DEXCOM INC
Form S-3/A
August 28, 2007

As filed with the Securities and Exchange Commission on August 28, 2007

Registration No. 333-143560

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 2

to

FORM S-3

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

DEXCOM, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**33-0857544**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

5555 Oberlin Drive

San Diego, California 92121
(858) 200-0200

(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Terrance H. Gregg

President and Chief Executive Officer

DexCom, Inc.

5555 Oberlin Drive

San Diego, California 92121
(858) 200-0200

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

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Mountain View, California 94041
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Approximate date of commencement of proposed sale to the public:

From time to time after this registration statement becomes effective.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. x

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box. o

If this Form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box. o

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission acting pursuant to said Section 8(a), may determine.

$60,000,000
4.75% Convertible Senior Notes due 2027
and the 7,692,306 shares of Common Stock issuable Upon Conversion of the Notes

Holders of our 4.75% Convertible Senior Notes due 2027 named in this prospectus or in prospectus supplements may offer for sale the notes and the shares of common stock into which the notes are convertible at any time at market prices prevailing at the time of sale or at privately negotiated prices. The selling securityholders may sell the notes or the common stock directly to purchasers or through underwriters, broker-dealers or agents, who may receive compensation in the form of discounts, concessions or commissions. We will not receive any of the proceeds from the sale of the notes or the shares of common stock issuable upon conversion of the notes by any of the selling securityholders.

We will pay interest on the notes on March 15 and September 15 of each year, beginning on September 15, 2007. The notes will mature on March 15, 2027. The notes are unsecured senior indebtedness and rank equally with all our other unsecured senior debt, but will be effectively subordinated to all our secured indebtedness, to the extent of the value of the assets securing such indebtedness, and to all debt incurred by our subsidiaries.

We may elect to automatically convert some or all of the notes at any time on or prior to maturity if the closing price of our common stock has exceeded 150% of the conversion price for at least 20 trading days during any consecutive 30-day trading period ending within five trading days prior to the notice of automatic conversion.

If we elect to automatically convert some or all of the notes prior to March 15, 2010, we will pay an additional amount of interest in cash or, at our option, in common stock, equal to three full years of interest on the converted notes, less any interest actually paid or provided for on the notes prior to automatic conversion.

Holders of the notes may convert each $1,000 principal amount of notes into shares of our common stock, subject to adjustments, at a conversion rate of 128.2051 shares of common stock per $1,000 principal amount of the notes (which is equivalent to a conversion price of approximately $7.80 per share) at any time before the close of business on March 15, 2027.

Holders of the notes may require us to repurchase the notes at a repurchase price equal to 100% of their principal amount, plus accrued and unpaid interest and any additional interest to, but excluding, the repurchase date, at any time prior to their maturity following a fundamental change, as defined herein.

Holders of the notes may require us to purchase for cash all or part of their notes on March 15, 2012, March 15, 2017 or March 15, 2022 at a price equal to 100% of the principal amount of the notes being purchased, plus accrued and unpaid interest and any additional and special interest to, but excluding, the purchase date.

On or after March 20, 2010, we may redeem all or a portion of the notes at a redemption price equal to 100% of the principal amount of the notes being redeemed, plus accrued and unpaid interest to, but excluding, the redemption date.

Our common stock currently trades on The Nasdaq Global Market under the symbol DXCM. The last reported sale price of our common stock on August 27, 2007 was $8.75 per share.

Investing in our common stock or the notes involves a high degree of risk. Please carefully consider the Risk Factors beginning on page 5 of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

The date of this prospectus is August , 2007.

You should rely only on the information contained in or incorporated by reference into this prospectus. No dealer, salesperson or any other person is authorized to give any information or to make any representation other than those contained in or incorporated by reference in this prospectus. If such information is given or representations are made, you may not rely on that information or representations as having been authorized by us. You may not imply from the delivery of this prospectus, nor from a sale made under this prospectus, that our affairs are unchanged since the date of this prospectus. This prospectus may only be used where it is legal to sell the securities.

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SUMMARY

This summary may not contain all the information that you should consider before investing in our note or common stocks. You should read the entire prospectus and the information incorporated by reference in this prospectus carefully, including Risk Factors and the financial data and related notes incorporated by reference, before making an investment decision.

DexCom, Inc.

We are a medical device company focused on the design, development and commercialization of continuous glucose monitoring systems for people with diabetes. On March 24, 2006, we received approval from the U.S. Food and Drug Administration, or FDA, for our Short-Term Continuous Glucose Monitoring System, or STS, and have launched this product throughout the United States. Our approval allows for the use of our STS by adults with diabetes to detect trends and track glucose patterns, to aid in the detection of hypoglycemia and hyperglycemia and to facilitate acute and long-term therapy adjustments. On May 31, 2007, we received approval from the FDA for our second generation continuous glucose monitoring system, the SEVEN , designed for up to seven days of continuous use, and we have begun commercializing this product.

We were incorporated in Delaware in May 1999. Our principal offices are located at 5555 Oberlin Drive, San Diego, California 92121, and our telephone number is (858) 200-0200. Our website address is http://www.dexcom.com. The information found on, or accessible through, our website is not a part of this prospectus.

THE OFFERING

The following is a brief summary of certain terms of the notes and common stock offered for resale in this prospectus. For a more complete description of the terms of the notes, see Description of Notes and Description of Capital Stock in this prospectus.

Issuer	DexCom, Inc.
Securities Offered	$60,000,000 aggregate principal amount of 4.75% Convertible Senior Notes due 2027 and the 7,692,306 shares of our convertible stock into which the notes are convertible.
Maturity	March 15, 2027.
Interest	4.75%. Interest on the notes accrues from March 9, 2007. Interest will be payable semiannually in arrears on March 15 and September 15 of each year, beginning September 15, 2007.
Conversion	Holders may convert their notes into shares of our common stock at the applicable conversion rate, in multiples of $1,000 principal amount, at their option, at any time prior to the close of business on the business day immediately preceding the maturity date. The initial conversion rate for the notes is 128.2051 shares per $1,000 principal amount of notes (equivalent to a conversion price of approximately $7.80 per share), and is subject to adjustment as described under Description of Notes Conversion Rate Adjustments. In addition, following certain corporate transactions consummated on or before March 15, 2010, we will increase the conversion rate for holders who elect to convert their notes in connection with such corporate transactions by a number of additional shares of common stock as described under Description of Notes Adjustments of Average Prices Adjustment to shares delivered upon conversion upon certain fundamental changes.
Ranking	The notes are unsecured senior indebtedness and rank equally with our other senior unsecured debt, but is effectively subordinated to all our secured debt, to the extent of the value of the assets securing such debt, and to all debt incurred by our subsidiaries. As of August 22, 2007, we had approximately $2.9 million in secured indebtedness.
Auto-Conversion	We may elect to automatically convert some or all of the notes on or prior to maturity if the closing price of our common stock has exceeded 150% of the conversion price for at least 20 trading days during any 30-day trading period, ending within five trading days prior to the notice of automatic conversion. During the two-year period after the issue date of the notes, we may automatically convert the notes only if a registration statement has been declared effective prior to the date of the notice of automatic conversion and such registration statement remains effective on the date of automatic conversion.
Interest Make-Whole Provisions during First Three Years Upon Auto-Conversion	If an automatic conversion occurs on or prior to March 15, 2010, we will pay additional interest in cash or, at our option, in common stock, equal to three full years of interest on the converted notes, less any interest actually paid or provided for on the notes prior to automatic conversion. If we elect to pay the additional interest in common stock, the shares of common stock will be valued at the auto-conversion price.

Redemption	On or after March 20, 2010, we may redeem for cash all or part of the notes, upon not less than 20 nor more than 60 days notice before the redemption date by mail to the trustee, the paying agent and each holder of notes, at 100% of the principal amount of the notes to be redeemed, plus accrued and unpaid interest, including additional and special interest, if any, to, but excluding, the redemption date.
Repurchase at the Option of the Holder	Holders may require us to repurchase the notes for cash on March 15, 2012, March 15, 2017 and March 15, 2022 at a repurchase price equal to 100% of the principal amount, plus accrued and unpaid interest.
Fundamental Change	If a fundamental change (as described under Description of Notes) occurs prior to maturity, holders may require us to purchase all or part of their notes at a repurchase price equal to 100% of their principal amount, plus accrued and unpaid interest, including additional and special interest, if any, to, but excluding, the date of repurchase.
Use of Proceeds	We will not receive any proceeds from the sale of the notes or shares of common stock underlying the notes by the selling securityholders.
Call Spread Transactions	We entered into issuer call spread transactions with one or more investors (the counterparty) pursuant to which we have the right to purchase a number of shares of our common stock in an amount equal to the number of shares underlying the notes at a strike price equal to the conversion price of the notes. Pursuant to any such issuer call spread transactions, we would also simultaneously sell to the counterparty options to purchase shares of our common stock in an amount equal to the number of shares underlying the convertible notes at prices in excess of the conversion price of the notes.
Registration Rights	We have agreed to keep a shelf registration statement, of which this prospectus forms a part, effective until the earlier of (1) the second anniversary of the closing date of the issuance of the notes; (2) the date when the holders of the notes and common stock issuable upon conversion of the notes are able to sell all such securities pursuant to Rule 144(k) under the Securities Act of 1933 or any successor provision, immediately without volume, manner of sale or other restriction; (3) the date when the holders of the notes and common stock issuable upon conversion of the notes are able to sell all such securities pursuant to Rule 144 under the Securities Act of 1933 or any successor provision, under which any legend borne by the common stock issuable upon conversion of the notes relating to restrictions on transferability thereof is removed; (4) the date when all notes and common stock issuable upon conversion of the notes registered under the shelf registration statement are sold or transferred pursuant thereto; (5) the date when all notes and common stock issuable upon conversion of the notes have ceased to be outstanding or are otherwise freely transferable.
U.S. Federal Income Tax Considerations	For information regarding the tax consequences of holding or disposing of a note, see U.S. Federal Income Tax Considerations below.

No Prior Market; the PORTAL Market	The notes are eligible for trading in the PORTAL market. However, notes sold using this prospectus will no longer be eligible for trading in the PORTAL market.
Nasdaq Global Market Symbol for our Common Stock	Our common stock is listed on The Nasdaq Global Market under the symbol DXCM.
Risk Factors	An investment in the notes or our common stock involves risk. You should carefully consider the information under Risk Factors and all other information included in this prospectus and the documents incorporated by reference before investing in the notes.

RISK FACTORS

Before you invest in any of our securities, you should be aware of various risks to which we may be subject, including those described below. The following lists the material risks and uncertainties, which may adversely affect our business, financial condition or results of operations. You should carefully consider these risks and uncertainties, together with all of the other information included or incorporated by reference in this prospectus, before you decide whether to purchase the notes or our common stock. The risks and uncertainties set out below are not the only risks and uncertainties we face. If any of the material risks or uncertainties we face were to occur, the trading price of our securities could decline, and you may lose part or all of your investment.

Risks Related to Our Business

Factors that May Affect our Financial Condition and Results of Operations

We have a limited operating history and our products may never achieve market acceptance.

We are a medical device company with a limited operating history. We received approval from the FDA for our STS on March 24, 2006 and have recently commercialized this product throughout the United States. On May 31, 2007, we received approval from the FDA for our second generation continuous glucose monitoring system, the SEVENTM, designed for up to seven days of continuous use, and we have begun commercializing this product. We expect that sales of our continuous glucose monitoring systems, which consist of a cell phone-sized receiver, transmitter and disposable sensor, will account for substantially all of our revenue for the foreseeable future. From inception through June 30, 2007, revenues from sales of our continuous glucose monitoring products total approximately $4.0 million. However, we have limited experience in selling our products and we might be unable to successfully commercialize our products for a number of reasons, including:

- market acceptance of our products by physicians and patients will largely depend on our ability to demonstrate their relative safety, efficacy, reliability, cost-effectiveness and ease of use;

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- we may not be able to manufacture our products in commercial quantities or at an acceptable cost;
- patients do not generally receive reimbursement from third-party payors for their purchase of our products, which may reduce widespread use of our products;
- our inexperience in marketing, selling and distributing our products;
- we may not have adequate financial or other resources to successfully commercialize our products;
- the uncertainties associated with establishing and qualifying our new manufacturing facility;
- our products are not labeled as a replacement for the information that is obtained from single-point finger stick devices;
- patients will need to incur the costs of our products in addition to single-point finger stick devices;
- the introduction and market acceptance of competing products and technologies;
- our inability to obtain sufficient quantities of supplies from our sole source and other key suppliers; and
- rapid technological change may make our technology and our products obsolete.

Our products are more invasive than current self-monitored glucose testing systems, including single-point finger stick devices, and patients may be unwilling to insert a sensor in their body, especially if their current diabetes management involves no more than two finger sticks per day. Moreover, patients may not perceive the benefits of continuous glucose monitoring and may be unwilling to change their current treatment regimens. In addition, physicians tend to be slow to change their medical treatment practices because of perceived liability risks arising from the use of new products. Physicians may not recommend or prescribe our products until there is long-term clinical evidence to convince them to alter their existing treatment methods, there are recommendations from prominent physicians that our products are effective in monitoring glucose levels and reimbursement or insurance coverage is available. We cannot predict when, if ever, physicians and patients may adopt the use of our products. If our products do not achieve an adequate level of acceptance by patients, physicians and healthcare payors, we may not generate significant product revenue and we may not become profitable.

Additionally, since the launch of the STS, we have experienced periodic field failures. We do not believe these failures created any patient safety concerns and we are not aware of any reports of adverse events or incidents related to these failures. Although we believe we have taken appropriate actions aimed at reducing or eliminating field failures, there can be no assurances that we will not experience additional failures going forward.

Our debt obligations expose us to risks that could adversely affect our business, operating results and financial condition.

In March 2007, we issued an aggregate principal amount of $60,000,000 in 4.75% Convertible Senior Notes due in 2027. The level of our indebtedness, among other things, could:

- require us to dedicate a portion of our expected cash flow or our existing cash to service our indebtedness, which would reduce the amount of our cash available for other purposes, including working capital, capital expenditures and research and development expenditures;
- make it difficult for us to incur additional debt or obtain any necessary financing in the future for working capital, capital expenditures, debt service, acquisitions or general corporate purposes;
- limit our flexibility in planning for or reacting to changes in our business;
- limit our ability to sell ourselves or engage in other strategic transactions;

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- make us more vulnerable in the event of a downturn in our business; or

- place us at a possible competitive disadvantage relative to less leveraged competitors and competitors that have greater access to capital resources.

If we fail to generate revenue due to any of the factors described in this section entitled Risk Factors, or otherwise, we could have difficulty paying amounts due on our indebtedness. Although the convertible senior notes mature in 2027, the holders of the convertible senior notes may require us to repurchase their notes prior to maturity under certain circumstances, including specified fundamental changes such as the sale of a majority of the voting power of the company. If we are unable to generate sufficient cash flow or otherwise obtain funds necessary to make required payments, or if we fail to comply with the various requirements of the convertible senior notes, we would be in default, which would permit the holders of our indebtedness to accelerate the maturity of the indebtedness and could cause defaults under any other indebtedness that we may have outstanding at such time. Any default under our indebtedness could have a material adverse effect on our business, operating results and financial condition.

Conversion of the convertible senior notes will dilute the ownership interests of existing stockholders.

The terms of the convertible senior notes permit the holders to convert the notes into shares of our common stock. The convertible senior notes are convertible into our common stock initially at a conversion price of $7.80 per share, which would result in an aggregate of approximately 7.7 million shares of our common stock being issued upon conversion, subject to adjustment upon the occurrence of specified events, provided that the total number of shares of common stock issuable upon conversion, as may be adjusted for fundamental changes or otherwise, may not exceed approximately 9.2 million shares. The conversion of some or all of the convertible senior notes will dilute the ownership interest of our existing stockholders. Any sales in the public market of the common stock issuable upon conversion could adversely affect prevailing market prices of our common stock.

We have incurred losses since inception and anticipate that we will incur continued losses for the foreseeable future.

We have incurred net losses in each year since our inception in May 1999, including a net loss of $22.3 million for the six months ended June 30, 2007. As of June 30, 2007, we had an accumulated deficit of $152.6 million. We have financed our operations primarily through private placements of our equity and debt securities and our public offerings, and have devoted a substantial portion of our resources to research and development relating to our continuous glucose monitoring systems, and more recently, we have incurred significant sales and marketing and manufacturing expenses associated with the commercialization of our products. In addition, we expect our research and development expenses to increase in connection with our clinical trials and other development activities related to our products. We also expect that our general and administrative expenses will continue to increase due to the additional operational and regulatory burdens applicable to public companies. As a result, we expect to continue to incur significant operating losses for the foreseeable future. These losses, among other things, have had and will continue to have an adverse effect on our stockholders equity and may adversely affect our ability to pay interest on, and principal of, the convertible senior notes.

If we are unable to establish adequate sales, marketing and distribution capabilities or enter into and maintain arrangements with third parties to sell, market and distribute our continuous glucose monitoring products, our business may be harmed.

To achieve commercial success for our products, we must either continue to develop and grow our sales and marketing organization or enter into arrangements with others to market and sell our products.

We currently employ a small direct sales force to market our products in the United States. Our sales organization competes with the experienced and well-funded marketing and sales operations of our competitors. We have limited experience developing and managing a direct sales organization and marketing and distributing our products, and we may be unsuccessful in our attempt to do so.

Developing and managing a direct sales organization is a difficult, expensive and time consuming process. To be successful we must:

- recruit and retain adequate numbers of effective sales personnel;
- effectively train our sales personnel in the benefits of our products;
- establish and maintain successful sales and marketing and education programs that encourage endocrinologists, physicians and diabetes educators to recommend our products to their patients; and
- manage geographically disbursed sales and marketing operations.

If we are unable to develop and maintain an adequate sales and marketing organization, or if our direct sales organization is not successful, we may have difficulty achieving market awareness and selling our products.

We may contract with third parties to market and sell our products in the United States if we are unable to develop an adequate direct sales organization. To the extent that we enter into arrangements with third parties to perform sales, marketing, distribution and billing services in the United States, our product margins could be lower than if we directly marketed and sold our STS. Furthermore, to the extent that we enter into co-promotion or other marketing and sales arrangements with other companies, any revenue received will depend on the skills and efforts of others, and we do not know whether these efforts will be successful. If we are unable to establish and maintain adequate sales, marketing and distribution capabilities, independently or with others, we may not be able to generate product revenue and may not become profitable.

We have limited manufacturing capabilities and manufacturing personnel, and if our manufacturing capabilities are insufficient to produce an adequate supply of products at appropriate quality levels, our growth could be limited and our business could be harmed.

We currently have limited resources, facilities and experience in commercially manufacturing sufficient quantities of product to meet expected demand for our products. During 2006, we had difficulty scaling our manufacturing operations to provide a sufficient supply of product to support our commercialization efforts. As a result of these product shortages, we experienced periods of backorder and, at times, had to limit the efforts of our sales force to introduce the STS to new customers. We have focused significant effort on continual improvement programs in our manufacturing operations intended to improve quality, yields and throughput and we believe we have remedied our supply shortages. Although we believe we have made progress in manufacturing to enable us to supply adequate amounts of product to support our commercialization efforts, there can be no assurances that supply will not be constrained going forward. In order to produce our products in the quantities we anticipate will be necessary to meet market demand, we will need to increase our manufacturing capacity by a significant factor over the current level. There are technical challenges to increasing manufacturing capacity, including equipment design and automation, materials procurement, problems with production yields and quality control and assurance. Developing commercial-scale manufacturing facilities will require the investment of substantial additional funds and the hiring and retention of additional management, quality assurance, quality control and technical personnel who have the necessary manufacturing experience. Also, the scaling of manufacturing capacity is subject to numerous risks and uncertainties, such as construction timelines, design, installation and maintenance of manufacturing equipment, among others, which can lead to unexpected delays. In addition, our facilities may have to undergo additional inspections by the FDA and corresponding state agencies. We cannot assure you that we will be able to develop and expand our manufacturing process and operations or obtain FDA and state agency approval of our facilities in a timely manner or at all. If we are unable to manufacture a sufficient supply of our current products or any future products for which we may receive approval, maintain control over expenses or otherwise adapt to anticipated growth, or if we underestimate growth, we may not have the capability to satisfy market demand and our business will suffer.

Additionally, the production of our products must occur in a highly controlled and clean environment to minimize particles and other yield-and quality-limiting contaminants. Weaknesses in process control or minute impurities in materials may cause a substantial percentage of defective products in a lot. If we are not able to maintain stringent quality controls, or if contamination problems arise, our clinical development and commercialization efforts could be delayed, which would harm our business and our results of operations.

Our products do not have reimbursement and are not approved for insurance coverage. If we are unable to obtain adequate reimbursement at acceptable prices for our products from third-party payors, we will be unable to generate significant revenue.

Our products do not have reimbursement and are not approved for insurance coverage. The availability of insurance coverage and reimbursement for newly approved medical devices is uncertain. In the United States, patients using existing single-point finger stick devices are generally reimbursed all or part of the product cost by Medicare or other third-party payors. The commercial success of our products in both domestic and international markets will be substantially dependent on whether third-party coverage and reimbursement is available for patients that use our products. In April 2007, the Centers for Medicare and Medicaid (CMS) Healthcare Common Procedure Coding System (HCPCS) Workgroup issued a preliminary decision recommending approval for our request to establish HCPCS codes for the three components of our continuous glucose monitoring system, however this preliminary decision does not represent a coverage decision nor is it final or binding upon CMS or any private payor and is subject to change. Third-party coverage may also be difficult to obtain if our products are not approved by the FDA as a replacement for existing single-point finger stick devices. Medicare, Medicaid, health maintenance organizations and other third-party payors are increasingly attempting to contain healthcare costs by limiting both coverage and the level of reimbursement of new medical devices, and, as a result, they may not cover or provide adequate payment for our products. In order to obtain reimbursement arrangements, we may have to agree to a net sales price lower than the net sales price we might charge in other sales channels. The continuing efforts of government and third-party payors to contain or reduce the costs of healthcare may limit our revenue. Our initial dependence on the commercial success of our products makes us particularly susceptible to any cost containment or reduction efforts. Accordingly, unless government and other third-party payors provide adequate coverage and reimbursement for our products, patients may not use it.

In some foreign markets, pricing and profitability of medical devices are subject to government control. In the United States, we expect that there will continue to be federal and state proposals for similar controls. Also, the trends toward managed healthcare in the United States and proposed legislation intended to reduce the cost of government insurance programs could significantly influence the purchase of healthcare services and products and may result in lower prices for our products or the exclusion of our products from reimbursement programs.

Our manufacturing operations are dependent upon third-party suppliers, making us vulnerable to supply problems and price fluctuations, which could harm our business.

We rely on Flextronics International, Ltd. to manufacture and supply the receiver included as part of our continuous glucose monitoring systems and the circuit boards for our short-term sensors; we rely on AMI Semiconductor, Inc. to manufacture and supply the application specific integrated circuit, or ASIC, that is incorporated into the transmitter for our continuous glucose monitoring systems; we rely on CardioTech, which manufactures the polymers used to synthesize our polymeric biointerface membranes for our products; we rely on Vita Needle to manufacture and supply the insertion needle in our products applicator; and we rely on The Tech Group to supply our injection molded components. Each of these suppliers is a sole-source supplier. In some cases, our agreements with these and our other suppliers can be terminated by either party upon short notice. In other cases we operate without a written agreement with the supplier. Our contract manufacturers also rely on sole-source suppliers to manufacture some of the components used in our products. Our manufacturers and suppliers may encounter problems during manufacturing due to a variety of reasons, including failure to follow specific protocols and procedures, failure to comply with applicable regulations, equipment malfunction and environmental factors, any of which could delay or impede their ability to meet our demand. Our reliance on these outside manufacturers and suppliers also subjects us to other risks that could harm our business, including:

- we may not be able to obtain adequate supply in a timely manner or on commercially reasonable terms;
- our products are technologically complex and it is difficult to develop alternative supply sources;
- we are not a major customer of many of our suppliers, and these suppliers may therefore give other customers needs higher priority than ours;
- our suppliers may make errors in manufacturing components that could negatively affect the efficacy or safety of our products or cause delays in shipment of our products;
- we may have difficulty locating and qualifying alternative suppliers for our sole-source supplies;
- switching components may require product redesign and submission to the FDA of a PMA supplement or possibly a separate PMA, either of which could significantly delay production;
- our suppliers manufacture products for a range of customers, and fluctuations in demand for the products these suppliers manufacture for others may affect their ability to deliver components to us in a timely manner; and
- our suppliers may encounter financial hardships unrelated to our demand for components, which could inhibit their ability to fulfill our orders and meet our requirements.

We may not be able to quickly establish additional or replacement suppliers, particularly for our single-source components, in part because of the FDA approval process and because of the custom nature of various parts we design. Any interruption or delay in the supply of components or materials, or our inability to obtain components or materials from alternate sources at acceptable prices in a timely manner, could impair our ability to meet the demand of our customers and cause them to cancel orders or switch to competitive products.

Abbott Diabetes Care, Inc. has filed a patent infringement lawsuit against us. If we are not successful in defending against its claims, our business could be materially impaired.

On August 11, 2005, Abbott Diabetes Care, Inc., or Abbott, filed a patent infringement lawsuit against us in the United States District Court for the District of Delaware, seeking a declaratory judgment that our short-term continuous glucose monitor infringes certain patents held by Abbott. In August 2005, we moved to dismiss these claims and filed requests for reexamination of the Abbott patents with the United States Patent and Trademark Office and in March 2006, the Patent Office ordered reexamination of each of the four patents originally asserted against us in the litigation. On June 27, 2006, Abbott amended its complaint to include three additional patents owned or licensed by Abbott which are allegedly infringed by our short-term continuous glucose monitor. On August 18, 2006 the court granted our motion to stay the lawsuit pending reexamination by the Patent Office of each of the four patents originally asserted by Abbott, and the court dismissed one significant infringement claim. In approving the stay, the court also granted our motion to strike, or disallow, Abbott s amended complaint in which Abbott had sought to add three additional patents to the litigation. In late 2006, the Patent Office issued a non-final rejection of all claims we submitted for reexamination in two of the Abbott patents cited in the original lawsuit. No decision has yet been published by the Patent Office on the other two patents cited in the original complaint which remain under reexamination. Subject to the stay, we intend to continue to vigorously contest the action.

Subsequent to the court s ruling on August 18, 2006, Abbott filed a separate action in the U.S. District Court for the District of Delaware alleging patent infringement of those same three additional patents. We believe this complaint, like the first, is without merit and we intend to vigorously contest the action. To that end, we filed requests with the Patent Office to reexamine each of the three additional patents cited by Abbott and on September 7, 2006, we filed a motion to strike Abbott s new complaint on the grounds that it is redundant of claims Abbott already improperly attempted to inject into the original case, and because the original case is now stayed, Abbott must wait until the court lifts that stay before it can properly ask the court to consider these claims. Alternatively, we asked the court to consolidate the new case with the original case and thereby stay the entirety of the case pending conclusion of the reexamination proceedings in the Patent Office. As of February 2007, the Patent Office has ordered reexamination of each of the three patents cited in this new lawsuit and in June 2007, the Patent Office issued a non-final rejection of all claims we submitted for reexamination in two of the Abbott patents cited in the new lawsuit.

Although it is our position that Abbott s assertions of infringement have no merit, neither the outcome of the litigation nor the amount and range of potential fees can be assessed. No assurances can be given that we will prevail in the lawsuit or that we can successfully defend ourselves against the claims made by Abbott, and we expect to incur significant costs in defending the action, which could have a material adverse effect on our business and our results of operations regardless of the final outcome of such litigation. Subject to the stay, Abbott could immediately seek a preliminary injunction that, if granted, would force us to stop making, using, selling or offering to sell our products. Our STS and SEVEN products are our only products that are approved for commercial sale, and if we were forced to stop selling either of them, our business and prospects would suffer. We cannot assure you that Abbott will not file for a preliminary injunction, that we would be successful in defending against such an action if filed or that we can successfully defend ourselves against the claim. In addition, defending against this action could have a number of harmful effects on our business, including those discussed in the following risk factor, regardless of the final outcome of such litigation.

We are subject to claims of infringement or misappropriation of the intellectual property rights of others, which could prohibit us from shipping affected products, require us to obtain licenses from third parties or to develop non-infringing alternatives, and subject us to substantial monetary damages and injunctive relief.

Other companies, including Abbott could, in the future, assert infringement or misappropriation claims against us with respect to our current or future products. Whether a product infringes a patent involves complex legal and factual issues, the determination of which is often uncertain. Therefore, we cannot be certain that we have not infringed the intellectual property rights of such third parties or others. Our competitors may assert that our continuous glucose monitoring systems or the methods we employ in the use of our systems are covered by U.S. or foreign patents held by them. This risk is exacerbated by the fact that there are numerous issued patents and pending patent applications relating to self-monitored glucose testing systems in the medical technology field. Because patent applications may take years to issue, there may be applications now pending of which we are unaware that may later result in issued patents that our products infringe. There could also be existing patents of which we are unaware that one or more components of our system may inadvertently infringe. As the number of competitors in the market for continuous glucose monitoring systems grows, the possibility of inadvertent patent infringement by us or a patent infringement claim against us increases.

Any infringement or misappropriation claim, including the claim brought by Abbott, could cause us to incur significant costs, could place significant strain on our financial resources, divert management s attention from our business and harm our reputation. If the relevant patents were upheld as valid and enforceable and we were found to infringe, we could be prohibited from selling our product that is found to infringe unless we could obtain licenses to use the technology covered by the patent or are able to design around the patent. We may be unable to obtain a license on terms acceptable to us, if at all, and we may not be able to redesign our products to avoid infringement. Even if we are able to redesign our products to avoid an infringement claim, we may not receive FDA approval for such changes in a timely manner or at all. A court could also order us to pay compensatory damages for such infringement, plus prejudgment interest and could, in addition, treble the compensatory damages and award attorney fees. These damages could be substantial and could harm our reputation, business, financial condition and operating results. A court also could enter orders that temporarily, preliminarily or permanently enjoin us and our customers from making, using, selling or offering to sell, or could enter an order mandating that we undertake certain remedial activities. Depending on the nature of the relief ordered by the court, we could become liable for additional damages to third parties.

Our inability to adequately protect our intellectual property could allow our competitors and others to produce products based on our technology, which could substantially impair our ability to compete.

Our success and our ability to compete is dependent, in part, upon our ability to maintain the proprietary nature of our technologies. We rely on a combination of patent, copyright and trademark law, and trade secrets and nondisclosure agreements to protect our intellectual property. However, such methods may not be adequate to protect us or permit us to gain or maintain a competitive advantage. Our patent applications may not issue as patents in a form that will be advantageous to us, or at all. Our issued patents, and those that may issue in the future, may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related products.

To protect our proprietary rights, we may in the future need to assert claims of infringement against third parties to protect our intellectual property. The outcome of litigation to enforce our intellectual property rights in patents, copyrights, trade secrets or trademarks is highly unpredictable, could result in substantial costs and diversion of resources, and could have a material adverse effect on our financial condition and results of operations regardless of the final outcome of such litigation. In the event of an adverse judgment, a court could hold that some or all of our asserted intellectual property rights are not infringed, invalid or unenforceable, and could award attorney fees.

Despite our efforts to safeguard our unpatented and unregistered intellectual property rights, we may not be successful in doing so or the steps taken by us in this regard may not be adequate to detect or deter misappropriation of our technology or to prevent an unauthorized third party from copying or otherwise obtaining and using our products, technology or other information that we regard as proprietary. Additionally, third parties may be able to design around our patents. Furthermore, the laws of foreign countries may not protect our proprietary rights to the same extent as the laws of the United States. Our inability to adequately protect our intellectual property could allow our competitors and others to produce products based on our technology, which could substantially impair our ability to compete.

The federal trademark application for the DEXCOM mark has been opposed, and we continue to vigorously defend against the opposition. The opposition proceeding only determines the right to federally register a trademark and cannot result in the award of any damages. We believe that we are entitled to a registration for our DEXCOM mark, but cannot assure you that we will succeed in these efforts. If we are unsuccessful, we could be forced to change our company name or market our products under a different name, which could result in a loss of brand recognition, could require us to retrieve product and interrupt supply and could require us to devote substantial resources to advertising and marketing our products under the new brand.

We operate in a highly competitive market and face competition from large, well-established medical device manufacturers with significant resources, and, as a result, we may not be able to compete effectively.

The market for glucose monitoring devices is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. In selling our products, we compete directly with Roche Disetronic, a division of Roche Diagnostics; LifeScan, Inc., a division of Johnson & Johnson; the MediSense and TheraSense divisions of Abbott Laboratories; and Bayer Corporation, each of which manufactures and markets products for the single-point finger stick device market. Collectively, these companies currently account for substantially all of the worldwide sales of self-monitored glucose testing systems. Several companies are developing or marketing short-term continuous glucose monitoring products that will compete directly with our products. To date, in addition to our products, two other companies, Cygnus and Medtronic have received approval from the FDA for continuous glucose monitors and Abbott is seeking approval for another. We believe that one of the products, originally developed and marketed by Cygnus, is no longer actively marketed. In addition, Johnson & Johnson announced in 2006 that it is developing and expects to commence clinical trials in support of a continuous glucose monitoring system in 2007. Most of the companies developing or marketing competing devices are publicly traded or divisions of publicly-traded companies, and these companies enjoy several competitive advantages, including:

- significantly greater name recognition;
- established relations with healthcare professionals, customers and third-party payors;
- established distribution networks;
- additional lines of products, and the ability to offer rebates or bundle products to offer higher discounts or incentives to gain a competitive advantage;
- greater experience in conducting research and development, manufacturing, clinical trials, obtaining regulatory approval for products and marketing approved products; and
- greater financial and human resources for product development, sales and marketing, and patent litigation.

As a result, we may not be able to compete effectively against these companies or their products.

No continuous glucose monitoring system, including either of our products, has yet received FDA clearance as a replacement for single-point finger stick devices, and our products may never be approved for that indication.

Our products do not eliminate the need for single-point finger stick devices and our future products may not be approved for that indication. No precedent for FDA approval of continuous glucose monitoring systems as a replacement for single-point finger stick devices has been established. Accordingly, there is no established study design or agreement regarding performance requirements or measurements in clinical trials for continuous glucose monitoring systems. We have not yet filed for FDA approval for replacement claim labeling and we cannot assure you that we will not experience delays if we do file. If any of our competitors were to obtain replacement claim labeling for a continuous glucose monitoring system, our products may not be able to compete effectively against that system and our business would suffer.

Technological breakthroughs in the glucose monitoring market could render our products obsolete.

The glucose monitoring market is subject to rapid technological change and product innovation. Our products are based on our proprietary technology, but a number of companies and medical researchers are pursuing new technologies for the monitoring of glucose levels. FDA approval of a commercially viable continuous glucose monitor or sensor produced by one of our competitors could significantly reduce market acceptance of our systems. Several of our competitors are in various stages of developing continuous glucose monitors or sensors, including non-invasive and invasive devices, and the FDA has approved several of these competing products. In addition, the National Institutes of Health and other supporters of diabetes research are continually seeking ways to prevent, cure or improve treatment of diabetes. Therefore, our products may be rendered obsolete by technological breakthroughs in diabetes monitoring, treatment, prevention or cure.

If we are unable to successfully complete the pre-clinical studies or clinical trials necessary to support additional PMA applications, we may be unable to commercialize our continuous glucose monitoring systems under development, which could impair our financial position.

Before submitting any additional PMA applications, we must successfully complete pre-clinical studies and clinical trials that we believe will demonstrate that the product is safe and effective. Product development, including pre-clinical studies and clinical trials, is a long, expensive and uncertain process and is subject to delays and failure at any stage. Furthermore, the data obtained from the studies and trial may be inadequate to support approval of a PMA application. While we have in the past obtained, and may in the future obtain, an Investigational Device Exemption, or IDE, prior to commencing clinical trials for our continuous glucose monitoring systems, FDA approval of an IDE application permitting us to conduct testing does not mean that the FDA will consider the data gathered in the trial to be sufficient to support approval of a PMA application, even if the trial s intended safety and efficacy endpoints are achieved.

The commencement or completion of any of our clinical trials may be delayed or halted, or be inadequate to support approval of a PMA application, for numerous reasons, including, but not limited to, the following:

- the FDA or other regulatory authorities do not approve a clinical trial protocol or a clinical trial, or place a clinical trial on hold;
- patients do not enroll in clinical trials at the rate we expect;
- patients do not comply with trial protocols;
- patient follow-up is not at the rate we expect;
- patients experience adverse side effects;
- patients die during a clinical trial, even though their death may not be related to our products;
- institutional review boards, or IRBs, and third-party clinical investigators may delay or reject our trial protocol;

- third-party clinical investigators decline to participate in a trial or do not perform a trial on our anticipated schedule or consistent with the investigator agreements, clinical trial protocol, good clinical practices or other FDA or IRB requirements;

- third-party organizations do not perform data collection, monitoring and analysis in a timely or accurate manner or consistent with the clinical trial protocol or investigational or statistical plans;

- regulatory inspections of our clinical trials or manufacturing facilities may, among other things, require us to undertake corrective action or suspend or terminate our clinical trials;

- changes in governmental regulations or administrative actions;

- the interim or final results of the clinical trial are inconclusive or unfavorable as to safety or efficacy; and

- the FDA concludes that our trial design is inadequate to demonstrate safety and efficacy.

The results of pre-clinical studies do not necessarily predict future clinical trial results, and predecessor clinical trial results may not be repeated in subsequent clinical trials. Additionally, the FDA may disagree with our interpretation of the data from our pre-clinical studies and clinical trials, or may find the clinical trial design, conduct or results inadequate to prove safety or efficacy, and may require us to pursue additional pre-clinical studies or clinical trials, which could further delay the approval of our products. If we are unable to demonstrate the safety and efficacy of our products in our clinical trials, we will be unable to obtain regulatory approval to market our products. The data we collect from our current clinical trials, our pre-clinical studies and other clinical trials may not be sufficient to support FDA approval.

We depend on clinical investigators and clinical sites to enroll patients in our clinical trials and other third parties to manage the trials and to perform related data collection and analysis, and, as a result, we may face costs and delays that are outside of our control.

We rely on clinical investigators and clinical sites to enroll patients in our clinical trials and other third parties to manage the trial and to perform related data collection and analysis. However, we may not be able to control the amount and timing of resources that clinical sites may devote to our clinical trials. If these clinical investigators and clinical sites fail to enroll a sufficient number of patients in our clinical trials or fail to ensure compliance by patients with clinical protocols or fail to comply with regulatory requirements, we will be unable to complete these trials, which could prevent us from obtaining regulatory approvals for our products. Our agreements with clinical investigators and clinical sites for clinical testing place substantial responsibilities on these parties and, if these parties fail to perform as expected, our trials could be delayed or terminated. If these clinical investigators, clinical sites or other third parties do not carry out their contractual duties or obligations or fail to meet expected deadlines, or if the quality or accuracy of the clinical data they obtain is compromised due to their failure to adhere to our clinical protocols, regulatory requirements or for other reasons, our clinical trials may be extended, delayed or terminated, or the clinical data may be rejected by the FDA, and we may be unable to obtain regulatory approval for, or successfully commercialize, our products.

We have not received, and may never receive, FDA approval to market our continuous glucose monitoring systems that are under development.

We are continuing to invest in the development of our technology platform and will seek to obtain additional FDA approvals for continuous glucose monitoring systems in addition to our currently approved products, including our continuous glucose monitoring system for the in-hospital market. The regulatory approval process for these continuous glucose monitoring systems that are under development involves, among other things, successfully completing clinical trials and obtaining a PMA from the FDA. The PMA process requires us to prove the safety and efficacy of our continuous glucose monitoring systems to the FDA s satisfaction. This process can be expensive and uncertain, requires detailed and comprehensive scientific and human clinical data, generally takes one to three years after a PMA application is filed and may never result in the FDA granting a PMA. The FDA can delay, limit or deny approval of a PMA application for many reasons, including:

- our systems may not be safe or effective to the FDA s satisfaction;
- the data from our pre-clinical studies and clinical trials may be insufficient to support approval;
- the manufacturing process or facilities we use may not meet applicable requirements; and
- changes in FDA approval policies or adoption of new regulations may require additional data.

Even if approved, our continuous glucose monitoring systems under development may not be approved for the indications that are necessary or desirable for successful commercialization. We may not obtain the necessary regulatory approvals to market these continuous glucose monitoring systems in the United States or anywhere else. Any delay in, or failure to receive or maintain, approval for our continuous glucose monitoring systems under development could prevent us from generating revenue from these products or achieving profitability.

We may be unable to continue the commercialization of our products or the development and commercialization of our other continuous glucose monitoring systems without additional funding.

Our operations have consumed substantial amounts of cash since inception. We expect to continue to spend substantial amounts on commercializing our products, including further development of our direct sales force and expansion of our manufacturing capacity, and on research and development, including conducting clinical trials for our next generation continuous glucose monitoring systems. For the six months ended June 30, 2007, our net cash used in operating activities was $16.0 million, compared to $25.0 million for the same period in 2006, and as of June 30, 2007, we had working capital of $80.1 million, including $84.2 million in cash, cash equivalents and short-term marketable securities. We expect that our cash used by operations will increase significantly in each of the next several years, and we may need additional funds to continue the commercialization of our products and for the development and commercialization of other continuous glucose monitoring systems. Additional financing may not be available on a timely basis on terms acceptable to us, or at all. Any additional financing may be dilutive to stockholders or may require us to grant a lender a security interest in our assets. The amount of funding we will need will depend on many factors, including:

- the revenue generated by sales of our products and other future products;
- the expenses we incur in manufacturing, developing, selling and marketing our products;
- our ability to scale our manufacturing operations to meet demand for our current and any future products;
- the costs to produce our continuous glucose monitoring systems;
- the costs and timing of additional regulatory approvals;
- the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights;
- the rate of progress and cost of our clinical trials and other development activities;
- the success of our research and development efforts;
- the emergence of competing or complementary technological developments;

- the terms and timing of any collaborative, licensing and other arrangements that we may establish; and

- the acquisition of businesses, products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

If adequate funds are not available, we may not be able to commercialize our products at the rate we desire and we may have to delay development or commercialization of our other products or license to third parties the rights to commercialize products or technologies that we would otherwise seek to commercialize. We also may have to reduce marketing, customer support or other resources devoted to our products. Any of these factors could harm our financial condition.

Potential long-term complications from our current products or other continuous glucose monitoring systems under development may not be revealed by our clinical experience to date.

