

MCF CORP  
Form 10-Q  
May 05, 2005

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**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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

**For the quarterly period ended March 31, 2005**

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

**For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 1-15831**

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**MCF CORPORATION  
(Exact Name of Registrant as Specified in its Charter)**

**Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)**

**600 California Street, 9th Floor  
San Francisco, CA  
(Address of Principal Executive Offices)**

**11-2936371  
(I.R.S. Employer  
Identification No.)**

**94108  
(Zip Code)**

**(415) 248-5600  
(Registrant's Telephone Number, Including Area Code)**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes  No

The number of shares of Registrant's common stock outstanding as of May 5, 2005 was 70,572,207.

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**Form 10-Q**  
**For the Three Months Ended March 31, 2005**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements (unaudited)**

**MCF CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(unaudited)**

|  | <b>Three Months Ended March 31,</b> |                     |
|--|-------------------------------------|---------------------|
|  | <b>2005</b>                         | <b>2004</b>         |
| <b>Revenue:</b>                                    |                                     |                     |
| Commissions  | \$ 6,021,963                        | \$ 5,906,064        |
| Principal transactions                             | (373,142)                           | 624,478             |
| Investment banking                                 | 6,758,810                           | 4,687,694           |
| Other  | 65,485                              | 4,040               |
| <b>Total revenue</b>                               | <b>12,473,116</b>                   | <b>11,222,276</b>   |
| <b>Operating expenses:</b>                         |                                     |                     |
| Compensation and benefits                          | 9,201,965                           | 7,601,180           |
| Brokerage and clearing fees                        | 521,718                             | 717,549             |
| Professional services                              | 271,426                             | 254,498             |
| Occupancy and equipment                            | 349,959                             | 152,271             |
| Communications and technology                      | 423,424                             | 265,280             |
| Depreciation and amortization                      | 105,749                             | 23,940              |
| Other  | 723,116                             | 518,035             |
| <b>Total operating expenses</b>                    | <b>11,597,357</b>                   | <b>9,532,753</b>    |
| Operating income                                   | 875,759                             | 1,689,523           |
| Interest income                                    | 74,827                              | 10,022              |
| Interest expense                                   | (17,187)                            | (58,676)            |
| Income before income taxes                         | 933,399                             | 1,640,869           |
| Income tax expense                                 | (284,974)                           | (396,448)           |
| <b>Net income</b>                                  | <b>\$ 648,425</b>                   | <b>\$ 1,244,421</b> |
| <b>Earnings per share:</b>                         |                                     |                     |
| Basic  | \$ 0.01                             | \$ 0.02             |
| Diluted  | \$ 0.01                             | \$ 0.02             |
| <b>Weighted average common shares outstanding:</b> |                                     |                     |
| Basic  | 65,508,467                          | 54,758,184          |
| Diluted  | 85,485,222                          | 79,879,489          |

The accompanying notes are an integral part of these condensed consolidated financial statements.



**MCF CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
**(unaudited)**

|  | March 31,<br>2005    | December 31,<br>2004 |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| Cash and cash equivalents  | \$ 17,450,276        | \$ 17,459,113        |
| Securities owned:  |                      |                      |
| Marketable, at fair value  | 3,778,321            | 2,342,225            |
| Not readily marketable, at estimated fair value  | 188,264              | 259,340              |
| Restricted cash  | 625,000              | 625,000              |
| Due from clearing broker   | 1,043,752            | 787,862              |
| Accounts receivable, net   | 1,533,946            | 1,579,393            |
| Equipment and fixtures, net  | 1,300,524            | 1,032,797            |
| Intangible assets  | 404,855              | —                    |
| Prepaid expenses and other assets  | 843,387              | 922,094              |
| <b>Total assets</b>  | <b>\$ 27,168,325</b> | <b>\$ 25,007,824</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                      |                      |
| Accounts payable   | \$ 592,576           | \$ 431,656           |
| Commissions payable  | 4,074,728            | 2,840,239            |
| Accrued liabilities  | 2,059,042            | 2,962,660            |
| Due to clearing and other brokers  | 110,638              | 99,205               |
| Securities sold, not yet purchased   | 10,278               | —                    |
| Deferred revenue   | 42,909               | —                    |
| Capital lease obligation   | 494,481              | 452,486              |
| Convertible notes payable, net   | 168,989              | 166,404              |
| Notes payable  | 1,299,270            | 1,321,324            |
| <b>Total liabilities</b>   | <b>8,852,911</b>     | <b>8,273,974</b>     |
| <b>Commitments and contingencies</b>   |                      |                      |
| <b>Stockholders' equity:</b>   |                      |                      |
| Preferred stock, Series A—\$0.0001 par value; 2,000,000 shares authorized; 0 shares issued and outstanding as of March 31, 2005 and December 31, 2004, respectively; aggregate liquidation preference of \$0     | —                    | —                    |
| Preferred stock, Series B—\$0.0001 par value; 12,500,000 shares authorized; 8,750,000 shares issued and 0 shares outstanding as of March 31, 2005 and December 31, 2004; aggregate liquidation preference of \$0 | —                    | —                    |
| Preferred stock, Series C—\$0.0001 par value; 14,200,000 shares authorized; 11,800,000 shares issued and 0 shares outstanding as of March 31, 2005 and December 31, 2004; aggregate liquidation                  | —                    | —                    |

preference of \$0

|   |               |               |
|---|---------------|---------------|
| Common stock, \$0.0001 par value; 300,000,000 shares authorized;<br>70,513,618 and 68,648,627 shares issued and outstanding as of March<br>31, 2005 and December 31, 2004, respectively | 7,051         | 6,865         |
| Additional paid-in capital  | 111,215,427   | 108,558,892   |
| Deferred compensation   | (4,887,458)   | (3,163,876)   |
| Accumulated deficit   | (88,019,606)  | (88,668,031)  |
| Total stockholders' equity  | 18,315,414    | 16,733,850    |
| Total liabilities and stockholders' equity  | \$ 27,168,325 | \$ 25,077,824 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**MCF CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited)

|  | <b>Three Months Ended March 31,</b> |              |
|--|-------------------------------------|--------------|
|  | <b>2005</b>                         | <b>2004</b>  |
| <b>Cash flows from operating activities:</b>   |                                     |              |
| Net income   | \$ 648,425                          | \$ 1,244,421 |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                                     |              |
| Depreciation and amortization  | 105,749                             | 23,940       |
| Stock-based compensation   | 525,670                             | 159,166      |
| Stock warrants issued  | —                                   | 9,849        |
| Tax benefits from employee stock options   | 62,359                              | —            |
| Amortization of discounts on convertible notes payable                                   | 2,585                               | 26,016       |
| Amortization of debt issuance costs  | —                                   | 23,340       |
| Unrealized (gain) loss on securities   | 40,720                              | (141,519)    |
| Common stock and stock warrants received for investment banking services                 | —                                   | (456,683)    |
| Other  | —                                   | 4,371        |
| <b>Changes in operating assets and liabilities:</b>                                      |                                     |              |
| Marketable securities owned  | (1,395,462)                         | (452,507)    |
| Due from clearing broker   | (255,890)                           | (485,458)    |
| Accounts receivable  | 45,447                              | (229,042)    |
| Prepaid expenses and other assets  | 96,858                              | 51,744       |
| Accounts payable   | 159,825                             | 126,199      |
| Commissions payable  | 1,234,489                           | 1,367,912    |
| Accrued liabilities  | (924,639)                           | 864,607      |
| Deferred revenue   | (19,520)                            | —            |
| Due to clearing and other brokers  | 11,433                              | (8,466)      |
| Net cash provided by operating activities  | 338,049                             | 2,127,890    |
| <b>Cash flows from investing activities:</b>   |                                     |              |
| Purchase of equipment and fixtures   | (282,886)                           | (17,481)     |
| Investment in Catalyst   | (345,368)                           | —            |
| Net cash used in investing activities  | (628,254)                           | (17,481)     |
| <b>Cash flows from financing activities:</b>   |                                     |              |
| Proceeds from the exercise of stock options and warrants                                 | 20,001                              | 629,760      |
| Proceeds from the issuance of common stock   | 325,109                             | 455,789      |
| Debt service payments  | (63,742)                            | (23,032)     |
| Net cash provided by financing activities  | 281,368                             | 1,062,517    |
| Increase (decrease) in cash and cash equivalents   | (8,837)                             | 3,172,926    |
| Cash and cash equivalents at beginning of period   | 17,459,113                          | 6,142,958    |
| Cash and cash equivalents at end of period   | \$ 17,450,276                       | \$ 9,315,884 |
| <b>Supplementary disclosure of cash flow information:</b>                                |                                     |              |
| <b>Cash paid during the period:</b>  |                                     |              |
| Interest   | \$ 13,047                           | \$ 22,570    |



