prior interim periods of the year of adoption.

The Company has begun, but has not completed, evaluating the impact of the adoption of SFAS 123R on its results of operations. In connection with evaluating the impact of SFAS 123R, the Company is considering the potential implementation of different valuation methods to determine the fair value of share-based compensation. Historically, the Company has used the Black-Scholes option pricing model, which is widely used to estimate the value of traded options that, unlike the Company's employee stock options, have no vesting restrictions and are fully transferable. The Company believes the adoption of SFAS 123R will have a material impact on its results of operations regardless of the valuation method used. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce the Company's net operating cash flows and increase its net financing cash flows in periods after adoption. SFAS 123R may also delay when the Company may become profitable.

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, 2004 (the "2004 Annual Report"), as filed with the Securities and Exchange Commission (the "SEC"). Operating results are not necessarily indicative of results that may occur in future periods.

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

OVERVIEW AND RECENT DEVELOPMENTS

We are a clinical-stage biopharmaceutical company with a pipeline of internally discovered small molecule product candidates that target G protein-coupled receptors, or GPCRs. Three of our product candidates are in clinical development:

APD356 for the treatment of obesity is in a Phase 2b clinical trial; APD125 for the treatment of insomnia is scheduled to begin a Phase 2 clinical trial by the end of 2005; and, as part of our collaboration with Merck & Co., Inc., a product candidate for the treatment of atherosclerosis and related disorders is in a Phase 1 clinical trial. We also have an active collaboration with another major pharmaceutical company, Ortho-McNeil Pharmaceutical, Inc., a Johnson & Johnson company, for the treatment of type 2 diabetes. Our product candidates act on or through known and orphan GPCRs, and have been discovered using

our GPCR-focused drug discovery technologies and capabilities. We believe these technologies and capabilities will allow us to continue to discover novel product candidates in our therapeutic areas of focus, which are metabolic, cardiovascular, inflammatory and central nervous system (or CNS) diseases. We incorporated on April 14, 1997, in the state of Delaware and commenced operations in July 1997.

Our recent developments include:

- Merck & Co., Inc. initiated a Phase 1 clinical trial of an orally administered drug candidate being developed under our collaboration encompassing 3 GPCRs that may have the potential to regulate plasma lipid profiles, including HDL cholesterol, similar to the therapeutic action of niacin. The initiation of the Phase 1 clinical trial triggered a $2.0 million milestone payment to us in August 2005.

- Obtained a patent from the European Patent Office relating to certain drug screening methods utilizing the 19AJ receptor, an orphan GPCR discovered by us and active in regulating blood glucose levels in a glucose-dependent manner. The invention set forth in the patent was utilized to identify the orally bioavailable compounds that we and Ortho-McNeil, Inc., a Johnson & Johnson company, are developing to treat diabetes as part of our collaboration.

- An assessment of follow-up echocardiograms taken approximately 90 days after patients received their first doses of APD356 in our Phase 2a obesity clinical trial indicated no apparent drug effect on heart valves or pulmonary artery pressure after four weeks of dosing.

- Completed enrollment of our Phase 2b clinical trial of APD356 for obesity with approximately 460 patients. The Phase 2b clinical trial was initiated in June 2005 and is evaluating safety and weight loss over 12 weeks. Preliminary results from the Phase 2b trial are expected around year-end 2005.

- Obtained a patent from the United States Patent and Trademark office for APD356 and other compounds that modulate the 5-HT2C serotonin receptor, which helps regulate food intake and may also influence metabolic rate. These modulators may be useful in pharmaceutical compositions for the treatment of obesity.

RESULTS OF OPERATIONS

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

Revenues	Three months ended September 30,		Nine months ended September 30,	
Collaborations	2005	2004	2005	2004
Ortho-McNeil	$ 3.5	$ —	$ 9.5	$ —
Merck	3.9	4.4	7.9	11.2
Other	—	—	—	0.4
Total revenues	$ 7.4	$ 4.4	$ 17.4	$ 11.6

Research & development expenses	Three months ended September 30,		Nine months ended September 30,	
Type of expense	2005	2004	2005	2004
Personnel costs	$ 5.9	$ 5.7	$ 18.2	$ 17.8
Research supplies	2.4	2.5	7.9	7.9
Facility and equipment costs	3.0	3.0	8.8	8.7
External preclinical and clinical study fees and expenses	9.1	2.1	22.7	6.4
Other	0.4	0.6	1.2	1.3
Total research & development expenses	$ 20.8	$ 13.9	$ 58.8	$ 42.1

General & administrative expenses	Three months ended September 30,		Nine months ended September 30,	
Type of expense	2005	2004	2005	2004
Personnel costs	$ 1.3	$ 1.1	$ 4.1	$ 3.7
Legal, accounting and other professional fees	0.7	0.8	2.1	1.5
Facility and equipment costs	0.4	0.5	1.4	1.4
Other	0.2	0.2	0.6	1.0
Total general & administrative expenses	$ 2.6	$ 2.6	$ 8.2	$ 7.6

THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004

Revenues. We recorded revenues of $7.4 million during the three months ended September 30, 2005, compared to $4.4 million in revenues during the three months ended September 30, 2004. One hundred percent of our revenues during the three months ended September 30, 2005, were from our collaborations with Ortho-McNeil and Merck, which included $2.4 million in amortization of milestone achievements and technology access and development fees, $2.0 million from a milestone achieved when Merck initiated a Phase 1 clinical trial in our cardiovascular collaboration, $2.0 million in research funding, and $1.0 million in additional sponsored research and patent activities. One hundred percent of our revenues during the three months ended September 30, 2004, were from our collaboration with Merck, which included a $3.0 million assay development milestone, $1.1 million in research funding, and $0.3 million in amortization of technology access and development fees.

Our collaborators often pay us before we recognize such payments as current revenues and, accordingly, these payments are recorded as deferred revenues until earned. As of September 30, 2005, we had deferred revenues totaling approximately $26.5 million. Our revenues for all of 2005 are expected to be substantially dependent on our collaborators, Ortho-McNeil and Merck and are expected to be significantly greater in 2005 than in 2004. Future revenues for research or clinical milestones that have not yet been achieved are difficult to predict, and our revenues from quarter to quarter and year to year could vary significantly. Our future revenues are dependent upon the clinical success of our partnered programs and whether we partner APD356, APD125 or one or more of our earlier stage product candidates.

Research and development expenses. In the three months ended September 30, 2005 and 2004, research and development expenses consisted primarily of costs associated with internal development of our product candidates, internal programs and our technologies. We generally do not track our research and development costs by program; rather, we track such costs by the type of cost incurred. We do, however, track external expenses incurred for our clinical-stage programs as well as our other lead programs, and we call this expense external preclinical and clinical study fees and expenses. Research and development expenses increased $6.9 million to $20.8 million for the three months ended September 30, 2005, from $13.9 million for the three months ended September 30, 2004. The difference was due primarily to external preclinical and clinical study fees and expenses increasing by $7.0 million as we continued to develop APD356 for the treatment of obesity and APD125 for the treatment of insomnia. Included in the $9.1 million in external preclinical and clinical study fees and expenses for the three months ended September 30, 2005, is $6.5 million in external fees and expenses related to our APD356 program and $1.3 million in external fees and expenses related to our APD125 program. Included in the $2.1 million in external preclinical and clinical study fees and expenses for the three months ended September 30, 2004, is $1.3 million in external preclinical and clinical study fees and expenses related to our APD356 program and $285,000 in external preclinical and clinical study fees and expenses related to our APD125 program. Research and development expenses is our single largest expense line item and we expect research and development expenses in 2005 to continue to significantly exceed our research and development expenses for all of 2004 due to greater external preclinical and clinical study fees and expenses related to developing our product candidates, including APD356 and APD125, as well as expenses related to the hiring of additional development staff needed to support our development activities.