If unanticipated long-term side-effects result from the use of our current products or other glucose monitoring systems under development, we could be subject to liability and our systems would not be widely adopted. Our clinical trials have been limited to seven days of continuous use with our products. Additionally, we have limited clinical experience with repeated use of our products in the same patient. We cannot assure you that long-term use would not result in unanticipated complications. Furthermore, the interim results from our current pre-clinical studies and clinical trials may not be indicative of the clinical results obtained when we examine the patients at later dates. It is possible that repeated use of our products will result in unanticipated adverse effects, potentially even after the device is removed.

If we or our suppliers fail to comply with ongoing regulatory requirements, or if we experience unanticipated problems with our products, these products could be subject to restrictions or withdrawal from the market.

Any product for which we obtain marketing approval, along with the manufacturing processes, post-approval clinical data and promotional activities for such product, will be subject to continual review and periodic inspections by the FDA and other regulatory bodies. The FDA s medical device reporting, or MDR, regulations require that we report to the FDA any incident in which our product may have caused or contributed to a death or serious injury, or in which our product malfunctioned and, if the malfunction were to recur, it would likely cause or contribute to a death or serious injury. We and our suppliers are required to comply with the FDA s Quality System Regulation, or QSR, and other regulations, which cover the methods and documentation of the design, testing, production, control, quality assurance, labeling, packaging, storage, shipping and servicing of our products. The FDA enforces the QSR through unannounced inspections. We currently manufacture our devices at our headquarters in San Diego, California, and a new facility located nearby. In these facilities we have more than 5,000 square feet of laboratory space and approximately 5,000 square feet of controlled environment rooms. In January 2007, both facilities were subject to a post-approval PMA and QSR audit by the FDA. Based on the results of this inspection, we believe we are in substantial compliance with the regulatory requirements for a commercial medical device manufacturer and there were no major observations from the FDA resulting from this audit. At the close of the inspection, the FDA issued a Form 483 indemnifying several inspectional observations and, although we had no formal requirements or obligations to provide anything further to the FDA regarding these observations, we voluntarily provided formal written evidence to the FDA of our actions taken to address these minor observations in April 2007. Compliance with ongoing regulatory requirements can be complex, expensive and time-consuming. Failure by us or one of our suppliers to comply with statutes and regulations administered by the FDA and other regulatory bodies, or failure to take adequate response to any observations, could result in, among other things, any of the following actions:

- warning letters;

- fines and civil penalties;
- unanticipated expenditures;
- delays in approving or refusal to approve our continuous glucose monitoring systems;
- withdrawal of approval by the FDA or other regulatory bodies;
- product recall or seizure;
- interruption of production;
- operating restrictions;
- injunctions; and
- criminal prosecution.

If any of these actions were to occur, it would harm our reputation and cause our product sales and profitability to suffer. In addition, we believe MDRs are generally underreported and any underlying problems could be of a larger magnitude than suggested by the number or types of MDRs we receive. Furthermore, our key component suppliers may not currently be or may not continue to be in compliance with applicable regulatory requirements.

Even if regulatory approval of a product is granted, the approval may be subject to limitations on the indicated uses for which the product may be marketed or contain requirements for costly post-marketing testing and surveillance to monitor the safety or efficacy of the product. Later discovery of previously unknown problems with our products, including software bugs, unanticipated adverse events or adverse events of unanticipated severity or frequency, manufacturing problems, or failure to comply with regulatory requirements such as the QSR, may result in restrictions on such products or manufacturing processes, withdrawal of the products from the market, voluntary or mandatory recalls, fines, suspension of regulatory approvals, product seizures, injunctions or the imposition of civil or criminal penalties.

We face the risk of product liability claims and may not be able to maintain or obtain insurance.

Our business exposes us to the risk of product liability claims that is inherent in the testing, manufacturing and marketing of medical devices, including those which may arise from the misuse or malfunction of, or design flaws in, our products. We may be subject to product liability claims if our products cause, or merely appear to have caused, an injury. Claims may be made by patients, healthcare providers or others selling our products. Although we have product liability and clinical trial liability insurance that we believe is appropriate, this insurance is subject to deductibles and coverage limitations. Our current product liability insurance may not continue to be available to us on acceptable terms, if at all, and, if available, the coverage may not be adequate to protect us against any future product liability claims. Further, if additional products are approved for marketing, we may seek additional insurance coverage. If we are unable to obtain insurance at an acceptable cost or on acceptable terms with adequate coverage or otherwise protect against potential product liability claims, we will be exposed to significant liabilities, which may harm our business. A product liability claim, recall or other claim with respect to uninsured liabilities or for amounts in excess of insured liabilities could result in significant costs and significant harm to our business.

We may be subject to claims against us even if the apparent injury is due to the actions of others or misuse of the device. Our customers, either on their own or following the advice of their physicians, may use our products in a manner not described in the products labeling and that differs from the manner in which it was used in clinical studies and approved by the FDA. For example, our SEVEN is designed to be used by a patient continuously for up to seven days, but the patient might be able to circumvent the safeguards designed into the SEVEN and use the product for longer than seven days. Off-label use of products by patients is common, and any such off-label use of our products could subject us to additional liability. These liabilities could prevent or interfere with our product commercialization efforts. Defending a suit, regardless of merit, could be costly, could divert management attention and might result in adverse publicity, which could result in the withdrawal of, or inability to recruit, clinical trial volunteers or result in reduced acceptance of our products in the market.

We may be subject to fines, penalties and injunctions if we are determined to be promoting the use of our products for unapproved off-label uses.

Although we believe our promotional materials and training methods are conducted in compliance with FDA and other regulations, if the FDA determines that our promotional materials or training constitutes promotion of an unapproved use, the FDA could request that we modify our training or promotional materials or subject us to regulatory enforcement actions, including the issuance of a warning letter, injunction, seizure, civil fine and criminal penalties. It is also possible that other federal, state or foreign enforcement authorities might take action if they consider promotional or training materials to constitute promotion of an unapproved use, which could result in significant fines or penalties under other statutory authorities, such as laws prohibiting false claims for reimbursement.

We conduct business in a heavily regulated industry and if we fail to comply with these laws and government regulations, we could suffer penalties or be required to make significant changes to our operations.

The healthcare industry is subject to extensive federal, state and local laws and regulations relating to:

- billing for services;
- financial relationships with physicians and other referral sources;
- inducements and courtesies given to physicians and other health care providers and patients;
- quality of medical equipment and services;
- confidentiality, maintenance and security issues associated with medical records and individually identifiable health information;
- medical device reporting;
- false claims;
- professional licensure; and
- labeling products.

These laws and regulations are extremely complex and, in some cases, still evolving. In many instances, the industry does not have the benefit of significant regulatory or judicial interpretation of these laws and regulations. If our operations are found to be in violation of any of the federal, state or local laws and regulations which govern our activities, we may be subject to the applicable penalty associated with the violation, including civil and criminal penalties, damages, fines or curtailment of our operations. The risk of being found in violation of these laws and regulations is increased by the fact that many of them have not been fully interpreted by the regulatory authorities or the courts, and their provisions are open to a

variety of interpretations. Any action against us for violation of these laws or regulations, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management s time and attention from the operation of our business.

In addition, healthcare laws and regulations may change significantly in the future. Any new healthcare laws or regulations may adversely affect our business. A review of our business by courts or regulatory authorities may result in a determination that could adversely affect our operations. Also, the healthcare regulatory environment may change in a way that restricts our operations.

We are not aware of any governmental healthcare investigations involving our executives or us. However, any future healthcare investigations of our executives, our managers or us could result in significant liabilities or penalties to us, as well as adverse publicity.

The majority of our operations are conducted at two facilities in San Diego, California. Any disruption at these facilities could increase our expenses.

Historically, the majority of our operations have been conducted at a single location in San Diego, California. We recently relocated a portion of our manufacturing operations and research and development to our new facility also located in San Diego, California. We take precautions to safeguard our facilities, including insurance, health and safety protocols, and off-site storage of computer data. However, a natural disaster, such as a fire, flood or earthquake, could cause substantial delays in our operations, damage or destroy our manufacturing equipment or inventory, and cause us to incur additional expenses. The insurance we maintain against fires, floods, earthquakes and other natural disasters may not be adequate to cover our losses in any particular case.

We may be liable for contamination or other harm caused by materials that we handle, and changes in environmental regulations could cause us to incur additional expense.

Our research and development and clinical processes involve the handling of potentially harmful biological materials as well as hazardous materials. We are subject to federal, state and local laws and regulations governing the use, handling, storage and disposal of hazardous and biological materials and we incur expenses relating to compliance with these laws and regulations. If violations of environmental, health and safety laws occur, we could be held liable for damages, penalties and costs of remedial actions. These expenses or this liability could have a significant negative impact on our financial condition. We may violate environmental, health and safety laws in the future as a result of human error, equipment failure or other causes. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with violations. We are subject to potentially conflicting and changing regulatory agendas of political, business and environmental groups. Changes to or restrictions on permitting requirements or processes, hazardous or biological material storage or handling might require an unplanned capital investment or relocation. Failure to comply with new or existing laws or regulations could harm our business, financial condition and results of operations.

Failure to obtain regulatory approval in foreign jurisdictions will prevent us from marketing our products abroad.

We may seek to market our products internationally. Outside the United States, we can market a product only if we receive a marketing authorization and, in some cases, pricing approval, from the appropriate regulatory authorities. The approval procedure varies among countries and can involve additional testing, and the time required to obtain approval may differ from that required to obtain FDA approval. The foreign regulatory approval process may include all of the risks associated with obtaining FDA approval in addition to other risks. We may not obtain foreign regulatory approvals on a timely basis, if at all. Approval by the FDA does not ensure approval by regulatory authorities in other countries, and approval by one foreign regulatory authority does not ensure approval by regulatory authorities in other foreign countries or by the FDA. We have not taken any actions to obtain foreign regulatory approvals. We may not be able to file for regulatory approvals and may not receive necessary approvals to commercialize our products in any market outside the United States on a timely basis, or at all.

Our success will depend on our ability to attract and retain our personnel.

We are highly dependent on our senior management, especially Terrance H. Gregg, our recently appointed President and Chief Executive Officer, Andrew K. Balo, our Vice President of Clinical and Regulatory Affairs, and Mark Brister, our Vice President of Advanced Development Teams. Our success will depend on our ability to retain our current management and to attract and retain qualified personnel in the future, including sales persons, scientists, clinicians, engineers and other highly skilled personnel. Competition for senior management personnel, as well as sales persons, scientists, clinicians and engineers, is intense and we may not be able to retain our personnel. In addition, some members of our management team have only recently joined our company. For example, Terrance H. Gregg, our President and Chief Executive Officer, joined us in June 2007. We expect that it will take time for Mr. Gregg to integrate into our company and our business could be harmed if the integration is not successful. The loss of the services of members of our senior management, scientists, clinicians or engineers could prevent the implementation and completion of our objectives, including the commercialization of our current products and the development and introduction of additional products. The loss of a member of our senior management or our professional staff would require the remaining executive officers to divert immediate and substantial attention to seeking a replacement. Each of our officers may terminate their employment at any time without notice and without cause or good reason. Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees.

We expect to continue to expand our operations and grow our research and development, manufacturing, sales, product development and administrative operations. This expansion is expected to place a significant strain on our management and will require hiring a significant number of qualified personnel. Accordingly, recruiting and retaining such personnel in the future will be critical to our success. There is intense competition from other companies and research and academic institutions for qualified personnel in the areas of our activities. If we fail to identify, attract, retain and motivate these highly skilled personnel, we may be unable to continue our development and commercialization activities.

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

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted or proposed by the Securities and Exchange Commission, or SEC, will result in increased costs to us as we evaluate the implications of any new rules and regulations and respond to new requirements under such rules and regulations. We are required to comply with many of these rules and regulations, and will be required to comply with additional rules and regulations in the future. As an early commercialization stage company with limited capital and human resources, we will need to divert management s time and attention away from our business in order to ensure compliance with these regulatory requirements. This diversion of management s time and attention may have a material adverse effect on our business, financial condition and results of operations.

Valuation of share-based payments, which we are required to perform for purposes of recording compensation expense under FAS 123(R), involves significant assumptions that are subject to change and difficult to predict.

On January 1, 2006, we adopted SFAS 123(R), which requires that we record compensation expense in the statement of income for share-based payments, such as employee stock options, using the fair value method. The requirements of SFAS 123(R) have and will continue to have a material effect on our future financial results reported under GAAP and make it difficult for us to accurately predict the impact our future financial results.

For instance, estimating the fair value of share-based payments is highly dependent on assumptions regarding the future exercise behavior of our employees and changes in our stock price. Our share-based payments have characteristics significantly different from those of freely traded options, and changes to the subjective input assumptions of our share-based payment valuation models can materially change our estimates of the fair values of our share-based payments. In addition, the actual values realized upon the exercise, expiration, early termination or forfeiture of share-based payments might be significantly different that our estimates of the fair values of those awards as determined at the date of grant. Moreover, we rely on third parties that supply us with information or help us perform certain calculations that we employ to estimate the fair value of share-based payments. If any of these parties do not perform as expected or make errors, we may inaccurately calculate actual or estimated compensation expense for share-based payments.

SFAS 123(R) could also adversely impact our ability to provide accurate guidance on our future financial results as assumptions that are used to estimate the fair value of share-based payments are based on estimates and judgments that may differ from period to period. We may also be unable to accurately predict the amount and timing of the recognition of tax benefits associated with share-based payments as they are highly dependent on the exercise behavior of our employees and the price of our stock relative to the exercise price of each outstanding stock option.

For those reasons, among others, SFAS 123(R) may create variability and uncertainty in the share-based compensation expense we will record in future periods, which could adversely impact our stock price and increase our expected stock price volatility as compared to prior periods.

Future changes in financial accounting standards or practices or existing taxation rules or practices may cause adverse unexpected revenue and/or expense fluctuations and affect our reported results of operations.

A change in accounting standards or practices or a change in existing taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation practice have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, as a result of changes approved by the Financial Accounting Standards Board, or FASB, on January 1, 2006 we began recording compensation expense in our statements of operations for equity compensation instruments, including employee stock options, using the fair value method. Our reported financial results beginning for the first quarter of 2006 and for all foreseeable future periods will be negatively and materially impacted by this accounting change. Other potential changes in existing taxation rules related to stock options and other forms of equity compensation could also have a significant negative effect on our reported results.

Our loan and security agreement contains restrictions that may limit our operating flexibility.

On March 20, 2006, we entered into a loan and security agreement that provides for a loan of up to $5.0 million to finance various equipment and leasehold improvement expenses. The agreement imposes certain limitations on us, including limitations on our ability to:

- transfer all or any part of our businesses or properties, other than transfers done in the ordinary course of business;
- engage in any business other than the businesses in which we are currently engaged;
- relocate our chief executive offices or state of incorporation;
- change our legal name or fiscal year;
- replace our chief executive officer or chief financial officer;
- merge or consolidate with or into any other business organizations, with certain exceptions;
- permit any person to beneficially own a sufficient number of shares entitling such person to elect a majority of our board of directors;
- incur additional indebtedness, with certain exceptions;
- incur liens with respect to any of our properties, with certain exceptions;
- pay dividends or make any other distribution or payment on account of or in redemption, retirement or purchase of any capital stock, other than repurchases of the stock of former employees;
- directly or indirectly acquire or own, or make any investment in, any persons, with certain exceptions;
- directly or indirectly enter into or permit to exist any material transaction with any affiliates except such transactions that are in the ordinary course of business that are done upon fair and reasonable terms that are no less favorable to us than would be obtained in an arm s length transaction with a non-affiliated company;
- make any payment in respect of any subordinated debt, or permit any of our U.S. domestic subsidiaries to make any such payment, except in compliance with the terms of such subordinated debt; or
- store any equipment or inventory in which the lender has any interest with any bailee, warehousemen or similar third party unless the third party has been notified of the lender s security interest, or become or be controlled by an investment company.

Complying with these covenants may make it more difficult for us to successfully execute our business strategy and compete against companies who are not subject to such restrictions.

Risks Related to the Notes and Our Common Stock

The effective subordination of the notes may limit our ability to satisfy our obligations under the notes.

The notes are our senior unsecured obligations and rank equally in right of payment with all of our other senior unsecured indebtedness. However, the notes are effectively subordinated in right of payment to all of our secured indebtedness, including any secured indebtedness we may incur in the future, to the extent of the value of the collateral securing such indebtedness. As of August 22, 2007, we had approximately $2.9 million of outstanding secured indebtedness. The indenture governing the notes does not prohibit us from incurring additional secured indebtedness in the future. Consequently, in the event of a bankruptcy, liquidation, dissolution, reorganization or similar proceeding with respect to us, the holders of any secured indebtedness will be entitled to proceed directly against the collateral that secures such indebtedness.

The notes also are effectively subordinated in right of payment to all unsecured and secured liabilities of our subsidiaries, if any. In the event of a bankruptcy, liquidation, dissolution, reorganization or similar proceeding with respect to our subsidiaries, we, as an equity owner of the subsidiary, and therefore holders of our debt, including the notes, will be subject to the prior claims of the subsidiary s creditors, including trade creditors and preferred equity holders. As of August 28, 2007, we had no subsidiaries. The indenture governing the notes does not prohibit any subsidiaries that we may form or acquire from incurring indebtedness in the future.

The notes contain no financial covenants, therefore, the note holders will not have protection against adverse changes in our business.

The indenture does not contain any financial covenants or restrict our ability to repurchase our securities other than the notes in accordance with their terms, pay dividends or make restricted payments. Furthermore, the indenture contains only limited protections in the event of a change in control. We could also engage in many types of transactions, such as acquisitions, refinancings or recapitalizations, that could substantially affect our capital structure and the value of the notes and our common stock.

Debt service obligations may adversely affect our cash flow.

We may be unable to generate cash sufficient to pay the principal of, interest on and other amounts due in respect of the notes and our other indebtedness when due. Our leverage could have significant negative consequences, including:

- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing on satisfactory terms, if at all;
- requiring the dedication of a portion of our expected cash flow from operations to service our indebtedness, thereby reducing the amount of our expected cash flow available for other purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and our industry; and
- placing us at a possible competitive disadvantage relative to less leveraged competitors and competitors that have better access to capital resources.

We may not have the ability to repurchase the notes in cash when required, or at maturity, as required by the indenture governing the notes.

Holders of the notes have the right to require us to repurchase the notes on specified dates or upon the occurrence of a fundamental change as described under Description of Notes. We may not have sufficient funds to repurchase the notes in cash when required or have the ability to arrange necessary financing on acceptable terms or at all. Similarly, if we default under any existing credit facilities to which we may be a party, we may be unable to make any cash payments due upon a fundamental change or upon the maturity of the notes.

A fundamental change may also constitute an event of default under, or result in the acceleration of the maturity of, our then-existing indebtedness. Our ability to repurchase the notes in cash or make any other required payments may be limited by law or the terms of agreements relating to our other indebtedness outstanding at the time.

Some significant restructuring transactions may not constitute a fundamental change, in which case we would not be obligated to offer to repurchase the notes.

Upon the occurrence of a fundamental change, holders have the right to require us to repurchase the notes. However, the fundamental change provisions do not afford protection to holders of notes in the event of certain transactions. For example, any leveraged recapitalization, refinancing, restructuring, or acquisition initiated by us will generally not constitute a fundamental change requiring us to repurchase the notes. In the event of any such transaction, holders of the notes will not have the right to require us to repurchase the notes, even though any of these transactions could increase the amount of our indebtedness, or otherwise adversely affect our capital structure or any credit ratings, thereby adversely affecting the holders of notes.

The conversion rate of the notes may not be adjusted for all dilutive events.

The conversion rate of the notes is subject to adjustment for certain events, including, but not limited to, the issuance of stock dividends on our common stock, the issuance of certain rights or warrants, subdivisions, combinations, distributions of capital stock, indebtedness or assets, cash dividends and certain issuer tender or exchange offers as described under Description of Notes.

However, the conversion rate will not be adjusted for other events, such as a third-party tender or exchange offer or an issuance of common stock for cash, that may adversely affect the trading price of the notes or the common stock. An event that adversely affects the value of the notes may occur, and that event may not result in an adjustment to the conversion rate.

The adjustment to the conversion rate for notes converted in connection with certain fundamental changes may not adequately compensate holders of notes for any lost value of your notes as a result of such transaction.

If a fundamental change occurs, under certain circumstances we will increase the conversion rate by a number of additional shares of our common stock for notes converted during the 30 business days prior to the anticipated effective date of such fundamental change. The increase in the conversion rate will be determined based on the date on which the specified corporate transaction becomes effective and the price paid per share of our common stock in such transaction, as described below under Description of Notes Adjustments of Average Prices Adjustments to shares delivered upon conversion upon certain fundamental changes. The adjustment to the conversion rate for notes converted in connection with a fundamental change may not adequately compensate holders of notes for any lost value of on the notes as a result of such transaction. In addition, if the price of our common stock in the transaction is greater than or equal to $50.00 per share or less than $6.50 (in each case, subject to adjustment), no adjustment will be made to the conversion rate. In addition, in no event will the total number of shares of common stock issuable upon conversion as a result of this adjustment exceed 153.8 per $1,000 principal amount of notes, subject to adjustments in the same manner as the conversion rate as set forth under Description of Notes Conversion Rate Adjustments.

Our obligation to increase the conversion rate in connection with any such fundamental change could be considered a penalty, in which case the enforceability thereof would be subject to general principles of reasonableness of economic remedies.

The notes may not have an active market and their price may be volatile. Holders may be unable to sell the notes at the price they desire or at all.

There can be no assurance that a liquid market will be maintained for the notes, that holders will be able to sell any of the notes at a particular time (if at all) or that the prices they receive if or when holders sell the notes will be above their initial offering price. We do not intend to list the notes on any national securities exchange. The initial purchaser has advised us that it intends to maintain a market in the notes, but it has no obligation to do so and may cease its market-making at any time without notice. In addition, market-making will be subject to the limits imposed by the Securities Act and the Securities Exchange Act of 1934, as amended, or the Exchange Act, and may be limited during the pendency of any shelf registration statement or exchange offer. The liquidity of the trading market in the notes, and the market price quoted for these notes, may be adversely affected by, among other things:

- changes in the overall market for debt securities;
- changes in the trading price of our common stock;
- changes in our financial performance or prospects;
- the prospects for companies in our industry generally;
- the number of holders of the notes;
- the interest of securities dealers in making a market for the notes; and
- prevailing interest rates.

The notes may not be rated or may receive a lower rating than anticipated.

We do not intend to seek a rating of the notes. However, if one or more rating agencies rates the notes and assigns the notes a rating lower than the rating expected by investors, or reduces their rating in the future, the market price of the notes and our common stock could be harmed.

Holders will not be entitled to any rights with respect to our common stock, but will be subject to all changes made with respect to our common stock.

Holders will not be entitled to any rights with respect to our common stock (including, without limitation, voting rights and rights to receive any dividends or other distributions on our common stock, other than extraordinary dividends that our board of directors designates as payable to the holders of the notes), but if holders subsequently convert their notes into common stock, such holders will be subject to all changes affecting the common stock. Holders will have rights with respect to our common stock only if and when we deliver shares of common stock to such holders upon conversion of their notes and, to a limited extent, under the conversion rate adjustments applicable to the notes. For example, in the event that an amendment is proposed to our certificate of incorporation or bylaws requiring stockholder approval and the record date for determining the stockholders of record entitled to vote on the amendment occurs prior to delivery of common stock to holders, such holders will not be entitled to vote on the amendment, although they will nevertheless be subject to any changes in the powers or rights of our common stock that result from such amendment.

Call spread transactions may affect the value of the notes and our common stock.

In an effort to reduce a portion of the potential dilution from conversion of the notes, we entered into issuer call spread transactions with investors pursuant to which we have the right to purchase shares of our common stock in an amount equal to the number of shares underlying the notes at a strike price equal to the conversion price of the notes. We may simultaneously sell to the counterparty options to purchase shares of our common stock in an amount equal to the number of shares underlying the convertible notes at prices in excess of the conversion price of the notes. We do not expect the call spread transactions to eliminate all, and they may not eliminate a material amount or any, of such dilution risk. The call spread transactions have expiration dates that result in 25% of the call options expiring every six months for two years from the date of the offering. As a result, they will not protect us from the effects of market appreciation of our stock after that time. The counterparty with whom we entered into these call spread transactions is likely to hedge its obligation to deliver shares under the call options we purchase by purchasing shares of our common stock, and is likely to modify its hedge positions throughout the life of the notes by purchasing and selling shares of our common stock. These activities may raise or maintain the market price of our common stock above independent market levels or prevent or retard a decline in the market price of our common stock, or they may cause a decrease in the market price of our common stock. Furthermore, these activities may increase or decrease the volatility of our common stock. In addition, if the counterparty concludes that we are unlikely to exercise our call option for any reason, including because the market price of our common stock is below the strike price for the call option, it may reduce or eliminate its hedge position, which could adversely effect the value of our common stock.

As a result, these activities may adversely affect the value of the notes and the value of the common stock you receive upon conversion of the notes.

Our stock price has been volatile historically and may continue to be volatile.

Fluctuations in the trading price of our common stock may prevent holders from being able to convert the notes, may impact the trading price of the notes and may make the notes more difficult to resell.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Since our initial public offering in April 2005, the closing sale price of our common stock on The Nasdaq Global Market ranged from $6.17 to $26.70 per share, and the closing sale price on August 24, 2007 was $8.81 per share. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new products by us or our competitors, changes in financial estimates and recommendations by securities analysts, the operating and stock price performance of other companies that investors may deem comparable to us, and new reports relating to trends in our markets or general economic conditions.

In addition, the stock market in general, and prices for companies in our industry, have experienced extreme volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our stock, regardless of our operating performance.

Because the notes are convertible into shares of our common stock, volatility or depressed prices of our common stock could have a similar effect on the trading price of our notes. Holders who receive common stock upon conversion also will be subject to the risk of volatility and depressed prices of our common stock. In addition, the existence of the notes may encourage short selling in our common stock by market participants because the conversion of the notes could depress the price of our common stock.

Sales of a significant number of shares of our common stock in the public markets, or the perception of such sales, could depress the market price of the notes.

Sales of a substantial number of shares of our common stock or other equity-related securities in the public markets could depress the market price of the notes, our common stock, or both, and impair our ability to raise capital through the sale of additional equity securities. We cannot predict the effect that future sales of our common stock or other equity-related securities would have on the market price of our common stock or the value of the notes. The price of our common stock could be affected by possible sales of our common stock by investors who view the notes as a more attractive means of equity participation in our company and by hedging or arbitrage trading activity which we expect to occur involving our common stock. This hedging or arbitrage could, in turn, affect the market price of the notes.

The receipt of common stock from a designated financial institution in an exchange in lieu of conversion will be a taxable event for U.S. federal income tax purposes.

As described below under Description of Notes Conversion Procedures, if a holder surrenders notes for conversion, we may direct such notes to be offered to a designated financial institution. If the designated financial institution accepts the notes and delivers common stock and cash for any fractional shares in exchange for the notes, such an exchange in lieu of conversion will be a taxable event for U.S. federal income tax purposes. See U.S. Federal Income Tax Considerations.

Holders may be subject to tax if we make or fail to make certain adjustments to the conversion rate of the notes even though holders do not receive a corresponding cash distribution.

The conversion rate of the notes is subject to adjustment in certain circumstances, including the payment of certain cash dividends. If the conversion rate is adjusted as a result of a distribution that is taxable to our common stockholders, such as a cash dividend, holders may be deemed to have received a taxable dividend subject to U.S. federal income tax without the receipt of any cash. In addition, a failure to adjust (or to adjust adequately) the conversion rate after an event that increases your proportionate interest in our company could be treated as a deemed taxable dividend to you.

If certain types of fundamental changes occur on or prior to the maturity date of the notes, under some circumstances, we will increase the conversion rate for notes converted in connection with the fundamental change. Such increase may also be treated as a distribution subject to U.S. federal income tax as a dividend. See U.S. Federal Income Tax Considerations.

If a holder is a Non U.S. Holder (as defined in U.S. Federal Income Tax Considerations), any deemed dividend would be subject to U.S. federal withholding tax at a 30% rate, or such lower rate as may be specified by an applicable treaty, which may be set off against subsequent payments. See U.S. Federal Income Tax Considerations.

Our charter documents and Delaware law may inhibit a takeover that stockholders consider favorable and could also limit the market price of our stock.

Our restated certificate of incorporation and restated bylaws and applicable provisions of Delaware law may make it more difficult for or prevent a third party from acquiring control of us without the approval of our board of directors. These provisions:

- establish a classified board of directors, so that not all members of our board may be elected at one time;

- set limitations on the removal of directors;
- limit who may call a special meeting of stockholders;
- establish advance notice requirements for nominations for election to our board of directors or for proposing matters that can be acted upon at stockholder meetings;
- do not permit cumulative voting in the election of our directors, which would otherwise permit less than a majority of stockholders to elect directors;
- prohibit stockholder action by written consent, thereby requiring all stockholder actions to be taken at a meeting of our stockholders; and
- provide our board of directors the ability to designate the terms of and issue a new series of preferred stock without stockholder approval.

In addition, Section 203 of the Delaware General Corporation Law generally limits our ability to engage in any business combination with certain persons who own 15% or more of our outstanding voting stock or any of our associates or affiliates who at any time in the past three years have owned 15% or more of our outstanding voting stock. These provisions may have the effect of entrenching our management team and may deprive you of the opportunity to sell your shares to potential acquirors at a premium over prevailing prices. This potential inability to obtain a control premium could reduce the price of our common stock.

We have also adopted a stockholder rights plan that may discourage, delay or prevent a change of control and make any future unsolicited acquisition attempt more difficult. Under the rights plan:

- the rights will become exercisable only upon the occurrence of certain events specified in the plan, including the acquisition of 15% of our outstanding common stock by a person or group, with limited exceptions;
- each right entitles the holder, other than an acquiring person, to acquire shares of our common stock at a 50% discount to the then prevailing market price; and
- our board of directors may redeem outstanding rights at any time prior to a person becoming an acquiring person, at a price of $0.0001 per right. Prior to a person becoming an acquiring person, the terms of the rights may be amended by our board of directors without the approval of the holders of the rights.

FORWARD-LOOKING STATEMENTS

This prospectus and documents incorporated herein by reference contain forward-looking statements that involve risks and uncertainties. All statements other than statements of historical fact contained in this prospectus or any documents incorporated by reference in this prospectus, including statements regarding future events, our future financial performance, business strategy and plans and objectives of management for future operations, are forward-looking statements. We have attempted to identify forward-looking statements by terminology including anticipates, believes, can, continue, could, estimates, expects, intends, may, plans, potential, predicts, should or wil terms or other comparable terminology. Although we do not make forward-looking statements unless we believe we have a reasonable basis for doing so, we cannot guarantee their accuracy. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including the risks outlined under Risk Factors or elsewhere in this prospectus or any documents incorporated by reference in this prospectus, which may cause our or our industry s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time and it is not possible for us to predict all risk factors, nor can we address the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause our actual results to differ materially from those contained in any forward-looking statements.

You should not place undue reliance on any forward-looking statement, each of which applies only as of the date of this prospectus. Before you invest in our common stock, you should be aware that the occurrence of the events described in the section entitled Risk Factors and elsewhere in this prospectus could negatively affect our business, operating results, financial condition and stock price. Except as required by law, we undertake no obligation to update or revise publicly any of the forward-looking statements after the date of this prospectus to conform our statements to actual results or changed expectations.

RATIO OF EARNINGS TO FIXED CHARGES

The financial information provided in the table below should read be in conjunction with our financial statements and the related notes incorporated by reference into this prospectus. The following table sets forth our ratio of earnings to fixed charges for each of the periods indicated. As earnings are inadequate to cover the combined fixed charges, we have provided the deficiency amounts. For purposes of calculating this deficiency, earnings consist of income (loss) from continuing operations before fixed charges. Fixed charges consist of interest expense, including amortization of debt issuance costs, and the portion of rent expense which we believe is representative of the interest component of rental expense. For the periods indicated below, we had no outstanding shares of preferred stock with required dividend payments.

	Fiscal Year Ended December 31,					**Six Months Ended June 30,**
	2002	**2003**	**2004**	**2005**	**2006**	**2007**
Deficiency of earnings available to cover fixed charges (in thousands)	$ (7,708)	$ (9,915)	$ (13,946)	$ (30,767)	$ (46,599)	$ (22,265)

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USE OF PROCEEDS

We will not receive any proceeds from the sale of the notes or shares of common stock underlying the notes by the selling securityholders.

DESCRIPTION OF NOTES

We issued the notes under an indenture dated as of March 9, 2007 (the indenture) between us and Wells Fargo Bank, National Association, as trustee (the trustee). The terms of the notes include those expressly set forth in the indenture and those made part of the indenture by reference to the Trust Indenture Act of 1939, as amended (the Trust Indenture Act).

Holders may request copies of the indenture and the registration rights agreement from us as described under Where you can find more information.

The following description is a summary of the material provisions of the notes, the indenture and the registration rights agreement and does not purport to be complete. This summary is subject to and is qualified by reference to all the provisions of the notes, the indenture and the registration rights agreement, including the definitions of certain terms used in those agreements. We urge holders to read these documents because they, and not this description, define your rights as a holder of the notes.

For purposes of this description, references to the Company, we, our and us refer only to DexCom, Inc.

General

The notes:

- are our general unsecured, senior obligations;
- are in an aggregate principal amount of $60 million;
- will mature on March 15, 2027, unless earlier converted or repurchased;
- are issued in denominations of $1,000 and integral multiples of $1,000;
- are represented by one or more registered notes in global form, but in certain limited circumstances may be represented by notes in certificated form. See Book Entry, settlement and clearance; and
- are eligible for trading on The PORTAL Market.

The notes may be converted initially at a conversion rate of 128.2051 shares of common stock per $1,000 principal amount of notes (equivalent to a conversion price of approximately $7.80 per share of common stock). The conversion rate is subject to adjustment if certain events occur. We will initially settle conversions of the notes by delivering a number of shares of our common stock equal to the conversion rate for each $1,000 principal amount of the notes. Holders will not receive any separate cash payment for interest or additional and special interest, if any, accrued and unpaid to the conversion date except under the limited circumstances described below.

The indenture does not limit the amount of debt that may be issued by us or our subsidiaries under the indenture or otherwise. Other than restrictions described under Fundamental Change Permits Holders to Require Us to Repurchase Notes and Consolidation, Merger and Sale of Assets below and except for the provisions set forth under Conversion Rights Conversion Rate Adjustments Adjustments to shares delivered upon conversion upon certain fundamental changes, the indenture does not contain any covenants or other provisions designed to afford holders of the notes protection in the event of a highly leveraged transaction involving us or in the event of a decline in our credit rating as the result of a takeover, recapitalization, highly leveraged transaction or similar restructuring involving us that could adversely affect such holders.

We may, without the consent of the holders, issue additional notes under the indenture with the same terms and with the same CUSIP numbers as the notes offered hereby in an unlimited aggregate principal amount, provided that such additional notes must be part of the same issue as the notes offered hereby for U.S. federal income tax purposes. We may also from time to time repurchase notes in open market purchases or negotiated transactions without prior notice to holders.

We do not intend to list the notes on a national securities exchange or interdealer quotation system.

Payments on the Notes; Paying Agent and Registrar; Transfer and Exchange

We will pay principal of and interest (including additional and special interest, if any) on notes in global form registered in the name of or held by DTC or its nominee in immediately available funds to DTC or its nominee, as the case may be, as the registered holder of such global note.

The registered holder of a note will be treated as the owner of it for all purposes including, without limitation, for all notices required under the indenture.

We will pay principal of certificated notes at an office or agency designated by us for that purpose. We have initially designated Wells Fargo Bank, National Association as our paying agent and registrar and notes may be presented for payment or for registration of transfer at their office. We may, however, change the paying agent or registrar without prior notice to the holders of the notes, and we may act as paying agent or registrar. Interest (including additional and special interest, if any), on certificated notes will be payable (i) to holders having an aggregate principal amount of $5,000,000 or less, by check mailed to the holders of these notes and (ii) to holders having an aggregate principal amount of more than $5,000,000, either by check mailed to each holder or, upon application by a holder to the registrar not later than the relevant record date, by wire transfer in immediately available funds to that holder s account within the U.S., which application shall remain in effect until the holder notifies the registrar to the contrary in writing.

A holder of notes may transfer or exchange notes at the office of the registrar in accordance with the indenture. The registrar and the trustee may require a holder, among other things, to furnish appropriate endorsements and transfer documents, including signature guarantees. No service charge will be imposed by us, the trustee or the registrar for any registration of transfer or exchange of notes, but we may require a holder to pay a sum sufficient to cover any transfer tax or other similar governmental charge required by law or permitted by the indenture. Holders may not sell or otherwise transfer notes or common stock issued upon conversion of notes except in compliance with the provisions set forth below under Transfer Restrictions and Registration Rights. We are not required to transfer or exchange any note surrendered for conversion or selected for redemption.

Interest

The notes bear interest at a rate of 4.75% per year. Interest on the notes accrues from March 9, 2007. Interest will be payable semiannually in arrears on March 15 and September 15 of each year, beginning September 15, 2007. We will pay additional and special interest, if any, under the circumstances described under Registration Rights. We will pay special interest, if any, under the circumstances described under Events of Default.

Interest will be paid to the person in whose name a note is registered at the close of business on March 1 or September 1, as the case may be, immediately preceding the relevant interest payment

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date. Interest on the notes will be computed on the basis of a 360-day year composed of twelve 30-day months.

If any interest payment date (other than an interest payment date coinciding with the stated maturity date or earlier required repurchase date upon a fundamental change) of a note falls on a day that is not a business day, such interest payment date will be postponed to the next succeeding business day. If the stated maturity date or earlier required repurchase date upon a fundamental change would fall on a day that is not a business day, the required payment of interest, if any, and principal (and additional and special interest, if any), will be made on the next succeeding business day and no interest on such payment will accrue for the period from and after the stated maturity date or earlier required repurchase date upon a fundamental change to such next succeeding business day. The term business day means, with respect to any note, any day other than a Saturday, a Sunday or a day on which the Federal Reserve Bank of New York is closed.

Ranking

The notes are our general unsecured obligations and rank senior in right of payment to all future indebtedness that is expressly subordinated in right of payment to the notes. The notes will rank equally in right of payment with all of our existing and future liabilities that are not so subordinated. The notes will effectively rank junior to any secured indebtedness we may incur to the extent of the value of the assets securing such indebtedness. In the event of our bankruptcy, liquidation, reorganization or other winding up, our assets that secure such secured indebtedness will be available to pay obligations on the notes only after all indebtedness under such secured indebtedness has been repaid in full from such assets. There may not be sufficient assets remaining to pay amounts due on any or all the notes then outstanding. As of August 22, 2007, our total short and long term indebtedness was approximately $63.5 million.

The notes are structurally subordinated to all liabilities of our subsidiaries. We currently have no subsidiaries.

Automatic Conversion

We may elect to automatically convert some or all of the notes at any time on or prior to maturity if the closing price of our common stock has exceeded 150% of the conversion price (referred to as the auto-conversion price) for at least 20 trading days during any consecutive 30-day trading period ending within five trading days prior to the notice of automatic conversion. We refer to this as an automatic conversion. The notice of automatic conversion must be given not more than 30 and not less than 20 days prior to the date of automatic conversion. During the two-year period after the issue date of the notes, we may automatically convert the notes only if a registration statement with respect to the resale of our common stock issuable upon conversion has been declared effective prior to the date of the notice of such automatic conversion and such registration statement remains effective on the date of automatic conversion.

If an automatic conversion occurs on or prior to March 15, 2010, we will pay additional interest in cash or, at our option in shares of our common stock to holders of new notes being converted. This additional interest shall be equal to three years worth of interest less any interest actually paid or provided for prior to the date of automatic conversion. We will specify in the automatic conversion notice whether we will pay the additional interest in cash or common shares. If we elect to pay the additional interest in common shares, the common shares will be valued at the auto-conversion price.

If we automatically convert some, but not all, of the notes, the trustee will select the notes to be automatically converted in principal amount of $1,000 or in whole multiples thereof, by lot or on a pro rata basis or by another method that the trustee considers fair and appropriate. If any notes are to be automatically converted in part only, we will issue a note or notes with a principal amount equal to the unconverted principal portion thereof. If a portion of a holder s new notes is selected for partial auto-conversion and such holder voluntarily converts a portion of such holder s new notes, the voluntarily converted portion will be deemed to be taken from the portion selected for auto-conversion.

Holders will not be required to pay any stamp, transfer, documentary or similar taxes or duties upon conversion but will be required to pay any stamp or transfer tax or duty if the common shares issued upon conversion of the new notes is in a name other than your name. Certificates representing common shares will not be issued or delivered unless all stamp or transfer taxes and duties, if any, payable by the holder have been paid.

Optional Redemption

No sinking fund is provided for the notes. Prior to March 20, 2010, the notes will not be redeemable. On or after March 20, 2010, we may redeem for cash all or part of the notes at any time, upon not less than 20 nor more than 60 days notice before the redemption date by mail to the trustee, the paying agent and each holder of notes, for a price equal to 100% of the principal amount of the notes to be redeemed plus any accrued and unpaid interest, including additional and special interest, if any, to, but excluding, the redemption date.

If we decide to redeem fewer than all of the outstanding notes, the trustee will select the notes to be redeemed (in principal amounts of $1,000 or integral multiples thereof) by lot, or on a pro rata basis by another method the trustee considers fair and appropriate, subject to applicable DTC procedures.

If the trustee selects a portion of your note for partial redemption and you convert a portion of the same note, the converted portion will be deemed to be from the portion selected for redemption.

Conversion Rights

General

Holders may convert their notes at the applicable conversion rate at any time prior to the close of business on the business day immediately preceding the maturity date. The initial conversion rate will be 128.2051 shares of common stock per $1,000 principal amount of notes (equivalent to a conversion price of approximately $7.80 per share of common stock), and will be subject to adjustment as provided below. We will settle conversions of the notes by delivering a number of shares of our common stock equal to the conversion rate for each $1,000 principal amount of the notes.

The conversion rate and the equivalent conversion price in effect at any given time are referred to as the applicable conversion rate and the applicable conversion price, respectively, and will be subject to adjustment as described below. A holder may convert fewer than all of such holder s notes so long as the notes converted are an integral multiple of $1,000 principal amount.

If a holder of notes has submitted notes for repurchase upon a fundamental change, the holder may convert those notes only if that holder withdraws the repurchase election made by that holder.

Upon conversion, holders will not receive any separate cash payment for accrued and unpaid interest and additional and special interest, if any, unless such conversion occurs between a regular record date and the interest payment date to which it relates and you were the holder of record on such record date. We will not issue fractional shares of our common stock upon conversion of notes. Instead, we will pay cash in lieu of fractional shares based on the daily VWAP (as defined below) of our common stock on the last day of the observation period (as defined below). Our delivery to you of the full number of shares of our common stock, together with any cash payment for any fractional share, into which a note is convertible, will be deemed to satisfy in full our obligation to pay:

- the principal amount of the note; and
- accrued and unpaid interest and additional and special interest, if any, to, but not including, the conversion date.