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|  |    |           |    |         |
|--|----|-----------|----|---------|
| Income taxes   | \$ | 49,000    | \$ | 120,800 |
| Non-cash investing and financing activities:               |    |           |    |         |
| Preferred stock dividends                                  | \$ | —         | \$ | 10,985  |
| Issuance of restricted stock                               | \$ | 2,249,252 | \$ | 294,294 |
| Issuance of stock options accounted for at intrinsic value | \$ | —         | \$ | 123,250 |
| Conversion of notes payable to common stock                | \$ | —         | \$ | 150,000 |
| Purchase of equipment and fixtures on capital lease        | \$ | 80,168    | \$ | 90,890  |
| Acquisition of Catalyst                                    | \$ | 59,487    | \$ | —       |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**MCF CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**1. Significant Accounting Policies**

*Basis of Presentation*

The interim financial statements included herein for MCF Corporation, or the Company, have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the financial statements included in this report reflect all normal recurring adjustments that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial position of the Company at the date of the interim statement of financial condition. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to understand the information presented. The operating results for interim periods are not necessarily indicative of the operating results for the entire year. These financial statements should be read in conjunction with the Company's 2004 audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

*Commission and Principal Transaction Revenue*

Commission revenue includes revenue resulting from executing stock exchange-listed securities, over-the counter securities and other transactions as agent for the Company's clients. Principal transactions consist of a portion of dealer spreads attributed to the Company's securities trading activities as principal in NASDAQ-listed and other securities, and include transactions derived from activities as a market-maker. Additionally, principal transactions include gains and losses resulting from market price fluctuations that occur while holding positions in trading security inventory. Revenue generated from trading activities and related expenses are recorded on a trade date basis.

*Investment Banking Revenue*

Investment banking revenue consists of fees earned from private placements, mergers and acquisitions, management fees for underwritten offerings, financial restructurings and other advisory services provided to clients. Investment banking fees are recorded as revenue when the related service has been rendered, the client is contractually obligated to pay, and its collection is probable. Certain fees for services rendered are recognized as revenue over the service period. As co-manager for registered equity underwriting transactions, management must estimate the Company's share of transaction related expenses incurred by the lead manager in order to recognize revenue. Transaction related expenses are deducted from the underwriting fee and therefore reduces the revenue that is recognized as co-manager. Such amounts are adjusted to reflect actual expenses in the period in which the Company receives the final settlement, typically 90 days following the closing of the transaction.

*Stock-Based Compensation*

The Company uses the intrinsic value-based method in accordance with Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, to account for employee stock-based compensation. Accordingly, compensation cost is recorded on the date of grant to the extent the fair value of the underlying share of common stock exceeds the exercise price for a stock option or the purchase price for a share of common stock. Such compensation cost is amortized on a straight-line basis over the vesting period of the individual award. Pursuant to

Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock-Based Compensation*, the Company discloses the pro forma effect of using the fair value method of accounting for employee stock-based compensation. Stock-based awards granted to nonemployees are accounted for pursuant to the fair value method in SFAS No. 123 and Issue No. 96-18 of the Emerging Issues Task Force. The associated expense is measured and recognized by the Company over the period the services are performed by the nonemployee.

In December 2004, the FASB issued its final standard on accounting for share-based payments, SFAS 123R, *Share-Based Payment*, which addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25 and requires instead that such transactions be accounted for using a fair-value-based method. The effective date of SFAS 123R is the beginning of the first annual reporting period that begins after June 15, 2005. Early adoption of SFAS 123R is allowed.

The Company has elected to continue to account for its stock-based compensation in accordance with the provisions of APB Opinion No. 25 as interpreted by FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, and will implement SFAS 123R effective January 1, 2006. The Company expects the adoption of SFAS 123R will have a material impact on the Company's financial position and results of operations.

**MCF CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—CONTINUED**  
**(unaudited)**

If the Company was to recognize compensation expense over the relevant service period under the fair value method with respect to stock options granted for the three months ended March 31, 2005 and all prior periods, net income would have changed, resulting in pro forma net income and pro forma net income per share as presented below:

|  | <b>Three Months Ended March 31,</b> |                   |
|--|-------------------------------------|-------------------|
|  | <b>2005</b>                         | <b>2004</b>       |
| Net income, as reported  | \$ 648,425                          | \$ 1,244,421      |
| Add: Stock-based employee compensation expense included in the reported net income | 19,203                              | 36,849            |
| Less: Stock-based employee compensation expense determined under fair value method | (330,844)                           | (403,127)         |
| <b>Pro forma net income</b>  | <b>\$ 336,784</b>                   | <b>\$ 878,143</b> |
|  |                                     |                   |
| Net income per share, as reported:   |                                     |                   |
| Basic  | \$ 0.01                             | \$ 0.02           |
| Diluted  | \$ 0.01                             | \$ 0.02           |
| Net income per share, pro forma:   |                                     |                   |
| Basic  | \$ 0.01                             | \$ 0.02           |
| Diluted  | \$ 0.00                             | \$ 0.01           |

The above pro forma disclosures are not necessarily representative of the effects on reported net income or loss for future years.

*Reclassification*

Certain prior year amounts have been reclassified to conform to current year consolidated financial statement presentation.

**MCF CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—CONTINUED**  
**(unaudited)**

**2. Net Income per Share**

The following is a reconciliation of the basic and diluted net income available to common stockholders and the number of shares used in the basic and diluted net income per common share computations for the periods presented:

|  | <b>Three Months Ended March 31,</b> |              |
|--|-------------------------------------|--------------|
|  | <b>2005</b>                         | <b>2004</b>  |
| Net income   | \$ 648,425                          | \$ 1,244,421 |
| Preferred stock dividends  | —                                   | (10,985)     |
| Net income (loss) available to common stockholders - basic                   | 648,425                             | 1,233,436    |
| Interest and dividends on dilutive securities                                | 4,084                               | 10,211       |
| Net income (loss) available to common stockholders - diluted                 | \$ 652,509                          | \$ 1,243,647 |
| Weighted-average number of common shares - basic                             | 65,508,467                          | 54,758,184   |
| Exercise or conversion of all potentially dilutive common shares outstanding | 19,976,755                          | 25,121,305   |
| Weighted-average number of common shares - diluted                           | 85,485,222                          | 79,879,489   |
| Basic net income (loss) per share  | \$ 0.01                             | \$ 0.02      |
| Diluted net income (loss) per share  | \$ 0.01                             | \$ 0.02      |

Basic earnings per share is computed by dividing net income, less dividends on preferred stock, by the weighted average number of common shares outstanding, excluding unvested restricted stock. Diluted earnings per share is calculated by dividing net income, less dividends on preferred stock plus interest and dividends on dilutive securities, by the weighted average number of common shares used in the basic earnings per share calculation plus the number of common shares that would be issued assuming exercise or conversion of all potentially dilutive common shares outstanding, including unvested restricted stock.

Shares used in the diluted net income per share computation in the above table include the dilutive impact of the Company's stock options and warrants. The impact of the Company's stock options and warrants on shares used for the diluted earnings per share computation is calculated based on the average share price of the Company's common stock for each period using the treasury stock method. Under the treasury stock method, the tax-effected proceeds that would be hypothetically received from the exercise of all stock options and warrants with exercise prices below the average share price of the Company's common stock are assumed to be used to repurchase shares of the Company's common stock. The dilutive impact of the Company's stock options was calculated using an average price of the Company's common stock of \$1.61 and \$1.74 per share for the three months ended March 31, 2005 and 2004, respectively.

