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MEMBERWORKS INC  
Form 10-K  
August 23, 2002

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of  
the Securities Exchange Act of 1934

For the fiscal year ended June 30, 2002

Commission File No. 0-21527

MEMBERWORKS INCORPORATED

-----  
(Exact name of registrant as specified in its charter)

DELAWARE

06-1276882

-----  
(State of Incorporation)

-----  
(I.R.S. Employer  
Identification No.)

680 Washington Boulevard  
Stamford, Connecticut

06901

-----  
(Address of principal executive offices)

-----  
(Zip Code)

(203) 324-7635

-----  
(Registrant's telephone number,  
including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:  
None

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:  
Common Stock, \$0.01 Par Value

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 [ X ] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405  
of Regulation S-K is not contained herein, and will not be contained, to the  
best of registrant's knowledge, in definitive proxy or information statements  
incorporated by reference in Part III of this Form 10-K or any amendment to this  
Form 10-K. [ ]

The aggregate market value of the voting stock held by non-affiliates of the  
Registrant at August 5, 2002 was \$115,053,670. The aggregate market value was  
computed by reference to the closing price of the Registrant's Common Stock as  
of that date. For purposes of calculating this amount only, all directors,  
executive officers and shareholders reporting beneficial ownership of more than  
10% of the Registrant's Common Stock are considered to be affiliates. The number  
of shares of Common Stock outstanding as of August 5, 2002 was 13,351,830.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Proxy Statement for the 2002 Annual Meeting of Stockholders of

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MemberWorks Incorporated are incorporated by reference in Part III of this report.

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### Item 1. Business

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#### OVERVIEW

MemberWorks Incorporated ("MemberWorks" or the "Company"), a Delaware Corporation organized in 1996 and doing business as CardMember Publishing Corporation since 1989, designs and manages innovative membership programs that provide substantial benefits to member consumers, those organizations offering the programs and vendors whose products and services are accessed through the programs. Members receive value-added benefits, insightful information and exclusive savings in the areas of healthcare, personal finance, insurance, travel, entertainment, fashion and personal security. MemberWorks believes that it is the leading designer and provider of innovative membership service programs due to its senior management's extensive knowledge of the industry and its relationships with leading consumer-driven organizations with large numbers of individual account holders and customers. The Company addresses the needs of organizations seeking to leverage the expertise of an outside provider in offering these programs. In return for providing the Company with members, the Company's clients receive royalty payments. Clients also benefit because the programs are designed and managed to strengthen the relationship between clients and their customers. MemberWorks offers its programs to increasingly sophisticated consumers seeking economy, efficiency and convenience in their purchase of products and services. Members save time by purchasing goods and services and obtaining useful information over the telephone or the Internet. Members also benefit from participating vendors who agree to provide discounts on products and services not generally available to non-members. For the participating vendors, the programs provide the opportunity to reach a large number of demographically attractive members at minimal incremental marketing cost. The Company's programs are primarily marketed to customers through arrangements with its client organizations which include banks and other financial institutions, retailers, major oil companies, direct response television companies, catalog companies, e-commerce companies and other organizations with large numbers of individual customers.

Businesses that sell services and products to consumers have substantially increased the use of direct marketing techniques to reach their customers. According to the Direct Marketing Association, total consumer sales as a result of direct marketing in the United States were \$1,085 billion in 2002, an increase of 8% over the prior year. Membership service programs, if designed, marketed and managed effectively, can be of substantial value to the consumers who become members of such programs, the businesses that market to consumers and the client organizations that offer the programs to their customers.

Historically, a substantial number of the businesses that utilize membership service programs have been issuers of credit cards. More recently, however, other businesses, including banks and other financial institutions, retailers, major oil companies, direct response television companies, catalog companies, e-commerce companies and insurance companies have also begun to offer service programs. In many cases, these businesses lack the core competency to successfully design, market and manage membership programs. As a result, these businesses seek to outsource to companies that are able to apply advanced database systems to capture, process and store consumer and market information, are able to use their experience to provide effective programs and are able to realize economies of scale. In addition, businesses seeking to implement membership service programs demand that the provider of those programs has the expertise to continue to introduce innovative new programs and that the provider has resources such as extensive vendor networks and experienced management teams in order to market programs quickly and successfully.

The Company's membership service programs, which combined had approximately 6.6 million retail members and over 13 million total members, including wholesale,

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as of June 30, 2002, offer unique and valuable services, information and savings opportunities. The service programs are generally marketed under the name of the program and are designed and developed to capitalize on the client's existing relationship with its customers or other constituents. In general, membership fees, which may be payable monthly or annually, vary depending upon the particular membership program. Annual membership fees averaged approximately \$90 per year during fiscal 2002 and monthly membership fees averaged \$9 per month during fiscal 2002. Most of the membership programs are for one-year renewable terms and members are generally entitled to unlimited use of the service during the membership period.