General and administrative expenses. General and administrative expenses were $2.6 million for each of the three months ended September 30, 2005 and 2004. General and administrative expenses are primarily comprised of personnel expenses and legal and accounting fees professional fees incurred to comply with the complex and demanding laws and regulations applicable to public companies, including the maintenance and monitoring of our internal control over financial reporting, and the cost of maintaining a growing and maturing patent portfolio. We expect general and administrative expenses to be greater in 2005 than in 2004 due to increases in staffing costs, professional fees, including legal and accounting fees incurred to comply with the complex and demanding laws and regulations applicable to public companies, and the cost of maintaining a growing and maturing patent portfolio.

Amortization of deferred compensation. For the three months ended September 30, 2005, we recorded amortization of deferred compensation of $88,000, of which $34,000 relates to research and development employees and consultants and $54,000 relates to general and administrative employees. For the three months ended September 30, 2004, we recorded amortization of deferred compensation of $283,000, of which $162,000 related to research and development employees and

consultants and $121,000 related to general and administrative employees. In December 2004, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 123R, “Share-Based Payment,” which requires companies to expense the estimated fair value of employee and director equity awards. In accordance with the new rule, the expensing provisions of SFAS 123R will be effective for us beginning in January 2006. We have begun, but have not completed, evaluating the impact of SFAS 123R on our results of operations. We expect amortization of deferred compensation to be significantly higher beginning in the first quarter of 2006 due to the implementation of SFAS 123R.

Interest income and other, net. Interest income and other, net, was $782,000 for the three months ended September 30, 2005, compared to $20,000 for the three months ended September 30, 2004. Interest income increased in 2005 due to higher average cash balances as well as higher interest rates. Interest income and other, net, for the three months ended September 30, 2005, was primarily comprised of (i) $1.2 million in interest income and (ii) interest expense and financing costs of $460,000, which included lease payments accounted for in accordance with SFAS 66, “Accounting for Sales of Real Estate,” on our 6138-6150 Nancy Ridge Drive facility that we sold in 2003 and are leasing back. Interest income and other, net, for the three months ended September 30, 2004, was primarily comprised of (i) $603,000 in interest income, (ii) interest expense and financing costs of $460,000 and (iii) $173,000 in expense attributable to our share of the net loss of TaiGen Biotechnology Co., Ltd. (“TaiGen”), which during 2004 we accounted for our ownership in TaiGen by the equity method of accounting.

Dividends on redeemable convertible preferred stock. We recorded a dividend expense of $494,000 related to our redeemable convertible preferred stock in the three months ended September 30, 2005, compared to $362,000 for the three months ended September 30, 2004. The increase is the result of an additional $11.5 million in redeemable convertible preferred stock issued in April 2005 as a result of the exercise of the preferred stockholders’ Unit Warrants. This dividend expense, payable by increasing the stated value of redeemable convertible preferred stock or in common stock, increases the net loss allocable to common stockholders. The holders of the series B-1 and B-2 preferred stock are entitled to dividends that accrue at an annual rate of 4%. Assuming that all of the redeemable convertible preferred stock is held until the mandatory redemption date, we expect to record dividends on redeemable convertible preferred stock of $499,000 for the remaining three months of 2005, and $2.0 million, $2.1 million, $2.2 million, $544,000 and $170,000 for the years ending December 31, 2006, 2007, 2008, 2009 and 2010, respectively.

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 $463,000 for the three months ended September 30, 2004. In accordance with Emerging Issues Task Force (“EITF”) Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments,” we allocated the total proceeds received in our preferred stock financing among the Series B-1 Convertible Preferred Stock (the “Series B-1 Preferred”) and the related Warrants and 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 stock into which the redeemable convertible preferred stock was convertible into on the date of issuance exceeded the proceeds allocated to the redeemable 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 redeemable convertible preferred stock. As a result of the public offering we completed in February 2005, which resulted in the Series B-1 Preferred becoming immediately redeemable at the option of the holders, we recorded a charge in the first quarter of 2005 of $7.4 million to accrete the remaining unaccreted discount and deemed dividend on the redeemable convertible preferred stock.

NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004

Revenues. We recorded revenues of $17.4 million during the nine months ended September 30, 2005, compared to $11.6 million in revenues during the nine months ended September 30, 2004. One hundred percent of our revenues during the nine months ended September 30, 2005, were from our collaborations with Ortho-McNeil and Merck, which included $7.2 million in amortization of milestone achievements and technology access and development fees, $6.1 million in research funding, $2.1 million in additional sponsored research and patent activities, and $2.0 million from a milestone achieved when Merck initiated a Phase 1 clinical trial in our cardiovascular collaboration. Ninety-six percent of our revenues during the nine months ended September 30, 2004, were from our collaboration with Merck. Revenues for the nine months ended September 30, 2004, included milestone achievements totaling $7.4 million, $3.2 million in research funding, and $1.0 million in amortization of technology access and development fees.

Research and development expenses. Research and development expenses increased $16.7 million to $58.8 million for the nine months ended September 30, 2005, from $42.1 million for the nine months ended September 30, 2004. The difference was due primarily to external preclinical and clinical study fees and expenses increasing by $16.3 million as we continued to

develop APD356 for the treatment of obesity and APD125 for the treatment of insomnia. Included in the $22.7 million in external preclinical and clinical study fees and expenses for the nine months ended September 30, 2005, is $14.8 million in external fees and expenses related to our APD356 program and $5.8 million in external preclinical and clinical study fees and expenses related to our APD125 program. Included in the $6.4 million in external preclinical and clinical study fees and expenses for the nine months ended September 30, 2004, is $3.0 million in external preclinical and clinical study fees and expenses related to our APD356 program and $1.8 million in external preclinical and clinical study fees and expenses related to our APD125 program.

General and administrative expenses. General and administrative expenses increased $0.6 million to $8.2 million for the nine months ended September 30, 2005, from $7.6 million for the nine months ended September 30, 2004. The increase is due primarily to (i) an increase in professional fees, including legal and accounting fees, of $540,000 primarily related to the cost of maintaining a growing and maturing patent portfolio, and (ii) $373,000 in increased personnel costs, including related recruiting costs. These increases are partially offset by a $250,000 expense in the nine months ended September 30, 2004, related to consulting and advisory services.

Amortization of deferred compensation. For the nine months ended September 30, 2005, we recorded amortization of deferred compensation of $351,000, of which $162,000 related to research and development employees and consultants and $189,000 related to general and administrative employees. For the nine months ended September 30, 2004, we recorded amortization of deferred compensation of $1.2 million, of which $682,000 relates to research and development employees and consultants and $486,000 relates to general and administrative employees.

Interest income (expense) and other, net. Interest income and other, net, was $2.3 million for the nine months ended September 30, 2005, compared to a net expense of $144,000 for the nine months ended September 30, 2004. Interest income increased in 2005 due to higher average cash balances as well as higher interest rates. Interest income and other, net, for the nine months ended September 30, 2005, was primarily comprised of (i) $3.1 million in interest income, (ii) a $500,000 payment received and classified as other income for the termination of our Fujisawa collaboration, and (iii) interest expense and financing costs of $1.4 million, which included lease payments accounted for in accordance with SFAS 66, “Accounting for Sales of Real Estate,” on our 6138-6150 Nancy Ridge Drive facility that we sold in 2003 and are leasing back. Interest income (expense) and other, net, for the nine months ended September 30, 2004, was primarily comprised of (i) $1.9 million in interest income, (ii) interest expense and financing costs of $1.4 million and (iii) $776,000 in expense attributable to our share of the net loss of TaiGen.