**MCF CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—CONTINUED**  
**(unaudited)**

The Company excludes all potentially dilutive securities from its diluted net income per share computation when their effect would be anti-dilutive. The following common stock equivalents were excluded from the earnings per share computation, as their inclusion would have been anti-dilutive:

|  | <b>Three Months Ended March 31,</b> |                  |
|--|-------------------------------------|------------------|
|  | <b>2005</b>                         | <b>2004</b>      |
| Stock options and warrants excluded due to the exercise price exceeding the average fair value of the Company's common stock during the period | 6,083,359                           | 6,516,220        |
| Weighted average shares issuable upon conversion of the convertible notes payable  | —                                   | 96,525           |
| Weighted average shares issuable upon conversion of the convertible preferred stock  | —                                   | 141,565          |
| <b>Total common stock equivalents excluded from diluted net income (loss) per share</b>  | <b>6,083,359</b>                    | <b>6,754,310</b> |

### **3. Regulatory Requirements**

Merriman Curhan Ford & Co. is a broker-dealer subject to Rule 15c3-1 of the Securities and Exchange Commission, which specifies uniform minimum net capital requirements, as defined, for their registrants. As of March 31, 2005, Merriman Curhan Ford & Co. had regulatory net capital, as defined, of \$12,087,000, which exceeded the amount required by \$11,542,000. Merriman Curhan Ford & Co. is exempt from Rules 15c3-3 and 17a-13 under the Securities Exchange Act of 1934 because it does not carry customer accounts, nor does it hold customer securities or cash.

### **4. Acquisition of Catalyst Financial Planning and Investment Management, Inc.**

On February 28, 2005, the Company acquired Catalyst Financial Planning & Investment Management, Inc., or Catalyst, a registered investment advisor with over \$100 million in assets under management. This is the Company's first acquisition of a registered investment advisor as the Company executes on its plan to build a fee-based, recurring revenue business to complement the cyclical nature of the investment banking and institutional sales and trading businesses. The Company creates liquidity for the founders and executives of its corporate clients through open market sales, private placements and underwritings. The Company intends to offer personalized financial planning and wealth management to these clients. The Company plans to introduce new potential clients to Catalyst from the corporate and venture services group as well as the investment banking department.

The purchase consideration for Catalyst consists of both cash and common stock that will be paid over a three year period. The Company paid to the sole shareholder of Catalyst, or Catalyst Shareholder, \$330,433 as initial consideration at the closing. The Company has also agreed to issue to the Catalyst Shareholder up to 925,325 shares of common stock over three years based upon amount of revenue growth for Catalyst. The payment of these shares is subject to specified conditions. Such additional amounts will be recorded, if any, when such amounts become due. The Company acquired 100% of the voting stock in Catalyst. The results of operations for Catalyst are included in the Company's consolidated financial statements beginning March 1, 2005.

### **5. Income Taxes**

The effective tax rate for the three months ended March 31, 2005 and 2004 was approximately 31% and 24%. The effective tax rate for 2005 and 2004 reflects the utilization of approximately \$2,056,000 of the Company's net operating loss carryforwards.

## **6. Subsequent Events**

On May 4, 2005, MCF Corporation entered into a strategic alliance with Ascend Services Ltd., or Ascend. In conjunction with this alliance, Ascend has entered into a stock purchase agreement with the Company. Ascend has also engaged the Company as an investment advisor for its short-term high credit-quality portfolio. The Company issued 1,078,749 shares of its common stock and Ascend has issued an unsecured promissory note payable to the Company in the amount of \$1.5 million. The shares will be held initially in escrow. Upon Ascend achieving specified milestones, the 1,078,749 shares of common stock will be released from escrow in three installments of 359,583 shares and provided to Ascend. Upon satisfaction of the conditions specified in the escrow agreement and simultaneous with the release of the related stock certificates, the related amount of the promissory note shall become effective and start accruing interest. The promissory note accrues interest at 10% per annum and matures on February 28, 2006. The securities described in this paragraph: (i) were issued to a private investor without the involvement of underwriters; (ii) were issued in reliance on the exemption from registration requirements contained in Section 4(2) of the Securities Act of 1933; and (iii) carried certain registration rights.

## **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Quarterly Report on Form 10-Q, including this Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements regarding future events and our future results that are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as "may," "will," "should," "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "predicts," "potential" or "continue," variations of such words, similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances, are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are referred to risks and uncertainties identified under "Risk Factors" beginning on Page 14 and elsewhere herein. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

### **Company Overview**

MCF Corporation is a financial services holding company that provides investment research, capital markets services, asset management, wealth management, corporate and venture services, and investment banking through its operating subsidiaries, Merriman Curhan Ford & Co., MCF Asset Management, LLC, and MCF Wealth Management, LLC. MCF Asset Management, LLC and MCF Wealth Management, LLC are two recently formed businesses that are predicated on fee-based, recurring revenue models.

Merriman Curhan Ford & Co. is a securities broker-dealer and investment bank focused on fast-growing companies and growth-oriented institutional investors. It provides investment research, brokerage and trading services primarily to institutions, as well as advisory and investment banking services to corporate clients. Its mission is to become a leader in the researching, advising, financing and trading of fast growing companies. Merriman Curhan Ford & Co. is registered with the Securities and Exchange Commission as a broker-dealer and is a member of the National Association of Securities Dealers, Inc. and Securities Investors Protection Corporation.

### **Business Environment**

The first quarter of 2005 was difficult for the equity markets. With the exception of energy and commodity related industries, stocks struggled with most yielding their gains of the fourth quarter 2004. Commodities as measured by the Commodity Research Bureau index spiked up during the quarter rising more than 10%. The Federal Open Market Committee, or FOMC, grew increasingly fixated on inflation risk and continued to hike the Fed Funds target rate. There has been little in the high frequency economic data points to suggest that the FOMC should be prepared to stand down from their attack on higher inflationary expectations. The futures market discounts another 100 basis points of tightening in the funds rate by year end. With short term rates climbing steadily and energy prices remaining stubbornly high, it has been a hard slog for equity bulls. The window for companies to access the capital markets was open to most worthy borrowers in the first quarter but it appears as though investor appetite for risk is waning. The prospective downgrade of credit ratings for the major auto manufacturers is putting unwanted additional stress on the system. In sum, the challenges for the financial markets continue to mount as we enter the second quarter and rising volatility and uncertainty seem to be part of the picture for the near term.

Our securities broker-dealer and investment banking activities are linked to the capital markets. In addition, our business activities are focused in the consumer growth, healthcare, specialty growth and technology sectors. By their nature, our business activities are highly competitive and are not only subject to general market conditions, volatile



trading markets and fluctuations in the volume of market activity, but also to the conditions affecting the companies and markets in our areas of focus.

Fluctuations in revenue also occur due to the overall level of market activity, which, among other things, affects the flow of investment dollars and the size, number and timing of investment banking transactions. In addition, a downturn in the level of market activity can lead to a decrease in brokerage commissions. Therefore, revenue in any particular period may vary significantly from year to year.

## Executive Overview

Revenue recognized in the first quarter 2005 was \$12,473,000, the highest quarterly level in our history. We increased our revenue by 11% over the first quarter 2004, despite a difficult business environment for both the fast growing companies that we serve and the institutions that invest in them. The increase in our first quarter revenue over 2004 reflects continued growth in our core businesses. We earned \$0.01 per diluted share for the three months ended March 31, 2005, compared to \$0.02 during the first quarter 2004. Our profitability was negatively impacted during 2005 by losses incurred on security positions held in connection with our proprietary trading and market making activities. Our financial condition continued to strengthen during the first quarter 2005 with stockholders' equity exceeding \$18,315,000 as of March 31, 2005.

Also during the first quarter 2005, we acquired Catalyst Financial Planning & Investment Management, Inc., or Catalyst, a registered investment advisor with over \$100 million in assets under management. This is our first acquisition of a registered investment advisor as we execute on our plan to build a fee-based, recurring revenue business to complement the cyclical nature of the investment banking and institutional sales and trading businesses.

Though our operating results were positive during the first quarter 2005, our business, by its nature, does not produce predictable earnings. Our results in any given period can be materially affected by conditions in global financial markets and economic conditions generally.