As a result, accrued and unpaid interest and additional and special interest, if any, to, but not including, the conversion date will be deemed to be paid in full rather than cancelled, extinguished or forfeited.

Notwithstanding the preceding paragraph, if notes are converted after 5:00 p.m., New York City time, on a regular record date for the payment of interest, holders of such notes at 5:00 p.m., New York City time, on such record date will receive the interest and additional and special interest, if any, payable on such notes on the corresponding interest payment date notwithstanding the conversion. Notes, upon surrender for conversion during the period from 5:00 p.m., New York City time, on any regular record date to 9:00 a.m., New York City time, on the immediately following interest payment date, must be accompanied by funds equal to the amount of interest and additional and special interest, if any, payable on the notes so converted; provided that no such payment need be made:

- if we have specified a redemption date or fundamental change repurchase date that is after a record date and on or prior to the third trading day after the corresponding interest payment date;
- in respect of any conversion that occurs after the record date for the interest payment due on March 15, 2012; or
- to the extent of any overdue interest, if any overdue interest exists at the time of conversion with respect to such note.

If a holder converts notes, we will pay any documentary, stamp or similar issue or transfer tax due on the issue of any shares of our common stock upon the conversion, unless the tax is due because the holder requests any shares to be issued in a name other than the holder s name, in which case the holder will pay that tax.

Notwithstanding the foregoing, in no event will the total number of shares of common stock issuable upon conversion exceed 153.8 per $1,000 principal amount of notes, whether as a result of an increase in the conversion rate in connection with a fundamental change or otherwise, subject in each case to adjustment in the same manner as the conversion rate as set forth under clause (1) through (3) of Conversion Rate Adjustments (the limitations on the conversion rate set forth in this sentence are herein referred to as the Conversion Rate Cap). We have agreed that we will not take any action described in clauses (4) or (5) under Conversion Rate Adjustments if, as a result of such action, the conversion rate adjustment that would otherwise be made pursuant to the provisions of (4) or (5) would be limited by the Conversion Rate Cap, unless such action would not result in a violation of NASD Rule 4350 as such rule or successor to such rule may be then in effect and interpreted by the NASD (or any similar rule of any other stock exchange which is the primary exchange upon which the company s common stock is listed). If such action would not result in a violation of NASD Rule 4350, or any successor rule or similar rule of any other stock exchange which is the primary exchange upon which our common stock is then listed, then the Conversion Rate Cap shall not apply to such action taken by us.

Conversion Procedures

If you hold a beneficial interest in a global note, to convert you must comply with DTC s procedures for converting a beneficial interest in a global note. If required, you must also pay funds equal to the interest (including additional and special interest, if any) payable on the next interest payment date and all transfer or similar taxes that may be applicable to such conversion.

If you hold a certificated note, to convert you must:

- complete and manually sign the conversion notice on the back of the note, or a facsimile of the conversion notice;
- deliver the conversion notice, which is irrevocable, and the note to the conversion agent;
- if required, furnish appropriate endorsements and transfer documents;
- if required, pay all transfer or similar taxes; and
- if required, pay funds equal to the interest payable on the next interest payment date. The date you comply with these requirements is the conversion date under the indenture.

When a holder surrenders notes for conversion, we may direct the conversion agent to surrender such notes to a financial institution designated by us for exchange in lieu of conversion. In order to accept any notes surrendered for conversion, the designated institution must agree to deliver, in exchange for such notes, the number of shares of our common stock and/or cash that the holder of those notes is entitled to receive upon conversion. We may, but will not be obligated to, enter into a separate agreement with the designated institution that would compensate it for any such transaction. If the designated institution accepts any such notes, it will deliver the appropriate number of shares of common stock and/or cash to the conversion agent and the conversion agent will deliver those shares and/or cash to the holder. Any notes exchanged by the designated institution will remain outstanding. If the designated institution agrees to accept any notes for exchange but does not timely deliver the related consideration, we will, as promptly as practical thereafter, convert the notes into shares of common stock. Our designation of an institution to which the notes may be submitted for exchange does not require the institution to accept any notes. Delivery to the holder of such common stock and/or cash will be deemed to satisfy our obligation to pay the principal amount and accrued and unpaid interest, including additional and special interest, if any, to, but not including, the conversion date, regardless of whether such delivery is made by us or by the designated institution.

If a holder has already delivered a repurchase notice as described under Fundamental Change Permits Holders to Require Us to Repurchase Notes with respect to a note, the holder may not surrender that note for conversion until the holder has withdrawn the repurchase notice in accordance with the indenture.

Payment Upon Conversion

We will settle conversions of the notes by delivering a number of shares of our common stock equal to the conversion rate for each $1,000 principal amount of the notes.

We will deliver cash in lieu of any fractional share of common stock issuable in connection with payment of the settlement amount (based on the daily VWAP for the final trading day of the applicable observation period).

Daily VWAP means, for each of the 20 consecutive trading days during the observation period, the per share volume-weighted average price as displayed under the heading Bloomberg VWAP on Bloomberg page DXCM.UQ <equity> AQR (or its equivalent successor if such page is not available) in respect of the period from 9:30 a.m. to 4:00 p.m. (New York City time) on such trading day (or if such volume-weighted average price is unavailable, the market value of one share of our common stock on such trading day determined, using a volume-weighted average method, by a nationally recognized independent investment banking firm retained for this purpose by us).

Observation period with respect to any note means the 20 consecutive trading day period beginning on and including the second trading day after the related conversion date, except that with respect to any conversion date occurring during the period beginning on December 15, 2011, and ending at 5:00 p.m. (New York City time) on the second scheduled trading day prior to maturity, observation period means the first 20 trading days beginning on and including the 22nd scheduled trading day prior to maturity.

For the purposes of determining payment upon conversion, trading day means a day during which (i) trading in our common stock generally occurs on the principal U.S. national or regional securities exchange or market on which our common stock is listed or admitted for trading and (ii) there is no market disruption event. Scheduled trading day means a day that is scheduled to be a trading day on the principal U.S. national or regional securities exchange or market on which our common stock is listed or admitted for trading.

Conversion Rate Adjustments

The conversion rate will be adjusted as described below, except that we will not make any adjustments to the conversion rate if holders of the notes participate, as a result of holding the notes, and at the same time as the common stockholders participate, in any of the transactions described below as if such holders of the notes held a number of shares of our common stock equal to the applicable conversion rate, *multiplied* by the principal amount (expressed in thousands) of notes held by such holder, without having to convert their notes.

(1) If we issue shares of our common stock as a dividend or distribution on shares of our common stock, or if we effect a share split or share combination, the conversion rate will be adjusted based on the following formula:

$$CR \quad CR_0 \frac{CR}{OS_0}$$

where,

CR_0 = the conversion rate in effect immediately prior to the ex date of such dividend or distribution, or the effective date of such share split or combination, as applicable;

CR = the conversion rate in effect immediately after such ex date or effective date;

OS_0 = the number of shares of our common stock outstanding immediately prior to such ex date or effective date; and

OS = the number of shares of our common stock outstanding immediately after such ex date or effective date.

(2) If we issue to all or substantially all holders of our common stock any rights or warrants entitling them for a period of not more than 60 calendar days to subscribe for or purchase shares of our common stock, at a price per share less than the average of the last reported sale prices of our common stock for the 10 consecutive trading day period ending on the business day immediately preceding the date of announcement of such issuance, the conversion rate will be adjusted based on the following formula (provided that the conversion rate will be readjusted to the extent that such rights or warrants are not exercised prior to their expiration):

$$CR \quad CR_0 \frac{OS_0 + X}{OS_0 + Y}$$

where,

CR_0 = the conversion rate in effect immediately prior to the ex date for such issuance; CR = the conversion rate in effect immediately after such ex date;

OS_0 = the number of shares of our common stock outstanding immediately after such ex date;

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X = the total number of shares of our common stock issuable pursuant to such rights; and

Y = the number of shares of our common stock equal to the aggregate price payable to exercise such rights divided by the average of the last reported sale prices of our common stock over the 10 consecutive trading day period ending on the business day immediately preceding the date of announcement of the issuance of such rights.

(3) If we distribute shares of our capital stock, evidences of our indebtedness or other assets or property of ours to all or substantially all holders of our common stock, excluding

- dividends or distributions and rights or warrants referred to in clause (1) or (2) above; and
- dividends or distributions paid exclusively in cash;

then the conversion rate will be adjusted based on the following formula:

$$CR \quad CR_0 \frac{SP_0}{SP_0 \quad FMV}$$

where,

CR_0 = the conversion rate in effect immediately prior to the ex date for such distribution;

CR = the conversion rate in effect immediately after such ex date;

SP_0 = the average of the last reported sale prices of our common stock over the 10 consecutive trading day period ending on the trading day immediately preceding the ex date for such distribution; and FMV = the fair market value (as determined by our board of directors) of the shares of capital stock,

evidences of indebtedness, assets or property distributed with respect to each outstanding share of our common stock on the ex date for such distribution.

With respect to an adjustment pursuant to this clause (3) where there has been a payment of a dividend or other distribution on our common stock or shares of capital stock of any class or series, or similar equity interest, of or relating to a subsidiary or other business unit, which we refer to as a spin-off, the conversion rate in effect immediately before 5:00 p.m., New York City time, on the effective date of the spin-off will be increased based on the following formula:

$$CR \quad CR_0 \frac{FMV_0 + MP_0}{MP_0}$$

where,

CR_0 = the conversion rate in effect immediately prior to the effective date of the adjustment;

CR = the conversion rate in effect immediately after the effective date of the adjustment;

FMV_0 = the average of the last reported sale prices of the capital stock or similar equity interest distributed to holders of our common stock applicable to one share of our common stock over the first 10 consecutive trading day period after the effective date of the spin-off; and

MP_0 = the average of the last reported sale prices of our common stock over the first 10 consecutive trading day period after the effective date of the spin-off.

The adjustment to the conversion rate under the preceding paragraph will occur on the tenth trading day from, and including, the effective date of the spin-off.

(4) If any cash dividend or distribution is made to all or substantially all holders of our common stock, the conversion rate will be adjusted based on the following formula:

$$CR \quad CR_0 \quad \frac{SP_0}{SP_0 \quad C}$$

where,

CR_0 = the conversion rate in effect immediately prior to the ex date for such distribution;

CR = the conversion rate in effect immediately after the ex date for such distribution;

SP_0 = the last reported sale price of our common stock on the trading day immediately preceding the ex date for such distribution; and

C = the amount in cash per share we distribute to holders of our common stock.

(5) If we or any of our subsidiaries make a payment in respect of a tender offer or exchange offer for our common stock, to the extent that the cash and value of any other consideration included in the payment per share of common stock exceeds the last reported sale price of our common stock on the trading day next succeeding the last date on which tenders or exchanges may be made pursuant to such tender or exchange offer, the conversion rate will be increased based on the following formula:

$$CR \quad CR_0 \quad \frac{AC + (SP \quad \text{x } OS \quad)}{OS_0 \text{ x } SP}$$

where,

CR_0 = the conversion rate in effect immediately prior to the effective date of the adjustment

CR = the conversion rate in effect immediately after the effective date of the adjustment;

AC = the aggregate value of all cash and any other consideration (as determined by our board of directors) paid or payable for shares purchased in such tender or exchange offer;

OS_0 = the number of shares of our common stock outstanding immediately prior to the date such tender or exchange offer expires;

OS = the number of shares of our common stock outstanding immediately after the date such tender or exchange offer expires; and

SP = the average of the last reported sale prices of our common stock over the 10 consecutive trading day period commencing on the trading day next succeeding the date such tender or exchange offer expires.

The adjustment to the conversion rate under the preceding paragraph will occur on the tenth trading day from, and including, the trading day next succeeding the date such tender or exchange offer expires.

If application of the foregoing formulas would result in a decrease in the conversion rate, no adjustment to the conversion rate will be made (other than as a result of a stock split).

We are permitted, to the extent permitted by law and subject to the applicable rules of The Nasdaq Global Stock Market (or other applicable exchange rules), to increase the conversion rate of the notes by any amount for a period of at least 20 days if our board of directors determines that such increase would be in our best interest. We may also (but are not required to) increase the conversion rate to avoid or diminish income tax to holders of our common stock or rights to purchase shares of our common stock in connection with a dividend or distribution of shares (or rights to acquire shares) or similar event.

A holder may, in some circumstances, including the distribution of cash dividends to holders of our shares of common stock, be deemed to have received a distribution or dividend subject to U.S. federal income tax as a result of an adjustment or the nonoccurrence of an adjustment to the conversion rate. For a discussion of the U.S. federal income tax treatment of an adjustment to the conversion rate, see U.S. Federal Income Tax Considerations.

We currently have a preferred stock rights plan. To the extent that we have a rights plan in effect upon conversion of the notes into common stock, you will receive, in addition to the common stock, the rights under the rights plan, unless prior to any conversion, the rights have separated from the common stock, in which case, and only in such case, the conversion rate will be adjusted at the time of separation as if we distributed to all holders of our common stock, shares of our capital stock, evidences of indebtedness or assets as described in clause (3) above, subject to readjustment in the event of the expiration, termination or redemption of such rights.

Notwithstanding any of the foregoing, the applicable conversion rate will not be adjusted:

- upon the issuance of any shares of our common stock pursuant to any present or future plan providing for the reinvestment of dividends or interest payable on our securities and the investment of additional optional amounts in shares of our common stock under any plan;

- upon the issuance of any shares of our common stock or options or rights to purchase those shares pursuant to any present or future employee, director or consultant benefit plan, program or agreement of or assumed by us or any of our subsidiaries;

- upon the issuance of any shares of our common stock pursuant to any option, warrant, right or exercisable, exchangeable or convertible security not described in the preceding bullet and outstanding as of the date the notes were first issued;

- for a change in the par value of the common stock; or

- for accrued and unpaid interest and additional and special interest, if any.

Adjustments to the applicable conversion rate will be calculated to the nearest 1/10,000th of a share. Except as described above in this section, we will not adjust the conversion rate.

Recapitalizations, Reclassifications and Changes of our Common Stock

In the case of any recapitalization, reclassification or change of our common stock (other than changes resulting from a subdivision or combination), a consolidation, merger or combination involving us, a sale, lease or other transfer to a third party of our and our subsidiaries consolidated assets substantially as an entirety, or any statutory share exchange, in each case as a result of which our common stock would be converted into, or exchanged for, stock, other securities, other property or assets (including cash or any combination thereof), then, at the effective time of the transaction, the right to convert a note will be changed into a right to convert it into the kind and amount of shares of stock, other securities or other property or assets (including cash or any combination thereof) that a holder of a number of shares of common stock equal to the conversion rate immediately prior to such transaction would have owned or been entitled to receive (the reference property) upon such transaction. If the transaction causes our common stock to be converted into the right to receive more than a single type of consideration (determined based in part upon any form of stockholder election), the reference property into which the notes will be convertible will be deemed to be the weighted average of the types and amounts of consideration received by the holders of our common stock that affirmatively make such an

election. We have agreed in the indenture not to become a party to any such transaction unless its terms are consistent with the foregoing.

Adjustments of Average Prices

Whenever any provision of the indenture requires us to calculate an average of last reported prices or daily VWAP over a span of multiple days, we will make appropriate adjustments to account for any adjustment to the conversion rate that becomes effective, or any event requiring an adjustment to the conversion rate where the ex date of the event occurs, at any time during the period from which the average is to be calculated.

Adjustments to shares delivered upon conversion upon certain fundamental changes

If you elect to convert your notes in connection with a transaction of the type described in clause (1), (2), (3) or (4) of the definition of fundamental change (as defined under Fundamental Change Permits Holders to Require Us to Repurchase Notes) that is consummated on or before March 15, 2010, the conversion rate will be increased by an additional number of shares of common stock (the additional shares) as described below.

The number of additional shares by which the conversion rate will be increased will be determined by reference to the table below, based on the date on which the fundamental change occurs or becomes effective (the effective date) and the price (the stock price) paid per share of our common stock in the fundamental change. If the fundamental change is a transaction described in clause (2) of the definition thereof, and holders of our common stock receive only cash in that fundamental change, the stock price will be the cash amount paid per share. Otherwise, the stock price will be the average of the last reported sale prices of our common stock over the five trading day period ending on the trading day preceding the effective date of the fundamental change.

The stock prices set forth in the first column of the table below (i.e., the column headings) will be adjusted as of any date on which the conversion rate of the notes is adjusted. The adjusted stock prices will equal the stock prices applicable immediately prior to such adjustment, multiplied by a fraction, the numerator of which is the conversion rate immediately prior to the adjustment giving rise to the stock price adjustment and the denominator of which is the conversion rate as so adjusted. The number of additional shares will be adjusted in the same manner as the conversion rate as set forth under Conversion Rate Adjustments.

The following table sets forth the hypothetical stock price and the number of additional shares to be received per $1,000 principal amount of notes:

Stock Price on Effective Date	**March 9, 2007**	**March 15, 2008**	**March 15, 2009**	**March 15, 2010**
$6.50	25.6	25.6	25.6	25.6
$8.50	19.3	15.7	10.6	0.0
$10.50	13.5	9.3	4.9	0.0
$12.50	11.3	7.6	3.8	0.0
$14.50	9.7	6.6	3.3	0.0
$16.50	8.5	5.8	2.9	0.0
$18.50	7.6	5.1	2.6	0.0
$20.50	6.9	4.6	2.3	0.0
$30.00	4.7	3.2	1.6	0.0
$40.00	3.5	2.4	1.2	0.0
$50.00	2.8	1.9	1.0	0.0

The exact stock prices and effective dates relating to a fundamental change may not be set forth in the table above, in which case:

- if the stock price is between two stock price amounts in the table or the effective date is between two effective dates in the table, the number of additional shares will be determined by a straight-line interpolation between the number of additional shares set forth for the higher and lower stock price amounts and the two dates, as applicable, based on a 365-day year;

- if the stock price is greater than $50.00 per share (subject to adjustment), no additional shares will be issued upon conversion; and

- if the stock price is less than $6.50 per share (subject to adjustment), no additional shares will be issued upon conversion.

The requirement that we increase the conversion rate by the additional shares could be considered a penalty, in which case the enforceability thereof would be subject to general principles of reasonableness and equitable remedies.

Repurchase at Option of the Holder

Holders have the right to require us to repurchase the notes for cash on March 15, 2012, March 15, 2017 and March 15, 2022. We will be required to repurchase any outstanding note for which holders deliver a written repurchase notice to the paying agent. This notice must be delivered during the period beginning at any time from the opening of business on the date that is 20 business days prior to the repurchase date until the close of business on the repurchase date. If a repurchase notice is given and withdrawn during that period, we will not be obligated to repurchase the notes listed in the notice. Our repurchase obligation will be subject to certain additional conditions.

The repurchase price payable for a note will be equal to 100% of the principal amount, plus accrued and unpaid interest to, but excluding, the repurchase date. Holders right to require us to repurchase notes is exercisable by delivering a written repurchase notice to the paying agent within 20 business days of the repurchase date.

To exercise the repurchase right, holders must deliver, on or before the business day immediately preceding the repurchase date, subject to extension to comply with applicable law, the notes to be repurchased, duly endorsed for transfer, together with a written repurchase notice and the form entitled Form of Repurchase Notice on the reverse side of the notes duly completed, to the paying agent. Your repurchase notice must state:

- if certificated, the certificate numbers of such holders notes to be delivered for repurchase;

- the portion of the principal amount of notes to be repurchased, which must be $1,000 or an integral multiple thereof; and

- that the notes are to be repurchased by us pursuant to the applicable provisions of the notes and the indenture.

Holders may withdraw any repurchase notice (in whole or in part) by a written notice of withdrawal delivered to the paying agent prior to the close of business on the business day prior to the repurchase date. The notice of withdrawal shall state:

- the principal amount of the withdrawn notes;

- if certificated notes have been issued, the certificate numbers of the withdrawn notes, or if not certificated, your notice must comply with appropriate DTC procedures; and

- the principal amount, if any, which remains subject to the repurchase notice.

We will be required to repurchase the notes on the repurchase date, subject to extension to comply with applicable law. Holders will receive payment of the repurchase price promptly following the later of the repurchase date or the time of book-entry transfer or the delivery of the notes. If the paying agent holds money or securities sufficient to pay the repurchase price of the notes on the business day following the repurchase date, then:

- the notes will cease to be outstanding and interest, including any additional and special interest, if any, will cease to accrue (whether or not book-entry transfer of the notes is made or whether or not the note is delivered to the paying agent); and

- all other rights of the holder will terminate (other than the right to receive the repurchase price and previously accrued and unpaid interest (including any additional and special interest) upon delivery or transfer of the notes).

No notes may be repurchased at the option of holders if there has occurred and is continuing an event of default other than an event of default that is cured by the payment of the repurchase price.

If a holder elects to cause us to repurchase its notes, we may not have enough funds to pay the repurchase price. Our ability to repurchase the notes for cash may be limited by restrictions on our ability to obtain funds for such repurchase through dividends from our subsidiaries, the terms of our then-existing borrowing arrangements or otherwise. See Risk Factors under the caption We may not have the ability to repurchase the notes when required, and our future debt may contain limitations on our ability to pay cash upon conversion or repurchase of the notes. If we fail to repurchase the notes when required, we will be in default under the indenture. In addition, we have, and may in the future incur, other indebtedness with similar change in control provisions permitting our holders to accelerate or to require us to purchase our indebtedness upon the occurrence of similar events or on some specific dates.

Fundamental Change Permits Holders To Require Us To Repurchase Notes

If a fundamental change occurs at any time, holders will have the right, at such holder s option, to require us to repurchase any or all of such holder s notes, or any portion of the principal amount thereof, that is equal to $1,000 or an integral multiple of $1,000. The price we are required to pay is equal to 100% of the principal amount of the notes to be repurchased plus accrued and unpaid interest, including additional and special interest, if any, to but excluding the fundamental change repurchase date (unless the fundamental change repurchase date is between a regular record date and the interest payment date to which it relates, in which case we will pay accrued and unpaid interest to the holder of record on such regular record date). The fundamental change repurchase date will be a business day specified by us that is not less than 20 nor more than 35 calendar days following the date of our fundamental change notice as described below. Any notes repurchased by us will be paid for in cash.

A fundamental change will be deemed to have occurred at the time after the notes are originally issued that any of the following occurs:

(1) a person or group within the meaning of Section 13(d) of the Exchange Act other than us, our subsidiaries or our or their employee benefit plans becomes the direct or indirect beneficial owner, as defined in Rule 13d-3 under the Exchange Act, of our common equity representing more than 50% of the voting power of our common equity;

(2) consummation of any share exchange, consolidation or merger of us pursuant to which our common stock will be converted into cash, securities or other property or any sale, lease or other transfer in one transaction or a series of transactions of all or substantially all of the consolidated assets of us and our subsidiaries, taken as a whole, to any person other than one of our subsidiaries; provided, however, that a transaction where the holders of more than 50% of all classes of our common equity immediately prior to such transaction own, directly or indirectly, more than 50% of all classes of common equity of the continuing or surviving corporation or transferee or the parent thereof immediately after such event shall not be a fundamental change;

(3) our stockholders approve any plan or proposal for the liquidation or dissolution of us; or

(4) our common stock (or other common stock or ADRs into which the notes are then convertible) ceases to be listed on a U.S. national securities exchange or quoted on an established over-the-counter trading market in the U.S.

A fundamental change as a result of clause (2) above will not be deemed to have occurred, however, if 90% or more of the consideration received or to be received by our common stockholders, excluding cash payments for fractional shares and cash payments in respect of dissenters or appraisal rights, in connection with the transaction or transactions otherwise constituting the fundamental change consists of shares of common stock or ADRs traded on a U.S. national securities exchange or quoted on an established automated over-the-counter trading market in the U.S. or which will be so traded or quoted when issued or exchanged in connection with a fundamental change (these securities being referred to as publicly traded securities) and as a result of this transaction or transactions the notes become convertible into such publicly traded securities, excluding cash payments for fractional shares and cash payments in respect of dissenters or appraisal rights.

On or before the 20th day after the occurrence of a fundamental change, we will provide to all holders of the notes and the trustee and paying agent a notice of the occurrence of the fundamental change and of the resulting repurchase right. Such notice shall state, among other things:

- the events causing the fundamental change;
- the date of the fundamental change;
- the last date on which a holder may exercise the repurchase right;
- the fundamental change repurchase price;
- the fundamental change repurchase date;
- the name and address of the paying agent and the conversion agent, if applicable;
- if applicable, the applicable conversion rate and any adjustments to the applicable conversion rate;
- if applicable, that the notes with respect to which a fundamental change repurchase notice has been delivered by a holder may be converted only if the holder withdraws the fundamental change repurchase notice in accordance with the terms of the indenture; and
- the procedures that holders must follow to require us to repurchase their notes.

Simultaneously with providing such notice, we will publish a notice containing this information in a newspaper of general circulation in The City of New York or publish the information on our website or through such other public medium as we may use at that time.

To exercise the repurchase right, holders must deliver, on or before the business day immediately preceding the fundamental change repurchase date, subject to extension to comply with applicable law, the notes to be repurchased, duly endorsed for transfer, together with a written repurchase notice and the form entitled Form of Fundamental Change Repurchase Notice on the reverse side of the notes duly completed, to the paying agent. Holders repurchase notice must state:

- if certificated, the certificate numbers of such holders notes to be delivered for repurchase;
- the portion of the principal amount of notes to be repurchased, which must be $1,000 or an integral multiple thereof; and
- that the notes are to be repurchased by us pursuant to the applicable provisions of the notes and the indenture.

Holders may withdraw any repurchase notice (in whole or in part) by a written notice of withdrawal delivered to the paying agent prior to the close of business on the business day prior to the fundamental change repurchase date. The notice of withdrawal shall state:

- the principal amount of the withdrawn notes;

- if certificated notes have been issued, the certificate numbers of the withdrawn notes, or if not certificated, your notice must comply with appropriate DTC procedures; and

- the principal amount, if any, which remains subject to the repurchase notice.

We will be required to repurchase the notes on the fundamental change repurchase date, subject to extension to comply with applicable law. Holders will receive payment of the fundamental change repurchase price promptly following the later of the fundamental change repurchase date or the time of book-entry transfer or the delivery of the notes. If the paying agent holds money or securities sufficient to pay the fundamental change repurchase price of the notes on the business day following the fundamental change repurchase date, then:

- the notes will cease to be outstanding and interest, including any additional and special interest, if any, will cease to accrue (whether or not book-entry transfer of the notes is made or whether or not the note is delivered to the paying agent); and

- all other rights of the holder will terminate (other than the right to receive the fundamental change repurchase price and previously accrued and unpaid interest (including any additional and special interest) upon delivery or transfer of the notes).

The repurchase rights of the holders could discourage a potential acquiror of us. The fundamental change repurchase feature, however, is not the result of management s knowledge of any specific effort to obtain control of us by any means or part of a plan by management to adopt a series of anti-takeover provisions.

The term fundamental change is limited to specified transactions and may not include other events that might adversely affect our financial condition. In addition, the requirement that we offer to repurchase the notes upon a fundamental change may not protect holders in the event of a highly leveraged transaction, reorganization, merger or similar transaction involving us.

No notes may be repurchased at the option of holders upon a fundamental change if there has occurred and is continuing an event of default other than an event of default that is cured by the payment of the fundamental change repurchase price.

The definition of fundamental change includes a phrase relating to the conveyance, transfer, sale, lease or disposition of all or substantially all of our consolidated assets. There is no precise, established definition of the phrase substantially all under applicable law. Accordingly, the ability of a holder of the notes to require us to repurchase its notes as a result of the conveyance, transfer, sale, lease or other disposition of less than all of our assets may be uncertain.

If a fundamental change were to occur, we may not have enough funds to pay the fundamental change repurchase price. Our ability to repurchase the notes for cash may be limited by restrictions on our ability to obtain funds for such repurchase through dividends from our subsidiaries, the terms of our then-existing borrowing arrangements or otherwise. If we fail to repurchase the notes when required following a fundamental change, we will be in default under the indenture. In addition, we have, and may in the future incur, other indebtedness with similar change in control provisions permitting our holders to accelerate or to require us to purchase our indebtedness upon the occurrence of similar events or on some specific dates.

We will not be required to make an offer to purchase the notes upon a fundamental change if a third party makes the offer in the manner, at the times, and otherwise in compliance with the requirements set forth in the indenture applicable to an offer by us to purchase the notes upon a fundamental change and such third party purchases all notes validly tendered and not withdrawn upon such offer.

Incurrence of Indebtedness

Unless and until the aggregate principal amount of notes outstanding is less than $10 million, we shall not, and shall not permit any of its subsidiaries to, directly or indirectly, create, incur, issue, assume, guaranty or otherwise become directly or indirectly liable, contingently or otherwise, with respect to

(collectively, incur) any Indebtedness that is senior to or pari passu with the Notes without the prior consent of holders of not less than a majority in aggregate principal amount of the Notes then outstanding. However, the foregoing limitation shall not limit (i) the incurrence by the Company of Indebtedness represented by mortgage financings or purchase money obligations, in each case incurred for the purpose of financing all or any part of the purchase price or cost of construction or improvement of property used in the business of the Company and related fees and expenses, (ii) Indebtedness incurred to finance accounts receivable or inventory not to exceed the greater of (a) $5 million and (b) the Borrowing Base, in each case at any one time outstanding, (iii) the incurrence by the Company of Indebtedness represented by the Notes or (iv) the incurrence by the Company of additional Indebtedness in an aggregate principal amount (or accreted value, as applicable) not to exceed $15 million at any one time outstanding. For the purposes of this covenant, the term Indebtedness shall mean any indebtedness of the Company or its subsidiaries in respect of borrowed money, whether or not evidenced by bonds, notes, debentures or similar instruments.

For the purposes of this covenant, Borrowing Base means, as of any date, an amount equal to:

(1) 85% of the face amount of all accounts receivable owned by the Company as of the end of the most recent fiscal quarter preceding such date that were not more than 90 days past due; plus

(2) 50% of the book value of all inventory, net of reserves, owned by the Company as of the end of the most recent fiscal quarter preceding such date.

For the purpose of this covenant, Indebtedness of subsidiaries will be deemed to be senior unless it is specifically by its terms made subordinated to the notes.

Consolidation, Merger and Sale of Assets

The indenture provides that we may not consolidate with or merge with or into, or convey, transfer or lease all or substantially all of our properties and assets to, another person, unless (i) the resulting, surviving or transferee person (if not us) is a person organized and existing under the laws of the United States of America, any State thereof or the District of Columbia, or is a corporation, limited liability company, partnership or trust organized and existing under the laws of a jurisdiction outside the United States; (ii) such entity (if not us) expressly assumes by supplemental indenture all of our obligations under the notes, the indenture and, to the extent then still operative, the registration rights agreement; and (iii) immediately after giving effect to such transaction, no default has occurred and is continuing under the indenture. Upon any such consolidation, merger or transfer, the resulting, surviving or transferee person shall succeed to, and may exercise every right and power of, the Company under the indenture. Although these types of transactions are permitted under the indenture, certain of the foregoing transactions could constitute a fundamental change (as defined above) permitting each holder to require us to repurchase the notes of such holder as described above.

Reports

We will deliver to the trustee, within 15 days after filing with the SEC, copies of our annual reports and of the information, documents and other reports (or copies of such portions of any of the foregoing as the SEC may by rules and regulations prescribe) which we are required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. In the event we are at any time no longer subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, we shall continue to provide the trustee with reports containing substantially the same information as would have been required to be filed with the SEC had we continued to have been subject to such reporting requirements. In such event, such reports will be provided at the times we would have been required to provide reports had we continued to have been subject to such reporting requirements. We will comply with the other provisions of Section 314(a) of the Trust Indenture Act.

Events of Default

Each of the following is an event of default:

(1) default in any payment of interest (including additional and special interest, if any) on any note when due and payable and such default continues for a period of 30 days; default in the payment of principal of any note when due and payable at its stated maturity, upon required repurchase or redemption, upon declaration or otherwise; our failure to comply with our obligation to convert the notes in accordance with the indenture upon exercise of a holder s conversion right and such default continues for a period of 5 days;

(2) our failure to give notice of a fundamental change as described under Fundamental Change Permits Holders to Require Us to Repurchase Notes when due;

(3) our failure to comply with our obligations under Consolidation, Merger and Sale of Assets ;

(4) our failure to comply with any of our other agreements contained in the notes or the indenture for 60 days after we receive written notice from the trustee or the holders of at least 25% in principal amount of the notes then outstanding;

(5) default by us or any of our significant subsidiaries (as defined in Regulation S-X under the Exchange Act) in the payment of the principal or interest (by the end of the applicable grace period, if any) on any mortgage, agreement or other instrument under which there may be outstanding, or by which there may be secured or evidenced, indebtedness for money borrowed in excess of $10,000,000 in the aggregate of us and/or any of our significant subsidiaries, whether such indebtedness now exists or shall hereafter be created resulting in such indebtedness in excess of $10,000,000 in the aggregate becoming or being declared due and payable prior to the scheduled maturity thereof or not being paid by us when due at the scheduled maturity thereof;

(6) the rendering of a final judgment for the payment of $10,000,000 or more (excluding any amounts covered by insurance) against us or any of our subsidiaries, which judgment is not discharged or stayed within 60 days after (i) the date on which the right to appeal thereof has expired if no such appeal has commenced, or (ii) the date on which all rights to appeal have been extinguished; or

(7) certain events of bankruptcy, insolvency, or reorganization involving us or any of our significant subsidiaries.

Our obligations under the indenture are not intended to provide creditor rights for amounts in excess of par plus accrued and unpaid interest and additional and special interest, if any, or, to the extent the notes are converted, amounts into which the notes are convertible.

If an event of default occurs and is continuing, the trustee by notice to us, or the holders of at least 25% in principal amount of the outstanding notes by notice to us and the trustee, may, and the trustee at the request of such holders shall, declare 100% of the principal of and accrued and unpaid interest, including additional and special interest, if any, on all the notes to be due and payable. In case of certain events of bankruptcy, insolvency or reorganization, involving us or a significant subsidiary, 100% of the principal of and accrued and unpaid interest on the notes will automatically become due and payable. Upon such a declaration, such principal and accrued and unpaid interest, including any additional and special interest will be due and payable immediately.

Notwithstanding the foregoing, the indenture will provide that, to the extent elected by us, the sole remedy for an event of default relating to the failure to comply with the reporting obligations in the indenture, which are described above under the caption Reports, and for any failure to comply with the requirements of Section 314(a)(1) of the Trust Indenture Act, will for the first 180 days after the occurrence of such an event of default consist exclusively of the right to receive special interest on the notes at an annual rate equal to 0.25% of the principal amount of the notes. This special interest will be paid semi-annually in arrears, with the first semi-annual payment due on the first interest payment date following the date on which the special interest began to accrue on any notes. The special interest will accrue on all outstanding notes from and including the date on which an event of default relating to a failure to comply with the reporting obligations in the indenture first occurs to but not including the 180th day thereafter (or such earlier date on which the event of default shall have been cured or waived). On such 180th day (or earlier, if the event of default relating to the reporting obligations is cured or waived prior to such 180th day), such special interest will cease to accrue and, if the event of default relating to reporting obligations has not been cured or waived prior to such 180th day, the notes will be subject to acceleration as provided above. The provisions of the indenture described in this paragraph will not affect the rights of holders in the event of the occurrence of any other event of default. In the event we do not elect to pay special interest upon an event of default in accordance with this paragraph, the notes will be subject to acceleration as provided above.

If we elect to pay special interest as the sole remedy for an event of default relating to the failure to comply with reporting obligations in the indenture, which are described above under Reports , and for any failure to comply with the requirements of Section 314(a)(1) of the Trust Indenture Act in accordance with the immediately preceding paragraph, we will notify all holders of notes and the trustee and paying agent of such election on or before the close of business on the date on which such event of default first occurs.

The holders of a majority in principal amount of the outstanding notes may waive all past defaults (except with respect to nonpayment of principal or interest, including any additional and special interest or any payment of the redemption price or fundamental change repurchase price or any provision which may not be modified or amended without the consent of the holder of each outstanding note affected) and rescind any such acceleration with respect to the notes and its consequences if (i) rescission would not conflict with any judgment or decree of a court of competent jurisdiction and (ii) all existing events of default, other than the nonpayment of the principal of and interest, including additional and special interest, on the notes that have become due solely by such declaration of acceleration, have been cured or waived.

Subject to the provisions of the indenture relating to the duties of the trustee, if an event of default occurs and is continuing, the trustee will be under no obligation to exercise any of the rights or powers under the indenture at the request or direction of any of the holders unless such holders have offered to the trustee indemnity or security reasonably satisfactory to it against any loss, liability or expense. Except to enforce the right to receive payment of principal or interest (including additional and special interest, if any) when due, no holder may pursue any remedy with respect to the indenture or the notes unless:

(1) such holder has previously given the trustee notice that an event of default is continuing;

(2) holders of at least 25% in principal amount of the outstanding notes have requested the trustee to pursue the remedy;

(3) such holders have offered the trustee security or indemnity reasonably satisfactory to it against any loss, liability or expense;

(4) the trustee has not complied with such request within 60 days after the receipt of the request and the offer of security or indemnity; and

(5) the holders of a majority in principal amount of the outstanding notes have not given the trustee a direction that, in the opinion of the trustee, is inconsistent with such request within such 60-day period.

Subject to certain restrictions, the holders of a majority in principal amount of the outstanding notes are given the right to direct the time, method and place of conducting any proceeding for any remedy available to the trustee or of exercising any trust or power conferred on the trustee.

The indenture provides that in the event an event of default has occurred and is continuing, the trustee will be required in the exercise of its powers to use the degree of care that a prudent person would use in the conduct of its own affairs. The trustee, however, may refuse to follow any direction that conflicts with law or the indenture or that the trustee determines is unduly prejudicial to the rights of any other holder or that would involve the trustee in personal liability. Prior to taking any action under the indenture, the trustee will be entitled to indemnification satisfactory to it in its sole discretion against all losses and expenses caused by taking or not taking such action.

The indenture provides that if a default occurs and is continuing and is known to the trustee, the trustee must mail to each holder notice of the default within 60 days after it occurs. Except in the case of a default in the payment of principal of or interest on any note, the trustee may withhold notice if and so long as a committee of trust officers of the trustee in good faith determines that withholding notice is in the interests of the holders. In addition, we are required to deliver to the trustee, within 120 days after the end of each fiscal year, a certificate indicating whether the signers thereof know of any default that occurred during the previous year. We are also required to deliver to the trustee, within 30 days after the occurrence thereof, written notice of any events which would constitute certain defaults, their status and what action we are taking or propose to take in respect thereof.

Modification and Amendment

Subject to certain exceptions, the indenture or the notes may be amended with the consent of the holders of at least a majority in principal amount of the notes then outstanding (including, without limitation, consents obtained in connection with a purchase of, or tender offer or exchange offer for, notes) and, subject to certain exceptions, any past default or compliance with any provisions may be waived with the consent of the holders of a majority in principal amount of the notes then outstanding (including, without limitation, consents obtained in connection with a purchase of, or tender offer or exchange offer for, notes). However, without the consent of each holder of an outstanding note affected, no amendment may, among other things:

(1) reduce the rate of or extend the stated time for payment of interest, including additional and special interest, on any note;

(2) reduce the principal of or extend the stated maturity of any note;

(3) make any change that impairs or adversely affects the right of a holder to convert any note or the conversion rate thereof;

(4) reduce the redemption price or repurchase price of any note or amend or modify in any manner adverse to the holders of notes our obligation to make such payments, whether through an amendment or waiver of provisions in the indenture, definitions or otherwise;

(5) make any note payable in currency other than that stated in the note;

(6) change the ranking of the notes in a manner adverse to holders of the notes;

(7) impair the right of any holder to institute suit for the enforcement of any payment on or with respect to such holder s notes; or

(8) make any change in the provisions of the indenture which require each holder s consent, in the provisions relating to waivers of past defaults or in the provisions relating to amendment of the indenture.

Without the consent of any holder, we and the trustee may amend the indenture to:

(1) cure any ambiguity or correct any omission, defect or inconsistency in the indenture, so long as such action will not adversely affect the interests of holders of the notes;

(2) provide for the assumption by a successor corporation, partnership, trust or limited liability company of our obligations under the indenture;

(3) provide for uncertificated notes in addition to or in place of certificated notes (provided that the uncertificated notes are issued in registered form for purposes of Section 163(f) of the Code, or in a manner such that the uncertificated notes are described in Section 163(f)(2)(B) of the Code);

(4) add guarantees with respect to the notes;

(5) secure the notes;

(6) add to our covenants for the benefit of the holders or surrender any right or power conferred upon us;

(7) make any change that does not materially adversely affect the rights of any holder;

(8) comply with any requirement of the Commission in connection with the qualification of the indenture under the Trust Indenture Act; or

(9) conform the provisions of the indenture to the "Description of Notes" section in the offering memorandum.

The consent of the holders is not necessary under the indenture to approve the particular form of any proposed amendment. It is sufficient if such consent approves the substance of the proposed amendment. After an amendment under the indenture becomes effective, we are required to mail to the holders a notice briefly describing such amendment. However, the failure to give such notice to all the holders, or any defect in the notice, will not impair or affect the validity of the amendment.

Discharge

We may satisfy and discharge our obligations under the indenture by delivering to the securities registrar for cancellation all outstanding notes or by depositing with the trustee or delivering to the holders, as applicable, after the notes have become due and payable, whether at stated maturity, or any discharge or repurchase date, or upon conversion or otherwise, cash or shares of common stock sufficient to pay all of the outstanding notes and paying all other sums payable under the indenture by us. Such discharge is subject to terms contained in the indenture.

Calculations in Respect of Notes

Except as otherwise provided above, we will be responsible for making all calculations called for under the notes. These calculations include, but are not limited to, determinations of the last reported sale prices of our common stock, accrued interest payable on the notes and the conversion rate of the notes. We will make all these calculations in good faith and, absent manifest error, our calculations will be final and binding on holders of notes. We will provide a schedule of our calculations to each of the trustee and the conversion agent, and each of the trustee and conversion agent is entitled to rely conclusively upon the accuracy of our calculations without independent verification. The trustee will forward our calculations to any holder of notes upon the request of that holder.