Dividends on redeemable convertible preferred stock. We recorded a dividend expense of $1.3 million related to our redeemable convertible preferred stock in the nine months ended September 30, 2005, compared to $1.1 million in the nine months ended September 30, 2004. In April 2005, we issued an additional $11.5 million in redeemable convertible preferred stock as a result of the exercise of the preferred stockholders’ Unit Warrants. The holders of the series B-1 and B-2 preferred stock are entitled to dividends that accrue at an annual rate of 4%.

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 $7.4 million for the nine months ended September 30, 2005, compared to $1.4 million for the nine months ended September 30, 2004. As a result of the public offering we completed in February 2005, the holders of our Series B-1 Preferred can require us to redeem all or some of their outstanding preferred shares. At September 30, 2005, the aggregate redemption price was approximately $37.6 million. Due to this redemption right, we recorded a charge in the first quarter of 2005 of $7.4 million to accrete the discount and deemed dividend on the redeemable convertible preferred stock.

LIQUIDITY AND CAPITAL RESOURCES

Short term

We anticipate that our research and development expenditures will increase as we continue to advance our lead product candidates, APD356 and APD125, and our research programs. We believe we have sufficient cash to meet our objectives over the next year, including completing our current clinical trials and initiating our planned clinical trials for APD356 and APD125, advancing other lead internal development programs into clinical trials, discovering and developing additional product candidates, continuing to build our development capabilities and maintaining our research discovery capabilities. We will continue to monitor and evaluate the proper level of research and development expenditures, and may adjust our expenditures based upon a variety of factors such as our clinical trial results and ability to generate cash through collaborative and financing activities.

The holders of our Series B-1 Preferred can require us to redeem all or some of their outstanding preferred shares. The aggregate redemption price at September 30, 2005, was approximately $37.6 million. If required to redeem, we may be able to satisfy all or a portion of this amount with shares of our common stock. Our ability and decision whether to use cash or equity to satisfy any redemption will depend on, among other factors, our stock price and the amount of common stock then held by our preferred stockholders.

In the short term, our sources of liquidity include our cash balances, short-term investments and funds received from our collaborators. As of September 30, 2005, we had $148.1 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 include (i) research funding and milestone payments from our collaborators, (ii) the license of our product candidates, internal drug programs and technologies to new collaborators, (iii) the sale of either or both of the facilities that we own, neither of which is subject to any outstanding loans, and (iv) the sale of securities.

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

Long term

We will need to raise or generate significant amounts of cash to execute our objectives of internally developing drugs, which take many years and potentially hundreds of millions of dollars to develop, and continuing our research programs. We do not currently have adequate internal liquidity to meet these objectives in the long term. In order to do so, we will need to continue our out-licensing activities and look to other external sources of liquidity, including the public and private financial markets and strategic partners.

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

A potential source of liquidity in the long term is from milestone and royalty payments from existing and future collaborators. We believe it is important to collaborate to share the costs, responsibilities and risks of developing drugs.

Sources and Uses of Our Cash

Net cash used in operating activities was approximately $23.0 million during the nine months ended September 30, 2005, and was primarily used to fund our net losses in the period, partially offset by a decrease in our accounts receivable balance of $21.1 million, primarily comprised of receipts from Ortho-McNeil in January 2005 of $22.6 million, which was in our accounts receivable balance at December 31, 2004, adjusted for non-cash expenses. Such non-cash expenses included $5.1 million in depreciation and amortization expense, $351,000 in amortization of deferred compensation, $1.2 million in amortization of acquired technology and other purchased intangibles, and changes in operating assets and liabilities. Net cash used in operating activities was approximately $30.9 million during the nine months ended September 30, 2004, and was used to fund our net loss in the period, adjusted for non-cash expenses. Such non-cash expenses included $5.3 million in depreciation and amortization expense, $1.2 million in amortization of deferred compensation, $1.2 million in amortization of acquired technology and other purchased intangibles, $776,000 for our minority interest in TaiGen’s operations, and changes in operating assets and liabilities.

Net cash used in investing activities was approximately $27.7 million during the nine months ended September 30, 2005, and was primarily the result of net purchases of short-term investments of $25.5 million as well $2.7 million for the purchase of equipment, leasehold improvements to the facilities we lease and capital improvements to the facilities we own. We expect our capital expenditures in 2005 to be less than our capital expenditures in 2004. Net cash provided by investing activities was approximately $32.7 million during the nine months ended September 30, 2004, and was primarily the result of net proceeds of short-term investments of $36.0 million, partially offset by $3.2 million for the purchase of equipment, leasehold improvements to the facilities we lease and capital improvements to the facilities we own.

Net cash provided by financing activities was $60.3 million during the nine months ended September 30, 2005, and was primarily attributable to net proceeds of $48.2 million we received in February 2005 from the public offering of 8,625,000 shares of our common stock at $6.00 per share as well as receiving $11.5 million in April 2005 from our preferred stockholders’ exercise of their Unit Warrants. Net cash provided by financing activities was $334,000 during the nine months ended September 30, 2004, and was primarily attributable to proceeds of $378,000 from the issuance of common stock upon exercise of options, partially offset by $44,000 in principal payments on our capital leases.

RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2004, the FASB issued SFAS 123R, “Share-Based Payment.” This statement replaces SFAS 123, supersedes Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees,” and amends FASB Statement No. 95, “Statement of Cash Flows.” SFAS 123R eliminates the ability to account for share-based compensation using the intrinsic value method allowed under APB 25 and will require us to recognize share-based compensation as compensation expense in the statement of operations based on the fair values of such equity on the date of the grant. The compensation expense is recognized over the period in which the recipient is required to provide service in exchange for the equity award. This statement will also require us to adopt a fair value-based method for measuring the compensation expense related to share-based compensation. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. In accordance with the new rule, the expense provisions of SFAS 123R will be effective for us beginning in January 2006.

SFAS 123R permits public companies to choose between the following two adoption methods:

- A “modified prospective” method in which compensation cost is recognized beginning with the effective date based on (i) the requirements of SFAS 123R for all share-based payments granted after the effective date and (ii) the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date, or

- A “modified retrospective” method which includes the requirements of the modified prospective method described above, but also permits companies to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (i) all prior periods presented or (ii) prior interim periods of the year of adoption.

We have begun, but have not completed, evaluating the impact of the adoption of SFAS 123R on our results of operations. In connection with evaluating the impact of SFAS 123R, we are considering the potential implementation of different valuation methods to determine the fair value of share-based compensation. Historically, we have used the Black-Scholes option pricing model, which is widely used to estimate the value of traded options that have no vesting restrictions and are fully transferable, which are significantly different characteristics from our employee stock options. We believe the adoption of SFAS 123R will have a material impact on our results of operations, regardless of the valuation method used. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce our net operating cash flows and increase our net financing cash flows in periods after adoption. SFAS 123R may also delay when we may become profitable.

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 U.S. generally accepted accounting principles ("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 and judgments 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 ("SAB") No. 104, "Revenue Recognition," and EITF 00-21, "Revenue Arrangements with Multiple Deliverables," which provide guidance on revenue recognition in financial statements and are based on the interpretations and practices developed by the

SEC. Some of our agreements contain multiple elements, including technology access and development fees, research funding, milestones and royalty obligations.

Revenues from a milestone achievement are recognized when earned, as evidenced by acknowledgment from our collaborator, provided that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) our performance obligations after the milestone achievement will continue to be funded by our collaborator at a level comparable to the level before the milestone achievement. If all of these criteria are not met, the milestone achievement is recognized over the remaining 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 revenues as the services are performed. Advance payments we receive in excess of amounts earned are classified as deferred revenues until earned.