## Results of Operations

The following table sets forth a summary of financial highlights for the three months ended March 31, 2005 and 2004:

|  | <b>Three Months Ended March 31,</b> |               |
|--|-------------------------------------|---------------|
|  | <b>2005</b>                         | <b>2004</b>   |
| Total revenue                            | \$ 12,473,116                       | \$ 11,222,276 |
| Total operating expenses                 | 11,597,357                          | 9,532,753     |
| Operating income                         | 875,759                             | 1,689,523     |
| Net income                               | 648,425                             | 1,244,421     |
| EBITDA                                   | 1,507,178                           | 1,882,478     |
| Adjustments:                             |                                     |               |
| Interest income                          | 74,827                              | 10,022        |
| Interest expense                         | (17,187)                            | (58,676)      |
| Income tax expense                       | (284,974)                           | (396,448)     |
| Depreciation and amortization            | (105,749)                           | (23,940)      |
| Amortization of stock-based compensation | (525,670)                           | (169,015)     |
| Net income                               | \$ 648,425                          | \$ 1,244,421  |

Our revenue during the first quarter 2005 increased \$1,251,000, or 11%, from the corresponding period in 2004 reflecting the overall growth of our investment banking and broker-dealer activities. Net income, however, decreased by \$596,000, or 48%, during the first quarter 2005 as compared to the first quarter 2004. Our revenue and profitability in 2005 reflected \$773,000 of losses incurred on equity security positions held in connection with our proprietary trading and market making activities. We recognized \$165,000 in gains on security positions held during the first quarter 2004. Earnings before interest, taxes, depreciation and amortization, or EBITDA, for the first three months of 2005 were \$1,507,000. The decline in EBITDA in first quarter 2005 as compared to first quarter 2004 was limited to \$375,000, or 20%, despite the \$938,000 swing in trading losses in 2005.

EBITDA (earnings before interest, taxes, depreciation and amortization) is a key metric we use in evaluating our financial performance. EBITDA is considered a non-GAAP financial measure as defined by Regulation G promulgated by the SEC pursuant to the Securities Act of 1933, as amended. We consider EBITDA an important measure of our ability to generate cash flows to service debt, fund capital expenditures and fund other corporate investing and financing activities. EBITDA eliminates the non-cash effect of tangible asset depreciation and intangible stock-based amortization. EBITDA should be considered in addition to, rather than as a substitute for, pre-tax income, net income and cash flows from operating activities.

**Commissions and Principal Transactions Revenue**

Our broker-dealer activity includes the following:

- Agency Commissions - Agency commissions include revenue resulting from executing stock trades for exchange-listed securities, over-the-counter securities and other transactions as agent.
- Principal Transactions - Principal transactions consist of a portion of dealer spreads attributed to our securities trading activities as principal in NASDAQ-listed and other securities, and include transactions derived from our activities as a market-maker. Additionally, principal transactions include gains and losses resulting from market price fluctuations that occur while holding positions in our trading security inventory.

The following table sets forth our revenue and several operating metrics which we utilize in measuring and evaluating performance and the results of our trading activity operations:

|  | <b>Three Months Ended March 31,</b> |              |
|--|-------------------------------------|--------------|
|  | <b>2005</b>                         | <b>2004</b>  |
| <b>Revenue:</b>  |                                     |              |
| Commissions  | \$ 6,021,963                        | \$ 5,906,064 |
| <b>Principal transactions:</b>   |                                     |              |
| Customer principal transactions, proprietary trading and market making | (530,719)                           | 498,177      |
| Investment portfolio   | 157,577                             | 126,301      |
| Total principal transactions revenue                                   | \$ (373,142)                        | \$ 624,478   |
| <b>Transaction Volumes:</b>  |                                     |              |
| Number of shares traded  | 220,949,930                         | 209,726,680  |
| Number of active clients   | 385                                 | 337          |

Agency commissions amounted to \$6,022,000, or 48%, of our revenue during the first three months of 2005, representing a 2% increase over \$5,906,000 recognized during the first three months of 2004. The higher agency commissions were primarily attributed to the hiring of additional sales and research professionals and an increase in the number of active client accounts during 2005 as compared to 2004. During the first quarter of 2005 and 2004, no single brokerage customer accounted for more than 10% of our revenue.

Principal transactions revenue, including market making and proprietary trading for our own account, amounted to (\$373,000), or (3%), of our revenue during the first quarter 2005, representing a 160% decrease compared to \$624,000 recognized during the first quarter 2004. We incurred losses on equity security positions held in connection with our proprietary trading and market making activities during the period. These security positions result from proprietary trading which is speculative in nature and market making activities to facilitate customer order flow. Additionally, our investment portfolio, which primarily consists of stock warrants and restricted common stock that we earn in connection with our investment banking activity, increased in value during the first quarter 2005.

**Investment Banking Revenue**

Our investment banking activity includes the following:

- Capital Raising - Capital raising includes private placements of equity and debt instruments and underwritten public offerings.
- Financial Advisory. Financial advisory includes advisory assignments with respect to mergers and acquisitions, divestitures, restructurings and spin-offs.

The following table sets forth our revenue and transaction volumes from our investment banking activities during the three months ended March 31, 2005 and 2004:

|   | <b>Three Months Ended March 31,</b> |                     |
|---|-------------------------------------|---------------------|
|   | <b>2005</b>                         | <b>2004</b>         |
| <b>Revenue:</b>                         |                                     |                     |
| Capital raising                         | \$ 6,593,685                        | \$ 4,199,058        |
| Financial advisory                      | 165,125                             | 488,636             |
| <b>Total investment banking revenue</b> | <b>\$ 6,758,810</b>                 | <b>\$ 4,687,694</b> |
| <b>Transaction Volumes:</b>             |                                     |                     |
| <b>Public offerings:</b>                |                                     |                     |
| Capital underwritten                    | 66,225,000                          | 43,010,000          |
| Number of transactions                  | 2                                   | 1                   |
| <b>Private placements:</b>              |                                     |                     |
| Capital raised                          | 183,994,000                         | 74,400,000          |
| Number of transactions                  | 6                                   | 5                   |

Our investment banking revenue amounted to \$6,759,000, or 54% of our revenue during the first quarter 2005, representing a 44% increase compared to \$4,688,000 recognized during the first quarter 2004. The growth in our investment banking revenue during the first quarter 2005 reflected (i) the strong demand for private placement transactions, (ii) the hiring of experienced investment bankers during 2004 and 2005, and (iii) the increased awareness of our firm's ability to complete capital raising and financial advisory transactions for fast growing companies. During the first quarter 2005, two investment banking customers each accounted for more than 10% of our revenue, and combined accounted for 34%. During the first quarter 2004, one investment banking customer accounted for 11% of our revenue.

**Compensation and Benefits Expenses**

Compensation and benefits expense represents the majority of our operating expenses and includes base salaries and discretionary bonuses, as well as incentive compensation paid to sales and trading, and investment banking professionals. Incentive compensation varies primarily based on revenue production. Discretionary bonuses paid to research analysts also vary with commission revenue production but includes other qualitative factors as well. Salaries, payroll taxes and employee benefits are relatively fixed in nature.



The following table sets forth the major components of our compensation and benefits for the three months ended March 31, 2005 and 2004:

|  | <b>Three Months Ended March 31,</b> |                     |
|--|-------------------------------------|---------------------|
|  | <b>2005</b>                         | <b>2004</b>         |
| Incentive compensation and discretionary bonuses | \$ 5,820,297                        | \$ 5,629,860        |
| Salaries and wages                               | 1,989,976                           | 1,203,044           |
| Stock-based compensation                         | 525,670                             | 159,165             |
| Payroll taxes, benefits and other                | 866,022                             | 609,111             |
| <b>Total compensation and benefits</b>           | <b>\$ 9,201,965</b>                 | <b>\$ 7,601,180</b> |

The increase in compensation and benefits expense of \$1,601,000, or 21%, from the first three months of 2004 to the corresponding period in 2005 was due primarily to higher salaries and wages, non-cash stock-based compensation and incentive compensation which is directly correlated to revenue production. We have grown our headcount at a brisk but measured pace during 2004 and 2005. Our headcount has increased from 93 at March 31, 2004 to 132 at March 31, 2005. The increase in stock-based compensation during 2005 reflects our decision to grant restricted stock to new and existing employees. The amount of compensation and benefits that we incur during a given period is largely dependent upon the level of revenue recognized during that period, since most of our employees are paid based on a percentage of the revenue attributed to their efforts.