Trustee

Wells Fargo Bank, National Association is the trustee, security registrar, paying agent and conversion agent. Wells Fargo Bank, National Association, in each of its capacities, including without limitation as trustee, security registrar, paying agent and conversion agent, assumes no responsibility for the accuracy or completeness of the information concerning us or our affiliates or any other party contained in this document or the related documents or for any failure by us or any other party to disclose events that may have occurred and may affect the significance or accuracy of such information.

We maintain banking relationships in the ordinary course of business with the trustee and its affiliates.

Governing Law

The indenture provides that it and the notes will be governed by, and construed in accordance with, the laws of the State of New York.

Book-Entry, Settlement and Clearance

The global notes

The notes were initially issued in the form of one or more registered notes in global form, without interest coupons, which we refer to as the global notes. Upon issuance, each of the global notes was deposited with the trustee as custodian for DTC and registered in the name of Cede & Co., as nominee of DTC.

Ownership of beneficial interests in a global note is limited to persons who have accounts with DTC, which we refer to as DTC participants, or persons who hold interests through DTC participants. We expect that under procedures established by DTC:

- upon deposit of a global note with DTC s custodian, DTC will credit portions of the principal amount of the global note to the accounts of the DTC participants designated by the initial purchaser; and

- ownership of beneficial interests in a global note will be shown on, and transfer of ownership of those interests will be effected only through, records maintained by DTC (with respect to interests of DTC participants) and the records of DTC participants (with respect to other owners of beneficial interests in the global note).

Beneficial interests in global notes may not be exchanged for notes in physical, certificated form except in the limited circumstances described below.

The global notes and beneficial interests in the global notes are subject to restrictions on transfer as described under Transfer Restrictions.

Book entry procedures for the global notes

All interests in the global notes are subject to the operations and procedures of DTC. We provide the following summary of those operations and procedures solely for the convenience of investors. The operations and procedures of DTC are controlled by that settlement system and may be changed at any time. Neither we nor the initial purchaser are responsible for those operations or procedures.

DTC has advised us that it is:

- a limited purpose trust company organized under the laws of the State of New York;

- a banking organization within the meaning of the New York State banking law;

- a member of the Federal Reserve System;

- a clearing corporation within the meaning of the Uniform Commercial Code; and

- a clearing agency registered under Section 17A of the Exchange Act.

DTC was created to hold securities for its participants and to facilitate the clearance and settlement of securities transactions between its participants through electronic book-entry changes to the accounts of its participants. DTC s participants include securities brokers and dealers, including the initial purchaser, banks and trust companies, clearing corporations and other organizations. Indirect access to DTC s system is also available to others such as banks, brokers, dealers and trust companies; these indirect participants clear through or maintain a custodial relationship with a DTC participant, either directly or indirectly. Investors who are not DTC participants may beneficially own securities held by or on behalf of DTC only through DTC participants or indirect participants in DTC.

So long as DTC s nominee is the registered owner of a global note, that nominee will be considered the sole owner or holder of the notes represented by that global note for all purposes under the indenture. Except as provided below, owners of beneficial interests in a global note:

- will not be entitled to have notes represented by the global note registered in their names;

- will not receive or be entitled to receive physical, certificated notes; and

- will not be considered the owners or holders of the notes under the indenture for any purpose, including with respect to the giving of any direction, instruction or approval to the trustee under the indenture.

As a result, each investor who owns a beneficial interest in a global note must rely on the procedures of DTC to exercise any rights of a holder of notes under the indenture (and, if the investor is not a

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participant or an indirect participant in DTC, on the procedures of the DTC participant through which the investor owns its interest).

Payments of principal and interest (including any additional and special interest) with respect to the notes represented by a global note will be made by the trustee to DTC s nominee as the registered holder of the global note. Neither we nor the trustee will have any responsibility or liability for the payment of amounts to owners of beneficial interests in a global note, for any aspect of the records relating to or payments made on account of those interests by DTC, or for maintaining, supervising or reviewing any records of DTC relating to those interests.

Payments by participants and indirect participants in DTC to the owners of beneficial interests in a global note will be governed by standing instructions and customary industry practice and will be the responsibility of those participants or indirect participants and DTC.

Transfers between participants in DTC will be effected under DTC s procedures and will be settled in same-day funds.

Certificated Notes

Notes in physical, certificated form will be issued and delivered to each person that DTC identifies as a beneficial owner of the related notes only if:

- DTC notifies us at any time that it is unwilling or unable to continue as depositary for the global notes and a successor depositary is not appointed within 90 days;

- DTC ceases to be registered as a clearing agency under the Exchange Act and a successor depositary is not appointed within 90 days;

- we, at our option, notify the trustee that we elect to cause the issuance of certificated notes, subject to DTC s procedures (DTC has advised that, under its current practices, it would notify its participants of our request, but will only withdraw beneficial interests from the global notes at the request of each DTC participant); or

- an event of default in respect of the notes has occurred and is continuing, and the trustee has received a request from DTC.

In addition, beneficial interests in a global note may be exchanged for certificated notes upon request of a DTC participant by written notice given to the trustee by or on behalf of DTC in accordance with customary procedures of DTC.

Registration Rights

This prospectus is part of a shelf registration statement under the Securities Act that was filed to register resales of the notes and shares of common stock into which the notes are convertible. The notes and shares of common stock into which the notes are convertible are referred to collectively as registrable securities. The following summary of the registration rights under the registration rights agreement is not complete. You should refer to the registration rights agreement and the form of note listed as exhibits to the registration statement in connection with this prospectus for a full description of the registration rights that apply to the notes.

We will use our reasonable best efforts to keep this shelf registration statement effective until the earliest of: (1) the second anniversary of the closing date of the issuance of the notes; (2) the date when the holders of the notes and common stock issuable upon conversion of the notes are able to sell all such securities pursuant to Rule 144(k) under the Securities Act of 1933 or any successor provision, immediately without volume, manner of sale or other restriction; (3) the date when the holders of the notes and common stock issuable upon conversion of the notes are able to sell all such securities pursuant to Rule 144 under the Securities Act of 1933 or any successor provision, under which any legend borne by the common stock issuable upon conversion of the notes relating to restrictions on transferability thereof is removed; (4) the date when all notes and common stock issuable upon conversion of the notes registered under the shelf registration statement are sold or transferred pursuant thereto; (5) the date when

all notes and common stock issuable upon conversion of the notes have ceased to be outstanding or are otherwise freely transferable.

We will provide to each registered holder copies of the prospectus and take certain other actions as are required to permit unrestricted resales of the notes and the common stock issuable upon conversion of the notes. A holder who sells those securities pursuant to the shelf registration statement will be required to be named as a selling securityholder in the related prospectus and to deliver a prospectus to purchasers and will be bound by the provisions of the registration rights agreement, which are applicable to that holder, including certain indemnification provisions.

In order to be named as a selling security holder in the related prospectus at the time of effectiveness, the holder must complete and deliver a notice and questionnaire to us within 10 days prior to effectiveness of the registration statement. Upon receipt of any completed questionnaire, together with such other information as we may reasonably request from a holder of such notes, we will, as promptly as reasonably practicable, but in any event within 30 business days of receipt, file such amendments to the shelf registration statement or supplements to the related prospectus as are necessary to permit such holder to deliver such prospectus to purchasers of registrable securities, subject to our right to suspend the use of the prospectus as discussed below. Any holder that does not complete and deliver a questionnaire or provide such other information will not be named as a selling securityholder in the prospectus and therefore will not be permitted to sell any registrable securities pursuant to the shelf registration statement.

We will be permitted to suspend the effectiveness of the shelf registration statement or the use of the prospectus that is part of the shelf registration statement during specified periods (not to exceed 120 days in the aggregate in any 12 month period or 60 days in any 6 month period) in certain circumstances, including circumstances relating to pending corporate developments. We need not specify the nature of the event giving rise to a suspension in any notice to holders of the notes of the existence of a suspension.

The following requirements and restrictions will generally apply to a holder selling securities pursuant to the shelf registration statement:

- the holder will be required to be named as a selling securityholder;
- the holder will be required to deliver a prospectus to purchasers;
- the holder will be subject to some of the civil liability provisions under the Securities Act in connection with any sales; and
- the holder will be bound by the provisions of the registration rights agreement that are applicable to the holder (including indemnification obligations).

We will agree to pay predetermined additional and special interest as described herein, which we refer to as additional and special interest, to holders of the notes if the prospectus is unavailable for periods in excess of those permitted above. The additional and special interest, if any, is payable at the same time and in the same manner and to the same persons as ordinary interest. The additional and special interest will accrue until unavailability is cured in respect of any notes required to bear the legend set forth in Transfer Restrictions, at a rate per year equal to 0.25% of the outstanding principal amount thereof for the first 90 days after the occurrence of the event and 0.5% after the first 90 days. However, no additional and special interest or other additional amounts will accrue following the end of the period during which we are required to use our reasonable efforts to keep the shelf registration statement effective. In addition, no additional and special interest or other additional amounts will be payable in respect of shares of common stock into which the notes have been converted.

The additional and special interest will accrue from and including the date on which any registration default occurs to but excluding the date on which all registration defaults have been cured. We will have no other liabilities for monetary damages with respect to our registration obligations. However, if we breach, fail to comply with or violate some provisions of the registration rights agreement, the holders of the notes may be entitled to equitable relief, including injunction and specific performance.

We will pay all expenses of the shelf registration statement, provide to each registered holder copies of the related prospectus, notify each registered holder when the shelf registration statement has become effective and take other actions that are required to permit, subject to the foregoing, unrestricted resales of the notes and the shares of common stock issued upon conversion of the notes.

The summary herein of provisions of the registration rights agreement is subject to, and is qualified in its entirety by reference to, all the provisions of the registration rights agreement.

DESCRIPTION OF CAPITAL STOCK

Our authorized capital stock consists of 100,000,000 shares of common stock, $0.001 par value per share, and 5,000,000 shares of undesignated preferred stock, $0.001 par value per share. The following description summarizes the most important terms of our capital stock. Because it is only a summary, it does not contain all the information that may be important to you. For a complete description you should refer to our restated certificate of incorporation and restated bylaws and to the provisions of applicable Delaware law.

Common Stock

As of August 24, 2007, there were 28,433,246 shares of common stock outstanding held by 197 stockholders of record.

Dividend rights. Subject to preferences that may apply to shares of preferred stock outstanding at the time, the holders of outstanding shares of common stock are entitled to receive dividends out of assets legally available at the times and in the amounts as our board of directors may from time to time determine.

Voting rights. Each holder of common stock is entitled to one vote for each share of common stock held on all matters submitted to a vote of stockholders. Cumulative voting for the election of directors is not provided for in our restated certificate of incorporation, which means that the holders of a majority of the shares voted can elect all of the directors then standing for election.

No preemptive or similar rights. The common stock is not entitled to preemptive rights and is not subject to conversion or redemption.

Right to receive liquidation distributions. Upon our liquidation, dissolution or winding-up, the assets legally available for distribution to stockholders will be distributable ratably among the holders of our common stock and any participating preferred stock outstanding at that time after payment of liquidation preferences, if any, on any outstanding preferred stock and payment of other claims of creditors. Each outstanding share of common stock is, and all shares of common stock to be outstanding upon conversion of the notes will be fully paid and nonassessable.

Preferred Stock

As of August 28, 2007, there were no shares of preferred stock outstanding. Our board of directors is authorized, subject to the limits imposed by Delaware law, to issue up to 5,000,000 shares of preferred stock in one or more series, to establish from time to time the number of shares to be included in each series and to fix the rights, preferences and privileges of the shares of each wholly unissued series and any of its qualifications, limitations or restrictions. Our board of directors can also increase or decrease the number of shares of any series, but not below the number of shares of a given series then outstanding, without any further vote or action by the stockholders.

The board of directors may authorize the issuance of preferred stock with voting or conversion rights that could adversely affect the voting power or other rights of the holders of the common stock. The issuance of preferred stock, while providing flexibility in connection with possible acquisitions and other corporate purposes, could, among other things, have the effect of delaying, deferring or preventing a change in control of DexCom and may adversely affect the market price of our common stock and the voting and other rights of the holders of common stock. We have no current plan to issue any shares of preferred stock.

Our restated certificate of incorporation authorizes 500,000 shares of Series A junior participating preferred stock that are purchasable upon exercise of the rights under our rights agreement. These shares are:

- not redeemable;
- entitled, when, as and if declared, to a minimum preferential quarterly dividend payment of an amount equal to 100 times the dividend declared per share of our common stock;
- in the event of a liquidation, dissolution or winding up, a minimum preferential payment of $1.00, and thereafter the holders of the preferred shares will be entitled to an aggregate payment of 100 times the aggregate payment made per common share;
- entitled to 100 votes, voting together with our common stock;
- in the event of a merger, consolidation or other transaction in which outstanding shares of our common stock are converted or exchanged, entitled to receive 1,000 times the amount received per share of our common stock; and
- entitled to anti-dilution protections.

Registration Rights

Pursuant to the terms of our second amended and restated investors rights agreement, holders of approximately 3,192,939 (other than holders of the notes) shares of common stock or their respective transferees have the right to require us to register such shares with the Securities and Exchange Commission so that those shares may be publicly resold, subject to certain limitations in such agreement.

Right to demand registration. Holders of 3,192,939 (other than holders of the notes) shares of common stock have demand registration rights. At any time six months after the closing of the offering, these stockholders can request that we file a registration statement so they can publicly sell their shares. The underwriters of any underwritten offering will have the right to limit the number of shares to be included in a registration statement.

Who may make a demand. The holders of at least 40% of the shares with the registration rights described above have the right to demand that we file a registration statement on a form other than Form S-3, so long as the amount of securities to be sold in that registration will result in aggregate proceeds of at least $7,500,000, net of any underwriters fees, discounts or commissions. If we are eligible to file a registration statement on Form S-3, the holders of 10% of the shares with the registration rights described above will have the right to demand that we file a registration statement on Form S-3, so long as the amount of securities to be sold in that registration will result in an aggregate price to the public of not less than $1,000,000, net of any underwriters fees, discounts or commissions.

Number of times holders can make demands. We are only be required to file an aggregate of two registration statements on demand, provided such registration statements have been declared or ordered effective, on a form other than Form S-3. If we are eligible to file a registration statement on Form S-3, we are not required to file more than two such registration statements during any 12-month period.

Postponement. We may postpone the filing of a registration statement on a form other than Form S-3 for up to 120 days once in a 12-month period if we determine that the filing would be seriously detrimental to us and our stockholders. In the case of a registration statement on Form S-3, our postponement period is limited to no more than 120 days once in a 12-month period.

Piggyback registration rights. Holders of approximately 3,192,939 (other than holders of the notes) shares of common stock have the right to include their shares in a registration statement, other than the registration statement for the notes and the common stock the notes are convertible into, if we register any securities for sale. The underwriters of any underwritten offering will have the right to limit or exclude the number of shares to be included in a registration statement, provided that no such limitation shall reduce the amount of securities held by the holders of shares with registration rights below 30% of the total amount of securities included in such registration.

Expenses of registration. We will pay all of the expenses relating to any demand, piggyback or Form S-3 registration. However, we will not pay for any expenses of any demand or Form S-3 registration if the request is subsequently withdrawn by the holders requesting that we file such registration statement, subject to limited exceptions. We are not obligated to pay any underwriting discounts or selling commission applicable to any such registration.

Expiration of registration rights. The registration rights described above expire in April 2012. The registration rights will terminate earlier with respect to a particular stockholder to the extent the shares held by and issuable to such holder may be sold under Rule 144 of the Securities Act in any 90 day period.

Anti-Takeover Provisions

Provisions of Delaware law and our restated certificate of incorporation and restated bylaws could make the acquisition of DexCom and the removal of incumbent directors more difficult. These provisions are expected to discourage certain types of coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of DexCom to negotiate with us first.

Delaware law

We are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. In general, the statute prohibits a publicly-held Delaware corporation from engaging in a business combination with an interested stockholder for a period of three years after the date that the person became an interested stockholder, subject to exceptions, unless the business combination or the transaction in which the person became an interested stockholder is approved by our board of directors in a prescribed manner. Generally, a business combination includes a merger, asset or stock sale, or other transaction resulting in a financial benefit to the stockholder. Generally, an interested stockholder is a person who, together with affiliates and associates, owns, or within three years prior, did own, 15% or more of the corporation s voting stock. These provisions may have the effect of delaying, deferring or preventing a change in control of us without further action by the stockholders.

Restated certificate of incorporation and restated bylaw provisions

Our restated certificate of incorporation and our restated bylaws include a number of provisions that may have the effect of deterring hostile takeovers or delaying or preventing changes in control of our management team, including the following:

- *Board of Directors Vacancies.* Our restated certificate of incorporation and restated bylaws authorize only our board of directors to fill vacant directorships. In addition, the number of directors constituting our board of directors may be set only by resolution adopted by a majority vote of our entire board of directors. These provisions prevent a stockholder from increasing the size of our board of directors and gaining control of our board of directors by filling the resulting vacancies with its own nominees.

- *Classified Board.* Our restated certificate of incorporation and restated bylaws provide that our board of directors is classified into three classes of directors. The existence of a classified

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board of directors could delay a successful tender offeror from obtaining majority control of our board of directors, and the prospect of such delay may deter a potential offeror.

- *Stockholder Action; Special Meeting of Stockholders.* Our restated certificate of incorporation provides that our stockholders may not take action by written consent, but may only take action at annual or special meetings of our stockholders. Stockholders will not be permitted to cumulate their votes for the election of directors. Our restated bylaws further provide that special meetings of our stockholders may be called only by a majority of our board of directors, the chairman of our board of directors, our chief executive officer or our president.

- *Advance Notice Requirements for Stockholder Proposals and Director Nominations.* Our restated bylaws provide advance notice procedures for stockholders seeking to bring business before our annual meeting of stockholders, or to nominate candidates for election as directors at our annual meeting of stockholders. Our bylaws also specify certain requirements as to the form and content of a stockholder s notice. These provisions may preclude our stockholders from bringing matters before our annual meeting of stockholders or from making nominations for directors at our annual meeting of stockholders.

- *Issuance of Undesignated Preferred Stock.* Our board of directors has the authority, without further action by the stockholders, to issue up to 5,000,000 shares of undesignated preferred stock with rights and preferences, including voting rights, designated from time to time by the board of directors. The existence of authorized but unissued shares of preferred stock enables our board of directors to render more difficult or to discourage an attempt to obtain control of us by means of a merger, tender offer, proxy contest or otherwise.

Rights agreement

Under our rights agreement, each share of our common stock has associated with it one preferred stock purchase right. Each of these rights entitles its holder to purchase, at a price of $150 for each one one-hundredth of a share of Series A junior participating preferred stock (subject to adjustment) under circumstances provided for in the rights agreement. The purpose of our rights agreement is to:

- give our board of directors the opportunity to negotiate with any persons seeking to obtain control of us;

- deter acquisitions of voting control of us without assurance of fair and equal treatment of all of our stockholders; and

- prevent a person from acquiring in the market a sufficient amount of voting power over us to be in a position to block an action sought to be taken by our stockholders.

The exercise of the rights under our rights agreement would cause substantial dilution to a person attempting to acquire us on terms not approved by our board of directors, and therefore would significantly increase the price that such person would have to pay to complete the acquisition. Our rights agreement may deter a potential acquisition or tender offer. Until a distribution date occurs, the rights will:

- not be exercisable;

- be represented by the same certificate that represents the shares with which the rights are associated; and

- trade together with those shares.

The rights will expire at the close of business on April 19, 2015, unless earlier redeemed or exchanged by us. Following a distribution date, the rights would become exercisable and we would issue separate certificates representing the rights, which would trade separately from the shares of our common stock. A distribution date would occur upon the earlier of:

- ten days after a public announcement that the person has become an acquiring person; or

- ten business days after a person announces its intention to commence a tender or exchange offer that, if successful, would result in the person becoming an acquiring person.

A holder of rights will not, as such, have any rights as a stockholder, including the right to vote or receive dividends.

Under our rights agreement, a person becomes an acquiring person if the person, alone or together with a group, acquires beneficial ownership of 15% or more of the outstanding shares of our common stock. In addition, an acquiring person shall not include us, any of our subsidiaries, or any of our employee benefit plans or any person or entity holding shares of our common stock pursuant to such employee benefit plans. Our rights agreement also contains provisions designed to prevent the inadvertent triggering of the rights by institutional or certain other stockholders.

If any person becomes an acquiring person, each holder of a right, other than the acquiring person, will be entitled to purchase, at the purchase price, a number of our shares of common stock having a market value of two times the purchase price. If, a person becomes an acquiring person and either:

- we merge or enter into any similar business combination transaction with the acquiring person and we are not the surviving corporation; or

- 50% or more of our assets or earning power is sold or transferred to an acquiring person,

each holder of a right, other than the acquiring person, will be entitled to purchase a number of shares of common stock of the acquiring entity having a market value of two times the purchase price.

After a person becomes an acquiring person, but prior to such person acquiring more than 50% of our outstanding common stock, our board of directors may exchange each right, other than rights owned by the acquiring person, for

- one share of common stock;

- one one-hundredth of a share of our Series A junior preferred stock; or

- other equivalent securities.

At any time before a person becomes an acquiring person, our board of directors may redeem all of the rights at a redemption price of $0.0001 per right. On the redemption date, the rights will expire and the only entitlement of the holders of rights will be to receive the redemption price.

At any time before a person becomes an acquiring person, our board of directors may amend any provision in the rights agreement without stockholder consent. After the rights are no longer redeemable, our board of directors may only amend the rights agreement without stockholder consent if such amendment would not adversely affect the interests of the holders of rights, or cause the rights to again become redeemable.

The adoption of the rights agreement and the distribution of the rights should not be taxable to our stockholders or us. Our stockholders may recognize taxable income when the rights become exercisable in accordance with the rights agreement.

Limitation of Liability and Indemnification of Officers and Directors

As permitted by the Delaware General Corporation Law, our restated certificate of incorporation includes a provision that eliminates the personal liability of its directors for monetary damages for breach of fiduciary duty as a director, except for liability:

- for any breach of the director s duty of loyalty to us or our stockholders,

- for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law,

- under section 174 of the Delaware General Corporation Law (regarding unlawful dividends and stock purchases), or

- for any transaction from which the director derived an improper personal benefit. As permitted by the Delaware General Corporation Law, our restated bylaws provide that:

- we are required to indemnify our directors and officers to the fullest extent permitted by the Delaware General Corporation Law, subject to very limited exceptions,

- we may indemnify our other employees and agents as set forth in the Delaware General Corporation Law,

- we are required to advance expenses, as incurred, to our directors and officers in connection with a legal proceeding to the fullest extent permitted by the Delaware General Corporation Law, subject to very limited exceptions, and the rights conferred in the bylaws are not exclusive.

NASDAQ Global Market Listing

Our common stock is listed on The Nasdaq Global Market under the trading symbol DXCM.

Transfer Agent

The Transfer Agent and Registrar for our common stock is American Stock Transfer & Trust Company.

U.S. FEDERAL INCOME TAX CONSIDERATIONS

This section summarizes the material U.S. federal income tax considerations relating to the purchase, ownership and disposition of the notes and of common stock into which the notes may be converted. This summary does not provide a complete analysis of all potential tax considerations. This summary is based on laws, regulations, rulings and decisions now in effect, all of which may change. Any change could apply retroactively and could affect the continued validity of this summary. There can be no assurances that the Internal Revenue Service (IRS) will not challenge one or more of the tax consequences described herein, and we have not obtained, nor do we intend to obtain, a ruling from the IRS with respect to the U.S. federal income tax consequences of acquiring or, holding or disposing of the notes or common stock. The summary generally applies only to investors that purchase notes in the initial offering at their initial issue price and hold the notes or common stock as capital assets (generally, for investment). This discussion does not purport to deal with all aspects of U.S. federal income taxation that may be relevant to a particular holder in light of the holder s circumstances (for example, persons subject to the alternative minimum tax provisions of the Internal Revenue Code (the Code) or a holder whose functional currency is not the U.S. dollar). Also, it is not intended to be wholly applicable to all categories of investors, some of which (such as dealers in securities or currencies, traders in securities that elect to use a mark-to-market method of accounting, banks, thrifts, regulated investment companies, insurance companies, tax-exempt organizations, and persons holding notes or common stock as part of a hedging or conversion transaction or straddle or persons deemed to sell notes or common stock under the constructive sale provisions of the Code) may be subject to special rules. Finally, the summary does not describe the effect of the federal estate and gift tax laws or the effects of any applicable foreign, state or local laws.

INVESTORS CONSIDERING THE PURCHASE OF NOTES SHOULD CONSULT THEIR OWN TAX ADVISORS REGARDING THE APPLICATION OF THE U.S. FEDERAL INCOME TAX LAWS TO THEIR PARTICULAR SITUATIONS AND THE CONSEQUENCES OF FEDERAL ESTATE OR GIFT TAX LAWS, FOREIGN, STATE OR LOCAL LAWS, AND TAX TREATIES.

U.S. Holders

As used herein, the term U.S. Holders means beneficial owners of notes or common stock that for U.S. federal income tax purposes are (1) individuals who are citizens or residents of the United States, (2) corporations, or entities treated as corporations, created or organized under the laws of the United States or any state thereof or the District of Columbia,

(3) estates the income of which is subject to U.S. federal income taxation regardless of its source, or

(4) trusts if (a) a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust or (b) a trust has in effect a valid election in effect under applicable Treasury Regulations to be treated as a United States person for U.S. federal income tax purposes. A Non-U.S. Holder is a beneficial owner of notes or shares of common stock that is not a U.S. Holder. If a partnership or other entity that is treated as fiscally transparent for U.S. federal income tax purposes is a beneficial owner of a note (or common stock acquired upon conversion of a note), the tax treatment of a partner in the partnership or an owner of the entity will depend upon the status of the partner or other owner and the activities of the partnership or other entity.

Taxation of interest

U.S. Holders will be required to recognize as ordinary income any interest paid or accrued on the notes, in accordance with their regular method of accounting. We may be required to make additional payments to holders of the notes in excess of stated principal and interest if we do not file or cause to be declared, or keep, effective, a registration statement, as described under Description of Notes Registration Rights or if we automatically convert some or all of the notes prior to maturity, as described under Description of Notes Automatic Conversion. We believe that the possibility that we would be required to make such payments is remote within the meaning of applicable Treasury Regulations under the Code and therefore are taking the position that the notes are not subject to the special rules governing contingent payment debt instruments (which, if applicable, would affect the timing, amount and character of income with respect to a note). Our determination in this regard, while not binding on the IRS, is binding on U.S. Holders unless they disclose their contrary position in a timely-filed tax return for the taxable year in which such U.S. Holder acquired the note. Assuming that our position is respected but that we do make additional payments, U.S. Holders would be required to recognize as ordinary income the amount of any such additional payment at the time such payment is received or accrued, in accordance with their regular method of accounting. If the IRS successfully challenged this position, and the notes were treated as contingent payment debt instruments, U.S. Holders could be required to accrue interest income on a constant yield basis at an assumed yield determined at the time of the issuance of the notes and to treat as ordinary income, rather than capital gain, any gain recognized on a sale or exchange of a note prior to the resolution of all contingencies. Please note that the tax consequences of this methodology are uncertain and subject to challenge by the IRS. You should consult your own tax advisors with respect to the tax consequences related to such payments or potential payments and the potential application of the contingent payment debt rules to the notes and the consequences thereof.

Possible effect of the adjustment to conversion rate upon a fundamental change

In certain situations, we may be obligated to adjust the conversion rate of the notes (as described above under Description of Notes Adjustments Of Average Prices Adjustments to shares delivered upon conversion upon certain fundamental changes). The treatment of such adjustment for tax purposes is uncertain. It is possible that such adjustment could be treated as (1) a contingent payment of additional interest, (2) a constructive dividend, as discussed under U.S. Holders Constructive dividends below, since it takes the form of an adjustment to the conversion rate, or (3) a deemed taxable exchange to a holder (see discussion, Sale exchange redemption or other disposition of notes), and the modified note could be treated as newly issued at that time. Each holder should consult its own tax advisor as to the effect of such adjustment. Although the issue is not free from doubt, we intend to take the position that the likelihood of the occurrence of a fundamental change is remote within the meaning of applicable Treasury Regulations and that therefore the notes should not be treated as contingent payment debt instruments. If the IRS successfully challenged this position, and the notes were treated as contingent payment debt instruments, U.S. Holders could be required to accrue interest income on a constant yield basis at an assumed yield determined at the time of the issuance of the notes and to treat as ordinary income, rather than capital gain, any gain recognized on a sale or exchange of a note prior to the resolution of all contingencies. Our determination that the likelihood of a fundamental change is remote is binding on you for federal income tax purposes unless you disclose your contrary position in a timely-filed tax return for the taxable year in which you acquire a note. You should consult your own tax advisors with respect to the tax consequences related to adjustments to the conversion rate and the potential application of the contingent payment debt rules to the notes and the consequences thereof.

Repurchase options

In the event that there is a fundamental change, holders of notes will have the right to require us to repurchase their notes at 100% of the principal amount plus accrued and unpaid interest, if any (see Description of Notes Fundamental Change Permits Holders to Require Us to Repurchase Notes). Further, on or after March 15, 2010, we may redeem the notes, in whole or in part, at our option at 100% of the principal amount of the notes to be redeemed plus any accrued and unpaid interest (see Description of Notes Optional Redemption). We intend to take the position that the likelihood of such payments is remote and/or incidental under the applicable Treasury Regulations under the Code; therefore, we do not intend to treat the potential payments as part of the yield to maturity of the notes for purposes of the original issue discount provisions of the Code. Our determination that these contingencies are remote and/or incidental is binding on a U.S. Holder unless such holder discloses its contrary position in the manner required by applicable Treasury Regulations. Our determination is not, however, binding on the IRS, and if the IRS were to challenge this determination, a U.S. Holder, under the original issue discount provisions of the Code and regulations, might be required to accrue income on its notes in excess of stated interest and prior to the receipt of cash, and may be required to treat as ordinary income rather than as capital gain any income realized on the taxable disposition of a note before the resolution of the contingencies. In the event that the Optional Redemption or Fundamental Change occurs, the amount and timing of the income recognized by a U.S. Holder would be affected.

Market Discount

A U.S. Holder that acquires a note at a market discount, that is, at a price less than the note s stated principal amount at maturity (generally, the sum of all payments required under the note other than payments of stated interest), may be affected by the market discount rules of the Code. Subject to a de minimis exception, the market discount rules generally require a U.S. Holder who acquires a note at a market discount to treat any principal payment on the note and any gain recognized on any disposition of the note as ordinary income to the extent of the accrued market discount, not previously included in income, at the time of such principal payment or note disposition. In general, the amount of market discount that has accrued is determined under the ratable accrual method, or, at the election of the holder, on a constant yield basis. Such an election applies only to the note with respect to which it is made and may not be revoked.

A U.S. Holder of a note acquired at a market discount also may elect to include the market discount in income as it accrues, rather than deferring the income inclusion until the time of a principal payment or note disposition. If a U.S. Holder so elects, the rules discussed above with respect to ordinary income recognition resulting from the payment of principal on a note or the disposition of a note would not apply, and the holder s tax basis in the note would be increased by the amount of the market discount included in income at the time it accrues. This election would apply to all market discount obligations acquired by the U.S. Holder on or after the first day of the first taxable year to which the election applies and could not be revoked without the consent of the IRS.

A U.S. Holder may be required to defer until maturity of the note (or, in certain circumstances, its earlier disposition) the deduction of all or a portion of the interest expense attributable to debt incurred or continued to purchase or carry a note with market discount, unless the holder elects to include market discount in income on a current basis.

Upon the conversion of a note, any accrued market discount on the note not previously included in income will be carried over to the common stock received upon conversion of the note, and any gain recognized upon the disposition of such common stock will be treated as ordinary income to the extent of such accrued market discount.

Amortizable Bond Premium

If a U.S. Holder acquires a note for a price that is in excess of the note s stated redemption price at maturity, the U.S. Holder generally will be considered to have acquired a note with amortizable bond premium. Amortizable bond premium, however, does not include any premium attributable to the conversion feature of the note. A U.S. Holder may elect to amortize amortizable bond premium on a constant yield basis. The amount amortized in any year generally will be treated as a deduction against the holder s interest income on the note. If the amortizable bond premium allocable to a year exceeds the amount of interest income allocable to that year, the excess is allowed as a deduction for that year but only to the extent of the Holder s prior inclusions of interest income (net of any deductions for bond premium) with respect to the note. The premium on a note held by a U.S. Holder that does not make the amortization election will decrease the gain or increase the loss otherwise recognizable on the disposition of the note.

The election to amortize the premium on a constant yield basis generally applies to all bonds held or subsequently acquired by the electing holder on or after the first day of the first taxable year to which the election applies and may not be revoked without the consent of the IRS.

Sale, exchange, redemption or other disposition of notes

Except as provided below under Conversion of notes, a U.S. Holder will generally recognize capital gain or loss if the holder disposes of a note in a sale, exchange, redemption or other disposition (including an exchange with a designated financial institution in lieu of a conversion, as described in Description of Notes Conversion Procedures and a transaction treated as a deemed taxable disposition) The holder s gain or loss will equal the difference between the proceeds received by the holder (other than amounts attributable to accrued but unpaid interest not previously included in income) and the holder s adjusted tax basis in the note. The proceeds received by the holder will include the amount of any cash and the fair market value of any other property received for the note. The holder s tax basis in the note will generally equal the amount the holder paid for the note. The portion of any proceeds that is attributable to accrued interest will not be taken into account in computing the holder s capital gain or loss. Instead, that portion will be recognized as ordinary interest income to the extent that the holder has not previously included the accrued interest in income. The gain or loss recognized by a holder on a disposition of the note will be long-term capital gain or loss if the holder has held the note for more than one year or short-term capital gain or loss if the holder held the note for one year or less. Long-term capital gains of non-corporate taxpayers are taxed at a maximum 15% federal rate through December 31, 2010. Short-term capital gains are taxed at ordinary income rates. The deductibility of capital losses is subject to limitation. Special rules may apply to a note redeemed in part; U.S. Holders should consult their own tax advisors in this regard.

Conversion of notes

A U.S. Holder generally will not recognize any income, gain or loss on converting a note into common stock (excluding an exchange with a designated financial institution in lieu of conversion, as described in Description of Notes Conversion Procedures) except with respect to cash or other property received in lieu of a fractional share of common stock and cash attributable to accrued but unpaid interest (including additional interest paid pursuant to an automatic conversion) which will be taxable as such to the extent not previously included in income. If the holder receives cash in lieu of a fractional share of stock, the holder would be treated as if he received the fractional share and then had the fractional share redeemed for the cash. The holder would recognize gain or loss equal to the difference between the cash received with respect to a fractional share and that portion of its basis in the stock attributable to the fractional share. The holder s aggregate basis in the common stock received upon conversion will equal its adjusted basis in the note that was converted, reduced by the portion of the tax basis that is attributable to any fractional share, and increased by the amount of any accrued but unpaid interest that is deemed paid by reason of conversion. The holder s holding period for the stock will include the period during which he held the note, except that the holding period of any common stock deemed received with respect to accrued but unpaid interest will commence on the day after conversion.

Dividends

If, after a U.S. Holder converts a note into common stock, we make a distribution in respect of that stock from our current or accumulated earnings and profits as determined under U.S. federal income tax principles, the distribution will be treated as a dividend and will be includible in a U.S. Holder s ordinary income as it is paid. If the distribution exceeds our current and accumulated earnings and profits, the excess will be treated first as a tax-free return of the holder s investment, up to the holder s basis in its common stock; and any remaining excess will be treated as capital gain. If the U.S. Holder is a U.S. corporation, it would generally be able to claim a deduction equal to a portion of any dividends received. U.S. Holders who are individuals and who receive dividends that are treated as qualified dividend income will be taxed at a maximum rate of 15%. Qualified dividend income for these purposes generally includes dividends received or accrued in taxable years beginning before January 1, 2011 with respect to our stock held by a non-corporate U.S. Holder provided certain holding period requirements are met. Dividends received or accrued by U.S. Holders who are not individuals, or dividends received or accrued which do not constitute qualified dividend income, will be subject to tax at ordinary income tax rates.

Constructive dividends

The terms of the notes allow for changes in the conversion rate of the notes in certain circumstances. A change in conversion rate that allows note holders to receive more shares of common stock on conversion may increase the note holders proportionate interests in our earnings and profits or assets. In that case, the note holders would be treated as though they received a dividend in the form of our stock. Such a constructive stock dividend could be taxable to the note holders even though they would not actually receive any cash or other property. A taxable constructive stock dividend would result, for example, if the conversion rate is adjusted to compensate note holders for distributions of cash or property to our stockholders. Not all changes in conversion rate that allow note holders to receive more stock on conversion, however, increase the note holders proportionate interests in the company. For instance, a change in conversion rate could simply prevent the dilution of the note holders interests upon a stock split or other change in capital structure. Changes of this type, if made pursuant to bona fide reasonable adjustment formula, are not treated as constructive stock dividends. Certain of the possible conversion rate adjustments provided in the notes may not qualify as being pursuant to a bona fide reasonable adjustment formula.

Conversely, if an event occurs that dilutes the note holders interests and the conversion rate is not adjusted, the resulting increase in the proportionate interests of our stockholders could be treated as a taxable stock dividend to them. Any taxable constructive stock dividends resulting from a change to, or failure to change, the conversion rate would be treated like dividends paid in cash or other property. This would result in a taxable dividend to the recipient to the extent of our current or accumulated earnings and profits, with any excess treated as a tax-free return of capital or as capital gain.

Sale of common stock

A U.S. Holder will generally recognize capital gain or loss on a sale or exchange of common stock. The holder s gain or loss will equal the difference between the proceeds received by the holder and the holder s adjusted tax basis in the stock. The proceeds received by the holder will include the amount of any cash and the fair market value of any other property received for the stock. The gain or loss recognized by a holder on a sale or exchange of stock will be long-term capital gain or loss if the holder held or is deemed to have held the stock for more than one year. The deductibility of capital losses is subject to certain limitations.

Non-U.S. Holders

The following discussion is limited to the U.S. federal income tax consequences relevant to a Non-U.S. Holder (as defined above).

Taxation of interest

Subject to the discussion below regarding backup withholding, interest paid on the notes to a Non-U.S. Holder generally will not be subject to U.S. federal income or withholding tax if such interest is not effectively connected with the conduct of a U.S. trade or business income (discussed below) and is portfolio interest. The portfolio interest exception will not apply to payments of interest to a Non-U.S. Holder that:

- owns, actually or constructively, at least 10% of the combined voting power of all classes of our stock entitled to vote;
- is a controlled foreign corporation that is related to us;
- is a bank that is receiving the interest on a loan made in the ordinary course of its trade or business; or
- fails to (a) provide its name and address on an IRS Form W-8BEN (or other applicable form), and certify, under penalties of perjury, that it is not a United States person or (b) hold its notes through certain foreign intermediaries and satisfy the certification requirements of applicable U.S. Treasury regulations.

In general, a foreign corporation is a controlled foreign corporation if more than 50% of its stock is owned, actually or constructively, by one or more U.S. persons that each owns, actually or constructively, at least 10% of the corporation s voting stock.

If the portfolio interest exception does not apply, payments of interest or payments treated as interest to a nonresident person or entity will be subject to withholding tax at a 30% rate, unless you provide us with a properly executed (i) IRS Form W-8BEN or successor form claiming a reduced or zero rate under the terms of an applicable income tax treaty between the United States and the Non-U.S. Holder s country of residence or (ii) IRS Form W-8ECI or successor form stating that interest paid on the note is not subject to withholding tax because it is effectively connected with the conduct of a U.S. trade or business.

If you are engaged in a trade or business in the United States and interest on the notes is effectively connected with the conduct of that trade or business and, if required by an applicable income tax treaty, is attributable to a U.S. permanent establishment or a fixed base, then you will be subject to U.S. federal income tax on that interest on a net income basis (although you will be exempt from the 30% U.S. federal withholding tax, provided the certification requirements discussed above are satisfied) generally in the same manner as if you were a United States person as defined under the Code. In addition, if you are a foreign corporation, you may be subject to a branch profits tax equal to 30% (or lower applicable income tax treaty rate) of such interest, subject to adjustments.

As more fully described under Description of Notes Registration Rights, upon the occurrence of certain enumerated events we may be required to pay additional interest to you. Payments of such additional interest may be subject to U.S. federal withholding tax. Non-U.S. Holders should contact their tax advisors concerning the treatment of receipt of such additional interest.

Sale, exchange, redemption or other disposition of notes or common stock

Non-U.S. Holders generally will not be subject to U.S. federal income tax on any gain realized on the sale, exchange, redemption or other disposition of notes or common stock. This general rule, however, is subject to several exceptions. For example, the gain would be subject to U.S. federal income tax if:

- the gain is effectively connected with the conduct by the Non-U.S. Holder of a U.S. trade or business (in which case the branch profits tax (discussed below) may also apply if you are a corporate Non-U.S. Holder);

- the Non-U.S. Holder was a citizen or resident of the United States and is subject to special rules that apply to expatriates;

- in the case of common stock, we are or have been a U.S. real property holding corporation (USRPHC) for U.S. federal income tax purposes at any time during the shorter of the five-year period ending on the date of disposition or the period that you held our common stock; or

- subject to certain exceptions, the Non-U.S. Holder is an individual who holds the notes or common stock as a capital asset and is present in the United States for 183 days or more in the year of disposition.

If your gain is described in the first bullet point above, you generally will be subject to U.S. federal income tax on the net gain derived from the sale. If you are a corporation, then any such effectively connected gain received by you may also, under certain circumstances, be subject to the branch profits tax at a 30% rate (or lower applicable income tax treaty rate).

If your gain is described in the second bullet point above, you should contact your tax advisors regarding the application of the U.S. federal income tax laws to your situation.

With respect to the third bullet point above, the Foreign Investment in Real Property Tax Act (or FIRPTA) rules may apply to a sale, exchange, redemption or other disposition of common stock if we are, or were within five years before the transaction, a USRPHC. In general, we would be a USRPHC if interests in U.S. real estate comprised most of our assets. We do not believe that we are a USRPHC or that we will become one in the future.

If you are an individual described in the fourth bullet point above, you will be subject to a flat 30% U.S. federal income tax on the gain derived from the sale, which may be offset by U.S. source capital losses, even though you are not considered a resident of the United States.