Clinical trial expenses. We review and accrue clinical trial expenses based on work performed. We rely on estimates of total costs incurred based on enrollment of subjects, completion of studies and other events. We follow this method because reasonably dependable estimates of the costs applicable to various stages of a clinical trial can be made. Accrued clinical costs are subject to revisions as clinical trials progress. Revisions are charged to expense in the period in which the information that gives rise to the revisions becomes known.

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 useful life and the value of the Melanophore technology. We will record a future write-down of the carrying value of the Melanophore technology if we determine that it has become impaired or we no longer use it internally as our primary screening technology or we will accelerate the amortization if we determine that its 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 the provisions of APB 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 FASB 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 SFAS 123, "Accounting for Stock-Based Compensation." If we had adopted SFAS 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 note 4 to the unaudited consolidated financial statements included above in this Quarterly Report on Form 10-Q.

Options issued to non-employees other than directors are accounted for under the fair value method in accordance with SFAS 123 and EITF 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 96-18 and is recognized over the service period.

In December 2004, the FASB issued SFAS 123R, which replaces SFAS 123, supersedes APB 25, and amends SFAS 95. SFAS 123R eliminates the ability to account for share-based compensation using the intrinsic value method allowed under APB 25 and requires public companies to recognize compensation expense in the statement of operations based on the fair values of such equity on the date of the grant, with the compensation expense recognized over the period in which the recipient is required to provide service in exchange for the equity award. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. This statement is effective for the first fiscal year that begins after June 15, 2005, and we will adopt the statement on January 1, 2006.

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 preferred stock financing among the Series B-1 Preferred and the related Warrants and 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 Preferred was convertible into on the date of issuance exceeded the proceeds allocated to the Series B-1 Preferred 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 Preferred. As a result of the public offering we completed in February 2005, the holders of our Series B-1 Preferred can require us to redeem all or some of their outstanding preferred shares. At September 30, 2005, the aggregate redemption price was approximately $37.6 million. Due to this redemption right, we recorded a charge in the nine months ended September 30, 2005, of $7.4 million to accrete the discount and deemed dividend on redeemable convertible preferred stock.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP. See our audited consolidated financial statements and notes thereto included in our 2004 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. You should consider carefully the risks described below, together with other information in this Form 10-Q and our other public filings, before making investment decisions regarding our stock. If any of the following events actually occur, our business, operating results, prospects or financial condition could be materially and adversely affected. This could cause the trading price of our common stock to decline and you may lose part or all of your investment. The risks described below are not the only ones that we face. Additional risks not presently known to us or that we currently deem immaterial may also affect our business, operating results, prospects or financial conditions.

Risks Relating to Our Business

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

We had losses of $57.5 million for the nine months ended September 30, 2005, and we had an accumulated deficit of $226.3 million from our inception in April 1997 through September 30, 2005. Our losses have resulted in large part from the significant research and development expenditures we have made in seeking to identify and validate new drug targets and develop compounds that could become marketed drugs.

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

We do not have any commercial products. 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 have substantially less money than we will need to successfully develop a compound into a marketed drug. Additional funding may not be available to us or may not be available on terms that you or we believe are favorable. If additional funding is not available, we may have to delay, reduce the scope of or eliminate one or more of our research or development programs.

Our stock price could decline significantly based on the results and timing of our clinical trials.

We expect to announce results from our Phase 2b clinical trial of our most advanced product candidate, APD356 for obesity, around the end of the year. In addition, we also expect to announce additional safety results from our recent Phase 1 clinical trial for our second most advanced product candidate, APD125 for insomnia. These results may not be favorable or viewed favorably by us or third parties, including investors, analysts and potential collaborators. Biotechnology company stock prices have declined significantly where clinical results were not favorable, were perceived negatively or otherwise did not meet expectations. Failure to initiate or delays in our clinical trials of APD356, APD125 or of any of our other product

candidates, or unfavorable results or negative perceptions regarding any of such trials, could cause our stock price to decline significantly.

Clinical trials for our product candidates are expensive, time consuming, may be interrupted and their outcome is uncertain.

Clinical trials are very expensive and difficult to design and implement. The clinical trial process is also time consuming. Assuming favorable results, we estimate that the clinical trials of our most advanced product candidates will continue for several years. Before we can obtain regulatory approval for the commercial sale of any product candidate that we wish to develop, we are required to complete extensive clinical trials in humans to demonstrate its safety and efficacy. The timing of the commencement, continuation and completion of clinical trials may be subject to significant delays relating to various causes, including:

- lack of effectiveness during the clinical trials;
- unforeseen or serious side effects experienced by study participants or other safety issues;
- slower than expected rates of patient recruitment and enrollment;
- delays or inability to manufacture or obtain sufficient quantities of materials for use in clinical trials;
- delays in obtaining regulatory approvals to commence a study or “clinical holds” or other delays requiring suspension or termination of a study by a regulatory agency such as the FDA after a study is commenced;

- delays in identifying and reaching agreement on acceptable terms with prospective clinical trial sites;
- uncertainty regarding proper dosing;
- scheduling conflicts with participating clinicians and clinical institutions;
- inability or unwillingness of medical investigators to follow our clinical protocols; or
- difficulty in maintaining contact with subjects during or after treatment, which may result in incomplete data.

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

Preclinical studies and Phase 1 and Phase 2 clinical trials are not primarily designed to test the efficacy of a product candidate, but rather to test safety, to study pharmacokinetics and pharmacodynamics, and to understand the product candidate's side effects at various doses and schedules. Success in preclinical or completed clinical trials does not ensure that later large-scale trials will be successful nor does it necessarily predict future results. Favorable results in early trials may not be repeated in later trials.

A number of companies in the biotechnology industry have suffered significant setbacks in advanced clinical trials, even after promising results in earlier trials. Clinical results are frequently susceptible to varying interpretations that may delay, limit or prevent regulatory approvals. Negative or inconclusive results or adverse medical events during a clinical trial could cause a clinical trial to be delayed, repeated or terminated. In addition, failure to construct appropriate clinical trial protocols could result in the test or control group experiencing a disproportionate number of adverse events and could cause a clinical trial to be delayed, repeated or terminated.

Clinical trials of our most advanced product candidates, APD356 and ADP125, have been conducted only in small numbers of subjects. Preclinical data and the limited clinical results we have obtained for APD356 and APD125 may not predict results from studies in larger numbers of subjects drawn from more diverse populations treated for longer periods of time or, in the case with APD125, when patients with insomnia are studied rather than normal volunteers, and also may not predict the ability of APD356 or APD125 to achieve or sustain the desired effects in the intended population or to do so safely.

We have developed APD356 to more selectively stimulate the 5-HT2C serotonin receptor because we believe this selectivity may avoid the cardiovascular side effects associated with fenfluramine and dexfenfluramine, two serotonin-releasing agents and non-selective serotonin receptor agonists, both of which were withdrawn from the market in 1997 after reported incidences of heart valve disease and pulmonary hypertension associated with their usage. We may not be correct in this belief, however, and APD356's selectivity profile may not avoid the undesired side effects. Moreover, the potential

relationship between the activity of APD356 and fenfluramine and dexfenfluramine may result in increased FDA regulatory scrutiny of the safety of APD356 and may raise potential adverse publicity in the marketplace. In response to our Investigational New Drug submission for APD356, the FDA recommended we assess the abuse potential and requested that we provide our plans for cardiac valve monitoring during Phase 2 and Phase 3 clinical trials. We have submitted to the FDA our plan for cardiac valve monitoring and our communication with the FDA on these issues is expected to be on-going.

We have developed APD125 to selectively inhibit the 5-HT2A serotonin receptor because we believe this mechanism may be better tolerated and improve sleep quality and maintenance as compared to existing sleep therapies. Preclinical data and the results from our Phase 1 clinical trial in subjects with normal sleep patterns may not predict APD125's effects on sleep quality, sleep maintenance or sleep onset latency in patients with insomnia.