#### ***Other Operating Expenses***

Brokerage and clearing fees include trade processing expenses that we pay to our clearing broker and execution fees that we pay to floor brokers and electronic communication networks. Merriman Curhan Ford & Co. is a fully-disclosed broker-dealer, which has engaged a third party clearing broker to perform all of the clearance functions. The clearing broker-dealer processes and settles the customer transactions for Merriman Curhan Ford & Co. and maintains the detailed customer records. Additionally, security trades are executed by third-party broker-dealers and electronic trading systems. These expenses are almost entirely variable with commission revenue and the volume of brokerage transactions. Despite an increase in commission revenue, brokerage and clearing fees decreased by \$196,000, or 27% in the first quarter 2005 as compared to the first quarter 2004. This reflected the cost savings that we achieved by negotiating lower fees with our new clearing broker during the fourth quarter 2004.

Professional services expense includes legal fees, accounting fees, expenses related to investment banking transactions, consulting fees and recruiting fees. Many of these expenses, such as legal and accounting fees, are to a large extent fixed in nature. The increase of \$17,000 or 7%, from the first quarter 2004 to the first quarter 2005 was primarily attributed to increased regulatory fees assessed by the NASD.

Occupancy and equipment includes rental costs for our office facilities and equipment, as well as equipment, software and leasehold improvement expenses. These expenses are largely fixed in nature. The increase of \$198,000, or 130%, from the first quarter 2004 to the first quarter 2005 resulted mostly from high office rents. During 2004, we moved into larger office spaces in San Francisco, New York, Boston, Los Angeles and Portland to accommodate our growth in business and headcount.

Communications and technology expense includes voice, data and Internet service fees, and data processing costs. While variable in nature, these do not tend to vary with revenue. The increase of \$158,000, or 60%, from the first quarter 2004 to the first quarter 2005 was due to higher telephone and data service fees incurred in our sales and trading operations. The higher telephone and data service charges are the result of increased headcount and the expansion of our offices.

Depreciation and amortization expense primarily relate to the depreciation of our computer equipment and leasehold improvements. Depreciation and amortization is mostly fixed in nature. The increase of \$82,000, or 342%, from the first quarter 2004 to the first quarter 2005 was due to increased capital expenditures, including leasehold improvements, to facilitate our growth and expansion.

Other operating expense includes professional liability and property insurance, travel and entertainment, printing and copying, business licenses and taxes, office supplies and other miscellaneous office expenses. The increase of approximately \$205,000, or 40%, from the first quarter 2004 to the first quarter 2005 was attributed to higher recruiting costs, travel expenses, and various business taxes.

***Income Tax Expense***

The effective tax rate for the three months ended March 31, 2005 and 2004 was approximately 31% and 24%. The effective tax rate for 2005 and 2004 reflects the utilization of some of the Company's net operating loss carryforwards.

**Off-Balance Sheet Arrangements**

We were not a party to any off-balance sheet arrangements during the three years ended December 31, 2004. In particular, we do not have any interest in so-called limited purpose entities, which include special purpose entities and structured finance entities.



## **Critical Accounting Policies and Estimates**

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to the valuation of securities owned and deferred tax assets. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

### *Valuation of Securities Owned*

Securities owned that are not readily marketable are carried at fair value, with the accompanying gains and losses reflected in our results of operations. The fair value of securities, for which a quoted market or dealer price is not available, is based on management's estimates. Among the factors considered by management in determining the fair value of securities are the cost of the securities, terms and liquidity, developments since the acquisition of the securities, the sales price of recently issued securities, the financial condition and operating results of the issuer, earnings trends and consistency of operating cash flows, the long-term business potential of the issuer, the quoted market price of securities with similar quality and yield that are publicly traded, and other factors generally pertinent to the valuation of securities. The fair value of these securities is subject to a high degree of volatility and may be susceptible to significant fluctuation in the near term. Where available, we use prices from independent sources such as listed market prices or dealer quotations.

### *Revenue Recognition*

We recognize brokerage revenue once the trade is consummated and the earnings process is complete. Investment banking revenue consists of fees earned from private placements, mergers and acquisitions, management fees for underwritten offerings, financial restructurings and other advisory services provided to clients. Investment banking fees are recorded as revenue when the related service has been rendered, the client is contractually obligated to pay, and its collection is probable. Certain fees received in advance of services rendered are recognized as revenue over the service period. Transaction-related expenses to date have been expensed as incurred. As co-manager for registered equity underwriting transactions, we must estimate the transaction related expenses incurred by the lead manager in order to recognize revenue. Transaction related expenses are deducted from the underwriting fee and therefore reduces the revenue that we will recognize as co-manager. Such amounts are adjusted to reflect actual expenses in the period in which we receive the final settlement, typically 90 days following the closing of the transaction.

### *Stock-Based Compensation*

As part of our compensation of employees, we may use stock-based compensation, including stock options, restricted stock and other stock-based awards. Compensation related to restricted stock and other stock-based awards is amortized over the vesting period of the award, which is generally three to four years, and is included in our results of operations as compensation. Accounting principles generally accepted in the United States allow alternative methods of accounting for stock options, including an "intrinsic value" method and a "fair value" method. The intrinsic value method is intended to reflect the impact of stock options on stockholders based on the appreciation in the stock option over time, generally driven by financial performance. The fair value method requires an estimate of the value of stock options to be recognized as compensation over the vesting period of the awards. Currently, we use the intrinsic value method and do not recognize the impact of these awards as compensation expense. Accordingly, we provide disclosure of the impact of the estimated fair value of the stock options on our compensation and reported income in

the notes to the consolidated financial statements. In determining the estimated fair value of stock options, we use the Black-Scholes option-pricing model, which requires judgment regarding certain assumptions, including the expected life of the options granted, dividend yields and stock volatility.

*Deferred Tax Valuation Allowance*

We account for income taxes in accordance with the provision of SFAS No. 109, *Accounting for Income Taxes*, which requires the recognition of deferred tax assets and liabilities at tax rates expected to be in effect when these balances reverse. Future tax benefits attributable to temporary differences are recognized to the extent that the realization of such benefits is more likely than not. We have concluded that it is more likely than not that our deferred tax assets as of March 31, 2005 and 2004 will not be realized based on the scheduling of deferred tax liabilities and projected taxable income. The amount of the deferred tax assets actually realized, however, could vary if there are differences in the timing or amount of future reversals of existing deferred tax liabilities or changes in the actual amounts of future taxable income. Should we determine that we will be able to realize all or part of the deferred tax asset in the future, an adjustment to the deferred tax asset will be recorded in the period such determination is made.

## Liquidity and Capital Resources

Historically, we have satisfied our liquidity and regulatory capital needs through the issuance of equity and debt securities. During the three months ended March 31, 2005, we experienced positive cash flow provided by our operations and through proceeds from the exercise of stock options and stock warrants and from the issuance of common stock. This was partially offset by the proceeds used to purchase Catalyst Financial Planning & Investment Management, Inc. As of March 31, 2004, we had capital leases and long-term notes payable amounting to \$1,963,000, net of certain discounts.

Our principal assets consist of cash and cash equivalents, marketable securities held for trading purposes, restricted cash, receivables and equipment and fixtures. As of March 31, 2005, liquid assets consisted primarily of cash and cash equivalents of \$17,450,000 and marketable securities of \$3,778,000, for a total of \$21,228,000.

Merriman Curhan Ford & Co., as a broker-dealer, is subject to Rule 15c3-1 of the Securities Exchange Act of 1934, which specifies uniform minimum net capital requirements, as defined, for their registrants. As of March 31, 2005, Merriman Curhan Ford & Co. had regulatory net capital, as defined, of \$12,087,000, which exceeded the amount required by \$11,542,000.

Cash and cash equivalents decreased by \$9,000 during the three months ended March 31, 2005. During the first quarter of 2005, cash provided by operating activities was \$338,000, primarily attributed to our net income adjusted for certain non-cash expenses and gains, as well as increases and decreases in operating assets and liabilities. Non-cash expenses included depreciation and amortization, stock based compensation and amortization of discounts on convertible notes payable. Cash used in investing activities during the first quarter of 2005 was \$628,000, reflecting the acquisition of Catalyst and the purchase of equipment and fixtures. Cash provided by financing activities was \$281,000 during the first three months of 2005 due primarily to the proceeds from the issuance of common stock for the Employee Stock Purchase Plan and exercises of stock options and stock warrants.