Conversion of notes

A Non-U.S. Holder generally will not recognize any income, gain or loss on converting a note into common stock. A Non-U.S. Holder who receives cash in exchange for notes pursuant to a conversion generally will not be subject to U.S. federal income tax on any gain recognized, unless the Non-U.S. Holder otherwise would recognize gain on the sale, exchange, redemption or other disposition of notes, as described above

Dividends and other potential withholding

Dividends paid to a Non-U.S. Holder on common stock received on conversion of a note (and any constructive dividends resulting from certain adjustments, or failure to make adjustments, to the number of shares of common stock to be issued on conversion, see U.S. Holders Constructive dividends above) will generally be subject to U.S. withholding tax at a 30% rate. However, the withholding tax might not apply, or might apply at a reduced rate, under the terms of an applicable income tax treaty between the United States and the Non-U.S. Holder s country of residence. A Non-U.S. Holder must demonstrate its entitlement to treaty benefits by certifying its nonresident status on a properly executed Form W-8BEN or appropriate substitute form. Some of the common means of meeting this requirement are described above under Non-U.S. Holders Taxation of interest.

Backup Withholding And Information Reporting

The Code and the Treasury regulations require those who make specified payments to report the payments to the IRS. Among the specified payments are interest, dividends, and proceeds paid by brokers to their customers. The required information returns enable the IRS to determine whether the recipient properly included the payments in income. This reporting regime is reinforced by backup withholding rules. These rules require the payors to withhold tax from payments subject to information reporting if the recipient fails to cooperate with the reporting regime by failing to provide its taxpayer identification number to the payor, furnishing an incorrect identification number, or repeatedly failing to report interest or dividends on its returns. The backup withholding tax rate is currently 28%. The backup withholding rules do not apply to payments to corporations, whether domestic or foreign.

Payments of interest or dividends to individual U.S. Holders of notes or common stock will generally be subject to information reporting, and will be subject to backup withholding unless the holder provides us or our paying agent with a correct taxpayer identification number and complies with applicable certification requirements.

Payments to Non-U.S. Holders of dividends on common stock, or interest on notes, will generally not be subject to backup withholding. To avoid backup withholding, a Non-U.S. Holder will have to certify its nonresident status. Some of the common means of doing so are described under

Non-U.S. Holders Taxation of interest. We must report annually to the IRS the interest and/or dividends paid to each Non-U.S. Holder and the tax withheld, if any, with respect to such interest and/or dividends including any tax withheld under the rules described above under Non-U.S. Holders Taxation of interest and Non-U.S. Holders Dividends and other potential withholding. Copies of these reports may be made available to tax authorities in the country where the Non-U.S. Holder resides.

Payments made to U.S. Holders by a broker upon a sale of notes or common stock will generally be subject to information reporting and backup withholding. If the sale is made through a foreign office of a foreign broker, the sale will generally not be subject to either information reporting or backup withholding. This exception may not apply, however, if the foreign broker is owned or controlled by U.S. persons, or is engaged in a U.S. trade or business.

Payments made to Non-U.S. Holders by a broker upon a sale of notes or common stock will not be subject to information reporting or backup withholding as long as the Non-U.S. Holder certifies its foreign status.

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from a payment to a holder may be refunded or credited against holder s U.S. federal income tax liability, provided that the required information is furnished to the IRS.

THE PRECEDING DISCUSSION OF U.S. FEDERAL INCOME TAX CONSIDERATIONS IS FOR GENERAL INFORMATION ONLY. IT IS NOT TAX ADVICE. EACH PROSPECTIVE INVESTOR SHOULD CONSULT ITS OWN TAX ADVISOR REGARDING THE PARTICULAR U.S. FEDERAL, STATE, LOCAL AND FOREIGN TAX CONSEQUENCES OF PURCHASING, HOLDING AND DISPOSING OF OUR NOTES OR COMMON STOCK, INCLUDING THE CONSEQUENCES OF ANY PROPOSED CHANGE IN APPLICABLE LAWS.

SELLING SECURITYHOLDERS

The notes were originally issued by us and sold by the initial purchasers in a transaction exempt from the registration requirements of the Securities Act. Selling securityholders, including their transferees, pledgees or donees or their successors, may from time to time offer and sell pursuant to this prospectus any or all of the notes and common stock into which the notes are convertible.

The following table sets forth information with respect to the selling securityholders and the principal amounts of notes beneficially owned by each selling securityholder that may be offered under this prospectus. The information is based on information provided by or on behalf of the selling securityholders. The selling securityholders may offer all, some or none of the notes or common stock into which the notes are convertible. Because the selling securityholders may offer all or some portion of the notes or the common stock, no estimate can be given as to the amount of the notes or the common stock that will be held by the selling securityholders upon termination of any sales. In addition, the selling securityholders identified below may have sold, transferred or otherwise disposed of all or a portion of their notes since the date on which they provided the information regarding their notes in transactions exempt from the registration requirements of the Securities Act. Unless otherwise indicated below, to our knowledge, no selling securityholder named in the table below beneficially owns one percent or more of our common stock, assuming conversion of a selling securityholder s notes.

Selling Securityholder(1)	Principal Amount of Notes Beneficially Owned and Offered Hereby(1)	Percentage of Notes Outstanding	Number of Shares of Common Stock Beneficially Owned(1)(2)	Offered Hereby	Owned After The Offering
Poylgon Global Opportunities Master Fund (3)	6,000,000	10	% 769,230	769,230	0
Stark Master Fund Ltd. ( ) (4)	6,000,000	10	% 769,230	769,230	0
CNH Master Account, L.P. (5)	4,000,000	6.7	% 512,820	512,820	0
Capital Ventures International( ) (6)	25,000,000	41.7	% 3,205,128	3,205,128	265,369
Highbridge International LLC (7)	5,000,000	8.3	% 641,025	641,025	0
Linden Capital LP (8)	3,000,000	5.0	% 384,615	384,615	0
Subtotal:	49,000,000	81.7	% 6,282,048	6,282,048	265,369
Any other holders of notes or future transferees from any holder(9)(10)	11,000,000	18.3	% 1,410,258	1,410,258	265,369
Total:	60,000,000	100.0	% 7,692,306	7,692,306	0

* Less than 1%

( ) Each of these selling securityholders is also an affiliate of a broker-dealer. Each of these selling securityholders has indicated to us that they have purchased the notes in the ordinary course of business, and at the time of such purchase, had no agreements or understandings, directly or indirectly, with any person to distribute the notes or the shares of common stock issuable upon conversion of the notes.

(1) Information regarding the selling securityholders may change from time to time. Any such changed information will be set forth in supplements to this prospectus if and when necessary.

(2) Assumes a conversion price of approximately $7.80 per share and a cash payment in lieu of any fractional share interest. However, this conversion price will be subject to adjustment as described under Description of Notes Conversion Rights. As a result, the amount of common stock issuable upon conversion of the notes may increase or decrease in the future.

(3) Alexander E. Jackson, Reade E. Griffith and Patrick G.G. Dear, each an authorized agent for the fund, have investment control over these securities.

(4) Brian Stark and Michael Roth, each an authorized agent for the fund, have investment control over these securities.

(5) Robert Krail, Mark Mitchell and Todd Pulvino, each an authorized agent for CNH Master Account, L.P., have investment control over these securities.

(6) Heights Capital Management, Inc., the authorized agent of Capital Ventures International (CVI), has discretionary authority to vote and dispose of the shares held by CVI and may be deemed to be the beneficial owner of these shares. CVI is affiliated with one or more registered broker-dealers. CVI purchased the shares being registered hereunder in the ordinary course of business and at the time of purchase, had no agreements or understandings, directly or indirectly, with any other person to distribute such shares.

(7) Highbridge Capital Management, LLC is the trading manager of Highbridge International LLC and has voting control and investment discretion over the securities held by Highbridge International LLC. Glenn Dubin and Henry Swieca control Highbridge Capital Management, LLC and have voting control and investment discretion over the securities held by Highbridge International LLC. Each of Highbridge Capital Management, LLC, Glenn Dubin and Henry Swieca disclaims beneficial ownership of the securities held by Highbridge International LLC.

(8) Siw Min Wong, an authorized agent for the fund, has investment control over these securities.

(9) Information concerning other selling securityholders of notes will be set forth in prospectus supplements from time to time, if required.

(10) Assumes that any other holders of notes or any future transferee from any holder does not beneficially own any common stock other than common stock into which the notes are convertible at the conversion price of approximately $7.80 per share.

PLAN OF DISTRIBUTION

The selling securityholders and their successors, including their transferees, pledgees or donees or their successors, may sell the notes and the common stock into which the notes are convertible directly to purchasers or through underwriters, broker-dealers or agents, who may receive compensation in the form of discounts, concessions or commissions from the selling securityholders or the purchasers of the notes and the underlying common stock. These discounts, concessions or commissions as to any particular underwriter, broker-dealer or agent may be in excess of those customary in the types of transactions involved.

The notes and the common stock into which the notes are convertible may be sold in one or more transactions at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market prices, at varying prices determined at the time of sale, or at negotiated prices. These sales may be effected in transactions, which may involve crosses or block transactions:

• on any national securities exchange or U.S. inter-dealer system of a registered national securities association on which the notes or the common stock may be listed or quoted at the time of sale;

• in the over-the-counter market;

• in transactions otherwise than on these exchanges or systems or in the over-the-counter market;

• through the writing of options, whether the options are listed on an options exchange or otherwise; or

• through the settlement of short sales.

In connection with the sale of the notes and the common stock into which the notes are convertible or otherwise, the selling securityholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the notes or the common stock into which the notes are convertible in the course of hedging the positions they assume. The selling securityholders may also sell the notes or the common stock into which the notes are convertible short and deliver these securities to close out their short positions, or loan or pledge the notes or the common stock into which the notes are convertible to broker-dealers that in turn may sell these securities.

The aggregate proceeds to the selling securityholders from the sale of the notes or common stock into which the notes are convertible offered by them will be the purchase price of the notes or common stock less discounts and commissions, if any. Each of the selling securityholders reserves the right to accept and, together with their agents from time to time, to reject, in whole or in part, any proposed purchase of notes or common stock to be made directly or through agents. We will not receive any of the proceeds from this offering.

Our outstanding common stock is listed for trading on The Nasdaq Global Market. We do not intend to list the notes for trading on any national securities exchange or on The Nasdaq Global Market and can give no assurance about the development of any trading market for the notes.

In order to comply with the securities laws of some states, if applicable, the notes and common stock into which the notes are convertible may be sold in these jurisdictions only through registered or licensed brokers or dealers. In addition, in some states the notes and common stock into which the notes are convertible may not be sold unless they have been registered or qualified for sale or an exemption from registration or qualification requirements is available and is complied with.

The selling securityholders and any underwriters, broker-dealers or agents that participate in the sale of the notes and common stock into which the notes are convertible may be underwriters within the meaning of Section 2(11) of the Securities Act. Any discounts, commissions, concessions or profit they earn on any resale of the shares may be deemed to be underwriting discounts and commissions under the Securities Act. Selling securityholders who are underwriters within the meaning of Section 2(11) of the Securities Act will be subject to the prospectus delivery requirements of the Securities Act and may be subject to statutory liabilities, including, but not limited to, liability under Sections 11, 12 and 17 of the Securities Act and Rule 10b-5 under the Exchange Act. The selling securityholders have acknowledged that they understand their obligations to comply with the provisions of the Exchange Act and the rules thereunder relating to stock manipulation, particularly Regulation M.

To our knowledge, there are currently no plans, arrangements or understandings between any selling securityholders and any underwriter, broker-dealer or agent regarding the sale of the notes and the underlying common stock. A selling securityholder may not sell any notes or common stock described in this prospectus and may not transfer, devise or gift these securities by other means not described in this prospectus. In addition, any securities covered by this prospectus which qualify for sale pursuant to Rule 144 or Rule 144A of the Securities Act may be sold under Rule 144 or Rule 144A rather than pursuant to this prospectus.

To the extent required, the specific notes or common stock to be sold, the names of the selling securityholders, the respective purchase prices and public offering prices, the names of any agent, dealer or underwriter, and any applicable commissions or discounts with respect to a particular offer will be set forth in an accompanying prospectus supplement.

We entered into a registration rights agreement for the benefit of holders of the notes to register their notes and common stock under applicable federal and state securities laws under specific circumstances and at specific times. The registration rights agreement provides for cross-indemnification of the selling securityholders and DexCom and their respective directors, officers and controlling persons against specific liabilities in connection with the offer and sale of the notes and the common stock, including liabilities under the Securities Act. We will pay substantially all of the expenses incurred by the selling securityholders incident to the offering and sale of the notes and the underlying common stock.

Under the registration rights agreement, we are obligated to use our reasonable best efforts to keep the registration statement of which this prospectus is a part effective until the earlier of:

- the second anniversary of the closing date of the issuance of the notes;

- the date when the holders of the notes and common stock issuable upon conversion of the notes are able to sell all such securities pursuant to Rule 144(k) under the Securities Act of 1933 or any successor provision, immediately without volume, manner of sale or other restriction;

- the date when the holders of the notes and common stock issuable upon conversion of the notes are able to sell all such securities pursuant to Rule 144 under the Securities Act of 1933 or any successor provision, under which any legend borne by the common stock issuable upon conversion of the notes relating to restrictions on transferability thereof is removed;

- the date when all notes and common stock issuable upon conversion of the notes registered under the shelf registration statement are sold or transferred pursuant thereto;

- the date when all notes and common stock issuable upon conversion of the notes have ceased to be outstanding or are otherwise freely transferable.

Our obligation to keep the registration statement to which this prospectus relates effective is subject to specified, permitted exceptions set forth in the registration rights agreement. In these cases, we may prohibit offers and sales of the notes and shares of common stock pursuant to the registration statement to which this prospectus relates.

We may suspend the use of this prospectus if we learn of any event that causes this prospectus to include an untrue statement of a material fact required to be stated in the prospectus or necessary to make the statements in the prospectus not misleading in light of the circumstances then existing. If this type of event occurs, a prospectus supplement or post-effective amendment, if required, will be distributed to each selling securityholder. Each selling securityholder has agreed not to trade securities from the time the selling securityholder receives notice from us of this type of event until the selling securityholder receives a prospectus supplement or amendment. This time period will not exceed 60 days in any three-month period or 120 days in a twelve-month period.

LEGAL MATTERS

The validity of the securities offered under this prospectus will be passed upon for us by Fenwick & West LLP, San Francisco, California and Boise, Idaho.

EXPERTS

The financial statements of DexCom, Inc. appearing in DexCom s Annual Report (Form 10-K) for the year ended December 31, 2006 including schedules appearing therein, and Dexcom, Inc. management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 included therein, have been audited by Ernst & Young LLP, an independent registered public accounting firm, as set forth in their reports thereon, and incorporated herein by reference. Such financial statements are incorporated herein by reference in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

INCORPORATION OF DOCUMENTS BY REFERENCE

This prospectus incorporates by reference some of the reports, proxy and information statements and other information that we have filed with the SEC under the Securities Exchange Act of 1934, or the Exchange Act. This means that we are disclosing important business and financial information to you by referring you to those documents. The information that we file later with the SEC will automatically update and supersede this information. We incorporate by reference the documents listed below and any future filings made with the SEC under sections 13(a), 14 or 15(d) of the Exchange Act until all of the securities offered by this prospectus are sold.

- Annual report on Form 10-K for the year ended December 31, 2006;
- Quarterly Reports on Form 10-Q for the quarters ended March 31, 2007 and June 30, 2007;
- Proxy Statement on Schedule 14A filed with the SEC on April 20, 2007, with respect to our 2007 Annual Meeting of Stockholders;
- our current report on Form 8-K filed on January 10, 2007;
- our current report on Form 8-K filed on February 9, 2007;
- our current reports on Form 8-K filed on March 6, 2007;
- our current report on Form 8-K filed on March 7, 2007;
- our current report on Form 8-K filed on March 12, 2007;
- our current report on Form 8-K filed on March 21, 2007;
- our current report on Form 8-K filed on April 9, 2007;
- our current report on Form 8-K filed on June 1, 2007;
- our current report on Form 8-K filed on June 20, 2007,
- our current report on Form 8-K filed on July 30, 2007 (with respect to Item 5.02); and
- the description of our common stock and preferred stock purchase rights contained in a registration statement on Form 8-A12G, filed March 25, 2005, including any amendment or report filed for the purpose of updating such description.

Any statements made in a document incorporated by reference in this prospectus is deemed to be modified or superseded for purposes of this prospectus to the extent that a statement in this prospectus or in any other subsequently filed document, which is also incorporated by reference, modifies or supersedes the statement. Any statement made in this prospectus is deemed to be modified or superseded to the extent a statement in any subsequently filed document, which is incorporated by reference in this prospectus, modifies or supersedes such statement. Any statement so modified or superseded will not be deemed, except as so modified or superseded, to constitute a part of this prospectus.

In addition, for so long as any of the notes remain outstanding and during any period in which we are not subject to Section 13 or Section 15(d) of the Exchange Act, we will make available to any prospective purchaser or beneficial owner of the securities in connection with the sale thereof that information required by Rule 144A(d)(4) under the Securities Act. The information relating to us contained in this prospectus should be read together with the information in the documents incorporated by reference. In addition, certain information, including financial information, contained in this prospectus or incorporated by reference in this prospectus should be read in conjunction with documents we have filed with the SEC.

We will provide to each person, including any beneficial holder, to whom a prospectus is delivered, at no cost, upon written or oral request, a copy of any or all of the information that has been incorporated by reference in the prospectus but not delivered with the prospectus. Requests for documents should be directed to Steven Pacelli, DexCom, Inc., 5555 Oberlin Drive, San Diego, California 92121, telephone number (858) 200-0200. Exhibits to these filings will not be sent unless those exhibits have been specifically incorporated by reference in such filings.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

We are subject to the information requirements of the Exchange Act and file reports, proxy statements and other information with the SEC. We are required to file electronic versions of these documents with the SEC. Our reports, proxy statements and other information can be inspected and copied at prescribed rates at the Public Reference Room of the SEC located at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the Public Reference Room. The SEC also maintains a website that contains reports, proxy and information statements and other information, including electronic versions of our filings. The website address is *http://www.sec.gov*.

$60,000,000

4.75% CONVERTIBLE SENIOR NOTES DUE 2027 and
Shares of Common Stock Issuable Upon Conversion
of the Notes

PROSPECTUS

August , 2007

PART II

INFORMATION NOT REQUIRED IN THE PROSPECTUS

ITEM 14. Other Expenses of Issuance and Distribution.

The following table sets forth the various expenses payable by us in connection with the sale and distribution of the securities being registered hereby. We are paying all of the selling securityholders expenses related to this offering, except that the selling securityholders will pay any applicable broker s commissions and expenses. All amounts are estimated except the Securities and Exchange Commission registration fee.

Securities and Exchange Commission registration fee	$ 1,842
Legal fees and expenses	50,000
Accounting fees and expenses	10,000
Printing fees and expenses	2,500
Miscellaneous	15,000
Total	$ 79,342

ITEM 15. Indemnification of Officers and Directors.

Section 145 of the Delaware General Corporation Law authorizes a court to award, or a corporation s board of directors to grant, indemnity to directors and officers in terms sufficiently broad to permit such indemnification under certain circumstances for liabilities (including reimbursement for expenses incurred) arising under the Securities Act of 1933, as amended (the Securities Act).

As permitted by the Delaware General Corporation Law, the Registrant s restated certificate of incorporation includes a provision that eliminates the personal liability of its directors for monetary damages for breach of fiduciary duty as a director, except for liability:

- for any breach of the director s duty of loyalty to the Registrant or its stockholders,
- for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law,
- under section 174 of the Delaware General Corporation Law (regarding unlawful dividends and stock purchases), or
- for any transaction from which the director derived an improper personal benefit.

As permitted by the Delaware General Corporation Law, the Registrant s restated bylaws provide that:

- the Registrant is required to indemnify its directors and officers to the fullest extent permitted by the Delaware General Corporation Law, subject to very limited exceptions,
- the Registrant may indemnify its other employees and agents as set forth in the Delaware General Corporation Law,
- the Registrant is required to advance expenses, as incurred, to its directors and officers in connection with a legal proceeding to the fullest extent permitted by the Delaware General Corporation Law, subject to very limited exceptions, and
- the rights conferred in the bylaws are not exclusive.

The Registrant has entered into Indemnification Agreements with its directors and officers to provide such directors and officers additional contractual assurances regarding the scope of the indemnification set forth in the Registrant s restated certificate of incorporation and restated bylaws and to provide additional procedural protections. At present, there is no pending litigation or proceeding involving a director, officer or employee of the Registrant regarding which indemnification is sought.

The Registrant has directors and officers liability insurance for securities matters.

ITEM 16. Exhibits.

The following exhibits are filed herewith or incorporated by reference herein:

		Incorporated by Reference			
Exhibit Number	**Exhibit Description**	**Form**	**File No.**	**Date of First Filing**	**Exhibit Number**
4.01	Registrants Restated Certificate of Incorporation.	S-1	333-122454	February 1, 2005	3.01
4.02	Registrant s Restated Bylaws.	S-1/A	333-122454	March 3, 2005	3.05
4.03	Form of Specimen Certificate for Registrant s common stock.	S-1/A	333-122454	March 24, 2005	4.01
4.04	Second Amended and Restated Investors Rights Agreement, dated December 30, 2004.	S-1	333-122454	February 1, 2005	4.02
4.05	Form of Rights Agreement, between DexCom, Inc. and American Stock Transfer & Trust Company, including the Certificate of Designations of Series A Junior Participating Preferred Stock, Summary of Stock Purchase Rights and Forms of Right Certificate attached thereto as Exhibit A, B and C, respectively.	S-1/A	333-122454	March 24, 2005	4.03
4.06	Indenture, dated as of March 9, 2007, between DexCom, Inc. and Wells Fargo Bank, National Association as trustee (including form of 4.75% Convertible Senior Note due 2027).	8-K	000- 51222	March 12, 2007	4.01
4.07	Registration Rights Agreement, dated as of March 9, 2007, between DexCom, Inc. and Piper Jaffray & Co.	8-K	000- 51222	March 12, 2007	4.02
5.01**	Opinion of Fenwick & West LLP.				
12.01**	Statement regarding computation of earnings to fixed charges.				
23.01**	Consent of Fenwick & West LLP, (included in Exhibit 5.01).				
23.02*	Consent of Independent Registered Public Accounting Firm.				
24.01**	Power of Attorney.				
25.01**	Statement of Eligibility under the Trust Indenture Act of 1939, as amended, of Wells Fargo Bank, National Association, trustee under the Indenture.				

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* Filed herewith

** Previously filed

ITEM 17. Undertakings.

The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) to include any prospectus required by Section 10(a)(3) of the Securities Act,

(ii) to reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement, and

(iii) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

(2) That, for the purpose of determining any liability under the Securities Act, each post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

The undersigned hereby undertakes that, for purposes of determining any liability under the Securities Act, each filing of the registrant s annual report pursuant to Section 13(a) or Section 15(d) of the Exchange Act (and, where applicable, each filing of an employee benefit plan s annual report pursuant to Section 15(d) of the Exchange Act) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such seGIN-LEFT: 0pt; TEXT-INDENT: 0pt; MARGIN-RIGHT: 0pt; TEXT-ALIGN: left"> 341,038,916

Payments on repurchase agreements of RCap
(312,346,171) (214,067,318) (550,946,586) (336,809,273)
Proceeds from reverse repurchase agreements of RCap
84,402,455 130,785,187 189,362,118 185,681,953
Payments on reverse repurchase agreements of RCap
(79,653,078) (130,254,085) (187,758,014) (186,831,887)
Proceeds from reverse repurchase agreements of Shannon
267,896 129,848 644,094 223,740
Payments on reverse repurchase agreements of Shannon
(255,042) (145,820) (608,337) (238,411)
Proceeds from securities borrowed
76,474,674 12,741,368 130,273,831 19,424,651
Payments on securities borrowed
(76,211,213) (13,084,242) (130,537,913) (19,961,246)
Proceeds from securities loaned
105,005,660 33,856,914 215,730,800 65,859,868
Payments on securities loaned
(105,051,475) (33,620,656) (215,254,870) (65,551,662)
Proceeds from U.S. Treasury securities
39,150,789 15,289,185 60,834,425 31,097,679

Payments on U.S. Treasury securities	(38,397,508)	(17,754,440)	(60,554,625)	(31,840,754)
Net payments on derivatives	(42,958)	(18,309)	(44,448)	(17,460)
Net change in:				
Due to / from brokers	659	-	659	-
Other assets	(3,350)	8,072	(18,128)	2,154
Accrued interest and dividends receivable	51,340	(1,562)	73,956	(12,130)
Receivable for investment advisory income	2,443	(1,135)	7,356	(1,193)
Accrued interest payable	(11,495)	45,711	(22,642)	35,854
Accounts payable and other liabilities	32,636	36,926	58,885	87,630
Net cash provided by (used in) operating activities	(3,820,856)	(1,305,682)	(7,703,110)	3,688,753
Cash flows from investing activities:				
Payments on purchases of Agency mortgage-backed securities and debentures	(8,499,751)	(18,020,975)	(26,199,223)	(38,120,124)
Proceeds from sales of Agency mortgage-backed securities and debentures	13,459,639	5,145,156	28,944,048	9,915,497
Principal payments on Agency mortgage-backed securities	6,548,595	7,877,543	15,062,669	15,254,031
Proceeds from Agency debentures called	1,300,000	698,523	2,147,205	850,163
Payments on purchase of corporate debt	(19,899)	(9,900)	(23,382)	(9,900)
Proceeds from corporate debt called	24,252	-	24,252	-
Principal payments on corporate debt	610	125	1,521	1,460
Acquisition of CreXus	(724,424)	-	(724,424)	-
Purchases of commercial real estate investments	(230,000)	-	(230,000)	-
Principal payments on commercial real estate investments	20,840	-	20,840	-
Earn out payment	-	-	-	(13,387)
Proceeds from derivatives	-	-	7,465	-
Proceeds from sales of equity securities	-	4,048	-	4,048
Net cash provided by (used in) investing activities	11,879,862	(4,305,480)	19,030,971	(12,118,212)
Cash flows from financing activities:				
Proceeds from repurchase agreements	123,341,832	84,206,888	224,973,415	167,136,997
Principal payments on repurchase agreements	(132,114,220)	(79,085,612)	(235,177,628)	(158,703,728)
Proceeds from exercise of stock options	1,939	3,549	2,204	5,391

Statement continued on following page.

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Statement continued from previous page.

Net proceeds from Series C Preferred offering	-	290,514	-	290,514
Net proceeds from issuance of 5% Convertible Senior Notes offering	-	727,500	-	727,500
Net proceeds from direct purchases and dividend reinvestments	670	845	1,431	845
Net (payments) proceeds from follow-on offerings	-	-	-	(231)
Payments on participation sold	(67)	-	(67)	-
Net payment on share repurchase	-	-	(141,149)	-
Dividends paid	(426,173)	(540,909)	(876,319)	(1,097,653)
Net cash provided by (used in) financing activities	(9,196,019)	5,602,775	(11,218,113)	8,359,635
Net (decrease) increase in cash and cash equivalents	(1,137,013)	(8,387)	109,748	(69,824)
Cash and cash equivalents, beginning of period	1,862,550	932,761	615,789	994,198
Cash and cash equivalents, end of period	$725,537	$924,374	$725,537	$924,374
Supplemental disclosure of cash flow information:				
Interest received	$1,078,672	$1,186,292	$2,266,874	$2,311,295
Dividends received	$6,431	$7,521	$13,528	$15,804
Fees received	$14,630	$20,794	$33,083	$41,502
Interest paid (excluding interest paid on interest rate swaps)	$168,898	$115,764	$353,324	$249,863
Net interest paid on interest rate swaps	$215,768	$220,738	$442,231	$441,353
Taxes paid	$4,057	$7,766	$6,439	$29,167
Noncash investing activities:				
Receivable for investments sold	$1,499,140	$1,320,996	$1,499,140	$1,320,996
Payable for investments purchased	$2,833,214	$7,387,410	$2,833,214	$7,387,410
Net change in unrealized gains (losses) on available-for-sale securities, net of reclassification adjustment	$(3,292,494)	$646,890	$(4,342,488)	$404,332
Noncash financing activities:				
Dividends declared, not yet paid	$396,888	$535,898	$396,888	$535,898
Conversion of Series B cumulative preferred stock	-	-	-	$32,272
Contingent beneficial conversion feature on 4% Convertible Senior Notes	$4,550	$23,020	$8,513	$46,341
Equity component of 5% Convertible Senior Notes	-	$11,717	-	$11,717

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. ("Annaly" or the "Company") was incorporated in Maryland on November 25, 1996. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital, and completed its initial public offering on October 14, 1997. The Company is a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended (the "Code"). On June 4, 2004, the Company acquired Fixed Income Discount Advisory Company ("FIDAC"). FIDAC is a registered investment advisor and is a wholly-owned taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment in an affiliated investment fund (the "Fund"), which is now wholly-owned by the Company. During the third quarter of 2008, the Company formed RCap Securities, Inc. ("RCap"). RCap was granted membership in the Financial Industry Regulatory Authority ("FINRA") on January 26, 2009, and operates as a broker-dealer. RCap is a wholly-owned taxable REIT subsidiary of the Company. On October 31, 2008, the Company acquired Merganser Capital Management, Inc. ("Merganser"). Merganser is a registered investment advisor and is a wholly-owned taxable REIT subsidiary of the Company. In 2010, the Company established Shannon Funding LLC ("Shannon"), which provides warehouse financing to residential mortgage originators in the United States. In 2010, the Company also established Charlesfort Capital Management LLC ("Charlesfort"), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited ("FIDAC Europe"), which the Company sold in December 2012. In 2011, the Company established FIDAC FSI LLC ("FIDAC FSI"), which invested in trading securities. FIDAC FSI was liquidated in August 2012. During the second quarter of 2013, the Company, through its wholly-owned subsidiary CXS Acquisition Corporation ("CXS Acquisition") which was formed in January 2013, acquired CreXus Investment Corp. ("CreXus"), a specialty finance company that specialized in acquiring, managing and financing commercial mortgage loans and other commercial real estate debt, commercial mortgage-backed securities and other commercial real estate-related assets. Following the acquisition, CXS Acquisition was renamed Annaly Commercial Real Estate Group, Inc. ("Annaly Commercial"). Annaly Commercial is a wholly-owned qualified REIT subsidiary of the Company.

A summary of the Company's significant accounting policies follows:

Basis of Accounting – The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of management, the consolidated financial statements reflect all adjustments considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows.

Principles of Consolidation – The consolidated financial statements include the accounts of the Company, FIDAC, FIDAC FSI, FIDAC Europe, Merganser, RCap, Shannon, Charlesfort, the Fund and Annaly Commercial. All intercompany balances and transactions have been eliminated in consolidation. Beginning with the Company's consolidated financial statements for the quarter and six month periods ended June 30, 2013, the Company reclassified previously presented financial information so that amounts previously presented in the Consolidated Statements of Operations and Comprehensive Income (Loss) as interest income from Investments are presented as interest income in Reverse repurchase agreements and Other. Consolidated financial statements for periods prior to June 30, 2013 have been conformed to the current presentation.

The Company has evaluated all of its investments in order to determine if they qualify as Variable Interest Entities ("VIEs") or as variable interests in VIEs. A VIE is defined as an entity in which equity investors (i) do not have the characteristics of a controlling financial interest, and/or (ii) do not have sufficient equity at risk for the entity to finance its activities without additional financial support from other parties. A variable interest is an investment or other interest that will absorb portions of a VIE's expected losses or receive portions of the entity’s expected residual returns. A VIE is required to be consolidated by its primary beneficiary, which is defined as the party that (i) has the power to control the activities that most significantly impact the VIE’s economic performance and (ii) has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Cash and Cash Equivalents – Cash and cash equivalents include cash on hand and cash held in money market funds on an overnight basis. RCap is a member of various clearing organizations with which it maintains cash required for the conduct of its day-to-day clearance activities. Cash and securities deposited with clearing organizations are carried at cost, which approximates fair value. The Company also maintains collateral in the form of cash on margin with counterparties to its interest rate swaps. Cash and securities deposited with clearing organizations and collateral held in the form of cash on margin with counterparties to its interest rate swaps totaled $561.6 million and $527.5 million at June 30, 2013 and December 31, 2012, respectively.

Reverse Repurchase Agreements – RCap enters into reverse repurchase agreements as part of its matched book trading activity. Reverse repurchase agreements are recorded on trade date at the contract amount and are collateralized by mortgage-backed or other securities. Margin calls are made by RCap as necessary based on the daily valuation of the underlying collateral as compared to the contract price. RCap generates income from the spread between what is earned on the reverse repurchase agreements and what is paid on the matched repurchase agreements. RCap's policy is to obtain possession of collateral with a market value in excess of the principal amount loaned under reverse repurchase agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is valued daily, and RCap will require counterparties to deposit additional collateral, when necessary. All reverse repurchase activities are transacted under master repurchase agreements that give RCap the right, in the event of default, to liquidate collateral held and to offset receivables and payables with the same counterparty.

Securities Borrowed and Loaned Transactions – RCap records securities borrowed and loaned transactions as collateralized financings. Securities borrowed transactions require RCap to provide the counterparty with collateral in the form of cash, or other securities. RCap receives collateral in the form of cash or other securities for securities loaned transactions in an amount generally in excess of the fair value of the securities loaned. RCap monitors the fair value of the securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary. Securities borrowed and securities loaned transactions are recorded at contract value. For these transactions, the rebates accrued by RCap are recorded as interest income or expense.

U.S. Treasury Securities – RCap trades in U.S. Treasury securities for its proprietary portfolio, which consists of long and short positions on U.S Treasury notes and bonds. U.S. Treasury securities are classified as trading investments and are recorded on the trade date at cost. Changes in fair value are reflected in the Company's Consolidated Statement of Operations and Comprehensive Income (Loss). Generally, RCap does not hold the U.S. Treasury notes and bonds to maturity and realizes gains and losses from trading those positions. Interest income or expense on U.S. Treasury notes and bonds is accrued based on the outstanding principal amount of those investments and their stated terms.

Agency Mortgage-Backed Securities and Agency Debentures – The Company invests primarily in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans, and certificates guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae (collectively, "Agency mortgage-backed securities"). The Company also invests in Agency debentures issued by Federal Home Loan Bank ("FHLB"), Freddie Mac, and Fannie Mae.

Investment Securities – Agency mortgage-backed securities, Agency debentures, and corporate debt are referred to herein as "Investment Securities." Although the Company generally intends to hold most of its Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Investment Securities classified as available-for-sale are reported at fair values estimated by management that are compared to independent sources for reasonableness, with unrealized gains and losses reported as a component of stockholders' equity. Investment Securities transactions are recorded on the trade date. Realized gains and losses on sales of Investment Securities are determined using the average cost method. The Company's investments in corporate debt are designated as held for investment, and are carried at their principal balance outstanding plus any premiums or discounts less allowances for loan losses. No allowance for loan losses was deemed necessary as of June 30, 2013 and December 31, 2012.

On April 1, 2011, the Company elected the fair value option for Agency interest-only mortgage-backed securities acquired on or after such date. Interest-only securities and inverse interest-only securities are collectively referred to as "interest-only securities." These Agency interest-only mortgage-backed securities represent the Company's right to receive a specified proportion of the contractual interest flows of specific Agency mortgage-backed securities. Agency interest-only mortgage-backed securities acquired on or after April 1, 2011 are measured at fair value through earnings in the Company's Consolidated Statements of Operations and Comprehensive Income (Loss). The interest-only securities are included in Agency mortgage-backed securities at fair value on the accompanying Consolidated Statements of Financial Condition.

Interest income from coupon payments is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized or accreted into interest income over the projected lives of the securities using the interest method. The Company's policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions. Adjustments are made for actual prepayment activity.

Other-Than-Temporary Impairment – Management evaluates available-for-sale securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. When the fair value of available-for-sale security is less than its amortized cost the security is considered impaired. For securities that are impaired, the Company determines if it (1) has the intent to sell the securities, (2) is more likely than not that it will be required to sell the securities before recovery, or (3) does not expect to recover the entire amortized cost basis of the securities. Further, the security is analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, will then be recognized in the Consolidated Statements of Operations and Comprehensive Income (Loss), while the balance of losses related to other factors will be recognized as a component of stockholders' equity. There was no other-than-temporary impairment for the quarters and six months ended June 30, 2013 and 2012.

Commercial Real Estate Investments

Commercial Real Estate Loans – The Company's commercial real estate mortgages and loans are comprised of fixed-rate and adjustable-rate loans. Commercial real estate mortgages and loans are designated as held for investment and are carried at their outstanding principal balance, plus any premiums or discounts, less allowances for loan losses. The difference between the principal amount of a loan and proceeds at acquisition is recorded as either a discount or premium.

Preferred Equity Interests Held for Investment – Preferred equity interests are designated as held for investment and are carried at their outstanding principal balance, plus premiums or discounts, less allowances for losses.

Investments in Real Estate – Investments in real estate are carried at historical cost less accumulated depreciation. Costs directly related to acquisitions deemed to be business combinations are expensed. Ordinary repairs and maintenance which are not reimbursed by the tenants are expensed as incurred. Major replacements and improvements that extend the useful life of the asset are capitalized and depreciated over their useful life.

Allowance for Loan Losses – The Company evaluates the need for a loan loss reserve on its commercial real estate loans and preferred equity interests. A provision is established when the Company believes a loan is impaired, which is when it is deemed probable that the Company will be unable to collect contractual principal and interest amounts. A provision for credit losses related to loans, including those accounted for under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30"), may be established when it is probable the Company will not collect amounts contractually due or all amounts previously estimated to be collected. Management assesses the credit quality of the portfolio and adequacy of loan loss reserves on a quarterly basis, or more frequently as necessary. Significant judgment is required in this analysis. Depending on the expected recovery of its investment, the Company considers the estimated net recoverable value of the loan as well as other factors, including but not limited to the fair value of any collateral, the amount and the status of any senior debt, the prospects for the borrower and the competitive landscape where the borrower does business. Because this determination is based upon projections of future economic events, which are inherently subjective, the amounts ultimately realized may differ materially from the carrying value as of the reporting date.

Revenue Recognition – Commercial Real Estate Investments - Interest income is accrued based on the outstanding principal amount of the loans or preferred equity investments and their contractual terms. Premiums and discounts associated with the purchase of the loans or preferred equity investments are amortized or accreted into interest income over the projected lives of the loans or preferred equity investments using the interest method based on the estimated recovery value.

Equity Securities – The Company invests in equity securities that are classified as available-for-sale or trading. Equity securities classified as available-for-sale are reported at fair value, based on market quotes, with unrealized gains and losses reported as a component of other comprehensive income (loss). Equity securities classified as trading are reported at fair value, based on market quotes, with unrealized gains and losses reported in the Consolidated Statements of Operations and Comprehensive Income (Loss) as Net gains (losses) on trading assets. Dividends are recorded in earnings based on the declaration date.

Derivative Instruments – The Company accounts for interest rate swaps at fair value as either assets or liabilities on the Consolidated Statements of Financial Condition. Changes in the fair value of interest rate swaps are recognized in earnings. The Company uses interest rate swaps to manage its exposure to changing interest rates on its repurchase agreements. Net payments on interest rate swaps are included in the Consolidated Statements of Cash Flows as a component of operating activities.

The Company elected to net, by counterparty, the fair value of interest rate swap contracts. These contracts contain legally enforceable provisions that allow for netting or setting off swap receivables and payables with each counterparty and, therefore, the fair value of those swap contracts are netted by counterparty. The credit support annex provisions of the Company’s interest rate swap contracts allow the parties to mitigate their credit risk by requiring the party which is out of the money to post collateral. As the Company elects to net by counterparty the fair value of interest rate swap contracts, it also nets by counterparty any collateral exchanged as part of the interest rate swap contracts. In addition, the Company’s agreements with certain of its counterparties with whom it has both interest rate swap contracts and master repurchase agreements contain legally enforceable provisions that allow for netting or setting off on an aggregate basis all receivables, payables and collateral postings required under both the interest rate swap contract and the master repurchase agreement with respect to such counterparty.

The Company may from time to time also use a variety of derivative instruments to economically hedge some of its exposure to market risks, including interest rate and prepayment risk. Any such hedging transactions could take a variety of forms, including the use of derivative instruments such as interest rate swap agreements, interest rate swaptions or forward contracts. The Company may also purchase or sell To-Be-Announced (“TBA”) securities, purchase or write put or call options on TBA securities or invest in other types of mortgage derivative securities. The Company maintains a margin account which is settled daily with futures and options commission merchants. The Company accounts for derivatives at fair value as either assets or liabilities on the Consolidated Statements of Financial Condition. Changes in the fair value of these derivatives are included in net gains (losses) on trading assets on the Consolidated Statements of Operations and Comprehensive Income (Loss).

RCap enters primarily into U.S. Treasury, Eurodollar, federal funds, U.S. equity index and currency futures and options contracts. RCap maintains a margin account which is settled daily with futures and options commission merchants. Changes in the unrealized gains or losses on the futures and options contracts as well as any foreign exchange gains and losses are reflected in the Company’s Consolidated Statements of Operations and Comprehensive Income (Loss). Unrealized gains (losses) are excluded from net income (loss) in arriving at cash flows from operating activities in the Consolidated Statements of Cash Flows.

Credit Risk – The Company has limited its exposure to credit losses on its portfolio of Agency mortgage-backed securities by only purchasing securities issued by Freddie Mac, Fannie Mae or Ginnie Mae and Agency debentures issued by the FHLB, Freddie Mac and Fannie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on Ginnie Mae Agency mortgage-backed securities are backed by the full faith and credit of the U.S. government. Principal and interest on Agency debentures are guaranteed by the agency issuing the debenture. Substantially all of the Company's Investment Securities have an actual or implied "AAA" rating. The Company faces credit risk on the portions of its portfolio which are not Agency mortgage-backed securities and Agency debentures. The Company is exposed to credit risk on commercial real estate loans, preferred equity interests and corporate debt.

Market Risk – Weakness in the mortgage market may adversely affect the performance and market value of the Company's investments. This could negatively impact the Company's net book value. Furthermore, if many of the Company's lenders are unwilling or unable to provide additional financing, the Company could be forced to sell its Investment Securities at an inopportune time when prices are depressed. The Company does not anticipate having difficulty converting its assets to cash or extending financing terms due to the fact that its Agency mortgage-backed securities and Agency debentures have an actual or implied "AAA" rating and principal payment is guaranteed by Freddie Mac, Fannie Mae, or Ginnie Mae.

The Company has established policies and procedures for mitigating market risk, including conducting scenario analysis and utilizing a range of hedging strategies.

Counterparty Credit Risk – The Company is exposed to risk of loss if an issuer or a counterparty fails to perform its obligations under contractual terms.

The Company has established policies and procedures for mitigating credit risk, including reviewing and establishing limits for credit exposure, limiting transactions with specific counterparties, maintaining qualifying collateral and continually assessing the creditworthiness of counterparties.