We will be required to demonstrate through larger-scale clinical trials that these product candidates are safe and effective for use in a diverse population before we can seek regulatory approvals for their commercial sale. There is typically an extremely high rate of attrition from the failure of product candidates proceeding through clinical trials. To date, long-term safety and efficacy have not yet been demonstrated in clinical trials for any of our product candidates. If APD356 or APD125 fails to demonstrate sufficient safety and efficacy in any clinical trial, we will experience potentially significant delays in, or decide to abandon development of, that product candidate. If we abandon or are delayed in our development efforts related to APD356 or APD125, or any other product candidate, we may not be able to generate sufficient revenues to continue our operations at the current level or become profitable, our reputation in the industry and in the investment community would likely be significantly damaged, it may not be possible to complete financings, and our stock price would likely decrease significantly.

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

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

The technologies on which we rely may not result in the discovery or development of commercially viable products.

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

Another company, organization or individual could have, or could develop, a technology targeting GPCRs to discover and develop compounds into drugs more effectively or efficiently than our screening and other technologies. Such a technology could render our technologies, in particular our constitutively activated receptor technology, or CART, and Melanophore technology, obsolete or noncompetitive.

Our product candidates are subject to extensive regulation, which can be costly and time consuming, cause unanticipated delays, or prevent the receipt of the required approvals to commercialize products.

The clinical development, manufacturing, labeling, packaging, storage, record-keeping, advertising, promotion, export, marketing, and distribution of our product candidates are subject to extensive regulation by the FDA and other regulatory agencies in the United States and by comparable governmental authorities in foreign markets. Neither we nor our collaborators are permitted to market our potential products in the United States until we receive regulatory approval from the FDA. Neither we nor our collaborators have received marketing approval for any of our product candidates. The process of obtaining regulatory approval is expensive, often takes many years, and can vary substantially based upon the type, complexity and novelty of the product involved. A New Drug Application, or NDA, must be supported by extensive clinical and preclinical data regarding manufacturing, process and controls to demonstrate the safety and effectiveness of the product candidate. Approval policies or regulations may change. Moreover, failure to comply with the FDA and other applicable

foreign and United States regulatory requirements may subject us to administrative or judicially imposed sanctions. These include warning letters, civil and criminal penalties, injunctions, product seizure and detention, product recalls, total or partial suspension of production, and refusal to approve pending NDAs, or supplements to approved NDAs.

In addition, we have not previously filed NDAs with the FDA. This lack of experience may impede our ability to obtain FDA approval in a timely manner, if at all, for our product candidates for which development and commercialization is our responsibility. Despite the time and expense invested, regulatory approval is very uncertain and never guaranteed and we could encounter problems that cause us to abandon clinical trials or to repeat or perform additional preclinical testing and clinical trials. The FDA has substantial discretion in the drug approval process. The number of preclinical studies and clinical trials that will be required for FDA approval varies depending on the product candidate, the disease or condition that the product candidate is designed to address, and the regulations applicable to any particular product candidate. The FDA can delay, limit or deny approval of a product candidate for many reasons, including:

- not finding a product candidate sufficiently safe and/or effective;
- not finding the data from preclinical testing and clinical trials sufficient;
- not approving of our or a third-party manufacturers' processes or facilities; or
- changes in its approval policies or the adoption of new regulations.

Because, in part, of the early stage of our product candidate research and development process, we cannot predict whether or not regulatory approval will be obtained for any product we develop. Only two of our product candidates, APD356 and APD125, are undergoing clinical trials by us, and only one of our product candidates is undergoing clinical trials by a partner, Merck. 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. Administering any of our product candidates to humans may produce undesirable side effects. These side effects could interrupt, delay or halt clinical trials of our product candidates and could result in the FDA or other regulatory authorities denying approval of our product candidates for any or all of the targeted indications. If regulatory approval of a product is granted, the approval will be limited to those disease states and conditions for which the product is demonstrated through clinical trials to be sufficiently safe and effective. Failure to obtain regulatory approval will 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. The FDA, other regulatory authorities, our collaborators or we may suspend or terminate clinical trials at any time. Any failure or significant delay in completing clinical trials for our product candidates, or in receiving regulatory approval for the sale of any drugs resulting from our product candidates, may severely harm our business and reputation.

If we are not successful in advancing our lead programs, we may have to curtail some of our activities.

If we are not successful in achieving additional milestones under our cardiovascular collaboration with Merck or our diabetes collaboration with Ortho-McNeil, or developing or partnering APD356 or APD125 or any of our other lead programs, we may not be able to raise additional capital or generate significant partnering revenues in the short term. If we do not receive additional capital or partnering revenues, we may need to license some or all of our programs on financial terms that are unfavorable to us. Also, without additional capital or partnering revenues, we would need to re-evaluate our strategy of moving multiple drug discovery and development programs forward while at the same time maintaining our research and discovery capabilities. Based on such evaluation, we may need to significantly curtail some of our current and planned programs and expenditures. We do not know what programs, if any, we would need to curtail, but we believe narrowing our pipeline would reduce our opportunity for success.

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

Our revenues were $13.7 million and $12.8 million for the years ended December 31, 2004 and 2003, respectively, and were $17.4 million for the nine months ended September 30, 2005. Our revenues depend upon the success of our existing collaborations and on our ability to enter into new collaborations. We will receive little additional revenues from our existing collaborators 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 in clinical testing. Only one of our partners, Merck, has advanced one of our compounds into clinical testing and paid us the applicable milestone. We cannot

guarantee that any of the other development, approval or sales milestones in our existing or future collaborations will be satisfied, or that we will receive any payments for the achievement of those other milestones.

For the year ended December 31, 2004, revenues recognized under our collaboration with Merck represented approximately 95% of our total revenues. For the nine months ended September 30, 2005, 100% of our revenues were from our collaborations with Merck and Ortho-McNeil. We expect substantially all of our revenues for the remaining three months of 2005 will be derived from our collaborations with Merck and Ortho-McNeil. Our revenues will be materially impacted if:

- our agreement with either Merck or Ortho-McNeil is terminated;
- our collaborators do not devote their time and financial resources to develop compounds under our collaborations;
- our collaborators dispute whether we have achieved a milestone, rights to a particular receptor or compound, or other terms of our agreements;
- our collaborators use alternative technologies to our technologies and compete with us in developing products; or
- our collaborators experience failures in the discovery or development of compounds identified with our technologies or in the clinic or marketplace with other products that cause them to discontinue or slow down our collaboration.

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

Our collaboration agreements with Merck and Ortho-McNeil may be terminated in certain circumstances.

The term of our amended collaborative research program with Merck is three years from October 21, 2004. Merck can terminate this program: (i) for "Technical Grounds," by giving 30 days prior notice, if both Merck and we agree that Technical Grounds have occurred; or (ii) in the event of our change in control (as defined in the agreement), by giving 30 days prior notice. Technical Grounds include circumstances where: (1) our joint research committee (a committee of an equal number of Merck and our representatives) concludes that (a) a significant adverse event affecting all the targets, all program compounds and all active compounds under the program has arisen during the conduct of the program, or (b) continuation of the program is no longer scientifically promising because the role of all the targets proves incorrect, or none of the targets are valid as a suitable target for development of a pharmaceutical product; or (2) Merck's patent department, upon consultation with our patent attorneys, makes a reasonable determination that valid third-party patent rights block the achievement of significant program goals.

In addition, either party can terminate the agreement if the other party breaches its material obligations under the agreement by causes and reasons within its control, has not cured such breach within 90 days of receiving a letter requesting such cure, and there is no dispute as to whether such breach has occurred. In lieu of terminating the agreement, however, Merck can terminate the research program and certain other aspects of the agreement after giving 90 days prior notice if we materially breach our obligations during the course of the program and fail to cure such breach, if such default cannot be cured within such 90-day period, or if we do not commence and diligently continue good faith efforts to cure such default during such period.