We believe that our existing cash balances and investments will be sufficient to meet our liquidity and capital spending requirements, both for the next twelve months as well as for the long-term. However, we have mostly incurred operating losses since inception and, to date, we have generated only limited revenue. Furthermore, we may require additional capital investment to fund our working capital if we incur future operating losses. We cannot be certain that additional debt or equity financing will be available when required or, if available, that we can secure it on terms satisfactory to us.

## Risk Factors

Investing in our securities involves a high degree of risk. In addition to the other information contained in this quarterly report, including reports we incorporate by reference, you should consider the following factors before investing in our securities.

*It is difficult to evaluate our business and prospects because we have a limited operating history.*

We began actively engaging in providing securities brokerage and investment banking services in January 2002. This was an entirely new business for us, and was a complete break with our previous business, the bandwidth brokerage business. Accordingly, we have a limited operating history on which to base an evaluation of our business and prospects. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by fast growing companies in their early stage of development. We cannot assure you that we will be successful in addressing these risks and our failure to do so could have a material adverse effect on our business and results of operations.

*We may not be able to maintain a positive cash flow and profitability.*

Our ability to maintain a positive cash flow and profitability depends on our ability to generate and maintain greater revenue while incurring reasonable expenses. This, in turn, depends, among other things, on the development of our securities brokerage and investment banking business, and we may be unable to maintain profitability if we fail to do any of the following:

- establish, maintain and increase our client base;
  - manage the quality of our services;
- compete effectively with existing and potential competitors;
  - further develop our business activities;
  - manage expanding operations; and
  - attract and retain qualified personnel.

We cannot be certain that we will be able to sustain or increase a positive cash flow and profitability on a quarterly or annual basis in the future. Our inability to maintain profitability or positive cash flow could result in disappointing financial results, impede implementation of our growth strategy or cause the market price of our common stock to decrease. Accordingly, we cannot assure you that we will be able to generate the cash flow and profits necessary to sustain our business expectations, which makes our ability to successfully implement our business plan uncertain.

Because we are a developing company, the factors upon which we are able to base our estimates as to the gross revenue and the number of participating clients that will be required for us to maintain a positive cash flow and any additional financing that may be needed for this purpose are unpredictable. For these and other reasons, we cannot assure you that we will not require higher gross revenue, and an increased number of clients, securities brokerage and investment banking transactions, and/or more time in order for us to complete the development of our business that we believe we need to be able to cover our operating expenses, or obtain the funds necessary to finance this development. It is more likely than not that our estimates will prove to be inaccurate because actual events more often than not differ from anticipated events. Furthermore, in the event that financing is needed in addition to the amount that is required for this development, we cannot assure you that such financing will be available on acceptable terms, if at all.

*The markets for securities brokerage and investment banking services are highly competitive. If we are not able to compete successfully against current and future competitors, our business and results of operations will be adversely affected.*

We are engaged in the highly competitive financial services and investment industries. We compete with large Wall Street securities firms, securities subsidiaries of major commercial bank holding companies, U.S. subsidiaries of large foreign institutions, major regional firms, smaller niche players, and those offering competitive services via the Internet. Many competitors have greater personnel and financial resources than we do. Larger competitors are able to advertise their products and services on a national or regional basis and may have a greater number and variety of distribution outlets for their products, including retail distribution. Discount and Internet brokerage firms market their services through aggressive pricing and promotional efforts. In addition, some competitors have much more extensive investment banking activities than we do and therefore, may possess a relative advantage with regard to access to deal flow and capital.

Increased pressure created by any current or future competitors, or by our competitors collectively, could materially and adversely affect our business and results of operations. Increased competition may result in reduced revenue and loss of market share. Further, as a strategic response to changes in the competitive environment, we may from time to time make certain pricing, service or marketing decisions or acquisitions that also could materially and adversely affect our business and results of operations. We cannot assure you that we will be able to compete successfully against current and future competitors. In addition, new technologies and the expansion of existing technologies may increase the competitive pressures on us.

*We may experience reduced revenue due to declining market volume, securities prices and liquidity, which can also cause counterparties to fail to perform.*

Our revenue may decrease in the event of a decline in the market volume of securities transactions, prices or liquidity. Declines in the volume of securities transactions and in market liquidity generally result in lower revenue from trading activities and commissions. Lower price levels of securities may also result in a reduction in our revenue from corporate finance fees, as well as losses from declines in the market value of securities held by us in trading. Sudden sharp declines in market values of securities can result in illiquid markets and the failure of counterparties to perform their obligations, as well as increases in claims and litigation, including arbitration claims from customers. In such markets, we may incur reduced revenue or losses in our principal trading, market-making, investment banking, and advisory services activities.

*We may experience significant losses if the value of our marketable security positions deteriorates.*

We conduct securities trading, market-making and investment activities for our own account, which subjects our capital to significant risks. These risks include market, credit, counterparty and liquidity risks, which could result in losses for us. These activities often involve the purchase, sale or short sale of securities as principal in markets that may be characterized as relatively illiquid or that may be particularly susceptible to rapid fluctuations in liquidity and price. Trading losses resulting from such trading could have a material adverse effect on our business and results of operations.

*We may experience significant fluctuations in our quarterly operating results due to the nature of our business and therefore may fail to meet profitability expectations.*

Our revenue and operating results may fluctuate from quarter to quarter and from year to year due to a combination of factors, including:

- the level of institutional brokerage transactions and the level of commissions we receive from those transactions;
  - the valuations of our principal investments;
- the number of capital markets transactions completed by our clients, and the level of fees we receive from those transactions; and
- variations in expenditures for personnel, consulting and legal expenses, and expenses of establishing new business units, including marketing and technology expenses.

*We record revenue from a capital markets advisory transaction only when we have rendered the services, the client is contractually obligated to pay and collection is probable; generally, most of the fee is earned only upon the closing of a transaction. Accordingly, the timing of our recognition of revenue from a significant transaction can materially affect our quarterly operating results.*

*We have registered one of our subsidiaries as a securities broker-dealer and, as such, are subject to substantial regulations. If we fail to comply with these regulations, our business will be adversely affected.*

Because we have registered Merriman Curhan Ford & Co. with the Securities and Exchange Commission, or SEC, and the National Association of Securities Dealers, Inc., or NASD, as a securities broker-dealer, we are subject to extensive regulation under federal and state laws, as well as self-regulatory organizations. The principal purpose of regulation and discipline of broker-dealers is the protection of customers and the securities markets rather than protection of creditors and stockholders of broker-dealers. The Securities and Exchange Commission is the federal agency charged with administration of the federal securities laws. Much of the regulation of broker-dealers, however, has been delegated to self-regulatory organizations, such as the NASD and national securities exchanges. The NASD is our primary self-regulatory organization. These self-regulatory organizations adopt rules, which are subject to SEC approval, that govern the industry and conduct periodic examinations of member broker-dealers. Broker-dealers are also subject to regulation by state securities commissions in the states in which they are registered. The regulations to which broker-dealers are subject cover all aspects of the securities business, including net capital requirements, sales methods, trading practices among broker-dealers, capital structure of securities firms, record keeping and the conduct of directors, officers and employees. The SEC and the self-regulatory bodies may conduct administrative proceedings, which can result in censure, fine, suspension or expulsion of a broker-dealer, its officers or employees. If we fail to comply with these rules and regulations, our business may be materially and adversely affected.

The regulatory environment in which we operate is also subject to change. Our business may be adversely affected as a result of new or revised legislation or regulations imposed by the SEC, other United States or foreign governmental regulatory authorities or the NASD. We also may be adversely affected by changes in the interpretation or enforcement of existing laws and rules by these governmental authorities and the NASD.

*Our business may suffer if we lose the services of our executive officers or operating personnel.*

We depend on the continued services and performance of D. Jonathan Merriman, our Chairman and Chief Executive Officer, for our future success. We currently have an employment agreement with Mr. Merriman, which ends on January 1, 2007, but can be terminated by either party on 60 days' notice. The agreement contains provisions that obligate us to make certain payments to Mr. Merriman and substantially reduce vesting periods of options granted to him if we should terminate him without cause or certain events resulting in a change of control of our Board were to occur.