Repurchase Agreements – The Company finances the acquisition of a significant portion of its Agency mortgage-backed securities with repurchase agreements. The Company examines each of the specified criteria in ASC 860, Transfers and Servicing, at the inception of each transaction and has determined that each of the financings meet the specified criteria in this guidance. None of the Company's repurchase agreements are accounted for as components of linked transactions. As a result, the Company separately accounts for the financial assets and related repurchase financings in the accompanying consolidated financial statements.

Reverse repurchase agreements and repurchase agreements with the same counterparty and the same maturity are presented net in the Consolidated Statements of Financial Condition when the terms of the agreements permit netting. The Company reports cash flows on repurchase agreements as financing activities in the Consolidated Statements of Cash Flows. The Company reports cash flows on repurchase agreements entered into by RCap as operating activities in the Consolidated Statements of Cash Flows.

Convertible Senior Notes – The Company records the 4% Convertible Senior Notes and 5% Convertible Senior Notes (collectively, the "Convertible Senior Notes") at their contractual amounts, adjusted by the effects of a beneficial conversion feature and a contingent beneficial conversion feature (collectively, the "Conversion Features"). The Conversion Features' intrinsic value is included in "Additional paid-in capital" on the Company's Consolidated Statements of Financial Condition and reduces the recorded liability amount associated with the Convertible Senior Notes.

The Convertible Senior Notes have a conversion price adjustment feature that is evaluated at the time of the conversion price adjustment. A contingent beneficial conversion feature may be recognized as a result of adjustments to the conversion price for dividends declared. The Company determined the intrinsic value of a contingent beneficial conversion feature on its 4% Convertible Senior Notes.

Income Taxes – The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Code, with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and certain of its direct and indirect subsidiaries, including FIDAC, Merganser, RCap and a subsidiary of Annaly Commercial, have made separate joint elections to treat these subsidiaries as taxable REIT subsidiaries. As such, each of these taxable REIT subsidiaries are taxable as a domestic C corporation and subject to federal, state and local income taxes based upon their taxable income. FIDAC Europe was located in Europe and was not required to pay United States income taxes. FIDAC Europe was sold by the Company in December 2012.

The provisions of ASC 740, Income Taxes, ("ASC 740") clarify the accounting for uncertainty in income taxes recognized in financial statements and prescribe a recognition threshold and measurement attribute for tax positions taken or expected to be taken on a tax return. ASC 740 also requires that interest and penalties related to unrecognized tax benefits be recognized in the financial statements. The Company does not have any unrecognized tax benefits that would affect its financial position. Thus, no accruals for penalties and interest were necessary as of June 30, 2013 or December 31, 2012.

Goodwill and Intangible Assets – The Company's acquisitions of FIDAC, Merganser and CreXus were accounted for using the acquisition method. Under the acquisition method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. The costs of FIDAC, Merganser and CreXus were allocated to the assets acquired, including identifiable intangible assets and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired was recognized as goodwill.

The Company tests goodwill for impairment on an annual basis and at interim periods when events or circumstances make it more likely than not that an impairment may have occurred. The impairment test for goodwill utilizes a two-step approach, whereby the Company compares the carrying value of each identified reporting unit to its fair value. If the carrying value of the reporting unit is greater than its fair value, the second step is performed, where the implied fair value of goodwill is compared to its carrying value. The Company recognizes an impairment charge for the amount by which the carrying amount of goodwill exceeds its fair value.

Intangible assets with an estimated useful life are amortized over the expected life.

Stock Based Compensation – The Company is required to measure and recognize in the consolidated financial statements the compensation cost relating to share-based payment transactions. The Company recognizes compensation expense on a straight-line basis over the requisite service period for the entire award.

Use of Estimates – The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. All assets classified as trading or available-for-sale and interest rate swaps are reported at their estimated fair value, based on market prices. The Company's policy is to obtain fair values from one or more independent sources to compare to internal prices for reasonableness. Actual results could differ from those estimates.

A Summary of Recent Accounting Pronouncements Follows:

Presentation

Balance Sheet (ASC 210)

On December 23, 2011, FASB released ASU 2011-11 Balance Sheet: Disclosures about Offsetting Assets and Liabilities. Under this update, the Company is required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and transactions subject to an agreement similar to a master netting arrangement. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements and securities borrowing and securities lending arrangements. This disclosure is intended to enable financial statement users to understand the effect of such arrangements on the Company's financial position. In January 2013, FASB released ASU 2013-01 Balance Sheet: Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, which served solely to clarify the scope of financial instruments included in ASU 2011-11 as there was concern about diversity in practice. The objective of these updates is to support further convergence of US GAAP and IFRS requirements. The updates are effective for annual reporting periods beginning on or after January 1, 2013 and did not have a significant impact on the consolidated financial statements.

Comprehensive Income (ASC 220)

On December 23, 2011, the FASB issued ASU 2011-12, Comprehensive Income: Deferral of Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income In ASU No. 2011-05, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated OCI. This was done to allow the FASB time to re-deliberate the presentation on the face of the financial statements the effects of reclassifications out of accumulated OCI on the components of net income and OCI. No other requirements under ASU 2011-05 are affected by ASU 2011-12. FASB tentatively decided not to require presentation of reclassification adjustments out of accumulated other comprehensive income on the face of the financial statements and to propose new disclosures instead.

In February 2013, the FASB issued ASU 2013-02 Comprehensive Income: Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This update addresses the disclosure issue left open at the deferral under ASU 2011-12. This update requires the provision of information about the amounts reclassified out of accumulated OCI by component. In addition, it requires presentation, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated OCI by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, a cross-reference must be provided to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This update is effective for reporting periods beginning after December 15, 2012. Adoption of ASU 2013-02 did not have a significant impact on the consolidated financial statements.

Broad Transactions

Financial Services – Investment Companies (ASC 946)

In June 2013, the FASB finalized ASU 2013-08 amending the scope, measurement and disclosure requirements under Topic 946 – Financial Services-Investment Companies. The FASB decided not to address issues related to the applicability of investment company accounting for real estate entities and the measurement of real estate investments at this time. Further, as stated in ASC 946-10-15-3, the guidance in Topic 946 does not apply to real estate investment trusts, and thus has no effect on the Company's consolidated financial statements.

2. AGENCY MORTGAGE-BACKED SECURITIES

The following tables present the Company's available-for-sale Agency mortgage-backed securities portfolio as of June 30, 2013 and December 31, 2012 which were carried at their fair value:

June 30, 2013	Freddie Mac	Fannie Mae	Ginnie Mae	Total Mortgage-Backed Securities
		(dollars in thousands)		
Agency mortgage-backed securities, par value	$ 32,331,213	$ 55,685,938	$ 204,526	$ 88,221,677
Unamortized discount	(12,845)	(13,134)	(382)	(26,361)
Unamortized premium	1,871,508	3,473,288	33,788	5,378,584
Amortized cost	34,189,876	59,146,092	237,932	93,573,900
Gross unrealized gains	427,974	893,025	11,893	1,332,892
Gross unrealized losses	(939,614)	(1,477,347)	(2,513)	(2,419,474)
Estimated fair value	$ 33,678,236	$ 58,561,770	$ 247,312	$ 92,487,318

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
		(dollars in thousands)		
Adjustable rate	$ 4,562,693	$ 240,181	$ (10,059)	$ 4,792,815
Fixed rate	89,011,207	1,092,711	(2,409,415)	87,694,503
Total	$ 93,573,900	$ 1,332,892	$ (2,419,474)	$ 92,487,318

December 31, 2012	Freddie Mac	Fannie Mae	Ginnie Mae	Total Mortgage Backed Securities
		(dollars in thousands)		
Agency mortgage-backed securities, par value	$ 44,296,234	$ 70,649,782	$ 273,988	$ 115,220,004
Unamortized discount	(9,515)	(12,315)	(389)	(22,219)
Unamortized premium	2,121,478	3,695,381	39,348	5,856,207
Amortized cost	46,408,197	74,332,848	312,947	121,053,992
Gross unrealized gains	1,166,299	1,913,334	17,583	3,097,216
Gross unrealized losses	(36,890)	(146,533)	(4,578)	(188,001)
Estimated fair value	$ 47,537,606	$ 76,099,649	$ 325,952	$ 123,963,207

	Amortized Cost	Gross Unrealized	Gross Unrealized	Estimated Fair Value

			Gain	Loss	
			(dollars in thousands)		
Adjustable rate	$ 5,786,718	$ 259,013	$ (4,613)	$ 6,041,118
Fixed rate	115,267,274	2,838,203	(183,388)	117,922,089
Total	$ 121,053,992	$ 3,097,216	$ (188,001)	$ 123,963,207

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Actual maturities of Agency mortgage-backed securities are generally shorter than stated contractual maturities because actual maturities of Agency mortgage-backed securities are affected by periodic payments and prepayments of principal on the underlying mortgages. The following table summarizes the Company's Agency mortgage-backed securities as of June 30, 2013 and December 31, 2012, according to their estimated weighted-average life classifications:

	June 30, 2013		December 31, 2012	
Weighted-Average Life	Fair Value	Amortized Cost	Fair Value	Amortized Cost
	(dollars in thousands)			
Less than one year	$ 556,408	$ 554,339	$ 1,264,094	$ 1,250,405
Greater than one year through five years	67,853,688	67,919,691	119,288,168	116,510,310
Greater than five years through ten years	23,828,194	24,869,574	3,104,073	2,992,054
Greater than 10 years	249,028	230,296	306,872	301,223
Total	$ 92,487,318	$ 93,573,900	$ 123,963,207	$ 121,053,992

The weighted-average lives of the Agency mortgage-backed securities at June 30, 2013 and December 31, 2012 in the table above are based upon principal prepayment rates for each security provided through subscription-based financial information services. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loans, loan age, margin, volatility, and other factors. The actual weighted average lives of the Agency mortgage-backed securities could be longer or shorter than estimated.

The following table presents the gross unrealized losses and estimated fair value of the Company's Agency mortgage-backed securities by length of time that such securities have been in a continuous unrealized loss position at June 30, 2013 and December 31, 2012.

	Unrealized Loss Position For:								
	Less than 12 Months			12 Months or More			Total		
	Estimated Fair Value	Unrealized Losses	Number of Securities	Estimated Fair Value	Unrealized Losses	Number of Securities	Estimated Fair Value	Unrealized Losses	N Se
	(dollars in thousands)								
June 30, 2013	$57,539,925	$(2,386,778)	618	$121,495	$(32,696)	33	$57,661,420	$(2,419,474)	65
December 31, 2012	$11,220,514	$(82,721)	187	$147,775	$(105,280)	39	$11,368,289	$(188,001)	22

The decline in value of these securities is solely due to market conditions and not the quality of the assets. Substantially all of the Agency mortgage-backed securities are "AAA" rated or carry an implied "AAA" rating. The investments are not considered to be other-than-temporarily impaired because the Company currently has the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments, and it is not more likely than not that the Company will be required to sell the investments before recovery of the amortized cost bases, which may be maturity. Also, the Company is guaranteed payment of the principal amount of the securities by the respective issuing government agency.

During the quarter and six months ended June 30, 2013, the Company sold $13.5 billion and $29.8 billion of Agency mortgage-backed securities, respectively, resulting in a net realized gain of $148.0 million and $330.8 million, respectively. During the quarter and six months ended June 30, 2012, the Company sold $5.7 billion and $10.9 billion of Agency mortgage-backed securities, respectively, resulting in a net realized gain of $94.8 million and $175.1 million, respectively. Average cost is used as the basis on which the realized gain or loss on sale is determined.

Agency interest-only mortgage-backed securities represent the right to receive a specified portion of the contractual interest flows of the underlying outstanding principal balance of specific Agency mortgage-backed securities. Agency interest-only mortgage-backed securities in the Company's portfolio as of June 30, 2013 had net unrealized gains of $50.5 million (consisting of net unrealized gains of $25.1 million included in accumulated deficit and net unrealized gains of $25.4 million included in accumulated other comprehensive income) and an amortized cost of $1.1 billion.

3. ACQUISITION OF CREXUS

On April 17, 2013, the Company, through its wholly-owned subsidiary CXS Acquisition, completed the acquisition of CreXus pursuant to the merger agreement dated January 30, 2013. CreXus owned a portfolio of commercial real estate assets which are now owned by the Company. Following the acquisition, CXS Acquisition was renamed Annaly Commercial Real Estate Group, Inc.

The business combination was accounted for under the acquisition method of accounting in accordance with ASC 805, Business Combinations, ("ASC 805"). Accordingly, goodwill was measured as the excess of the aggregate of the acquisition-date fair value of the consideration transferred and the acquisition-date fair value of the Company's previously held equity interest in CreXus over the fair value, at acquisition date, of the identifiable assets acquired net of assumed liabilities. The following table summarizes the aggregate consideration and preliminary fair value of the assets acquired and liabilities assumed recognized at the acquisition date:

	April 17, 2013 (dollars in thousands)
Cash consideration transferred	$ 876,267
Fair value of equity interest in CreXus held before the business combination	106,521
	$ 982,788
Recognized amounts of identifiable assets acquired and liabilities assumed	
Cash and cash equivalents	$ 151,843
Commercial real estate investments	796,950
Accrued interest receivable	3,485
Other assets	5,617
Mortgages payable	(19,376)
Participation sold	(14,352)
Accounts payable and accrued expenses	(12,729)
Total identifiable net assets	911,438
Goodwill	71,350
	$ 982,788

The Company recorded $71.4 million of goodwill associated with the acquisition of CreXus in the Consolidated Statements of Financial Condition. The final goodwill recorded on the Consolidated Statements of Financial Condition may differ from that reflected herein as a result of future measurement period adjustments. In management's opinion, the goodwill represents the synergies that will result from integrating CreXus' commercial real estate platform into the Company, which the Company believes is complementary to its existing business and return profile.

The acquisition-date fair value of the previously held equity interest in CreXus excluded the estimated fair value of the control premium that resulted from the merger transaction. The Company recognized a loss of $18.9 million for the three and six months ended June 30, 2013 as a result of remeasuring the fair value of its equity interest in CreXus held before the business combination.

Under ASC 805, merger-related transaction costs (such as advisory, legal, valuation and other professional fees) are not included as components of consideration transferred but are accounted for as expenses in the periods in which the costs are incurred. Transaction costs of $6.5 million and $7.3 million were incurred during the quarter and sixth months ended June 30, 2013, respectively, and were included in other general and administrative expenses in the Consolidated Statements of Operations and Comprehensive Income (Loss).

4. COMMERCIAL REAL ESTATE INVESTMENTS

At June 30, 2013, commercial real estate investments are composed of the following:

Commercial Mortgage Loans and Preferred Equity Held for Investment

	June 30, 2013		
	Outstanding Principal	Carrying Value	Percentage of Loan Portfolio(1)
	(dollars in thousands)		
Senior mortgages	$ 330,864	$ 331,372	35.3 %
Subordinate notes	41,235	41,733	4.4 %
Mezzanine loans	524,393	526,167	56.0 %
Preferred equity	39,769	39,085	4.3 %
Total	$ 936,261	$ 938,357	100.0 %

(1) Based on outstanding principal.

	June 30, 2013				
	Senior Mortgages	Subordinate Notes	Mezzanine Loans	Preferred Equity	Total
	(dollars in thousands)				
Beginning principal balance at acquisition	$ 100,907	$ 41,293	$ 545,109	$ 39,769	$ 727,078
Purchases/advances, principal balance	230,000	-	-	-	230,000
Remaining premium (discount)	508	498	1,774	(684)	2,096
Principal payments	(43)	(58)	(20,716)	-	(20,817)
Net carrying value	$ 331,372	$ 41,733	$ 526,167	$ 39,085	$ 938,357

Internal Loan and Preferred Equity Ratings

	June 30, 2013			
			Internal Ratings	
Investment type	Outstanding Principal	Percentage of Portfolio	Performing Loans	Watch List Loans
	(dollars in thousands)			
Senior mortgages	$ 330,864	35.3 %	$ 317,891	$ 12,973 (1)
Subordinate notes	41,235	4.4 %	41,235	-
Mezzanine loans	524,393	56.0 %	524,393	-

Preferred equity	39,769	4.3 %	39,769	-
	$ 936,261	100.0 %	$ 923,288	$ 12,973

(1) Loan on non-accrual status. Amount represents recorded investment.

Real Estate Investment

	June 30, 2013 (dollars in thousands)
Real estate held for investment, at amortized cost	
Land	$ 6,639
Buildings and improvements	31,099
Subtotal	37,738
Less: accumulated depreciation	(246)
Real estate held for investment, net	37,492
Real estate held for sale, at fair value	29,711
Total real estate investments	$ 67,203

5. GOODWILL

At June 30, 2013 and December 31, 2012, goodwill totaled $102.8 million and $55.4 million, respectively. During the second quarter of 2013, the Company recorded $71.4 million of additional goodwill associated with the acquisition of CreXus. During the first quarter of 2012, Merganser's prior owners received an additional payment of $13.4 million relating to earn-out provisions in the merger agreement, which was recorded as additional goodwill. The Company also recorded a goodwill impairment charge of $24.0 million during the second quarter of 2013 based on market information that became available to the Company. No goodwill impairment losses were recognized prior to the second quarter of 2013.

6. FAIR VALUE MEASUREMENTS

The Company follows fair value guidance in accordance with U.S. GAAP to account for its financial instruments. The Company categorizes its financial instruments, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument. Financial assets and liabilities recorded at fair value on the Consolidated Statements of Financial Condition or disclosed in the related notes are categorized based on the inputs to the valuation techniques as follows:

Level 1– inputs to the valuation methodology are quoted prices (unadjusted) for identical assets and liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to overall fair value.

Agency mortgage-backed securities, Agency debentures and interest rate swaps and swaptions are valued using quoted prices, including dealer quotes, or internally estimated prices for similar assets. The Company incorporates common market pricing methods, including a spread measurement to the Treasury curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period and expected life of the security in its estimates of fair value. Management reviews the fair values generated by the model to determine whether prices are reflective of the current market. Management indirectly corroborates its estimates of the fair value using pricing models by comparing its results to independent prices provided by dealers in the securities and/or third party pricing services. Certain liquid asset classes, such as Agency fixed-rate pass-throughs, may be priced using independent sources such as quoted prices for TBA securities.

The Agency mortgage-backed securities, interest rate swap, and swaption market is considered to be an active market such that participants transact with sufficient frequency and volume to provide transparent pricing information on an ongoing basis. The liquidity of the Agency mortgage-backed securities interest rate swap, and swaption market and the similarity of the Company's securities to those actively traded enable the Company to observe quoted prices in the market and utilize those prices as a basis for formulating fair value measurements. Consequently, the Company has classified Agency mortgage-backed securities interest rate swaps, and swaptions as Level 2 inputs in the fair value hierarchy.

The fair value of U.S. Treasury securities and investments in affiliates are based on quoted prices in active markets.

The following table presents the estimated fair values of financial instruments measured at fair value on a recurring basis.

	Level 1	Level 2	Level 3
At June 30, 2013		(dollars in thousands)	
Assets:			
Agency mortgage-backed securities	$-	$92,487,318	$-
Agency debentures	-	3,306,473	-
Investment in affiliate	134,948	-	-
Interest rate swaps	-	38,950	-
Other derivative contracts	940	90,330	-
Liabilities:			
Interest rate swaps	-	1,189,178	-

	Level 1	Level 2	Level 3
At December 31, 2012		(dollars in thousands)	
Assets:			
U.S. Treasury securities	$752,076	$-	$-
Agency mortgage-backed securities	-	123,963,207	-
Agency debentures	-	3,009,568	-
Investments in affiliates	234,120	-	-
Other derivative contracts	7,955	1,875	-
Liabilities:			
U.S. Treasury securities sold, not yet purchased	495,437	-	-
Interest rate swaps	-	2,584,907	-

GAAP requires disclosure of fair value information about financial instruments, whether or not recognized in the financial statements, for which it is practical to estimate the value. In cases where quoted market prices are not available, fair values are based upon discounted cash flows using market yields or other valuation methodologies. Considerable judgment is necessary to interpret market data and develop estimated fair value. Accordingly, fair values are not necessarily indicative of the amount the Company could realize on disposition of the financial instruments. The use of different market assumptions or estimation methodologies could have a material effect on the estimated fair value amounts.

The following table summarizes the estimated fair value for all financial assets and liabilities as of June 30, 2013 and December 31, 2012.

		June 30, 2013		December 31, 2012	
	Level in Fair Value Hierarchy	Carrying Value	Fair Value	Carrying Value	Fair Value
		(dollars in thousands)			
Financial assets:					
Cash and cash equivalents(1)	1	$ 725,537	$ 725,537	$ 615,789	$ 615,789
Reverse repurchase agreements(1)	1	171,234	171,234	1,811,095	1,811,095
U.S. Treasury securities(2)	1	-	-	752,076	752,076
Securities borrowed(2)	2	2,425,024	2,425,024	2,160,942	2,160,942
Agency mortgage-backed securities	2	92,487,318	92,487,318	123,963,207	123,963,207
Agency debentures	2	3,306,473	3,306,473	3,009,568	3,009,568
Investments in affiliates(2)	1	134,948	134,948	234,120	234,120
Commercial real estate investments(3)	3	938,357	933,028	-	-
Corporate debt(4)	2	61,682	61,772	63,944	64,271
Interest rate swaps	2	38,950	38,950	-	-
Other derivatives(2)	1,2	91,270	91,270	9,830	9,830
Financial liabilities:					
U.S. Treasury securities sold, not yet purchased(2)	1	$ -	$ -	$ 495,437	$ 495,437
Repurchase agreements(1)(5)	1,2	81,397,335	81,769,214	102,785,697	103,332,832
Securities loaned(2)	2	2,284,245	2,284,245	1,808,315	1,808,315
Convertible Senior Notes(2)	1	824,229	876,190	825,541	899,192
Mortgages payable(6)	2	19,361	19,211	-	-
Participation sold(7)	3	14,324	14,174	-	-
Interest rate swaps	2	1,189,178	1,189,178	2,584,907	2,584,907

(1) Carrying value approximates fair value due to the short-term maturities of these items.
(2) Fair value is determined using end of day quoted prices in active markets.
(3) Commercial real estate investments include commercial mortgage loans and preferred equity held for investment. Commercial mortgage loans are held for investment and are recorded at amortized cost less an allowance for losses. The fair value of commercial real estate loans is based on the loan's contractual cash flows and estimated changes in the yield curve. The estimated fair value of the commercial mortgage loans take into consideration expected changes in interest rates and changes in the underlying collateral cash flows. The fair value also reflects consideration of changes in credit risk since the loan was originated or purchased. The preferred equity investment is recorded at amortized cost less an allowance for losses. The fair value of preferred equity is based on the underlying cash flows and estimated changes in the yield curve. The fair value also reflects consideration of changes in credit risk since the time of initial investment.
(4) The carrying value of corporate debt is based on amortized cost. Estimates of fair value of corporate debt require the use of judgments and inputs including, but not limited to, the enterprise value of the borrower (i.e., an estimate of the total fair value of the borrower's debt and equity), the nature and realizable value of any collateral, the borrower's ability to make payments when due and its earnings history. Management also considers factors that affect the macro and local economic markets in which the borrower operates.

(5) The fair value of repurchase agreements with maturities greater than one year is valued as pay fixed versus receive floating interest rate swaps.
(6) The fair value of mortgages payable is based on the related contractual cash flows and estimated changes in the yield curve from the time of origination. The fair value of mortgages payable also reflects consideration of the value of the underlying collateral and changes in credit risk from the time the debt was originated.
(7) The carrying value of participations sold is based on the loan's amortized cost. The fair value of participations sold is based on the fair value of the underlying related commercial loan.

7. REPURCHASE AGREEMENTS

The Company had outstanding $81.4 billion and $102.8 billion of repurchase agreements with weighted average borrowing rates of 1.72% and 1.53%, after giving effect to the Company's interest rate swaps, and weighted average remaining maturities of 191 days and 191 days as of June 30, 2013 and December 31, 2012, respectively. Investment Securities and U.S. Treasury securities pledged as collateral under these repurchase agreements and interest rate swaps had an estimated fair value and accrued interest of $89.3 billion and $284.7 million at June 30, 2013, respectively, and $109.2 billion and $363.8 million at December 31, 2012, respectively.

At June 30, 2013 and December 31, 2012, the repurchase agreements had the following remaining maturities and weighted average rates:

	June 30, 2013		December 31, 2012	
	Repurchase Agreements	Weighted Average Rate	Repurchase Agreements	Weighted Average Rate
	(dollars in thousands)			
1 day	$ 6,823,271	0.33 %	$ -	-
2 to 29 days	25,925,976	0.44 %	33,191,448	0.50 %
30 to 59 days	18,675,058	0.41 %	28,383,851	0.45 %
60 to 89 days	2,827,502	0.58 %	8,602,680	0.42 %
90 to 119 days	6,522,227	0.37 %	4,804,671	0.57 %
Over 120 days	20,623,301	1.27 %	27,803,047	1.03 %
Total	$ 81,397,335	0.64 %	$ 102,785,697	0.63 %

Repurchase agreements and reverse repurchase agreements with the same counterparty and the same maturity are presented net in the Consolidated Statements of Financial Condition when the terms of the agreements permit netting. The following table summarizes the gross amounts of reverse repurchase agreements and repurchase agreements, amounts offset in accordance with netting arrangements and net amounts of repurchase agreements and reverse repurchase agreements as presented in the Consolidated Statements of Financial Condition as of June 30, 2013 and December 31, 2012.

	June 30, 2013		December 31, 2012	
	Reverse Repurchase Agreements	Repurchase Agreements	Reverse Repurchase Agreements	Repurchase Agreements
	(dollars in thousands)			
Gross Amounts	$ 6,540,117	$ 87,766,218	$ 3,650,053	$ 104,624,655
Amounts Offset	(6,368,883)	(6,368,883)	(1,838,958)	(1,838,958)
Netted Amounts	$ 171,234	$ 81,397,335	$ 1,811,095	$ 102,785,697

8. DERIVATIVE INSTRUMENTS

In connection with the Company's interest rate risk management strategy, the Company economically hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. As of June 30, 2013, such instruments are comprised of interest rate swaps, which in effect modify the cash flows on repurchase agreements, or convert floating rate liabilities to fixed rates. The purpose of the swaps is to mitigate the risk of rising interest rates that affect the Company's cost of funds. The use of interest rate swaps creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. In the event of a default by the counterparty, the Company could have difficulty obtaining its Investment Securities pledged as collateral for interest rate swaps and repurchase agreements. The Company's interest rate swaps have not been designated as hedging instruments for accounting purposes.

The Company elected to net, by counterparty, the fair value of interest rate swap contracts. These contracts contain legally enforceable provisions that allow for netting or setting off swap receivables and payables with each counterparty and, therefore, the fair value of those swap contracts are netted by counterparty. The following table summarizes notional amounts and unrealized gains (losses) of interest rate swap contracts on a gross basis, amounts offset in accordance with netting arrangements and net amounts as presented in the Consolidated Statements of Financial Condition as of June 30, 2013 and December 31, 2012.

	June 30, 2013			
	Interest Rate Swaps - Asset		Interest Rate Swaps - Liability	
	Notional	Unrealized Gains	Notional	Unrealized Losses
	(dollars in thousands)			
Gross Amounts	$ 12,360,000	$ 389,096	$ 36,112,290	$ (1,539,324)
Amounts Offset	(9,210,000)	(350,146)	9,210,000	350,146
Netted Amounts	$ 3,150,000	$ 38,950	$ 45,322,290	$ (1,189,178)

	December 31, 2012			
	Interest Rate Swaps - Asset		Interest Rate Swaps - Liability	
	Notional	Unrealized Gains	Notional	Unrealized Losses
	(dollars in thousands)			
Gross Amounts	$ 1,100,000	$ 26,020	$ 45,811,800	$ (2,610,927)
Amounts Offset	(1,100,000)	(26,020)	1,100,000	26,020
Netted Amounts	$ -	$ -	$ 46,911,800	$ (2,584,907)

The effect of interest rate swaps on the Consolidated Statements of Operations and Comprehensive Income (Loss) is as follows:

	Location on Consolidated Statements of Operations and Comprehensive Income (Loss)		
	Realized Gains (Losses) on Interest Rate Swaps(1)	Realized Gains (Losses) on Termination of Interest Rate Swaps	Unrealized Gains (Losses) on Interest Rate Swaps
	(dollars in thousands)		
For the Quarter Ended June 30, 2013	$ (212,727)	$ (35,649)	$ 1,109,022
For the Quarter Ended June 30, 2012	$ (222,002)	$ -	$ (611,215)

(1) Net interest payments on interest rate swaps is presented in the Company’s Consolidated Statements of Operations and Comprehensive Income (Loss) as realized gains (losses) on interest rate swaps.

The weighted average pay rate on the Company’s interest rate swaps at June 30, 2013 was 2.05% and the weighted average receive rate was 0.22%. The weighted average pay rate at December 31, 2012 was 2.21% and the weighted average receive rate was 0.24%.

Certain of the Company’s derivative contracts are subject to International Swaps and Derivatives Association Master Agreements (“ISDA”) which contain provisions that grant counterparties certain rights with respect to the applicable ISDA upon the occurrence of (i) negative performance that results in a decline in net assets in excess of specified thresholds or dollar amounts over set periods of time, (ii) the Company’s failure to maintain its REIT status, (iii) the Company’s failure to comply with limits on the amount of leverage, and (iv) the Company’s stock being delisted from the New York Stock Exchange (NYSE). Upon the occurrence of items (i) through (iv), the counterparty to the applicable ISDA has a right to terminate the ISDA in accordance with its provisions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a net liability position at June 30, 2013 is approximately $1.2 billion, which represents the maximum amount the Company would be required to pay upon termination. This amount is fully collateralized.

The Company also utilizes interest rate swaptions in connection with its interest rate risk management strategy. As of June 30, 2013 the Company had outstanding interest rate swaptions with a notional amount of $2.5 billion. During the quarter ended June 30, 2013 the Company realized net gains of $45.1 million on its portfolio of interest rate swaptions.

In connection with RCap's proprietary trading activities, it enters primarily into U.S. Treasury, Eurodollar, federal funds, German government and U.S. equity index futures and options contracts. RCap invests in futures and options contracts for economic hedging purposes to reduce exposure to changes in yields of its U.S. Treasury securities and for speculative purposes to achieve capital appreciation. The use of futures and options contracts creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. RCap uses an appropriately licensed futures commission merchant and options broker dealer to execute its orders to buy and sell futures and options contracts. RCap's derivative contracts are presented in the Consolidated Statements of Financial Condition as Other derivative contracts, at fair value.

9. CONVERTIBLE SENIOR NOTES

In 2010, the Company issued $600.0 million in aggregate principal amount of its 4% convertible senior notes due 2015 ("4% Convertible Senior Notes") for net proceeds of approximately $582.0 million. Interest on the 4% Convertible Senior Notes is paid semi-annually at a rate of 4% per year and the 4% Convertible Senior Notes will mature on February 15, 2015 unless repurchased or converted earlier. The 4% Convertible Senior Notes are convertible into shares of Common Stock at a conversion rate for each $1,000 principal amount of 4% Convertible Senior Notes. The initial conversion rate was 46.6070, which was equivalent to an initial conversion price of approximately $21.4560 per share of Common Stock. The conversion rate at June 30, 2013 was 75.1250, which is equivalent to a conversion price of approximately $13.3111 per share of Common Stock. The conversion rate is subject to adjustment in certain circumstances. There is no limit on the total number of shares of Common Stock that the Company would be required to issue upon a conversion.

The intrinsic value of the contingent beneficial conversion feature was $84.3 million and $75.8 million at June 30, 2013 and December 31, 2012, respectively, which is reflected in Additional paid-in capital on the Company's Consolidated Statements of Financial Condition, and reduces the recorded liability on the 4% Convertible Senior Notes. The unamortized contingent beneficial conversion feature of the 4% Convertible Senior Notes at June 30, 2013 and December 31, 2012 of $26.0 million and $22.7 million, respectively, is recognized in interest expense over the remaining life of the notes.

In May 2012, the Company issued $750.0 million in aggregate principal amount of its 5% convertible senior notes due 2015 ("5% Convertible Senior Notes") for net proceeds of approximately $727.5 million. Interest on the 5% Convertible Senior Notes is paid semi-annually at a rate of 5% per year and the 5% Convertible Senior Notes will mature on May 15, 2015 unless repurchased or converted earlier. The 5% Convertible Senior Notes are convertible into shares of Common Stock at a conversion rate for each $1,000 principal amount of 5% Convertible Senior Notes. The initial conversion rate and conversion rate at June 30, 2013 was 52.7969, which was equivalent to an initial conversion price of approximately $18.94 per share of Common Stock, subject to adjustment in certain circumstances. Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of Common Stock or a combination of cash and shares of Common Stock, at the Company's sole discretion. There is no limit on the total number of shares of Common Stock that the Company would be required to issue upon a conversion.

At issuance, the Company determined that the 5% Convertible Senior Notes included an equity component of $11.7 million, which is reflected in Additional paid-in capital on the Company's Consolidated Statements of Financial Condition, and reduces the recorded liability on the 5% Convertible Senior Notes. The $11.7 million discount to the principal amount of the Convertible Senior Notes is recognized in interest expense over the remaining life of the notes. At June 30, 2013 and December 31, 2012, $7.3 million and $9.3 million, respectively, of the discount had not been reflected in interest expense.

The 4% Convertible Senior Notes due 2015 and the 5% Convertible Senior Notes due 2015 rank pari passu with each other. They are each general corporate obligations and therefore rank junior to collateralized debt of the company with respect to secured collateral.

The 4% Convertible Senior Notes and the 5% Convertible Senior Notes rank senior to the 7.875% Series A Cumulative Redeemable Preferred Stock, 7.625% Series C Cumulative Redeemable Preferred Stock and 7.50% Series D Cumulative Redeemable Preferred Stock. The 7.875% Series A Cumulative Redeemable Preferred Stock, 7.625% Series C Cumulative Redeemable Preferred Stock and 7.50% Series D Cumulative Redeemable Preferred Stock rank pari passu with each other.

The 7.875% Series A Cumulative Redeemable Preferred Stock, 7.625% Series C Cumulative Redeemable Preferred Stock and 7.50% Series D Cumulative Redeemable Preferred Stock rank senior to the common stock of the Company.

10. COMMON STOCK AND PREFERRED STOCK

(A) Common Stock

During the six months ended June 30, 2013 and 2012, 166,000 and 394,000 options were exercised for an aggregate exercise price of $2.2 million and $5.4 million, respectively.

During the six months ended June 30, 2013 and 2012, the Company issued 94,000 and 51,000 shares and raised $1.4 million and $845,000, respectively, through the Direct Purchase and Dividend Reinvestment Program.

During the six months ended June 30, 2012, 1.3 million shares of 6.00% Series B Cumulative Convertible Preferred Stock (“Series B Preferred Stock”) were converted into 4.0 million shares of common stock.

On March 19, 2012, the Company entered into six separate Distribution Agency Agreements (“Distribution Agency Agreements”) with each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., J.P. Morgan Securities LLC, Morgan Stanley & Co. LLC and RCap Securities, Inc. (together, the Agents). Pursuant to the terms of the Distribution Agency Agreements, the Company may sell from time to time through the Agents, as its sales agents, up to 125,000,000 shares of the Company’s common stock. The Company did not make any sales under the Distribution Agency Agreements during the six months ended June 30, 2013 and 2012.

On May 16, 2012, the Company amended its charter through the filing of articles supplementary to its charter to reclassify 12,650,000 shares of authorized shares of Common Stock as 7.625% Series C Cumulative Redeemable Preferred Stock (“Series C Preferred Stock”).

In May 2012, the Company issued 12,000,000 shares of Series C Preferred Stock, with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared).

On September 13, 2012, the Company amended its charter through the filing of articles supplementary to its charter to reclassify 18,400,000 shares of authorized shares of Common Stock as 7.50% Series D Cumulative Redeemable Preferred Stock (“Series D Preferred Stock”).

In September 2012, the Company issued 18,400,000 shares of Series D Preferred Stock, with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared).

Following the effectiveness of the articles supplementary to its charter the Company’s authorized shares of capital stock, par value of $0.01 per share, consists of 1,956,937,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock, 12,650,000 shares classified as 7.625% Series C Cumulative Redeemable Preferred Stock and 18,400,000 shares classified as 7.50% Series D Cumulative Redeemable Preferred Stock.

On October 16, 2012, the Company announced that its Board of Directors has authorized the repurchase of up to $1.5 billion of its outstanding common shares over a 12 month period. All common shares purchased are part of a publicly announced plan in open-market transactions. During the year ended December 31, 2012, the Company repurchased approximately 27.8 million shares of its outstanding common stock for $397.1 million, of which $141.1 million had not settled at December 31, 2012. During the six months ended June 30, 2013, the Company did not repurchase any shares of its outstanding common stock.

(B) Preferred Stock

At June 30, 2013 and December 31, 2012, the Company had issued and outstanding 7,412,500 shares of Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock"), with a par value $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series A Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on April 5, 2009 (subject to the Company's right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve its qualification as a REIT). The Series A Preferred Stock is senior to the Company's common stock and is on parity with the Series C Preferred Stock and Series D Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series A Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series A Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series A Preferred Stock, together with the Series C Preferred Stock and Series D Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series A Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series A Preferred Stock, Series C Preferred Stock and Series D Preferred Stock. Through June 30, 2013, the Company had declared and paid all required quarterly dividends on the Series A Preferred Stock.

At June 30, 2013 and December 31, 2012, the Company had issued and outstanding 12,000,000 shares of Series C Preferred Stock, with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series C Preferred Stock is entitled to a dividend at a rate of 7.625% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series C Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on May 16, 2017 (subject to the Company's right under limited circumstances to redeem the Series C Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). The Series C Preferred Stock is senior to the Company's common stock and is on parity with the Series A Preferred Stock and Series D Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series C Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series C Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series C Preferred Stock, together with the Series A Preferred Stock and Series D Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series C Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series C Preferred Stock and Series A Preferred Stock and Series D Preferred Stock. Through June 30, 2013, the Company had declared and paid all required quarterly dividends on the Series C Preferred Stock.

At June 30, 2013 and December 31, 2012, the Company had issued and outstanding 18,400,000 shares of Series D Preferred Stock, with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series D Preferred Stock is entitled to a dividend at a rate of 7.50% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series D Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on September 13, 2017 (subject to the Company's right under limited circumstances to redeem the Series D Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). The Series D Preferred Stock is senior to the Company's common stock and is on parity with the Series A Preferred Stock and Series C Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series D Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series D Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series D Preferred Stock, together with the Series A Preferred Stock and Series C Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series D Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series D Preferred Stock. Through June 30, 2013, the Company had declared and paid all required quarterly dividends on the Series D Preferred Stock.

(C) Distributions to Shareholders

During the six months ended June 30, 2013, the Company declared dividends to common shareholders totaling $805.1 million, or $0.85 per share, of which $378.9 million, or $0.40 per share, was paid to shareholders on July 25, 2013. During the six months ended June 30, 2013, the Company declared dividends to Series A Preferred Stock shareholders totaling approximately $7.3 million, or $0.984 per share, of which $3.6 million, or $0.492 per share, was paid to shareholders on July 1, 2013. During the six months ended June 30, 2013, the Company declared dividends to Series C Preferred Stock shareholders totaling approximately $11.4 million or $0.953 per share, of which $5.7 million, or $0.477 per share, was paid on July 1, 2013. During the six months ended June 30, 2013, the Company declared dividends to Series D Preferred Stock shareholders totaling approximately $17.3 million, or $0.938 per share, of which $8.6 million, or $0.469 per share, was paid on July 1, 2013.

During the six months ended June 30, 2012, the Company declared dividends to common shareholders totaling $1.1 billion, or $1.10 per share, of which $535.9 million, or $0.55 per share, was paid to shareholders on July 26, 2012. During the six months ended June 30, 2012, the Company declared dividends to Series A Preferred shareholders totaling approximately $7.3 million, or $0.984 per share. During the six months ended June 30, 2012, the Company declared dividends to Series B shareholders totaling approximately $289,000, or $0.375 per share. During the six months ended June 30, 2012, the Company declared dividends to Series C shareholders totaling approximately $2.9 million or $0.238 per share.

11. NET INCOME PER COMMON SHARE

The following table presents a reconciliation of the net income and shares used in calculating basic and diluted earnings per share for the quarters and six months ended June 30, 2013 and 2012.

	For the Quarter Ended		For the Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
	(dollars in thousands)			
Net income (loss)	$1,638,213	$(91,159)	$2,508,491	$810,647

Less: Preferred stock dividends	17,992	6,508	35,984	10,446
Net income (loss) available to common shareholders, prior to adjustment for dilutive potential common shares, if necessary	1,620,221	(97,667)	2,472,507	800,201
Add: Interest on Convertible Senior Notes, if dilutive	10,450	-	20,901	16,896
Net income (loss) available to common shareholders, as adjusted	$1,630,671	$(97,667)	$2,493,408	$817,097
Weighted average shares of common stock outstanding- basic	947,411,380	974,555,392	947,331,087	973,141,546
Add: Effect of dilutive stock options and Convertible Senior Notes, if dilutive	47,818,257	-	47,820,855	79,746,755
Weighted average shares of common stock outstanding- diluted	995,229,637	974,555,392	995,151,942	1,052,888,301

Options to purchase 3.4 million shares of common stock were outstanding and considered anti-dilutive as their exercise price and associated option expense exceeded the average stock price for the quarter and six months ended June 30, 2013. Options to purchase 5.8 million and 2.8 million shares of common stock were outstanding and considered anti-dilutive as their exercise price and associated option expense exceeded the average stock price for the quarter and six months ended June 30, 2012, respectively.

12. LONG-TERM STOCK INCENTIVE PLANS

The Company has adopted the 2010 Equity Incentive Plan, which authorizes the Compensation Committee of the Board of Directors to grant options, stock appreciation rights, dividend equivalent rights, or other share-based awards, including restricted shares up to an aggregate of 25,000,000 shares, subject to adjustments as provided in the 2010 Equity Incentive Plan. The Company had adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the Prior Plan). The Prior Plan authorized the Compensation Committee of the Board of Directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Prior Plan authorized the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company’s common stock, up to a ceiling of 8,932,921 shares. No further awards will be made under the Prior Plan, although existing awards remain effective.

Stock options were issued at the market price on the date of grant, subject to an immediate or four year vesting in four equal installments with a contractual term of 5 or 10 years.

The Company has issued and outstanding the following stock options as of June 30, 2013 and 2012:

	For the Quarter Ended			
	June 30, 2013		June 30, 2012	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding at the beginning of period	5,618,686	$15.74	6,216,805	$15.57
Granted	-	-	7,500	17.11
Exercised	(166,375)	13.25	(394,019)	13.68
Forfeited	(943,975)	16.57	-	-
Options outstanding at the end of period	4,508,336	$15.66	5,830,286	$15.68
Options exercisable at the end of the period	4,508,336	$15.66	4,943,055	$15.99

The weighted average remaining contractual term was approximately 3.9 years for stock options outstanding and approximately 3.9 years for stock options exercisable as of June 30, 2013. As of June 30, 2013, there was no unrecognized compensation cost related to nonvested share-based compensation awards.