Our agreement with Ortho-McNeil will continue until the expiration of Ortho-McNeil's payment obligations for research funding, milestone payments and royalties, unless the agreement is terminated earlier by either party. We and Ortho-McNeil each have the right to terminate the agreement early if the other party commits an uncured material breach of its obligations. Further, Ortho-McNeil may terminate the agreement without cause during the term of the research program, provided that in such event it pays us the balance of its research funding obligation in a lump sum, unless the termination is due to a change of control of Arena (as defined in the agreement), in which case Ortho-McNeil may terminate either the agreement or the research program under the agreement, without the payment of additional research funding to us. At any time after the end of the research program, Ortho-McNeil may terminate the agreement by providing us at least 60 days prior written notice. Upon termination of the agreement, all rights to the compounds developed under the collaboration will revert to us.

We may have conflicts with our collaborators that could delay or prevent the development or commercialization of our product candidates.

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

- unwillingness on the part of a collaborator to pay us research funding, milestone payments or royalties we believe are due to us under a collaboration;
- uncertainty regarding ownership of intellectual property rights arising from our collaborative activities, which could prevent us from entering into additional collaborations;
- unwillingness on the part of a collaborator to keep us informed regarding the progress of its development and commercialization activities or to permit public disclosure of the results of those activities; or
- slowing or cessation of a collaborator's development or commercialization efforts with respect to our product candidates.

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

We focus our efforts on GPCRs. Because GPCRs are an important target class for drug discovery efforts, we believe that many pharmaceutical and biotechnology companies and other organizations have internal drug discovery programs focused on GPCRs. Many of the drugs that we or our collaborators are attempting to discover and develop would compete with existing therapies. In addition, many companies are pursuing the development of new drugs that

target the same diseases and conditions that we target. Many of our competitors, particularly large pharmaceutical companies, have substantially greater research 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 or newly discovered products or therapies.

Consolidation and setbacks 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, setbacks caused by safety concerns relating to high-profile drugs like Vioxx and Celebrex, competition from generic drugs and litigation may have an adverse effect on us. In addition, pharmaceutical companies may be less willing to enter into new collaborations or continue existing collaborations if they are integrating a new operation as a result of a merger or acquisition, if their therapeutic areas of focus change following a merger, or if they have reduced research budgets as a result of some financial setback.

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 payers. Government and third-party payers are increasingly attempting to contain healthcare costs by limiting coverage and reimbursement levels for new drugs. These efforts may limit our commercial opportunities by reducing the amount a potential collaborator is willing to pay to license our programs or product candidates in the future by reducing the potential revenues that we and our collaborators could generate from drug sales.

We rely on third parties to conduct our clinical trials. If those parties do not successfully carry out their contractual duties or meet expected deadlines, we may not be able to advance our product candidates in a timely manner or at all.

In the course of our discovery, preclinical testing and clinical trials, we have relied and continue to rely on third parties, including laboratories, investigators, clinical research organizations and manufacturers, to perform critical services for us. For example, we are relying on contract clinical sites to conduct our clinical trials for APD356 and APD125. Clinical research

organizations will be responsible for many aspects of the trials, including finding and enrolling subjects for testing and administering the trials. These third parties may not be available when we need them or, if they are available, may not comply with all regulatory and contractual requirements or may not otherwise perform their services in a timely or acceptable manner. These independent third parties may also have relationships with other commercial entities, some of which may compete with us. 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.

Any performance failure on the part of a third-party manufacturer could delay clinical development or regulatory approval of our product candidates. Third-party manufacturers often encounter difficulties involving production yields, quality control and quality assurance, as well as shortages of qualified personnel. The manufacturers are subject to ongoing periodic unannounced inspection by the FDA, the Drug Enforcement Administration of the U.S. Department of Justice and corresponding state agencies to ensure strict compliance with current good manufacturing practices and other applicable government regulations and corresponding foreign standards. We do not have control over third-party manufacturers' compliance with these regulations and standards. If one of our manufacturers fails to maintain compliance, the production of our product candidates could be interrupted, resulting in delays, additional costs and potentially lost revenues.

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

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

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

Our success depends on the continued contributions of our principal management, development and scientific personnel, and the ability to hire and retain key personnel, particularly in the clinical development area as we transition more of our programs from research into drug development. We face intense competition for such personnel. The loss of services of any principal member of our management or scientific staff, particularly Jack Lief, our President 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 plans to leave, retire or otherwise disassociate with us in the near future.

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

We have a chemical development facility 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 for use in clinical trials.

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;

- failure 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.

We may not be able to operate our chemical development facility in a cost-effective manner or in a time frame that is consistent with our expected future manufacturing needs. If this were the case, we would need to seek alternative means to fulfill our manufacturing needs, which could delay progress on our programs.

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 and safety or the environment. These materials and various wastes resulting from their use are stored at our facility pending ultimate use and disposal. We cannot completely eliminate the risk of contamination, which could cause:

- an interruption of our research and development efforts;
- injury to our employees and others;
- environmental damage resulting in costly clean up; and
- liabilities under federal, state and local laws and regulations governing the use, storage, handling and disposal of these materials and specified waste products.

In such an event, we could be held liable for any resulting damages, and any such liability could exceed our resources. Although we carry insurance in amounts and type that we consider commercially reasonable, we 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.

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

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

- decreased demand for our product candidates;
- injury to our reputation;
- withdrawal of clinical trial subjects;
- costs of related litigation;
- substantial monetary awards to subjects or other claimants;
- loss of revenues; and
- the inability to commercialize our product candidates.

We have limited product liability insurance that covers our clinical trials. We intend to expand our insurance coverage to include the sale of commercial products if marketing approval is obtained for any of our product candidates. However, insurance coverage is increasingly expensive. We may not be able to maintain insurance coverage at a reasonable cost, and we may not have insurance coverage that will be adequate to satisfy any liability that may arise.

We may incur increased costs as a result of recently enacted changes in laws and regulations relating to corporate governance matters.

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

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

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

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

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

If any of our product candidates receive United States regulatory approval, the FDA may still impose significant restrictions on the indicated uses for which such products may be marketed or impose ongoing requirements for potentially costly post-approval studies. In addition, regulatory agencies subject a product, its manufacturer and the manufacturer's facilities to continual review and inspections. The subsequent discovery of previously unknown problems with a product, including adverse events of unanticipated severity or frequency, or problems with the facility where the product is manufactured, may result in restrictions on the marketing of that product, and could include withdrawal of the product from the market. Failure to comply with applicable regulatory requirements may result in:

- issuance of warning letters by the FDA;
- fines and other civil penalties;
- criminal prosecutions;
- injunctions, suspensions or revocations of marketing licenses;
- suspension of any ongoing clinical trials;
- suspension of manufacturing;
- delays in commercialization;
- refusal by the FDA to approve pending applications or supplements to approved applications filed by us or our collaborators;
- refusals to permit products to be imported or exported to or from the United States;
- restrictions on operations, including costly new manufacturing requirements; and
- product recalls or seizures.

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

In order to market any products outside of the United States, we and our collaborators must establish and comply with numerous and varying regulatory requirements of other countries regarding safety and efficacy. Approval procedures vary among countries and can involve additional product testing and additional administrative review periods. The time required

to obtain approval in other countries might differ from that required to obtain FDA approval. The regulatory approval process in other countries may include all of the risks associated with FDA approval as well as additional presently unanticipated risks. Regulatory approval in one country does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one country may negatively impact the regulatory process in others. Failure to obtain regulatory approval in other countries or any delay or setback in obtaining such approval could have the same adverse effects associated with regulatory approval in the United States, including the risk that our product candidates may not be approved for all indications requested and that such approval may be subject to limitations on the indicated uses for which the product may be marketed.