In addition to Mr. Merriman, we are currently managed by a small number of key management and operating personnel. We do not maintain "key man" insurance on any employee. Our future success depends, in part, on the continued service of our key executive, management and technical personnel, and our ability to attract highly skilled employees. Our business could be harmed if any key officer or employee were unable or unwilling to continue in his or her current position. From time to time we have experienced, and we expect to continue to experience, difficulty in hiring and retaining highly skilled employees. Competition for employees in our industry is significant. If we are unable to retain our key employees or attract, integrate or retain other highly qualified employees in the future, such failure may have a material adverse effect on our business and results of operations.

*Our business is dependent on the services of skilled professionals, and may suffer if we can not recruit or retain such skilled professionals.*

During the three months ended March 31, 2005, one sales professional accounted for 11% of our revenue. We have a number of revenue producers employed by our securities brokerage and investment banking subsidiary. We do not have employment contracts with these employees. The loss of one or more of these employees could adversely affect our business and results of operations.

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*Our compensation structure may negatively impact our financial condition if we are not able to effectively manage our expenses and cash flows.*

We are able to recruit and retain investment banking, research and sales and trading professionals, in part because our business model provides that we pay our revenue producing employees a percentage of their earned revenue. Compensation and benefits is our largest expenditure and this variable compensation component represents a significant proportion of this expense. Compensation for our employees is derived as a percentage of our revenue regardless of the profitability of the Company. Therefore, we may continue to pay individual revenue producers a significant amount of cash compensation as the overall business experiences negative cash flows and/or net losses. We may not be able to recruit or retain revenue producing employees if we modify or eliminate the variable compensation component from our business model.

*We may be dependent on a limited number of customers for a significant portion of our revenue.*

During the three months ended March 31, 2005, two investment banking customers each accounted for more than 10% of our revenue, and combined accounted for 34%. We cannot assure you that we will not become dependent on one customer, or on a small number of customers, for a large percentage of our revenue in the future. If we do become dependent on a single customer or small group of customers, the loss of one or more large customers could materially adversely affect our business and results of operations.

*We may suffer losses through our investments in securities purchased in secondary market transactions or private placements.*

Occasionally, our company, its officers and/or employees may make principal investments in securities through secondary market transactions or through direct investment in companies through private placements. In many cases, employees and officers with investment discretion on behalf of our company decide whether to invest in our company's account or their personal account. It is possible that gains from investing will accrue to these individuals because investments were made in their personal accounts, and our company will not realize gains because it did not make an investment. Conversely, it is possible that losses from investing will accrue to our company, while these individuals do not experience losses in their personal accounts because the individuals did not make investments in their personal accounts.

*We may be unable to successfully integrate acquired businesses into our existing business and operations.*

On February 28, 2005, the Company acquired Catalyst Financial Planning & Investment Management, Inc., a registered investment advisor with over \$100 million in assets under management. We may experience difficulty integrating the operations of Catalyst into our existing business and operations including our accounting, finance, compensation, information technology and management systems. We may not be able to retain the services of Catalyst employees. These factors could result in higher than anticipated costs associated with the Catalyst acquisition. Additionally, they may cause revenue from the Catalyst acquisition to be lower than forecast. If costs are higher or revenue lower than we expect, our business and results of operations could be materially adversely affected. Although we have no specific plans to do so at this time, we may buy one or more other businesses in the future. If we are unable to successfully integrate such businesses into our existing business and operations in the future, our business and results of operations could be materially adversely affected.

*We may be unable to effectively manage rapid growth that we may experience, which could place a continuous strain on our resources and, accordingly, adversely affect our business.*

We plan to expand our operations. Our growth, if it occurs, will impose significant demands on our management, financial, technical and other resources. We must adapt to changing business conditions and improve existing systems or implement new systems for our financial and management controls, reporting systems and procedures and expand, train and manage a growing employee base in order to manage our future growth. We may not be able to implement improvements to our internal reporting systems in an efficient and timely manner and may discover deficiencies in existing systems and controls. We believe that future growth will require implementation of new and enhanced communications and information systems and training of our personnel to operate such systems. Furthermore, we may acquire existing companies or enter into strategic alliances with third parties, in order to achieve rapid growth. For us to succeed, we must make our existing business and systems work effectively with those of any strategic partners without undue expense, management distraction or other disruptions to our business. We may be unable to implement our business plan if we fail to manage any of the above growth challenges successfully. Our financial results may suffer and we could be materially and adversely affected if that occurs.

*Our business and operations would suffer in the event of system failures.*

Our success, in particular our ability to successfully facilitate securities brokerage transactions and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications systems. Our systems and operations are vulnerable to damage or interruption from fire, flood, power loss, telecommunication failures, break-ins, earthquake and similar events. Despite the implementation of network security measures, redundant network systems and a disaster recovery plan, our servers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays, loss of data or the inability to accept and fulfill customer orders. Additionally, computer viruses may cause our systems to incur delays or other service interruptions, which may cause us to incur additional operating expenses to correct problems we may experience. Any of the foregoing problems could materially adversely affect our business or future results of operations.

*We are highly dependent on proprietary and third-party systems; therefore, system failures could significantly disrupt our business.*

Our business is highly dependent on communications and information systems, including systems provided by our clearing brokers. Any failure or interruption of our systems, the systems of our clearing broker or third party trading systems could cause delays or other problems in our securities trading activities, which could have a material adverse effect on our operating results.

In addition, our clearing brokers provide our principal disaster recovery system. We cannot assure you that we or our clearing brokers will not suffer any systems failure or interruption, including one caused by an earthquake, fire, other natural disaster, power or telecommunications failure, act of God, act of war or otherwise, or that our or our clearing brokers' back-up procedures and capabilities in the event of any such failure or interruption will be adequate.

*Our common stock price may be volatile, which could adversely affect the value of your shares.*

The market price of our common stock has in the past been, and may in the future continue to be, volatile. A variety of events may cause the market price of our common stock to fluctuate significantly, including:

- variations in quarterly operating results;
- our announcements of significant contracts, milestones, acquisitions;
- our relationships with other companies;
- our ability to obtain needed capital commitments;
- additions or departures of key personnel;
- sales of common stock, conversion of securities convertible into common stock, exercise of options and warrants to purchase common stock or termination of stock transfer restrictions;
- general economic conditions, including conditions in the securities brokerage and investment banking markets;
- changes in financial estimates by securities analysts; and
- fluctuation in stock market price and volume.

Many of these factors are beyond our control. Any one of the factors noted herein could have an adverse effect on the value of our common stock.

In addition, the stock market in recent years has experienced significant price and volume fluctuations that have particularly affected the market prices of equity securities of many companies and that often have been unrelated to the operating performance of such companies. These market fluctuations have adversely impacted the price of our common stock in the past and may do so in the future.

*We could be sued in a securities class action lawsuit.*

In the past, following periods of volatility in the market price of a company's securities, securities class action litigation often has been instituted against that company. Such litigation is expensive and diverts management's attention and resources. We can not assure you that we will not be subject to such litigation. If we are subject to such litigation, even if we ultimately prevail, our business and financial condition may be adversely affected.

*Your ability to sell your shares may be restricted because there is a limited trading market for our common stock.*

Although our common stock is currently traded on the American Stock Exchange, a trading market in our stock has been sporadic. Accordingly, you may not be able to sell your shares when you want or at the price you want.

*Anti-takeover provisions of the Delaware General Corporation Law could discourage a merger or other type of corporate reorganization or a change in control even if it could be favorable to the interests of our stockholders.*

The Delaware General Corporation Law contains provisions that may enable our management to retain control and resist our takeover. These provisions generally prevent us from engaging in a broad range of business combinations with an owner of 15% or more of our outstanding voting stock for a period of three years from the date that such person acquires his or her stock. Accordingly, these provisions could discourage or make more difficult a change in control or a merger or other type of corporate reorganization even if it could be favorable to the interests of our stockholders.