The weighted average remaining contractual term was approximately 4.9 years for stock options outstanding and approximately 4.5 years for stock options exercisable as of June 30, 2012. As of June 30, 2012, there was approximately $2.1 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 1 year.

13. INCOME TAXES

For the quarter and six months ended June 30, 2013 the Company is qualified to be taxed as a REIT. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its taxable income to its shareholders. To maintain qualification as a REIT, the Company must distribute at least 90% of its annual REIT taxable income to its shareholders and meet certain other requirements. It is generally the Company's policy to distribute to its shareholders all of the Company's taxable income except for the amount of taxable income attributable to certain employee remuneration deductions disallowed for tax purposes pursuant to Internal Revenue Code Section 162(m). As a result of the externalization of management effective as of July 1, 2013, the Company does not expect to be subject to federal, state and local income taxes on taxable income attributable to the Section 162(m) disallowance after July 1, 2013. It is assumed that the Company intends to retain its REIT status by complying with the REIT regulations and its distribution policy in the future. The state and city tax jurisdictions for which the Company is subject to tax filing obligations recognize the Company's status as a REIT.

During the quarter and six months ended June 30, 2013, the Company's taxable REIT subsidiaries recorded $4.0 million and $5.8 million, respectively, of income tax expense for income attributable to those subsidiaries, and the portion of earnings retained based on Code Section 162(m) limitations. During the quarter ended June 30, 2013, the Company reversed the previously recorded estimated income tax of $3.9 million.

During the quarter and six months ended June 30, 2012, the Company's taxable REIT subsidiaries recorded $4.3 million and $6.0 million, respectively, of income tax expense for income attributable to those subsidiaries, and the portion of earnings retained based on Code Section 162(m) limitations. During the quarter and six months ended June 30, 2012, the Company recorded $7.4 million and $22.1 million, respectively, of income tax expense for a portion of earnings retained based on Section 162(m) limitations.

The Company's effective tax rate differs from its combined federal, state, and city corporate statutory tax rate primarily due to the deduction of dividend distributions and Sec 162(m) limitations.

The Company's 2009, 2010 and 2011 federal and state tax returns remain open for examination.

14. LEASE COMMITMENTS AND CONTINGENCIES

Commitments

The Company has a non-cancelable lease for office space which commenced in May 2002 and expires in December 2014. Merganser has a non-cancelable lease for office space, which commenced on May 2003 and expires in May 2014. Merganser subleases a portion of its leased space to a subtenant. FIDAC has a lease for office space which commenced in October 2010 and expires in February 2016. The lease expense for the quarters ended June 30, 2013 and 2012 were $556,000 and $607,000, respectively. The Company's aggregate future minimum lease payments total $4.0 million. The following table details the lease payments.

Year Ending December	Lease Commitment	Sublease Income	Net Amount
		(dollars in thousands)	
2013 (remaining)	$ 1,469	$ 90	$ 1,379
2014	2,509	60	2,449
2015	159	-	159
2016	27	-	27
Later years	-	-	-

$ 4,164	$ 150	$ 4,014

Contingencies

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Company's consolidated financial statements and therefore no accrual is required as of June 30, 2013 and December 31, 2012.

15. INTEREST RATE RISK

The primary market risk to the Company is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest-bearing liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates can also affect the value of the Interest Earning Assets and the Company's ability to realize gains from the sale of these assets. A decline in the value of the Interest Earning Assets pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. The Company may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of Interest Earning Assets by entering into interest rate agreements such as interest rate caps and interest rate swaps. As of June 30, 2013 and December 31, 2012, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with a total notional amount of $48.5 billion and $46.9 billion, respectively.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Agency mortgage-backed securities. The Company will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. To date, the aggregate premium exceeds the aggregate discount on the Agency mortgage-backed securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

16. RCAP REGULATORY REQUIREMENTS

RCap is subject to regulations of the securities business that include but are not limited to trade practices, use and safekeeping of funds and securities, capital structure, recordkeeping, and conduct of directors, officers and employees.

As a self clearing, registered broker dealer, RCap is required to maintain minimum net capital by the Financial Industry Regulatory Authority ("FINRA"). As of June 30, 2013 RCap had a minimum net capital requirement of $286,000. RCap consistently operates with capital in excess of its regulatory capital requirements. RCap's regulatory net capital as defined by SEC Rule 15c3-1, as of June 30, 2013 was $336.0 million with excess net capital of $335.7 million.

17. RELATED PARTY TRANSACTIONS

Investment in Affiliate, Available-For-Sale Equity Security

At June 30, 2013, substantially all of the Company's available-for-sale equity securities represent shares of Chimera Investment Corporation ("Chimera"), which are reported at fair value. The Company owned approximately 45.0 million shares of Chimera at a fair value of approximately $134.9 million at June 30, 2013 and approximately 45.0 million shares of Chimera at a fair value of approximately $117.4 million at December 31, 2012. At June 30, 2013 and December 31, 2012, the investment in Chimera had unrealized losses of $3.9 million and $21.5 million, respectively. The Company also held shares of CreXus prior to its acquisition, which closed during the second quarter of 2013. The Company owned approximately 9.5 million shares of CreXus at a fair value of approximately $116.7 million at

December 31, 2012. At December 31, 2012, the investment in CreXus had an unrealized loss of $8.7 million.

The Company has evaluated the near-term prospects of its investments in affiliates in relation to the severity and length of time of the impairment. Based on this evaluation, management has determined that its investments in affiliates was not considered to be other-than-temporarily impaired as of June 30, 2013 and December 31, 2012 as the Company had the intent and ability to retain its investments for a period of time sufficient to allow for any anticipated recovery in market value.

Advisory fees

For the quarter and six months ended June 30, 2013, the Company recorded advisory fees from Chimera and CreXus, prior to its acquisition, totaling $8.1 million and $17.3 million respectively. For the quarter and six months ended June 30, 2012, the Company recorded advisory fees from Chimera and CreXus totaling $17.4 million and $33.9 million, respectively. At June 30, 2013 the Company had amounts receivable from Chimera of $6.5 million and at December 31, 2012, the Company had amounts receivable from Chimera and CreXus of $14.1 million.

Management Agreement and Externalization

On June 26, 2013, the Company and Annaly Management Company LLC (the “Manager”) entered into a Management Agreement (the “Management Agreement”), effective as of July 1, 2013 and applicable for the entire 2013 calendar year, pursuant to which the Company’s management will be conducted by the Manager through the authority delegated to it in the Management Agreement and pursuant to the policies established by the Company’s board of directors (the “Board of Directors”) (the “Externalization”). Subject at all times to the supervision and direction of the Company’s Board of Directors, the Manager is responsible for, among other things, (i) managing the Company’s investment portfolio, including purchasing and selling Company assets; (ii) recommending alternative forms of capital raising; (iii) supervising the Company’s financing and hedging activities; (iv) day to day management functions; and (v) such other supervisory and management services and activities relating to the Company’s assets and operations as may be appropriate or may be requested by the Board of Directors.

Pursuant to the terms of the Management Agreement, the Company pays the Manager a monthly management fee in an amount equal to 1/12th of 1.05% of stockholders’ equity, as defined, for its management services. Effective July 1, 2013, a majority of the Company’s employees were terminated by the Company and were hired by the Manager. The Company has a limited number of employees following the Externalization, all of whom are employees of the Company’s subsidiaries for regulatory or corporate efficiency reasons. All compensation expenses associated with such retained employees reduce the management fee. The Company pays directly, or reimburses the Manager, for all of the Company’s expenses and all the Manager’s documented expenses incurred on the Company’s behalf, other than compensation and benefits related to any and all personnel of the Manager and costs of certain insurance with respect to such personnel. Pursuant to a pro forma calculation that computed the management fee as though it was in effect beginning January 1, 2013, the Company paid the Manager an amount equal to the pro forma calculation minus the actual compensation paid to the Company’s and its subsidiaries’ employees from January 1, 2013 to June 30, 2013.

The Management Agreement may be amended or modified by agreement between the Company and the Manager. The initial term of the Management Agreement expires on December 31, 2014 and will be automatically renewed for a one year term each anniversary date thereafter unless previously terminated pursuant to the terms of the Management Agreement. There is no termination fee for a termination of the Management Agreement by either the Company or the Manager.

ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

Certain statements contained in this quarterly report, and certain statements contained in our future filings with the Securities and Exchange Commission (the SEC or the Commission), in our press releases or in our other public or shareholder communications may not be based on historical facts and are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements, which are based on various assumptions, (some of which are beyond our control) may be identified by reference to a future period or periods, or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms, or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates, changes in the yield curve, changes in prepayment rates, the availability of mortgage-backed securities and other securities for purchase, the availability of financing, and, if available, the terms of any financings, changes in the market value of our assets, changes in business conditions and the general economy, our ability to integrate the commercial mortgage business, our ability to consummate any contemplated investment opportunities and other corporate transactions, changes in governmental regulations affecting our business, our ability to maintain our classification as a REIT for federal income tax purposes, our ability to maintain our exemption from registration under the Investment Company Act of 1940, and risks associated with the business of our subsidiaries, including the investment advisory businesses of our subsidiaries, including the removal by their clients of assets they manage, their regulatory requirements, and competition in the investment advisory business, and risks associated with the broker dealer business of our subsidiary. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q. We do not undertake and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

All references to “we,” “us,” or “our” mean Annaly Capital Management, Inc. and all entities owned by us, except where it is made clear that the term means only the parent company. The following defines certain of the commonly used terms in this quarterly report on Form 10-Q: Agency refers to a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae; Agency mortgage-backed securities refers to residential mortgage-backed securities that are issued or guaranteed by an Agency; Investment Securities refers to Agency mortgage-backed securities, Agency debentures and corporate debt; and Interest Earning Assets refers to Investment Securities, securities borrowed, U.S. Treasury securities, reverse repurchase agreements and commercial real estate loans and preferred equity interests.

Overview

We own, manage and finance a portfolio of real estate related investments, including mortgage pass-through certificates, collateralized mortgage obligations (or CMOs), Agency callable debentures, other securities representing interests in or obligations backed by pools of mortgage loans, and commercial real estate assets. Our principal business objective is to generate net income for distribution to our stockholders from our Investment Securities and from our other assets. While we remain committed to the Agency market, given the current environment, we believe it is prudent to diversify a portion of our investment portfolio. Therefore, we may allocate up to 25% of our stockholders’ equity to real estate assets other than Agency mortgage-backed securities.

We are a Maryland corporation that commenced operations on February 18, 1997. We are externally managed by Annaly Management Company LLC (or the Manager). We acquired Fixed Income Discount Advisory Company (or FIDAC) on June 4, 2004 and Merganser Capital Management, Inc. (or Merganser) on October 31, 2008. FIDAC and Merganser manage a number of investment vehicles and separate accounts for which they earn fee income. Our subsidiary, RCap Securities, Inc. (or RCap), operates as a broker-dealer, and was granted membership in the Financial Industry Regulatory Authority (or FINRA) in January 2009. In 2010, we established Shannon Funding LLC (or Shannon), which provides warehouse financing to residential mortgage originators in the United States. In 2010, we also established Charlesfort Capital Management LLC (or Charlesfort), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited, which we sold in December 2012. In 2011, we established FIDAC FSI LLC, which invested in trading securities. FIDAC FSI was liquidated in August 2012.We also own an additional subsidiary which owns trading securities. During the second quarter of 2013, we acquired CreXus Investment Corp. (or CreXus), a specialty finance company that specializes in acquiring, managing and financing commercial mortgage loans and other commercial real estate debt, commercial mortgage-backed securities and other commercial real estate-related assets, through our wholly-owned subsidiary CXS Acquisition Corporation (or CXS Acquisition) which was formed in January 2013. Following the acquisition, CXS Acquisition was renamed Annaly Commercial Real Estate Group, Inc. (or Annaly Commercial).

We have elected and believe that we are organized and have operated in a manner that qualifies us to be taxed as a real estate investment trust (or REIT) under the Internal Revenue Code of 1986, as amended (or the Code). If we qualify for taxation as a REIT, we generally will not be subject to federal income tax on our taxable income that is distributed to our stockholders. Therefore, substantially all of our assets, other than FIDAC, Merganser and RCap, which are our taxable REIT subsidiaries, consist of qualified REIT real estate assets (of the type described in Section 856(c)(5)(B) of the Code). We have financed our purchases of Agency mortgage-backed securities and Agency debentures with the net proceeds of equity offerings, convertible notes offerings and borrowings under repurchase agreements whose interest rates adjust based on changes in short-term market interest rates.

Capital Investment Policy

Under our capital investment policy, at least 75% of our total assets must be comprised of high-quality mortgage-backed securities and short-term investments. High quality securities means securities that (1) are rated within one of the two highest rating categories by at least one of the nationally recognized rating agencies, (2) are unrated but are guaranteed by the United States government or an agency of the United States government, or (3) are unrated but we determine them to be of comparable quality to high-quality rated mortgage-backed securities.

The remainder of our assets, comprising not more than 25% of our total assets, may consist of other qualified REIT real estate assets which are unrated or rated less than high quality, but which are at least “investment grade” (rated “BBB” or better by Standard & Poor’s Corporation (or S&P) or the equivalent by another nationally recognized rating agency) or, if not rated, we determine them to be of comparable credit quality to an investment which is rated “BBB” or better. In addition, we may directly or indirectly invest part of this remaining 25% of our assets in other types of securities, including without limitation, unrated debt, equity or derivative securities, to the extent consistent with our REIT qualification requirements. The derivative securities in which we invest may include securities representing the right to receive interest only or a disproportionately large amount of interest, as well as inverse floaters, which may have imbedded leverage as part of their structural characteristics.

We may acquire Agency mortgage-backed securities backed by single-family residential mortgage loans as well as securities backed by loans on multi-family, commercial or other real estate related properties. While we remain committed to the Agency market, given the current environment, we believe it is prudent to diversify a portion of our investment portfolio. Therefore, we may allocate up to 25% of our stockholders’ equity to real estate assets other than Agency mortgage-backed securities.

GAAP and Non-GAAP Reconciliation

This Management Discussion and Analysis section contains analysis and discussion of non-GAAP measurements reflected in the Management’s Discussion and Analysis of Financial Condition and Results of Operations. The non-GAAP measurements are economic interest expense and economic net interest income.

For the purpose of calculating average interest-earning assets and interest-bearing liabilities, daily balances are used. For the purpose of computing net interest income and ratios relating to cost of funds measures throughout this report, interest expense includes interest expense on interest rate swaps, which is recorded in the Consolidated Statements of Operations and Comprehensive Income (Loss) as Realized gains (losses) on interest rate swaps. Interest rate swaps are used to hedge the increase in interest expense on repurchase agreements in a rising rate environment. Presenting the contractual interest payments on interest rate swaps with the interest expense on interest-bearing liabilities reflects total contractual interest payments. This presentation depicts the economic value of our investment strategy. Interest expense, including interest expense on interest rate swaps, is referred to as economic interest expense. Net interest income, including interest expense on interest rate swaps, is referred to as economic net interest income.

The following table compares the GAAP and non-GAAP measurements reflected in the Management's Discussion and Analysis of Financial Condition and Results of Operations. The non-GAAP measurements are economic interest expense and economic net interest income.

	GAAP Interest Expense	Add: Realized Losses on Interest Rate Swaps (1)	Economic Interest Expense	GAAP Net Interest Income	Less: Realized Losses on Interest Rate Swaps	Economic Net Interest Income
	(dollars in thousands)					
For the Quarter Ended June 30, 2013	$164,255	$212,727	$376,982	$548,681	$212,727	$335,954
For the Quarter Ended March 31, 2013	$177,590	$225,476	$403,066	$559,627	$225,476	$334,151
For the Year Ended December 31, 2012	$667,172	$893,769	$1,560,941	$2,591,973	$893,769	$1,698,204
For the Quarter Ended December 31, 2012	$185,491	$228,155	$413,646	$571,170	$228,155	$343,015
For the Quarter Ended September 30, 2012	$181,893	$224,272	$406,165	$579,372	$224,272	$355,100
For the Quarter Ended June 30, 2012	$166,443	$222,002	$388,445	$719,881	$222,002	$497,879
For the Quarter Ended March 31, 2012	$133,345	$219,340	$352,685	$721,550	$219,340	$502,210

(1) Interest expense related to our interest rate swaps is recorded in realized gains (losses) on interest rate swaps on the Consolidated Statements of Operations and Comprehensive Income (Loss).

We believe that economic interest expense and economic net interest income provide meaningful information to consider, in addition to the respective amounts prepared in accordance with GAAP. The non-GAAP measures help us to evaluate our financial position and performance without the effects of certain transactions and GAAP adjustments that are not necessarily indicative of our current investment portfolio and operations.

Our presentation of the economic value of our investment strategy has important limitations. Other market participants may calculate economic interest expense and economic net interest income differently than we calculate them.

Although we believe that the calculation of the economic value of our investment strategy described above helps our financial position and performance without the effects of certain transactions, it is of limited usefulness as an analytical tool. Therefore, the economic value of our investment strategy should not be viewed in isolation and is not a substitute for interest expense and net interest income computed in accordance with GAAP.

Factors That May Impact Our Financial Results

The results of our operations are affected by various factors, many of which are beyond our control. Our results of operations primarily depend on, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. Our net interest income, which reflects the amortization of purchase premiums and accretion of discounts, varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds on our Agency mortgage-backed securities portfolio increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. The CPR on our Agency mortgage-backed securities portfolio averaged 16% and 19% for the quarters ended June 30, 2013 and December 31, 2012, respectively. Since changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT. We continue to explore alternative business strategies, alternative investments and other strategic initiatives to complement our core business strategy of investing, on a leveraged basis, in high quality Investment Securities. No assurance, however, can be provided that any such strategic initiative will or will not be implemented in the future.

The table below provides quarterly information regarding our average interest-earning assets, total interest income, yield on average interest-earning assets, average interest-bearing liabilities, economic interest expense, cost of funds on average interest-bearing liabilities, economic net interest income and net interest rate spread for the periods presented.

	Average Interest-Earning Assets(1)	Total Interest Income	Yield on Average Interest-Earning Assets	Average Interest-Bearing Liabilities	Economic Interest Expense (2)	Cost of Funds on Average Interest-Bearing Liabilities	Economic Net Interest Income(3)	Net Interest Rate Spread
	(ratios for the quarters have been annualized, dollars in thousands)							
Quarter Ended June 30, 2013	$ 113,660,254	$ 712,936	2.51 %	$ 98,278,276	$ 376,982	1.53 %	$ 335,954	0.98 %
Quarter Ended March 31, 2013	$ 124,414,754	$ 737,217	2.37 %	$ 110,722,615	$ 403,066	1.46 %	$ 334,151	0.91 %
Year Ended December 31, 2012	$ 116,356,100	$ 3,259,145	2.80 %	$ 103,362,717	$ 1,560,941	1.51 %	$ 1,698,204	1.29 %
Quarter Ended December 31, 2012	$ 123,378,860	$ 756,661	2.45 %	$ 110,257,173	$ 413,646	1.50 %	$ 343,015	0.95 %
Quarter Ended September 30, 2012	$ 119,880,120	$ 761,265	2.54 %	$ 106,973,056	$ 406,165	1.52 %	$ 355,100	1.02 %
Quarter Ended June 30, 2012	$ 116,458,864	$ 886,324	3.04 %	$ 103,668,465	$ 388,445	1.50 %	$ 497,879	1.54 %
Quarter Ended March 31, 2012	$ 105,706,554	$ 854,895	3.23 %	$ 92,552,175	$ 352,685	1.52 %	$ 502,210	1.71 %

(1) Does not reflect unrealized gains/ (losses) or premium/ (discount).
(2) Economic interest expense includes interest expense on interest rate swaps.
(3) Economic net interest income includes interest expense on interest rate swaps.

The following table presents the CPR experienced on our Agency mortgage-backed securities portfolio, on an annualized basis, for the quarterly periods presented.

Quarter Ended	CPR
June 30, 2013	16%
March 31, 2013	18%

December 31, 2012	19%
September 30, 2012	20%
June 30, 2012	19%

Monetary Policy

On September 13, 2012, the Federal Open Market Committee (“FOMC”) announced an increase in its quantitative easing program of large scale asset purchases, commonly known as QE3. QE3 entails monthly purchase of U.S. Treasury securities and Agency mortgage-backed securities at the pace of $45 billion and $40 billion respectively. In addition, the FOMC announced that it would maintain its existing policy of reinvesting principal payments from its holdings of Agency mortgage-backed securities into new Agency mortgage-backed securities purchases in order to “put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.” The program is open-ended in nature, and the FOMC noted that it would continue or expand the program as necessary until the outlook for the labor market improved substantially.

On May 1, 2013, after a string of moderately stronger employment reports, the FOMC announced that it was prepared to “increase or reduce the pace of its purchases” under QE3. The announcement of the possibility for a change in the execution of QE3 sparked a sell-off in the bond market. The 10-year Treasury, which closed at a price to yield 1.63% on May 2, 2013, had fallen in price to yield 2.49% on June 30, 2013. The decline in bond prices, in particular those of Agency mortgage-backed securities, have had an unfavorable effect on our book value. Continued uncertainty over evolving economic conditions and the outlook for labor market improvement, and the response of monetary policy, is reasonably likely to have either favorable or unfavorable effects on our financial results.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with GAAP, which require us to make estimates and assumptions (see Note 1 to the consolidated financial statements). We believe that of our significant accounting policies, the following involve a higher degree of judgment and complexity:

Valuation of Financial Instruments

Agency mortgage-backed securities and debentures:

There is an active market for Agency mortgage-backed securities and debentures. Since we primarily invest in securities that can be measured from actively quoted prices, there is a high degree of observable inputs and less subjectivity in measuring fair value. Internal market values are determined using quoted prices from the TBA market, the Treasury curve, and the underlying characteristics of the individual securities, which may include coupon, periodic and life caps, reset dates, and the expected life of the security. All internal market values are compared to external sources or dealer quotes to determine reasonableness. Additionally, securities used as collateral for repurchase agreements are priced daily by counterparties to ensure sufficient collateralization, providing additional verification of our internal pricing.

Interest rate swaps:

We use the overnight indexed swap ("OIS") curve as an input to value substantially all of our interest rate swaps. We believe using the OIS curve, which reflects the interest rate typically paid on cash collateral, enables us tomost accurately determine the fair value of interest rate swaps. Consistent with market practice, we have negotiated agreements with certain counterparties to exchange collateral ("margining") based on the level of fair values of the interest rate swaps. Through this margining process, one party or each party to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required, providing additional verification of our recorded fair value of the interest rate swaps.

Revenue Recognition

Interest income on Agency mortgage-backed securities and debentures is recognized over the projected life of the securities using the interest method. The projected life of the securities is determined based on expected prepayment speeds, past prepayment history of the security, government initiatives that would affect the Agency mortgage-backed securities market, and market consensus. Adjustments are made for actual prepayment activity as it relates to calculating the effective yield. Gains or losses on investment securities are recorded on trade date based on the average cost of the security.

Income Taxes

We elected to be taxed as a REIT, under Sections 856 through 860 of the Internal Revenue Code, beginning with our taxable year ended December 31, 1997. To qualify as a REIT, we must meet certain organizational and operational requirements, including a requirement to distribute at least 90% of our ordinary taxable income, if any, to stockholders. As a REIT, we generally will not be subject to U.S. federal income tax on taxable income that we distribute to our stockholders. If we fail to qualify as a REIT in any taxable year, we will then be subject to U.S. federal income taxes on our taxable income at regular corporate rates and we will not be permitted to qualify for treatment as a REIT for U.S. federal income tax purposes for four years following the year during which qualification is lost unless the Internal Revenue Service grants us relief under certain statutory provisions. Such an event could materially adversely affect our net income and net cash available for distributions to stockholders. However, we believe that we will be organized and operate in such a manner as to qualify for treatment as a REIT and we intend to operate in the foreseeable future in such a manner so that we will qualify as a REIT for U.S. federal income tax purposes. We may, however, be subject to certain state and local taxes and our taxable REIT subsidiaries are subject to federal, state and local taxes.

Exposure to European financial counterparties

A significant portion of our Agency mortgage-backed securities are financed with repurchase agreements. We secure our borrowings under these agreements by pledging our Agency mortgage-backed securities as collateral to the lender. The collateral we pledge exceeds the amount of the borrowings under each agreement, typically with the extent of over-collateralization being at least 3% of the amount borrowed. If the counterparty to the repurchase agreement defaults on its obligations and we are not able to recover our pledged assets, we are at risk of losing the amount of over-collateralization. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

We also use interest rate swaps to manage our interest rate risks. Under these swap agreements, we pledge Agency mortgage-backed securities as collateral as part of a margin arrangement for interest rate swaps that are in an unrealized loss position. If a counterparty were to default on its obligation, we would be exposed to a loss to a swap counterparty to the extent that the amount of our Agency mortgage-backed securities pledged exceeded the unrealized loss on the associated swaps and we were not able to recover the excess collateral.

Over the past several years, several large European financial institutions have experienced financial difficulty and have been either rescued by government assistance or by other large European banks or institutions. Some of these financial institutions or their U.S. subsidiaries have provided us financing under repurchase agreements or we have entered into interest rate swaps with such institutions. We have entered into repurchase agreements and/or interest rate swaps with 12 financial institution counterparties that are either domiciled in Europe or a U.S.-based subsidiary of a European domiciled financial institution. The following table summarizes our exposure to such counterparties as of June 30, 2013.

Country	Number of Counterparties	Repurchase Agreement Financing	Interest Rate Swaps at Fair Value	Exposure(1)	Exposure as a Percentage of Total Assets
(dollars in thousands)					
France	4	$ 3,374,288	$ (107,100)	$ 214,705	0.21%
Germany	1	1,694,368	(132,285)	120,896	0.12%
Netherlands	2	3,661,702	23,959	239,758	0.23%
Scotland	1	1,160,972	-	70,430	0.07%
Switzerland	2	4,680,579	(147,588)	282,800	0.28%
England	2	11,312,460	(10,607)	573,447	0.56%
Total	12	$ 25,884,369	$ (373,621)	$ 1,502,036	1.47%

(1) Represents the amount of cash and/or securities pledged as collateral to each counterparty less the aggregate of repurchase agreement financing and unrealized loss on interest rate swaps for each counterparty.

At June 30, 2013, we did not use credit default swaps or other forms of credit protection to hedge the exposures summarized in the table above.

If the European economic crisis continues to impact these major European financial institutions, it is possible that it will also impact the operations of their U.S. subsidiaries. Our financings and operations could be adversely affected by such events. We monitor our exposure to our repurchase agreement and swap counterparties on a regular basis, using various methods, including review of recent rating agency actions, financial relief plans, credit spreads or other developments and by monitoring the amount of cash and securities collateral pledged and the associated loan amount under repurchase agreements and/or the fair value of swaps with our counterparties. We make reverse margin calls on our counterparties to recover excess collateral as permitted by the agreements governing our financing arrangements or interest rate swaps, or may try to take other actions to reduce the amount of our exposure to a counterparty when necessary.

Management Agreement and Externalization

On June 26, 2013, we entered into a Management Agreement, or the Management Agreement, with Annaly Management Company LLC , or the Manager, effective as of July 1, 2013 and applicable for the entire 2013 calendar year, pursuant to which our management is conducted by the Manager through the authority delegated to it in the Management Agreement and pursuant to the policies established by our Board of Directors. We refer to this as the Externalization. Subject at all times to the supervision and direction of our Board of Directors, the Manager is responsible for, among other things, (i) managing our investment portfolio, including purchasing and selling our assets; (ii) recommending alternative forms of capital raising; (iii) supervising our financing and hedging activities; (iv) day to day management functions; and (v) such other supervisory and management services and activities relating to our assets and operations as may be appropriate or may be requested by our Board of Directors.

Pursuant to the terms of the Management Agreement, we pay the Manager a monthly management fee in an amount equal to 1/12th of 1.05% of stockholders' equity, as defined, for its management services. Effective July 1, 2013, a majority of our employees were terminated by us and were hired by the Manager. We have a limited number of employees following the Externalization, all of whom are employees of our subsidiaries for regulatory or corporate efficiency reasons. All compensation expenses associated with such retained employees reduce the management fee. We pay directly, or reimburse the Manager, for all of our expenses and all the Manager's documented expenses incurred on our behalf, other than compensation and benefits related to any and all personnel of the Manager and costs of certain insurance with respect to such personnel. Pursuant to a pro forma calculation that computed the management fee as though it was in effect beginning January 1, 2013, we paid the Manager an amount equal to the pro forma calculation minus the actual compensation paid to us and our subsidiaries' employees from January 1, 2013 to June 30, 2013.

The Management Agreement may be amended or modified by agreement between us and the Manager. The initial term of the Management Agreement expires on December 31, 2014 and will be automatically renewed for a one year term each anniversary date thereafter unless previously terminated pursuant to the terms of the Management Agreement. There is no termination fee for a termination of the Management Agreement by either us or the Manager.

Results of Operations:

Net Income Summary

For the quarter ended June 30, 2013, our net income was $1.6 billion, or $1.71 per basic average common share, as compared to a $91.2 million net loss, or $0.10 loss per basic average common share, for the quarter ended June 30, 2012. We attribute the majority of the change in net income (loss) for the quarter ended June 30, 2013 from the quarter ended June 30, 2012 to the change in unrealized gains (losses) on interest rate swaps, which resulted in a gain of $1.1 billion for the quarter ended June 30, 2013 compared to a loss of $611.2 million for the same period in 2012. The change in our total swap mark to market was primarily attributable to the rise in interest rates experienced during the second quarter of 2013.

For the six months ended June 30, 2013, our net income was $2.5 billion, or $2.61 per basic average common share, as compared to $810.6 million, or $0.82 per basic average common share, for the six months ended June 30, 2012. Net income per basic average common share increased by $1.79 and total net income increased by $1.7 billion for the six months ended June 30, 2013, when compared to the six months ended June 30, 2012. We attribute the majority of the increase in net income for the six months ended June 30, 2013 from the six months ended June 30, 2012 to the change in unrealized gains (losses) on interest rate swaps, which resulted in a gain of $1.4 billion for the six months ended June 30, 2013 compared to a loss of $269.6 million for the same period in 2012. The change in total swap mark to market was primarily attributable to the rise in interest rates experienced during the first half of 2013.

The table below presents the net income summary for the quarters and six months ended June 30, 2013 and 2012.

Net Income Summary
(dollars in thousands, except for per share data)

	For the Quarters Ended		For the Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Interest income:				
Investment Securities	$ 686,577	$ 874,984	$ 1,411,397	$ 1,725,408
U.S. Treasury securities	7,242	7,397	13,238	8,815
Securities loaned	2,302	2,698	4,914	5,216
Commercial real estate investments	13,906	-	13,906	-
Reverse repurchase agreements	2,775	1,122	6,411	1,544
Other	134	123	287	236
Total interest income	712,936	886,324	1,450,153	1,741,219
Interest expense:				
Repurchase agreements	141,945	139,579	299,009	253,493
Convertible Senior Notes	16,364	18,965	32,177	33,692
U.S. Treasury securities sold, not yet purchased	4,075	5,801	6,863	8,445
Securities borrowed	1,737	2,098	3,662	4,158
Participation sold	134	-	134	-
Total interest expense	164,255	166,443	341,845	299,788
Net interest income	548,681	719,881	1,108,308	1,441,431
Other income (loss):				
Investment advisory income	12,187	21,810	25,595	42,450
Net gains (losses) on disposal of investments	147,998	94,837	330,841	175,136
Dividend income from affiliates	4,048	6,621	10,479	14,142
Net gains (losses) on trading assets	54,046	1,105	55,595	6,361
Net unrealized gains (losses) on interest-only Agency mortgage-backed securities	111,521	(26,103)	191,648	4,774
Impairment of goodwill	(23,987)	-	(23,987)	-
Loss on previously held equity interest in CreXus	(18,896)	-	(18,896)	-
Other income (loss)	7,192	119	7,324	245
Subtotal	294,109	98,389	578,599	243,108
Realized gains (losses) on interest rate swaps(1)	(212,727)	(222,002)	(438,203)	(441,342)
Realized gains (losses) on termination of interest rate swaps	(35,649)	-	(52,027)	(2,385)
Unrealized gains (losses) on interest rate swaps	1,109,022	(611,215)	1,434,756	(269,576)
Subtotal	860,646	(833,217)	944,526	(713,303)

Total other income (loss)	1,154,755	(734,828)	1,523,125	(470,195)
General and administrative expenses:				
Compensation expense	43,764	53,536	82,207	112,550
Other general and administrative expenses	21,367	11,020	34,836	19,921
Total general and administrative expenses	65,131	64,556	117,043	132,471
Income (loss) before income taxes	1,638,305	(79,503)	2,514,390	838,765
Income taxes	92	11,656	5,899	28,118
Net income (loss)	1,638,213	(91,159)	2,508,491	810,647
Dividends on preferred stock	17,992	6,508	35,984	10,446
Net income (loss) available (related) to common shareholders	$ 1,620,221	$ (97,667)	$ 2,472,507	$ 800,201
Net income (loss) per share available (related) to common shareholders:				
Basic	$ 1.71	$ (0.10)	$ 2.61	$ 0.82
Diluted	$ 1.64	$ (0.10)	$ 2.51	$ 0.78
Weighted average number of common shares outstanding:				
Basic	947,411,380	974,555,392	947,331,087	973,141,546
Diluted	995,229,637	974,555,392	995,151,942	1,052,888,301
Average total assets	$ 113,985,220	$ 124,293,056	$ 120,474,245	$ 119,405,371
Average equity	$ 14,284,837	$ 16,112,596	$ 14,831,372	$ 16,006,035
Return on average total assets	5.75 %	(0.29 %)	4.16 %	1.36 %
Return on average equity	45.87 %	(2.26 %)	33.83 %	10.13 %

(1) Interest expense related to our interest rate swaps is recorded in realized gains (losses) on interest rate swaps on the Consolidated Statements of Operations and Comprehensive Income (Loss).

Interest Income and Average Earning Asset Yield

Our interest income for the quarters ended June 30, 2013 and 2012 was $712.9 million and $886.3 million, respectively. We had average interest earning assets of $113.7 billion and $116.5 billion, and the yield on our average interest earning assets was 2.51% and 3.04% for the quarters ended June 30, 2013 and 2012, respectively. Our average interest earning assets decreased for the quarter ended June 30, 2013 by $2.8 billion when compared to the quarter ended June 30, 2012 and interest income decreased by $173.4 million, due to the decline in yield on interest earning assets of 0.53%.

Our interest income for the six months ended June 30, 2013 and 2012 was $1.5 billion and $1.7 billion, respectively. We had average interest earning assets of $119.0 billion and $111.1 billion for the six months ended June 30, 2013 and 2012, respectively. While our average interest earning assets increased period-over-period by $7.9 billion, the yield on our average interest earning assets decreased from 3.13% for the six months ended June 30, 2012 to 2.44% for the six months ended June 30, 2013 due to a decline in coupon income and an increase in premium amortization for the six months ended June 30, 2013 when compared to the six months ended June 30, 2012.

Economic Interest Expense and the Cost of Interest-Bearing Liabilities

Our largest expense is the cost of interest-bearing liabilities and interest expense on interest rate swaps. We had average interest-bearing liabilities of $98.3 billion and total economic interest expense of $377.0 million, which includes $212.7 million in interest expense on interest rate swaps, for the quarter ended June 30, 2013. We had average interest-bearing liabilities of $103.7 billion and total economic interest expense of $388.4 million, which includes $222.0 million in interest expense on interest rate swaps, for the quarter ended June 30, 2012. Our cost of funds on average interest-bearing liabilities was 1.53%, including interest expense on interest rate swaps, for the quarter ended June 30, 2013 and 1.50% for the quarter ended June 30, 2012. Economic interest expense, including interest expense on interest rate swaps, for the quarter ended June 30, 2013 decreased by $11.4 million when compared to the quarter ended June 30, 2012, due to the decrease in interest-bearing liabilities. The cost of interest-bearing liabilities increased by 3 basis points and the average interest-bearing liabilities decreased by $5.4 billion for the quarter ended June 30, 2013, when compared to the quarter ended June 30, 2012.

We had average interest-bearing liabilities of $104.5 billion and total economic interest expense of $780.0 million, which includes $438.2 million in interest paid on interest rate swaps, for the six months ended June 30, 2013. We had average interest-bearing liabilities of $98.1 billion and total economic interest expense of $741.1 million, which includes $441.3 million in interest paid on interest rate swaps, for the six months ended June 30, 2012. Our average cost of interest-bearing liabilities was 1.49%, including interest paid on interest rate swaps, for the six months ended June 30, 2013 and 1.51% for the six months ended June 30, 2012. The cost of interest-bearing liabilities rate decreased by 2 basis points and the average interest-bearing liabilities increased by $6.4 billion for the six months ended June 30, 2013, when compared to the six months ended June 30, 2012. Economic interest expense, including interest paid on interest rate swaps, for the six months ended June 30, 2013 increased by $38.9 million when compared to the six months ended June 30, 2012, due to the increase in interest-bearing liabilities.

The table below shows our average interest-bearing liabilities and cost of funds on average interest-bearing liabilities as compared to average one-month and average six-month LIBOR for the periods presented.

Cost of Funds on Average Interest-Bearing Liabilities
(Quarterly ratios have been annualized, dollars in thousands)

	Average Interest-Bearing Liabilities	Interest-Bearing Liabilities at Period End	Economic Interest Expense(1)	Cost of Funds on Average Interest-Bearing Liabilities	Average One-Month LIBOR	Average Six-Month LIBOR	Average One-Month LIBOR Relative to Average Six-Month LIBOR	Cost of Funds on Average Interest-Bearing Liabilities Relative to Average One-Month LIBOR	Cost of Funds on Average Interest-Bearing Liabilities Relative to Average Six-Month LIBOR
For the Quarter Ended June 30, 2013	$ 98,278,276	$ 84,520,133	$ 376,982	1.53 %	0.20 %	0.42 %	(0.22 %)	1.33 %	1.11 %
For the Quarter Ended March 31, 2013	$ 110,722,615	$ 104,089,071	$ 403,066	1.46 %	0.20 %	0.47 %	(0.27 %)	1.26 %	0.99 %
For the Year Ended December 31, 2012	$ 103,362,717	$ 105,914,990	$ 1,560,941	1.51 %	0.24 %	0.69 %	(0.45 %)	1.27 %	0.82 %
For the Quarter Ended December 31, 2012	$ 110,257,173	$ 105,914,990	$ 413,646	1.50 %	0.21 %	0.54 %	(0.33 %)	1.29 %	0.96 %
For the Quarter Ended September 30, 2012	$ 106,973,056	$ 104,700,613	$ 406,165	1.52 %	0.24 %	0.71 %	(0.47 %)	1.28 %	0.81 %
For the Quarter Ended June 30, 2012	$ 103,668,465	$ 101,004,741	$ 388,445	1.50 %	0.24 %	0.73 %	(0.49 %)	1.26 %	0.77 %
For the Quarter	$ 92,552,175	$ 95,700,039	$ 352,685	1.52 %	0.26 %	0.76 %	(0.50 %)	1.26 %	0.76 %

Ended
March 31,
2012

(1) Economic interest expense includes interest expense on interest rate swaps.

We do not manage our portfolio to have a pre-designated amount of borrowings at quarter or year end. Our borrowings at period end are a snapshot of our borrowings as of a date, and this number should be expected to differ from average borrowings over the period for a number of reasons. The mortgage-backed securities we own pay principal and interest towards the end of each month and the mortgage-backed securities we purchase are typically settled during the beginning of the month. As a result, depending on the amount of mortgage-backed securities we have committed to purchase, we may retain the principal and interest we receive in the prior month, or we may use it to pay down our borrowings. Moreover, we use interest rate swaps to hedge our portfolio and as we pledge or receive collateral under these agreements, our borrowings on any given day may be increased or decreased. Our average borrowings during a quarter will differ from period end borrowings as we implement our portfolio management strategies and risk management strategies over changing market conditions by increasing or decreasing leverage. Additionally, these numbers will differ during periods when we conduct capital raises, as in certain instances we may purchase additional assets and increase leverage with the expectation of a successful capital raise. Since our average borrowings and period end borrowings can be expected to differ, we believe our average borrowings during a period provides a more accurate representation of our exposure to the risks associated with leverage.

Economic Net Interest Income

Our economic net interest income, including interest expense on interest rate swaps, totaled $336.0 million, and $497.9 million for the quarters ended June 30, 2013 and 2012, respectively. Our economic net interest income decreased during the quarter ended June 30, 2013, as compared to the quarter ended June 30, 2012, by $161.9 million. The decline was due to a decrease in interest-earning assets and a reduced economic interest rate spread. Our average interest-earning assets decreased during the quarter ended June 30, 2013, as compared to the quarter ended June 30, 2012, by $2.8 billion. Our economic net interest rate spread for the quarter ended June 30, 2013 was 0.98%, as compared to the interest rate spread for the quarter ended June 30, 2012 of 1.54%.

Our economic net interest income, including interest paid on interest rate swaps, totaled $670.1 million, and $1.0 billion for the six months ended June 30, 2013 and 2012, respectively. Even though our average interest-earning assets increased during the six months ended June 30, 2013, as compared to the six months June 30, 2012, by $7.9 billion, economic net interest income declined. The decline was primarily due to a reduced economic interest rate spread. Our economic net interest rate spread for the six months ended June 30, 2013 was 0.95%, as compared to the interest rate spread for the six months ended June 30, 2012 of 1.62%.

The table below shows our average interest earning assets, total interest income, yield on average interest earning assets, average interest-bearing liabilities, economic interest expense, cost of funds on average interest-bearing liabilities, economic net interest income, and net interest rate spread for the periods presented.