New accounting pronouncements may impact our future results of operations.

In December 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 123R, "Share-Based Payment." This statement, which will be effective in our first quarter of 2006, will change how we account for share-based compensation, and may have a significant impact on our future results of operations.

We currently account for share-based payments to employees and directors using the intrinsic value method. Under this method, we generally do not recognize any compensation related to stock option grants we issue under our stock option plans or the discounts we provide under our employee stock purchase plan.

SFAS No. 123R will require us to recognize share-based compensation as compensation expense in the statement of operations based on the fair values of such equity on the date of the grant, with the compensation expense recognized over the period in which the recipient is required to provide service in exchange for the equity award. This statement will also require us to adopt a fair value-based method for measuring the compensation expense related to share-based compensation. We have begun, but have not completed, evaluating the impact of the adoption of SFAS 123R on our results of operations. Historically, we have used the Black-Scholes option pricing model, which is widely used to estimate the value of traded options that have no vesting restrictions and are fully transferable, which are significantly different characteristics from our employee stock options. In connection with evaluating the impact of SFAS 123R, we are considering the potential implementation of different valuation methods to determine the fair value of share-based compensation. We believe the adoption of SFAS 123R will have a material impact on our results of operations, regardless of the valuation method used. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce our net operating cash flows and increase our net financing cash flows in periods after adoption. SFAS 123R may also delay when we may become profitable.

Future changes in generally accepted accounting principles, including pronouncements relating to revenue recognition, may have a significant effect on our reported results, including reporting of transactions completed before the effective date of such pronouncements.

Risks Relating to Our Intellectual Property

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

Our success will depend on our own and on our collaborators' abilities to obtain, secure and defend patents. In particular, the patents directed to our most advanced product candidates and other compounds discovered using our technologies are important to commercializing drugs. We have numerous U.S. 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, and compounds discovered using CART and Melanophore and other technologies.

The procedures for obtaining a patent in the U.S. 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, the analysis of our patent applications will be complex and time consuming. Our patent position is very uncertain and we do not know when, or if, we will obtain additional patents for our technologies.

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

As of October 31, 2005, we owned, in part or in whole, or had exclusively licensed the following patents: 17 in the United States, 63 in European countries, eight in New Zealand, six in Australia, four in Lebanon, one in Japan, one in Singapore, one in Hong Kong and one in Israel. In addition, as of October 31, 2005, we had approximately 344 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 80 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. Seven of our patent families containing a total of nine patents and 57 patent applications were the subject of joint inventions by our employees and the employees of other entities. The remaining 72 patent families containing a total of 92 patents and 287 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.

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 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 significant impact on our potential revenues from any drugs that we are able to develop.

We also rely on trade secrets to protect our technologies. However, trade secrets are difficult to protect. We require 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 to their legal obligations under these agreements. We also require collaborators, service providers 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.

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

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

Our commercial success also depends upon our ability to develop, manufacture, market and sell our product candidates and conduct our research and development activities without infringing or misappropriating the proprietary rights of other entities. There are many patents and patent applications filed, and that may be filed, by others relating to drug discovery and development programs that could be determined to be similar, identical or superior to ours or our licensors or collaborators. We may be exposed to future litigation by other entities based on claims that our product candidates, technologies or activities

infringe the intellectual property rights of others. Numerous U.S. and foreign issued patents and pending patent applications owned by others exist in the area of GPCRs, some of which purport to allow the patent holder 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. Numerous U.S. and foreign issued patents and pending patent applications owned by others also exist in the therapeutic areas in which we are developing products. These could materially affect our ability to develop our product candidates or sell our products, and our activities, or those of our licensors or collaborators, could be determined to infringe these patents. Because patent applications can take many years to issue, there may be currently pending applications, unknown to us, which may later result in issued patents that our product candidates or technologies may infringe. There also may be existing patents, of which we are not aware, that our product candidates or technologies may inadvertently infringe. Further, there may be issued patents and pending patent applications in fields relevant to our business, of which we are or may become aware, that we believe we do not infringe or that we believe are invalid or relate to immaterial portions of our overall drug discovery and development efforts. We cannot assure you that other entities holding any of these patents or patent applications will not assert

infringement claims against us for damages or seeking to enjoin our activities. We also cannot assure you that, in the event of litigation, we will be able to successfully assert any belief we may have as to non-infringement, invalidity or immateriality, or that any infringement claims will be resolved in our favor.

In addition, other entities 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 other entities.

Other organizations, companies and individuals are seeking proprietary positions on genomics information that overlap with the government sponsored project to sequence the human genome. Our activities, or those of our licensors or collaborators, could be affected by conflicting positions that may exist between any overlapping genomics information made available publicly as a result of the government sponsored project and genomics information that other organizations, companies or individuals consider to be proprietary.

There could be significant litigation and other administrative proceedings in our industry that affect us regarding patent and other intellectual property rights. Any legal action or administrative action against us, or our collaborators, claiming damages or seeking to enjoin commercial activities relating to our drug discovery and development programs could:

- require us, or our collaborators, to obtain a license to continue to use, manufacture or market the affected 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.

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

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

We cannot protect our intellectual property rights throughout the world.

Filing, prosecuting and defending 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.

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

Risks Relating to Our Securities

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

Our stock price has fluctuated historically. From January 1, 2003, to October 31, 2005, the market price of our stock was as low as $3.48 per share and as high as $10.54 per share.

Very few biotechnology products being tested will ultimately receive FDA approval, and a biotechnology company may experience a significant drop in its stock price based on an adverse clinical trial result or regulatory action. Our stock price may fluctuate significantly, 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 our product candidates;
- entering into a new collaboration or modifying or terminating an existing collaboration;
- the timing and receipt by us of milestone and royalty payments or failing to achieve and receive the same;
- changes in the research and development budgets of our existing or potential collaborators;
- others introducing new drug discovery techniques or introducing or withdrawing drugs that target the same diseases and conditions that we or our collaborators target;
- regulatory actions; 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. In addition, 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.

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

On December 24, 2003, we completed the private placement to two institutional investors of (i) an aggregate of 3,500 shares of our Series B-1 Preferred, (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 (subject to weighted-average adjustment in certain circumstances) and (iii) Unit Warrants to purchase for a period of approximately 16 months from December 24, 2003, up to $11.5 million of our Series B-2 Preferred 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 (subject to weighted-average adjustment in certain circumstances). On April 22, 2005, the investors exercised their Unit Warrants in full.

The holders of our Series B-1 Preferred can require us to redeem all or some of their shares of Series B-1 Preferred at such shares' stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties. The stated value is the original holder's investment plus any dividends settled by increasing the stated value at the time the dividend is payable.The aggregate redemption price of our Series B-1 Preferred at September 30, 2005, was approximately $37.6 million, and accrues interest at 4.0% annually.

The holders of our Series B-2 Preferred will be entitled to require us to redeem their shares of Series B-2 Preferred at such shares' stated value, plus accrued but unpaid dividends thereon to the date of payment and any applicable penalties, if, following the 21st month anniversary of the original issue date of the Series B-2 Preferred, the average of the closing prices of our common stock for any 30 consecutive trading days is below $7.00, which is the conversion price for the Series B-2 Preferred.