*Because our Board of Directors can issue common stock without stockholder approval, you could experience substantial dilution.*

Our Board of Directors has the authority to issue up to 300,000,000 shares of common stock and to issue options and warrants to purchase shares of our common stock without stockholder approval in certain circumstances. Future issuance of additional shares of our common stock could be at values substantially below the price at which you may purchase our stock and, therefore, could represent substantial dilution. In addition, our Board of Directors could issue large blocks of our common stock to fend off unwanted tender offers or hostile takeovers without further stockholder approval.

*Our ability to issue additional preferred stock may adversely affect your rights as a common stockholder and could be used as an anti take-over device.*

Our Articles of Incorporation authorize our Board of Directors to issue up to an additional 37,293,000 shares of preferred stock, without approval from our stockholders. If you hold our common stock, this means that our Board of Directors has the right, without your approval as a common stockholder, to fix the relative rights and preferences of the preferred stock. This would affect your rights as a common stockholder regarding, among other things, dividends and liquidation. We could also use the preferred stock to deter or delay a change in control of our Company that may be opposed by our management even if the transaction might be favorable to you as a common stockholder.

*Our officers and directors exercise significant control over our affairs, which could result in their taking actions of which other stockholders do not approve.*

Our executive officers and directors, and entities affiliated with them, currently control approximately 23% of our outstanding common stock including exercise of their options and warrants. These stockholders, if they act together, will be able to exercise substantial influence over all matters requiring approval by our stockholders, including the election of directors and approval of significant corporate transactions. This concentration of ownership may also have

the effect of delaying or preventing a change in control of us and might affect the market price of our common stock.

*Any exercise of outstanding stock options and warrants will dilute then-existing stockholders' percentage of ownership of our common stock.*

We have a significant number of outstanding stock options and warrants. During the three months ended March 31, 2005, shares issuable upon the exercise of these options and warrants, at prices ranging currently from approximately \$0.18 to \$1.61 per share, represent approximately 17% of our total outstanding stock on a fully diluted basis using the treasury stock method.

The exercise of the outstanding options and warrants would dilute the then-existing stockholders' percentage ownership of our common stock. Any sales resulting from the exercise of options and warrants in the public market could adversely affect prevailing market prices for our common stock. Moreover, our ability to obtain additional equity capital could be adversely affected since the holders of outstanding options and warrants may exercise them at a time when we would also wish to enter the market to obtain capital on terms more favorable than those provided by such options and warrants. We lack control over the timing of any exercise or the number of shares issued or sold if exercises occur.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The following discussion about market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We may be exposed to market risks related to changes in equity prices, interest rates and foreign currency exchange rates. We do not use derivative financial instruments for speculative, trading or any other purpose.

#### *Equity Price Risk*

The potential for changes in the market value of our trading positions is referred to as “market risk.” Our trading positions result from proprietary trading activities. Equity price risks result from exposures to changes in prices and volatilities of individual equities and equity indices. We seek to manage this risk exposure through diversification and limiting the size of individual positions within the portfolio. The effect on earnings and cash flows of an immediate 10% increase or decrease in equity prices generally is not ascertainable and could be positive or negative, depending on the positions we hold at the time. We do not establish hedges in related securities or derivatives.

#### *Interest Rate Risk*

Our exposure to market risk resulting from changes in interest rates relates primarily to our investment portfolio and long term debt obligations. Our interest income and cash flows may be impacted by changes in the general level of U.S. interest rates. We do not hedge this exposure because we believe that we are not subject to any material market risk exposure due to the short-term nature of our investments. We would not expect an immediate 10% increase or decrease in current interest rates to have a material effect on the fair market value of our investment portfolio.

Our long term debt obligations bear interest at a fixed rate. Accordingly, an immediate 10% increase or decrease in current interest rates would not have an impact on our interest expense or cash flows. The fair market value of our long term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. We would not expect an immediate 10% increase or decrease in current interest rates to have a material impact on the fair market value of our long term debt obligations.

#### *Foreign Currency Risk*

We do not have any foreign currency denominated assets or liabilities or purchase commitments and have not entered into any foreign currency contracts. Accordingly, we are not exposed to fluctuations in foreign currency exchange rates.

### **Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures** - We have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the officers who certify the Company’s financial reports and to other members of senior management and the Board of Directors.

Based on their evaluation of the Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934), the Principal Executive Officer and Principal Financial Officer of the Company have concluded that the disclosure controls and procedures are effective as of March 31, 2005.

**Changes in internal controls** - During the first quarter 2005, the Company upgraded its accounting system from QuickBooks to MAS 500, an enterprise management system. This system represents the core accounting platform for the Company and integrates with other business applications used by the Company. Appropriate testing of the system was performed by the Company prior to adding MAS 500 into operation. Aside from the change just described, there was no other change in the Company's internal control over financial reporting (as defined in Rules 13a-15(d) and 15d-15(d) of the Exchange Act) that occurred during the quarter ended March 31, 2005, that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.



## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

#### **Merriman Curhan Ford & Co. v. The Seidler Companies, Inc. — NASD Arbitration**

During 2004, our broker-dealer subsidiary hired a research analyst. Prior to employment with Merriman Curhan Ford & Co. the analyst was employed by The Seidler Companies, Inc., or Seidler, in a similar capacity. The analyst was employed under an employment contract that included terms which general counsel and outside counsel believe unlawfully restrict the analyst's employment activities.

In March 2004, we acted as a co-agents for a small private placement for a client. The client was introduced to one of our investment banking managing directors. At the time of introduction, Seidler had been trying to win the investment banking business, but had failed to obtain a signed engagement letter with the client. We subsequently received a signed engagement letter from the client that named Merriman Curhan Ford & Co. as co-placement agent. The investment banking transaction was completed.

Thereafter, in March 2004 we received a cease and desist letter from attorneys representing Seidler. Seidler claims that our analyst used proprietary information in violation of his employment agreement when introducing Merriman Curhan Ford & Co. to the client. Seidler further claims that we used unfair business tactics to win the business. In response to the claims, Merriman Curhan Ford & Co. and our analyst filed a claim in arbitration with the NASD in June 2004. It is our belief that as members of the NASD, Merriman Curhan Ford & Co. and Seidler must resolve their disputes before the NASD arbitration board. We allege unfair business practice and seek a declaration that our analyst's prior employment contract is unenforceable.

On July 16, 2004, we were served with a complaint from Seidler filed in the Los Angeles County Superior Court. Plaintiffs are seeking unspecified damages. We have successfully moved to stay the legal action. The matter is in the preliminary stages of discovery, an arbitration panel has been selected and a hearing is scheduled for October 2005. Based upon the facts as we know them to date, we do not believe that the outcome will have a material effect on the Company.

Additionally, from time to time, we are involved in ordinary routine litigation incidental to our business.

### **Item 2. Recent Sales of Unregistered Securities**

On February 28, 2005, the Company acquired Catalyst Financial Planning & Investment Management, Inc., or Catalyst, a registered investment advisor with over \$100 million in assets under management. The purchase consideration for Catalyst consists of both cash and common stock that will be paid over a three year period. The Company paid to the sole shareholder of Catalyst, or Catalyst Shareholder, \$330,433 as initial consideration at the closing. The Company has also agreed to issue to the Catalyst Shareholder up to 925,325 shares of common stock over three years based upon amount of revenue growth for Catalyst. The payment of these shares is subject to specified conditions. In exchange for its cash and shares, the Company acquired 100% of the voting stock in Catalyst. This transaction was exempt from the registration requirements of the Securities Act of 1933, as amended, pursuant to the exemption provided for in Section 4(2) of such Act.

### **Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

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10.43 Stock Purchase Agreement by and between MCF Corporation and Ascend Services Ltd., dated April 29, 2005; together with the following documents which form exhibits thereto: Escrow Agreement and Registration Rights Agreement.

10.44 Promissory Note issued by Ascend Services Ltd dated April 29, 2005.

31.1 Certification of Principal Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

None.

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**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.

MCF CORPORATION

May 5, 2005

By:

/s/ D. JONATHAN  
MERRIMAN  
D. Jonathan Merriman,  
Chairman of the Board and Chief  
Executive Officer  
(Principal Executive Officer)

May 5, 2005

By:

/s/ JOHN D. HIESTAND  
John D. Hiestand  
Chief Financial Officer  
(Principal Financial Officer)