Economic Net Interest Income
(Quarterly ratios have been annualized, dollars in thousands)

	Average Interest Earning Assets	Total Interest Income	Yield on Average Interest Earning Assets	Average Interest-Bearing Liabilities	Economic Interest Expense(1)	Cost of Funds on Average Interest-Bearing Liabilities	Economic Net Interest Income (1)	Net Interest Rate Spread
For the Quarter Ended June 30, 2013	$113,660,254	$712,936	2.51 %	$98,278,276	$376,982	1.53 %	$335,954	0.98 %
For the Quarter Ended March 31, 2013	$124,414,754	$737,217	2.37 %	$110,722,615	$403,066	1.46 %	$334,151	0.91 %
For the Year Ended December 31, 2012	$116,356,100	$3,259,145	2.80 %	$103,362,717	$1,560,941	1.51 %	$1,698,204	1.29 %
For the Quarter Ended December 31, 2012	$123,378,860	$756,661	2.45 %	$110,257,173	$413,646	1.50 %	$343,015	0.95 %
For the Quarter Ended September 30, 2012	$119,880,120	$761,265	2.54 %	$106,973,056	$406,165	1.52 %	$355,100	1.02 %
For the Quarter Ended June 30, 2012	$116,458,864	$886,324	3.04 %	$103,668,465	$388,445	1.50 %	$497,879	1.54 %
For the Quarter Ended March 31, 2012	$105,706,554	$854,895	3.23 %	$92,552,175	$352,685	1.52 %	$502,210	1.71 %

(1) Economic interest expense and economic net interest income include interest expense on interest rate swaps.

Investment Advisory Income

FIDAC and Merganser are registered investment advisors specializing in managing fixed income securities. Investment advisory income for the quarters ended June 30, 2013 and 2012 totaled $12.2 million and $21.8 million, respectively, net of fees paid to third parties pursuant to distribution service agreements for facilitating and promoting distribution of shares or units to FIDAC's and Merganser's clients.

Gains and Losses on Sales of Agency Mortgage-Backed Securities and Agency Debentures

For the quarters ended June 30, 2013 and 2012, we disposed of investments with a carrying value of $14.8 billion and $6.4 billion for an aggregate net gain of $148.0 million and $94.8 million, respectively. We may from time to time sell existing assets to acquire new assets, which our management believes might have higher risk-adjusted returns, or to manage our balance sheet as part of our asset/liability management strategy.

Dividend Income from Available-For-Sale Equity Securities

Dividend income from our investments in Chimera Investment Corporation and CreXus (we held shares prior to our acquisition of CreXus, which closed during the second quarter of 2013), which is managed pursuant to a management contract by our wholly-owned subsidiary FIDAC, totaled $4.0 million and $10.5 million for the quarter and six months ended June 30, 2013, as compared to $6.6 million and $14.1 million for the quarter and six months ended June 30, 2012. The decline in dividend income for the quarter and six months ended June 30, 2013 as compared to the quarter and six months ended June 30, 3012 is primarily due to CreXus not declaring a dividend for the second quarter of 2013 as a result of its acquisition.

General and Administrative Expenses

General and administrative (or G&A) expenses were $65.1 million and $117.0 million for the quarter and six months ended June 30, 2013 respectively, compared to $64.5 million and $132.5 million for the quarter and six months ended June 30, 2012, respectively. G&A expenses as a percentage of average total assets was 0.23% and 0.21% for the quarters ended June 30, 2013 and 2012, respectively. The decrease in G&A expenses of $15.5 million for the six months ended June 30, 2013 as compared to June 30, 2012 was primarily the result of the pro forma adjustment to the management fee which resulted in lower compensation expenses for the first six months of 2013.

The table below shows our total G&A expenses as compared to average total assets and average equity for the periods presented.

G&A Expenses and Operating Expense Ratios
(ratios for the quarters have been annualized, dollars in thousands)

	Total G&A Expenses	Total G&A Expenses/Average Assets	Total G&A Expenses/Average Equity
For the Quarter Ended June 30, 2013	$65,131	0.23%	1.82%
For the Quarter Ended March 31, 2013	$51,912	0.16%	1.33%
For the Year Ended December 31, 2012	$235,559	0.19%	1.45%
For the Quarter Ended December 31, 2012	$40,084	0.12%	0.97%
For the Quarter Ended September 30, 2012	$63,004	0.19%	1.51%
For the Quarter Ended June 30, 2012	$64,556	0.21%	1.60%
For the Quarter Ended March 31, 2012	$67,915	0.24%	1.71%

Net Income and Return on Average Equity

Our net income was $1.6 billion for the quarter ended June 30, 2013 and our net loss was $91.2 million for the quarter ended June 30, 2012. Our annualized return on average equity was 45.87% for the quarter ended June 30, 2013, and our annualized loss on average equity was 2.26% for the quarter ended June 30, 2012. We attribute the majority of the change in net income (loss) for the quarter ended June 30, 2013 from the quarter ended June 30, 2012 to the change in unrealized gains (losses) on interest rate swaps, which resulted in a gain of $1.1 billion for the quarter ended June 30, 2013 compared to a loss of $611.2 million for the same period in 2012.

Our net income was $2.5 billion for the six months ended June 30, 2013 and $810.6 million for the six months ended June 30, 2012. Our annualized return on average equity was 33.83% for the six months ended June 30, 2013, and 10.13% for the six months ended June 30, 2012. Net income increased by $1.7 billion for the six months ended June 30, 2013 as compared to the six months ended June 30, 2012, primarily due to the change in unrealized gains (losses) on interest rate swaps, which resulted in a gain of $1.4 billion for the six months ended June 30, 2013 compared to a loss of $269.6 million for the same period in 2012.

The table below shows the components of our return on average equity for the periods presented.

Components of Return on Average Equity
(Ratios for the quarters have been annualized)

	Economic Net Interest Income/ Average Equity(1)	Investment Advisory Income/ Average Equity	Realized and Unrealized Gains and Losses/ Average Equity	Other Income (Loss)/ Average Equity(2)	G&A Expenses/ Average Equity	Income Taxes/ Average Equity	Return on Average Equity
For the Quarter Ended June 30, 2013	9.41 %	0.34 %	38.83 %	(0.89 %)	(1.82 %)	(0.00 %)	45.87 %
	8.56 %	0.35 %	14.70 %	0.16 %	(1.33 %)	(0.15 %)	22.29 %

For the Quarter Ended March 31, 2013							
For the Year Ended December 31, 2012	10.48 %	0.51 %	1.22 %	0.17 %	(1.45 %)	(0.22 %)	10.71 %
For the Quarter Ended December 31, 2012	8.31 %	0.46 %	8.85 %	0.17 %	(0.97 %)	0.15 %	16.97 %
For the Quarter Ended September 30, 2012	8.51 %	0.50 %	(1.95 %)	0.17 %	(1.51 %)	(0.33 %)	5.39 %
For the Quarter Ended June 30, 2012	12.37 %	0.54 %	(13.44 %)	0.16 %	(1.60 %)	(0.29 %)	(2.26 %)
For the Quarter Ended March 31, 2012	12.66 %	0.52 %	11.49 %	0.19 %	(1.71 %)	(0.42 %)	22.73 %

(1) Economic net interest income includes interest expense on interest rate swaps.

(2) Other income (loss) includes dividend income from affiliates, impairment of goodwill, loss on previously held equity interest in CreXus and other income (loss).

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Financial Condition:

Investment Securities

Substantially all of our Agency mortgage-backed securities at June 30, 2013 and December 31, 2012 were mortgage-backed securities backed by single-family mortgage loans. Substantially all of the mortgage assets underlying these mortgage-backed securities were secured with a first lien position on the underlying single-family properties. Substantially all of our mortgage-backed securities were Freddie Mac, Fannie Mae or Ginnie Mae pass through certificates or CMOs, which carry an actual or implied "AAA" rating. We carry all of our Agency mortgage-backed securities at fair value.

We accrete discount balances as an increase to interest income over the expected life of the related interest earning assets and we amortize premium balances as a decrease to interest income over the expected life of the related interest earning assets. At June 30, 2013 and December 31, 2012 we had on our Consolidated Statements of Financial Condition a total of $32.1 million and $27.4 million, respectively, of unamortized discount (which is the difference between the remaining principal value and current amortized cost of our Investment Securities acquired at a price below principal value) and a total of $5.4 billion and $5.9 billion, respectively, of unamortized premium (which is the difference between the remaining principal value and the current amortized cost of our Investment Securities acquired at a price above principal value).

We received mortgage principal repayments of $6.5 billion and $7.9 billion for the quarters ended June 30, 2013 and 2012, respectively. The average prepayment speed for the quarters ended June 30, 2013 and 2012 was 16% and 19%, respectively. Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our mortgage-backed securities, all other factors being equal, our net interest income would decrease during the life of these mortgage-backed securities as we would be required to amortize our net premium balance into income over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our mortgage-backed securities, all other factors being equal, our net interest income would increase during the life of these mortgage-backed securities as we would amortize our net premium balance over a longer time period.

The table below summarizes certain characteristics of our Agency mortgage-backed securities, Agency debentures and corporate debt as of the dates presented.

Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt
(dollars in thousands)

	Principal Amount	Net Premium	Amortized Cost	Amortized Cost/Principal Amount	Carrying Value	Carrying Value/ Principal Amount
At June 30, 2013	$91,769,320	$5,346,442	$97,115,762	105.83 %	$95,855,473	104.45 %
At March 31, 2013	$105,018,772	$5,361,216	$110,379,988	105.11 %	$112,293,489	106.93 %
At December 31, 2012	$118,291,085	$5,828,840	$124,119,925	104.93 %	$127,036,719	107.39 %
At September 30, 2012	$123,176,544	$5,448,108	$128,624,652	104.42 %	$132,598,180	107.65 %
At June 30, 2012	$111,975,194	$4,463,950	$116,439,144	103.99 %	$119,811,793	107.00 %
At March 31, 2012	$105,296,991	$3,815,555	$109,112,546	103.62 %	$111,841,645	106.22 %

The tables below summarize certain characteristics of our Agency mortgage-backed securities, Agency debentures and corporate debt as of the dates presented. The index level for adjustable-rate Agency mortgage-backed securities, Agency debentures and corporate debt is the weighted average rate of the various short-term interest rate indices, which determine the coupon rate.

Adjustable-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt Characteristics
(dollars in thousands)

	Principal Amount	Weighted Average Coupon Rate	Weighted Average Term to Next Adjustment	Weighted Average Lifetime Cap	Principal Amount at Period End as % of Total Investment Securities
At June 30, 2013	$ 7,514,274	3.39 %	29 months	6.99 %	8.19 %
At March 31, 2013	$ 8,527,853	3.19 %	35 months	7.56 %	8.12 %
At December 31, 2012	$ 8,363,385	3.29 %	35 months	8.21 %	7.07 %
At September 30, 2012	$ 9,285,709	3.28 %	39 months	8.39 %	7.54 %
At June 30, 2012	$ 8,648,932	3.67 %	38 months	9.42 %	7.72 %
At March 31, 2012	$ 9,104,082	3.72 %	38 months	8.80 %	8.65 %

Fixed-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt Characteristics
(dollars in thousands)

	Principal Amount	Weighted Average Coupon Rate	Principal Amount at Period End as % of Total Investment Securities
At June 30, 2013	$ 84,255,046	3.88 %	91.81 %
At March 31, 2013	$ 96,490,919	3.96 %	91.88 %
At December 31, 2012	$ 109,927,700	4.04 %	92.93 %
At September 30, 2012	$ 113,890,835	4.17 %	92.46 %
At June 30, 2012	$ 103,326,262	4.52 %	92.28 %
At March 31, 2012	$ 96,192,909	4.63 %	91.35 %

At June 30, 2013 and December 31, 2012, we held Agency mortgage-backed securities, Agency debentures and corporate debt with coupons linked to various indices. The following tables detail the portfolio characteristics by index.

Adjustable-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt by Index
June 30, 2013

	One-Month LIBOR	Six-Month LIBOR	Twelve Month LIBOR	12-Month Moving Average	11th District Cost of Funds	1-Year Treasury Index	Other Indices(1)
Weighted Average Term to Next Adjustment	1 mo.	4 mo.	34 mo.	2 mo.	2 mo.	22 mo.	39 mo.
Weighted Average Annual Period Cap	0.19 %	1.64 %	2.00 %	0.00 %	0.13 %	1.98 %	0.00 %
Weighted Average Lifetime Cap at June 30, 2013	6.10 %	10.54 %	9.95 %	9.42 %	10.72 %	10.76 %	3.26 %
Investment Principal Value as Percentage of Investment Securities at June 30, 2013	0.02 %	0.35 %	3.65 %	0.24 %	0.23 %	0.20 %	3.50 %

(1) Combination of indices that account for less than 0.05% of total or adjust over time, without a reset index.

Adjustable-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt by Index
December 31, 2012

	One-Month LIBOR	Six-Month LIBOR	Twelve Month LIBOR	12-Month Moving Average	11th District Cost of Funds	1-Year Treasury Index	Other Indices(1)
Weighted Average Term to Next Adjustment	1 mo.	5 mo.	42 mo.	3 mo.	3 mo.	23 mo.	40 mo.
	0.82 %	1.70 %	2.00 %	0.00 %	0.17 %	1.89 %	0.00 %

Weighted Average Annual Period Cap							
Weighted Average Lifetime Cap at December 31, 2012	6.10 %	11.15 %	9.85 %	9.44 %	10.71 %	11.34 %	4.82 %
Investment Principal Value as Percentage of Investment Securities at December 31, 2012	0.10 %	0.30 %	3.71 %	0.21 %	0.20 %	0.25 %	2.30 %

(1) Combination of indices that account for less than 0.05% of total or adjust over time, without a reset index.

Borrowings

As of each of June 30, 2013 and December 31, 2012, 99% of our debt consisted of borrowings collateralized by a pledge of our Investment Securities. These borrowings appear on our Consolidated Statements of Financial Condition as repurchase agreements. All of our Agency mortgage-backed securities and debentures are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and thus increase the liquidity and strength of our balance sheet. As of June 30, 2013, the term to maturity of our repurchase agreements ranged from one day to six years. Additionally, we have entered into borrowings giving the counterparty the right to call the balance prior to maturity. At June 30, 2013 and December 31, 2012, the weighted average cost of funds for all of our borrowings was 1.76% and 1.55%, respectively, including the effect of the interest rate swaps, 4% Convertible Senior Notes due 2015 and 5% Convertible Senior Notes due 2015 (collectively, the “Convertible Senior Notes”), and the weighted average days to maturity was 196 days and 197 days, respectively.

Liquidity

Liquidity, which is our ability to turn non-cash assets into cash, allows us to purchase additional interest earning assets and to pledge additional assets to secure existing borrowings should the value of our pledged assets decline. Potential immediate sources of liquidity for us include cash balances and unused borrowing capacity. Our non-cash assets are largely actual or implied AAA assets, and accordingly, we have not had, nor do we anticipate having, difficulty in converting our assets to cash. Our balance sheet also generates liquidity on an on-going basis through mortgage principal repayments and net earnings held prior to payment of dividends. Should our needs ever exceed these on-going sources of liquidity plus the immediate sources of liquidity discussed above, we believe that in most circumstances our interest earning assets could be sold to raise cash. The maintenance of liquidity is one of the goals of our capital investment policy. Under this policy, we limit asset growth in order to preserve unused borrowing capacity for liquidity management purposes.

We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. We have not at the present time entered into any commitment agreements under which the lender would be required to enter into new repurchase agreements during a specified period of time, nor do we presently plan to have liquidity facilities with commercial banks.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a margin call), which may take the form of additional securities or cash. Similarly, if the estimated fair value of interest earning assets increases due to changes in market interest rates or market factors, lenders may release collateral back to us. Specifically, margin calls result from a decline in the value of our Agency mortgage-backed securities securing our repurchase agreements and from prepayments on the mortgages securing such Agency mortgage-backed securities. Changes in market interest rates and other market factors may also result in a margin call. Our repurchase agreements generally provide that the valuations for the Agency mortgage-backed securities securing our repurchase agreements are to be obtained from a generally recognized source agreed to by the parties. However, in certain circumstances and under certain of our repurchase agreements our lenders have the sole discretion to determine the value of the Agency mortgage-backed securities securing our repurchase agreements. In instances where we have agreed to permit our lenders to make a determination of the value of the Agency mortgage-backed securities securing our repurchase agreements, such lenders are required to act in good faith in making such valuation determinations and in certain of these instances are also required to act reasonably in this determination. Our repurchase agreements generally provide that in the event of a margin call we must provide additional securities or cash on the same business day that a margin call is made, if the lender provides us notice prior to the margin notice deadline on such day. Through June 30, 2013, we did not have any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should prepayment speeds on the mortgages underlying our Agency mortgage-backed securities and/or market interest rates suddenly increase or market rates sharply increase, margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

At June 30, 2013, we had total pledged collateral for repurchase agreements and interest rate swaps of $89.3 billion. The weighted average haircut was approximately 5% on repurchase agreements. The excess collateral cushion totaled approximately $4.0 billion. The quality and character of the Agency mortgage-backed securities that we pledge as collateral under the repurchase agreements and interest rate swaps did not materially change during the quarter ended June 30, 2013 compared to the quarter ended June 30, 2012, and our counterparties did not materially alter any requirements, including required haircuts, related to the collateral we pledge under repurchase agreements and interest rate swaps during the quarter ended June 30, 2013.

The following table summarizes the effect on our liquidity and cash flows from contractual obligations for repurchase agreements, interest expense on repurchase agreements and Convertible Senior Notes, the non-cancelable office leases and employment agreements as of June 30, 2013. The table does not include the effect of net interest rate payments under our interest rate swap agreements. The net swap payments will fluctuate based on monthly changes in the receive rate. As of June 30, 2013, the interest rate swaps had a net negative fair value of $1.2 billion.

Contractual Obligations
(dollars in thousands)

	Within One Year	One to Three Years	Three to Five Years	More than Five Years	Total
Repurchase agreements	$71,047,335	$5,055,000	$5,195,000	$100,000	$81,397,335
Interest expense on repurchase agreements, based on rates at June 30, 2013	269,154	343,813	92,363	2,292	707,622
Convertible Senior Notes	-	857,541	-	-	857,541
Interest expense on Convertible Senior Notes	41,802	35,501	-	-	77,303
Long-term operating lease obligations	2,490	1,524	-	-	4,014
Employment contracts	4,510	1,128	-	-	5,638
Total	$71,365,291	$6,294,507	$5,287,363	$102,292	$83,049,453

In the coming periods, we expect to continue to finance our activities in a manner that is consistent with our current operations via repurchase agreements. During the quarter and six months ended June 30, 2013, we received $6.5 billion and $15.1 billion from principal repayments and $14.8 billion and $31.1 billion in cash from disposal of Investment Securities. During the quarter and six months ended June 30, 2012, we received $7.9 billion and $15.3 billion from principal repayments and $5.8 billion and $10.8 billion in cash from disposal of Investment Securities during the quarter ended June 30, 2012.

Stockholders' Equity

During the six months ended June 30, 2013 and 2012, 166,000 and 394,000 options were exercised for an aggregate exercise price of $2.2 million and $5.4 million, respectively.

During the six months ended June 30, 2013 and 2012, we issued 94,000 and 51,000 shares and raised $1.4 million and $845,000, respectively, through the Direct Purchase and Dividend Reinvestment Program.

During the six months ended June 30, 2012, 1.3 million shares of 6.00% Series B Cumulative Convertible Preferred Stock (or Series B Preferred Stock) were converted into 4.0 million shares of common stock.

On March 19, 2012, we entered into six separate Distribution Agency Agreements (or Distribution Agency Agreements) with each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., J.P. Morgan Securities LLC, Morgan Stanley & Co. LLC and RCap Securities, Inc. (together, the Agents). Pursuant to the terms of the Distribution Agency Agreements, we may sell from time to time through the Agents, as our sales agents, up to 125,000,000 shares of our common stock. We did not make any sales under the Distribution Agency Agreements during the six months ended June 30, 2013 and 2012.

On May 16, 2012, we amended our charter through the filing of articles supplementary to our charter to reclassify 12,650,000 shares of authorized shares of common stock as 7.625% Series C Cumulative Redeemable Preferred Stock (or Series C Preferred Stock).

In May 2012, we issued 12,000,000 shares of Series C Preferred Stock, with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared).

On September 13, 2012, we amended our charter through the filing of articles supplementary to our charter to reclassify 18,400,000 shares of authorized shares of common stock as 7.50% Series D Cumulative Redeemable

Preferred Stock (or Series D Preferred Stock).

In September 2012, we issued 18,400,000 shares of Series D Preferred Stock, with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared).

Following the effectiveness of the articles supplementary to our charter our authorized shares of capital stock, par value of $0.01 per share, consists of 1,956,937,500 shares classified as common stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock, 12,650,000 shares classified as 7.625% Series C Cumulative Redeemable Preferred Stock and 18,400,000 shares classified as 7.50% Series D Cumulative Redeemable Preferred Stock.

On October 16, 2012, we announced that our Board of Directors has authorized the repurchase of up to $1.5 billion of our outstanding common shares over a 12 month period. All common shares purchased are part of a publicly announced plan in open-market transactions. During the year ended December 31, 2012, we repurchased approximately 27.8 million shares of our outstanding common stock for $397.1 million, of which $141.1 million had not settled at December 31, 2012. During the six months ended June 30, 2013, we did not repurchase any shares of our outstanding common stock.

Unrealized Gains and Losses

With our "available-for-sale" accounting treatment, unrealized fluctuations in market values of assets do not impact our GAAP or taxable income but rather are reflected on our balance sheet by changing the carrying value of the asset and stockholders' equity under "Accumulated Other Comprehensive Income (Loss)." As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

The table below shows cumulative unrealized gains and losses reflected in the Consolidated Statements of Financial Condition.

Unrealized Gains and Losses
(dollars in thousands)

	June 30, 2013	March 31, 2013	December 31, 2012	September 30, 2012	June 30, 2012
Unrealized gain	$ 1,238,509	$ 2,334,373	$ 3,092,778	$ 4,110,450	$ 3,497,635
Unrealized loss	(2,527,755)	(331,125)	(39,536)	(40,843)	(84,315)
Net unrealized gain (loss)	$ (1,289,246)	$ 2,003,248	$ 3,053,242	$ 4,069,607	$ 3,413,320

Unrealized changes in the estimated fair value of available-for-sale investments may have a direct effect on our potential earnings and dividends: positive changes will increase our equity base and allow us to increase our borrowing capacity while negative changes tend to limit borrowing capacity under our capital investment policy. A very large negative change in the net fair value of our available-for-sale investments securities might impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale.

Leverage

Our debt-to-equity ratio at June 30, 2013 (including loan participations and mortgages payable which are non-recourse to us) and December 31, 2012 was 6.2:1 and 6.5:1, respectively. We generally expect to maintain a ratio of debt-to-equity of less than 12:1. The ratio varies from time to time based upon various factors, including our management's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, the availability of credit, over-collateralization levels required by lenders when we pledge assets to secure borrowings and our assessment of domestic and international market conditions. Our debt-to-equity ratios have been below our historical average ratios since the credit crisis of 2008. We believe that it is prudent to maintain our existing debt-to-equity ratio because there continues to be volatility in the mortgage and credit markets primarily driven by the uncertainty in Europe and U.S. capital markets.

Our target debt-to-equity ratio is determined under our capital investment policy. Should our actual debt-to-equity ratio increase above the target level due to asset acquisition or market value fluctuations in assets, we would cease to acquire new assets. Our management will, at that time, present a plan to our Board of Directors to bring us back to our target debt-to-equity ratio; in many circumstances, this would be accomplished over time by the monthly reduction of the balance of our Agency mortgage-backed securities through principal repayments.

Asset/Liability Management and Effect of Changes in Interest Rates

We continually review our asset/liability management strategy with respect to interest rate risk, mortgage prepayment risk, credit risk and the related issues of capital adequacy and liquidity. Our goal is to provide attractive risk-adjusted stockholder returns while maintaining what we believe is a strong balance sheet.

We seek to manage the extent to which our net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. In addition, we have attempted to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in our portfolio of Agency mortgage-backed securities and Agency debentures primarily by entering into interest rate swaps. At June 30, 2013, we had entered into swap agreements with a total notional amount of $48.5 billion. We agreed to pay a weighted average pay rate of 2.05% and receive a floating rate based on LIBOR. At December 31, 2012, we had entered into swap agreements with a total notional amount of $46.9 billion. We agreed to pay a weighted average pay rate of 2.21% and receive a floating rate based on LIBOR. The weighted average pay rate declined by 0.16% from December 31, 2012 to June 30, 2013. The decline was the direct result of interest rate swaps maturing or being terminated with higher pay rates being replaced with interest rate swaps with lower pay rates. We believe that for the immediately foreseeable periods, our weighted average pay rate will continue to decline as a result of interest rate swaps with higher pay rates maturing or being terminated and the replacement of such swaps with interest rate swaps with lower pay rates. We may enter into similar derivative transactions in the future by entering into interest rate collars, caps or floors or purchasing interest only securities. Changes in interest rates may also affect the rate of mortgage principal prepayments and, as a result, prepayments on mortgage-backed securities. We seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets we purchase at a premium with assets we purchase at a discount. To date, the aggregate premium exceeds the aggregate discount on our mortgage-backed securities. As a result, prepayments, which result in the amortization of unamortized premiums, will reduce our net income compared to what net income would be absent such prepayments.

The following table summarizes certain characteristics of our interest rate swaps as of June 30, 2013:

Maturity of Interest Rate Swaps
(dollars in thousands)

Maturity		Current Notional	Weighted Average Pay Rate		Weighted Average Receive Rate		Weighted Average Years to Maturity
0 - 3 years	$	21,567,050	1.94	%	0.21	%	2.18
3 - 6 years		14,738,490	1.69	%	0.23	%	3.99
6 - 10 years		7,700,000	2.31	%	0.25	%	7.53
Greater than 10 years		4,466,750	3.32	%	0.22	%	18.08
Total / Weighted Average	$	48,472,290	2.05	%	0.22	%	5.04

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide funding to any such entities. As such, we are not materially exposed to any market, credit, liquidity or financing risk that could arise if we had engaged in such relationships.

Capital Resources

At June 30, 2013, we had no material commitments for capital expenditures.

Inflation

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our dividends are based upon our net income as calculated for tax purposes; in each case, our activities and financial condition are measured with reference to historical cost or fair market value without considering inflation.

Other Matters

We calculate that at least 75% of our assets were qualified REIT assets, as defined in the Code for the quarter ended June 30, 2013 and for the year ended December 31, 2012. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the quarter ended June 30, 2013 and the year ended December 31, 2012 and for each quarter therein. Consequently, we met the REIT income and asset tests. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income. Therefore, for the quarter ended June 30, 2013 and the year ended December 31, 2012, we believe that we qualified as a REIT under the Code.

We at all times intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, or the Investment Company Act. If we were to become regulated as an investment company, then our use of leverage would be substantially reduced.

We currently rely on the exemption from registration provided by Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C) as interpreted by the staff of the Securities and Exchange Commission (or the SEC), requires us to invest at least 55% of our assets in “mortgages and other liens on and interest in real estate” (or Qualifying Real Estate Assets) and at least 80% of our assets in Qualifying Real Estate Assets plus real estate related assets. The assets that we acquire, therefore, are limited by the provisions of the Investment Company Act and the rules and regulations promulgated under the Investment Company Act.

We rely on an interpretation that “whole pool certificates” that are issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae (or Agency Whole Pool Certificates) are Qualifying Real Estate Assets under Section 3(c)(5)(C). This interpretation was promulgated by the SEC staff in a no-action letter over 30 years ago, was reaffirmed by the SEC in 1992 and has been commonly relied on by mortgage REITs.

On August 31, 2011, the SEC issued a concept release titled “Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments” (SEC Release No. IC-29778). Under the concept release, the SEC is reviewing interpretive issues related to the Section 3(c)(5)(C) exemption. Among other things, the SEC specifically requested comments on whether it should revisit whether Agency Whole Pool Certificates may be treated as Qualifying Real Estate Assets and whether entities, such as us, whose primary business consists of investing in Agency Whole Pool Certificates are the type of entities that Congress intended to be encompassed by the exclusion provided by Section 3(c)(5)(C). The potential outcomes of the SEC’s actions are unclear as is the SEC’s timetable for its review and actions.

We determined that as of June 30, 2013 and December 31, 2012, we were in compliance with the exemption from registration provided by Section 3(c)(5)(C) of the Investment Company Act as interpreted by the staff of the SEC.

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the U.S. Commodity Futures Trading Commission (or CFTC) gained jurisdiction over the regulation of interest rate swaps. The CFTC has asserted that this causes the operators of mortgage real estate investment trusts that use swaps as part of their business model to fall within the statutory definition of Commodity Pool Operator (or CPO), and, absent relief from the Division or the Commission, to register as CPOs. On December 7, 2012, as a result of numerous requests for no-action relief from the CPO registration requirement for operators of mortgage real estate investment trusts, the Division of Swap Dealer and Intermediary Oversight of the CFTC issued no-action relief entitled "No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Mortgage Real Estate Investment Trusts" that permits a CPO to receive relief by filing a claim to perfect the use of the relief. A claim submitted by a CPO will be effective upon filing, so long as the claim is materially complete. The conditions that must be met to claim the relief are that the mortgage real estate investment trust must:

Limit the initial margin and premiums required to establish its commodity interest positions to no more than five percent of the fair market value of the mortgage real estate investment trust's total assets;

Limit the net income derived annually from its commodity interest positions that are not qualifying hedging transactions to less than five percent of the mortgage real estate investment trust's gross income;

Ensure that interests in the mortgage real estate investment trust are not marketed to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets; and

Either:

o identify itself as a "mortgage REIT" in Item G of its last U.S. income tax return on Form 1120-REIT; or

o if it has not yet filed its first U.S. income tax return on Form 1120-REIT, it must disclosee to its shareholders that it intends to identify itself as a "mortgage REIT" in its first U.S. income tax return on Form 1120-REIT.

While we disagree with the CFTC's position that mortgage real estate investment trusts that use swaps as part of their business model fall within the statutory definition of a CPO, we submitted a claim for the no-action relief described above and believe we meet the criteria for such relief set forth therein.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risk to which we are exposed is interest rate risk, which is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of our Agency mortgage-backed securities and our ability to realize gains from the sale of these assets. We may utilize a variety of financial instruments, including interest rate swaps, swaptions, caps, floors, interest-only securities and other interest rate exchange contracts, in order to limit the effects of interest rates on our operations. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of securities and that the losses may exceed the amount we invested in the instruments.

The profitability and the value of our portfolio (including interest rate swaps) may be adversely affected during any period as a result of changing interest rates. The following table quantifies the potential changes in economic net interest income and portfolio value given a 75 basis point parallel interest rate shock in 25 basis point intervals. All changes in income and value are measured as percentage changes from the projected net interest income and portfolio value using the June 30, 2013 level of interest rates. This scenario analysis includes various assumptions regarding levels of prepayments, the amount of leverage we employ, reinvestment rates on principal received during the course of the year, Agency mortgage-backed securities spreads to US Treasury securities and interest rate swaps, as well as our yields to funding spreads. As a result, actual results could differ significantly from these estimates.

Change in Interest Rate	Projected Percentage Change in Economic Net Interest Income(1)	Projected Percentage Change in Portfolio Value, with Effect of Interest Rate Swaps(2)
-75 Basis Points	(28.7%)	1.1%)
-50 Basis Points	(19.5%)	0.9%)
-25 Basis Points	(10.6%)	0.5%)
Base Interest Rate	-	-
+25 Basis Points	7.4%	(0.6%)
+50 Basis Points	14.1%	(1.2%)
+75 Basis Points	19.9%	(1.9%)

(1) Change in annual economic net interest income. Includes interest expense on interest rate swaps.

(2) Projected Percentage Change in Portfolio Value is based on instantaneous moves in interest rates.

PREPAYMENT RISK

Mortgage obligors have the right to prepay their loans prior to its contractual maturity, which may impact the assumed prepayment speeds and cash flows of mortgage-backed securities. In cases whereby prepayments are due to lower interest rates presenting opportunities for obligors to refinance their loans at lower rates, we may encounter the reduction in assets carrying higher yields that can only be replaced with assets carrying a lower yield. Should actual prepayments differ from our estimated prepayments, adjustments to the amortization or accretion of premiums and discounts may be required that would impact future income. In addition, variations in prepayment speeds due to changes in market interest rates cause variations in the cash flows of mortgage-backed securities thereby increasing the difficulty to hedge interest rate risk.

BASIS RISK

We seek to limit our interest rate risk by hedging portions of our portfolio through interest rate swaps and other similar types of hedge instruments. Interest rate swaps are generally tied to underlying Treasury benchmark interest rates. Basis risk relates to the risk of the spread between our mortgage-backed securities and underlying hedges widening. Such a widening may cause a decline in the fair value of our mortgage-backed securities that is greater than the increase in fair value of our hedges resulting in a net decline in book value. The widening of mortgage-backed securities yields and Treasury benchmark interest rates may result from a variety of factors such as anticipated or actual monetary policy actions or other market factors.

ASSET/LIABILITY MANAGEMENT

Our asset/liability management practice utilizes a series of tools to measure and manage risks related to the timing and magnitude of the repricing of assets and liabilities. We attempt to control risks associated with interest rate movements. Methods for evaluating interest rate risk include an analysis of our interest rate sensitivity "gap" and measurement of duration and convexity. The gap is the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest-rate sensitive assets exceeds the amount of interest-rate sensitive liabilities. A gap is considered negative when the amount of interest-rate sensitive liabilities exceeds interest-rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution were perfectly matched in each maturity category.

The following table sets forth the estimated maturity or repricing of our interest-earning assets and interest-bearing liabilities at June 30, 2013. The amount of assets and liabilities shown within a particular period were determined in accordance with the contractual terms of the assets and liabilities, except adjustable-rate loans, and securities are included in the period in which their interest rates are first scheduled to adjust and not in the period in which they mature and does include the effect of the interest rate swaps. The interest rate sensitivity of our assets and liabilities in the table could vary substantially based on actual prepayment experience.

	Within 3 Months	3 to 12 Months	More than 1 Year to 3 Years	3 Years and Over	Total
			(dollars in thousands)		
Rate Sensitive Assets:					
Cash and cash equivalents	$ 725,537	$ -	$ -	$ -	$ 725,537
Reverse repurchase agreements	171,234	-	-	-	171,234
Securities borrowed	2,425,024	-	-	-	2,425,024
Agency mortgage-backed securities (principal)	619,604	1,805,946	478,251	85,317,876	88,221,677
Agency debentures (principal)	-	-	809,950	2,675,573	3,485,523
Corporate debt	62,120	-	-	-	62,120

Commercial real estate loans and preferred equity	30,000	33,473	539,387	333,401	936,261
Total Rate Sensitive Assets	4,033,519	1,839,419	1,827,588	88,326,850	96,027,376
Rate Sensitive Liabilities:					
Repurchase agreements, with the effect of interest rate swaps	5,905,767	18,209,638	25,449,780	31,832,150	81,397,335
Securities loaned	2,284,245	-	-	-	2,284,245
Convertible Senior Notes (principal)	-	-	857,541	-	857,541
Participation sold (principal)	-	-	-	13,846	13,846
Total Rate Sensitive Liabilities	8,190,012	18,209,638	26,307,321	31,845,996	84,552,967
Interest rate sensitivity gap	$ (4,156,493)	$ (16,370,219)	$ (24,479,733)	$ 56,480,854	$ 11,474,409
Cumulative interest rate sensitivity gap	$ (4,156,493)	$ (20,526,712)	$ (45,006,445)	$ 11,474,409	
Cumulative interest rate sensitivity gap as a percentage of total rate-sensitive assets	(4 %)	(21 %)	(47 %)	12 %	

Duration is a measure of the change in price of a fixed income security given a change in interest rates. Convexity is a second approximation of expected price change given a change in market interest rates. Mortgage-backed securities generally have negative convexity meaning that the value of the security will rise less following a decline in interest rates than the value will fall following an increase in interest rates. We employ various financial models to measure the duration and convexity of our portfolio and utilize the outputs of such models in our attempt to control interest rate risk.

Our analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by our management may produce results that differ significantly from the estimates and assumptions used in our models and the projected results shown in the above tables and in this report. These analyses contain certain forward-looking statements and are subject to the safe harbor statement set forth under the heading, "Special Note Regarding Forward-Looking Statements."

ITEM 4 CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act) as of the end of the period covered by this quarterly report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, (1) were effective in ensuring that information regarding the Company and its subsidiaries is accumulated and communicated to our management, including our CEO and CFO, by our employees, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in providing reasonable assurance that information the Company must disclose in its periodic reports under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods prescribed by the SEC's rules and forms.

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2013 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time-to-time, we are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on our consolidated financial statements.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors disclosed in Item 1A – Risk Factors of our most recent Annual Report on Form 10-K. The materialization of any risks and uncertainties identified in our Special Note Regarding Forward-Looking Statements contained in this report together with those previously disclosed in our most recent Annual Report on Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations – Special Note Regarding Forward-Looking Statements" in this quarterly report or our most recent Annual Report on Form 10-K.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On October 16, 2012 we announced that our Board of Directors authorized the repurchase of up to $1.5 billion of our outstanding common shares over a 12 month period. There were also no purchases made by or on behalf of us or any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934, as amended), of our common stock during the quarter ended June 30, 2013. At June 30, 2013, the maximum dollar value of shares that may yet be purchased under this plan was $1.1 billion.

ITEM 5. OTHER INFORMATION

On August 7, 2013, our board of directors adopted an amendment to our amended and restated bylaws that requires that any of the following four types of litigation be brought in the Circuit Court for Baltimore City, Maryland (or, if that court does not have jurisdiction, the United States District Court for the District of Maryland, Baltimore Division): (a) a derivative lawsuit; (b) an action asserting breach of fiduciary duty; (c) an action pursuant to any provision of the Maryland General Corporation Law; and (d) any other action asserting a claim governed by the internal affairs doctrine.

ITEM 6. EXHIBITS

Exhibits:

The exhibits required by this item are set forth on the Exhibit Index attached hereto.

Exhibit Number	Exhibit Description
3.1	Articles of Amendment and Restatement of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant’s Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on August 5, 1997).
3.2	Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant’s Registration Statement on Form S-3 (Registration Statement 333-74618) filed with the Securities and Exchange Commission on June 12, 2002).
3.3	Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K (filed with the Securities and Exchange Commission on August 3, 2006).
3.4	Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.4 of the Registrant's Quarterly Report on Form 10-Q (filed with the Securities and Exchange Commission on May 7, 2008).
3.5	Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K (filed with the Securities and Exchange Commission on June 23, 2011).
3.6	Form of Articles Supplementary designating the Registrant’s 7.875% Series A Cumulative Redeemable Preferred Stock, liquidation preference $25.00 per share (incorporated by reference to Exhibit 3.3 to the Registrant’s Registration Statement on Form 8-A filed April 1, 2004).
3.7	Articles Supplementary of the Registrant’s designating an additional 2,750,000 shares of the Company’s 7.875% Series A Cumulative Redeemable Preferred Stock, as filed with the State Department of Assessments and Taxation of Maryland on October 15, 2004 (incorporated by reference to Exhibit 3.2 to the Registrant’s Current Report on Form 8-K filed with the Securities and Exchange Commission on October 4, 2004).

3.8	Articles Supplementary designating the Registrant's 6% Series B Cumulative Convertible Preferred Stock, liquidation preference $25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed April 10, 2006).

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3.9	Articles Supplementary designating the Registrant’s 7.625% Series C Cumulative Redeemable Preferred Stock, liquidation preference $25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant’s Current Report on Form 8-K filed May 16, 2012).
3.10	Articles Supplementary designating the Registrant’s 7.50% Series D Cumulative Redeemable Preferred Stock, liquidation preference $25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant’s Current Report on Form 8-K filed September 13, 2012).
3.11	Amended and Restated Bylaws of the Registrant, as amended (incorporated by reference to Exhibit 3.1 to the Registrant’s Current Report on Form 8-K filed with the Securities and Exchange Commission on March 22, 2011).
3.12	Amendment to the Amended and Restated Bylaws of the Registrant.
4.1	Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the Registrant’s Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on September 17, 1997).
4.2	Specimen Preferred Stock Certificate (incorporated by reference to Exhibit 4.2 to the Registrant’s Registration Statement on Form S-3 (Registration No. 333-74618) filed with the Securities and Exchange Commission on December 5, 2001).
4.3	Specimen Series A Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on April 1, 2004).
4.4	Specimen Series B Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant’s Current Report on Form 8-K filed with the Securities and Exchange Commission on April 10, 2006).
4.5	Specimen Series C Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant’s Form 8-K filed with the Securities and Exchange Commission on May 16, 2012).
4.6	Specimen Series D Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant’s Form 8-K filed with the Securities and Exchange Commission on September 13, 2012).
4.7	Indenture, dated as of February 12, 2010, between the Registrant and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.1 to the Registrant’s Form 8-K filed with the Securities and Exchange Commission on February 12, 2010).
4.8	Supplemental Indenture, dated as of February 12, 2010, between the Registrant and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.2 to the Registrant’s Form 8-K filed with the Securities and Exchange Commission on February 12, 2010).
4.9	Form of 4.00% Convertible Senior Note due 2015 (included in Exhibit 4.6).
4.10	Second Supplemental Indenture, dated as of May 14, 2012, between the Registrant and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.2 to the Registrant’s Form 8-K filed with the Securities and Exchange Commission on May 14, 2012).
4.11	Form of 5.00% Convertible Senior Note due 2015 (included in Exhibit 4.10).
31.1	Certification of Wellington J. Denahan, Chairman and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Kathryn Fagan, Chief Financial Officer and Treasurer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1	Certification of Wellington J. Denahan, Chairman and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Kathryn Fagan, Chief Financial Officer and Treasurer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 101.INS XBRL	Instance Document*
Exhibit 101.SCH XBRL	Taxonomy Extension Schema Document*
Exhibit 101.CAL XBRL	Taxonomy Extension Calculation Linkbase Document*
Exhibit 101.DEF XBRL	Additional Taxonomy Extension Definition Linkbase Document Created*
Exhibit 101.LAB XBRL	Taxonomy Extension Label Linkbase Document*
Exhibit 101.PRE XBRL	Taxonomy Extension Presentation Linkbase Document*

* Submitted electronically herewith. Attached as Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition at June 30, 2013 (Unaudited) and December 31, 2012 (Derived from the audited Consolidated Statement of Financial Condition at December 31, 2012); (ii) Consolidated Statements of Operations and Comprehensive Income (Loss) (Unaudited) for the quarters and six months ended June 30, 2013 and 2012; (iii) Consolidated Statement of Stockholders' Equity (Unaudited) for the six months ended June 30, 2013 and 2012; (iv) Consolidated Statements of Cash Flows (Unaudited) for the quarters and six months ended June 30, 2013 and 2012; and (v) Notes to Consolidated Financial Statements (Unaudited). Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, in the city of New York, State of New York.

	ANNALY CAPITAL MANAGEMENT, INC.
Dated: August 8, 2013	By: /s/ Wellington J. Denahan Wellington J. Denahan (Chief Executive Officer, and authorized officer of registrant)
Dated: August 8, 2013	By: /s/ Kathryn Fagan Kathryn Fagan (Chief Financial Officer and Treasurer and principal financial and chief accounting officer)

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