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

In addition to the foregoing redemption rights, at any time following the occurrence of a "Triggering Event," a holder of the Series B Preferred may require us to repurchase all or any portion of the Series B Preferred then held by such holder at a price per share equal to the greater of 115.0% of the stated value or the market value (as calculated under the Certificate of Designations for the Series B-1 Preferred and the Series B-2 Preferred) of such shares of Series B Preferred plus all accrued but unpaid dividends thereon to the date of payment. "Triggering Events" include any of the following events: (i) immediately prior to a bankruptcy event; (ii) we fail for any reason to timely deliver a certificate evidencing any securities to a purchaser or the exercise or conversion rights of the holders are otherwise suspended for other than a permissible reason; (iii) any Event (as defined in the Registration Rights Agreement with the Series B Preferred holders) occurs and remains uncured for 60 days; (iv) we fail to make any cash payment required under the Series B Preferred transaction documents and such failure is not timely cured; (v) the issuance of a going concern opinion by our independent registered public accounting firm that is not timely cured; (vi) we breach a section of the Series B Preferred purchase agreement relating to indebtedness and subordination; or (vii) we default in the timely performance of any other obligation under the Series B Preferred transaction documents and such default is not timely cured.

We will also be required to redeem any shares of the Series B Preferred that remain outstanding on the fifth anniversary of their issuance at a price equal to the amount of the original holder's original investment, plus all accrued but unpaid dividends thereon to the date of such payment. "Triggering Event" is specifically defined in the Certificate of Designations for the Series B-1 Preferred and the Series B-2 Preferred.

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

- we have sufficient number of shares of common stock available for issuance;
- the shares of common stock to be issued are registered under an effective registration statement or are otherwise available for sale under Rule 144(k) under the Securities Act;
- our common stock is listed on the Nasdaq National Market or other eligible market;
- the shares to be issued can be issued without violating the rules of the Nasdaq National Market or any applicable trading market or a provision of our certificate of designations; and
- no bankruptcy event has occurred.

If we are permitted to satisfy a portion of a redemption by using shares of our common stock, and if we elect to do so, the number of shares to be issued to holders of Series B Preferred will be determined by dividing their cash redemption price by the lesser of the conversion price or 95.0% of the average of the volume weighted average price of our common stock for either 10 or 15 trading days.

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

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

There were 35,387,800 shares of our common stock outstanding as of October 31, 2005. The outstanding shares of our Series B-1 Preferred are convertible into up to 5,009,546 shares of common stock at $7.50 per share of common stock. The outstanding shares of our Series B-2 Preferred are convertible into up to 1,672,282 shares of common stock at $7.00 per share of common stock. Holders of Series B Preferred are entitled to receive a 4.0% annual dividend that is payable by issuing common stock or by increasing the amount of common stock that is issuable upon conversion of the Series B Preferred. In addition, holders of our Series B Preferred own Warrants to acquire common stock, which, if exercised and converted, would obligate us to issue up to 1,936,200 additional shares of common stock at an exercise price of $10.00 per share. In addition, as of October 31, 2005, there were 3,639,732 common stock options issued and outstanding under our equity compensation plans at a weighted average exercise price of $8.00, 636,961 additional shares of common stock issuable under our equity compensation plans, 554,976 shares of common stock reserved for issuance under our 2001 Employee Stock

Purchase Plan and 134,169 shares issuable under our Deferred Compensation Plan. A substantial number of the shares described above, when issued upon exercise, will be available for immediate resale in the public market. The market price of our common stock could decline as a result of such resales due to the increased number of shares available for sale in the market.

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

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

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

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

A small number of our stockholders hold a significant amount of our outstanding stock. These stockholders may support competing transactions and have interests that are different from yours. In addition, the average number of shares of our stock that trade each day is generally 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.

Provisions of our Series B Preferred may prevent or make it more difficult for us to raise funds or take certain other actions.

Provisions of our Series B Preferred require us to obtain approval of the preferred stockholders, or otherwise trigger rights of first refusal or payment provisions, to (i) offer or sell new securities, other than in specified underwritten offerings or strategic partnerships or joint venture and certain other exceptions, (ii) sell or issue common stock or securities issuable into common stock below certain prices, (iii) incur debt or allow liens on our property, other than certain permitted debt and liens, (iv) amend our certificate of incorporation so as to affect adversely any rights of the preferred stockholders, (v) authorize or create a new class of stock that will be senior or equal to the Series B Preferred in terms of dividends, redemption or distribution of assets, (vi) use more than $25.0 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.

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 plan will cause substantial dilution to any person who attempts to acquire us

in a manner or on terms not approved by our board of directors.

The rights agreement and Certificate of Designations for the Series B Preferred, as well as other provisions in our certificate of incorporation and 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 that you may consider to be in your best interest. For example, these provisions:

- allow our board of directors to issue preferred stock without stockholder approval;
- limit who can call a special meeting of stockholders;
- eliminate stockholder action by written consent; and
- establish advance notice requirements for nomination for election to the board of directors or for proposing matters to be acted upon at stockholders meetings.

Item 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 quality financial 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 no more than four years with no one instrument having a duration exceeding five years and one month. We do not invest in derivative instruments or any financial instruments for trading purposes. Our primary market risk exposure as it affects our cash equivalents, short-term investments, and securities 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 September 30, 2005, we would expect future interest income from our portfolio to decline by less than $1.5 million over the next 12 months.

As of December 31, 2004, our estimate for the effect of this same hypothetical reduction in interest rates was a decline in interest income of less than $1.1 million. The difference in these two estimates is due to the difference in the gross amount of our cash and cash equivalents, short-term investments and securities held for sale between the two periods.

The model we use is not intended to forecast actual losses in interest income, but is used as a risk estimation and investment management tool. 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 and Vice President, Finance of the effectiveness of our disclosure controls and procedures, our Chief Executive Officer and Vice President, Finance have concluded that, as of the end of such period, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) are effective.

Changes in Internal Control Over Financial Reporting

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

PART II. OTHER INFORMATION

Item 6. Exhibits

EXHIBIT NO.	DESCRIPTION
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)
4.1	Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena's 8-K filed with the Securities and Exchange Commission on November 1, 2002, Commission File No. 000-31161)
4.2	Amendment No. 1, December 24, 2003, to Rights Agreement dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena's 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
4.3	Form of common stock certificates (incorporated by reference to Exhibit 4.2 to Arena's registration statement on Form S-1, as amended, filed with the Securities and Exchange Commission on July 19, 2000, Commission File No. 333-3594)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934.
31.2	Certification of principal financial officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934.
32.1	Certification of Chief Executive Officer and principal financial officer pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(B) promulgated under the Securities Exchange Act of 1934.

SIGNATURES

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

Date: November 4, 2005

ARENA PHARMACEUTICALS, INC.

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

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

EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
3.1	Fifth Amended and Restated Certificate of Incorporation of Arena 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)
4.1	Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena's 8-K filed with the Securities and Exchange Commission on November 1, 2002, Commission File No. 000-31161)
4.2	Amendment No. 1, December 24, 2003, to Rights Agreement dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena's 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
4.3	Form of common stock certificates (incorporated by reference to Exhibit 4.2 to Arena's registration statement on Form S-1, as amended, filed with the Securities and Exchange Commission on July 19, 2000, Commission File No. 333-3594)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934.
31.2	Certification of principal financial officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934.
32.1	Certification of Chief Executive Officer and principal financial officer pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(B) promulgated under the Securities Exchange Act of 1934.

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)) and internal control over financial reporting (as defined in Exchange Act rules 13a-15(f) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) 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

   d) 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: November 4, 2005

/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)) and internal control over financial reporting (as defined in Exchange Act rules 13a-15(f) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) 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

   d) 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):

   c) 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

   d) 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: November 4, 2005

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

Exhibit 32.1

CERTIFICATION 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 September 30, 2005, 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 Chief 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 to the best of his knowledge:

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	Vice President, Finance and Chief Accounting Officer
Date: November 4, 2005	Date: November 4, 2005