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### DESCRIPTION OF BUSINESS

MemberWorks is a leader in bringing value to consumers by designing innovative membership programs that offer easy access to significant savings at national brand name providers and retailers in healthcare, insurance, travel, entertainment, shopping, personal security, home improvement and more. MemberWorks combines marketing innovation, entrepreneurial energy and consumer insight to create industry leading membership programs. These programs create new revenue streams and increase customer loyalty for clients. MemberWorks continues to enhance its existing membership programs to add more member value while systematically increasing the membership fee. During 2002, MemberWorks introduced four new premium products. These premium products offer members even more services and discounts at an increased membership fee. The Company's money-saving programs fall into the following four key categories:

#### Health and Insurance

The Health membership programs offer significant savings on a comprehensive array of products including: prescription drugs, vitamins and supplements, eye glasses and contact lenses, hearing aides and durable medical equipment; and professional services, including medical, dental, chiropractic, alternative medicine and elder care.

The Insurance membership programs offer competitively priced insurance products, including life, accidental death, short-term and catastrophic disability, supplemental medical and warranty coverage.

#### Travel, Entertainment and Shopping

These membership programs offer exclusive members only savings with leading brand name partners. Members have multiple opportunities to save on: travel, including air fare, hotel rates, car rental and cruise packages; entertainment, featuring theme parks, amusements parks, restaurants and movie theaters; and shopping, offering savings on a wide range of merchandise, apparel and personal services.

#### Privacy, Protection and Home Improvement

These membership programs offer discounts on products and services that enhance and improve the member's sense of security and well being. Members have access to bundles of services that enable them to better manage their: privacy, including card registration, credit reporting, scoring and monitoring, and personal information monitoring services; protection, offering savings on security systems, 24-hour protection services, roadside assistance, financial, tax and retirement planning and extended warranty protection; home and household expenses, featuring discounts on home improvement, consumer electronics and entertainment and family activities.

#### Specialty Markets and Custom Programs

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MemberWorks offers a full line of membership programs in Canada, as well as, Hispanic versions of certain membership programs. Membership materials and customer service are offered in English, Spanish and French.

MemberWorks also partners with large clients to offer custom, private label or co-branded membership programs to meet the specific needs of a defined customer base.

In general, members subscribe for renewable one-year memberships in the Company's programs. When consumers agree to enroll in a program, they generally receive a trial membership. During this time, the member may use the program's services without obligation, as outlined in the marketing solicitation. A membership kit, which includes a membership brochure and a membership card with a membership identification number, is mailed to the consumer during the trial period. The brochure outlines in detail the benefits offered and contains toll-free numbers which may be called to access membership benefits and information. In the event that a consumer elects not to participate in the service, he or she can call a toll-free number during the trial period to cancel the service without charge. Trial memberships are generally for a period of 30 days and there are no conditions with respect to the ability of the consumer to terminate a trial membership. MemberWorks does not record any revenue with respect to trial memberships.

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If the membership is not canceled during the trial period, the consumer is charged the annual or monthly membership fee, depending upon the billing method selected. For annual members, in the event that the member does not cancel the membership after the initial membership term, generally one year, he or she generally receives a renewal notice in the mail in advance of each membership year and is charged for the succeeding year's membership fee. During the course of an initial annual membership term or renewal term, a member may cancel his or her membership in the program, either for a complete refund of the membership fee for that period or a prorata refund based on the remaining portion of the membership period depending upon the terms of the membership program. Monthly members are billed each month after a free trial period and continue to be billed each month until the member cancels.

MemberWorks markets its programs primarily through arrangements with companies such as banks and other financial institutions, retailers, major oil companies, direct response television companies, catalog companies, e-commerce companies and other organizations with large numbers of individual account holders and customers, who have an existing relationship with its consumers. Participating marketing partners provide lists of consumers which MemberWorks inputs into its database management system to model, analyze and identify likely members. MemberWorks only collects and maintains customer data that is required to administer its business activities, such as a customer's name, address and billing information. MemberWorks pays participating marketing partners an annual royalty for initial and renewal membership fees received from consumers provided to MemberWorks by the client.

MemberWorks also offers its service programs through clients who have inbound call centers. This type of marketing method which MemberWorks refers to as MemberLinkSM, essentially turns the client call center into a profit center. Under these arrangements, inbound callers to a client meeting certain criteria are offered the Company's membership service programs by the client's service representative or by a MemberWorks membership service representative through a

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call transfer. MemberWorks pays the client either an annual royalty for initial and renewal membership fees or a fee per marketing pitch or per sale. Generally, MemberLinkSM arrangements serve as a more efficient and cost effective way to acquire members than the Company's traditional marketing model.

MemberWorks coordinates the efforts of its sales and marketing group with those of its client management group in order to anticipate clients' needs for new product offerings. The Company's senior management works with both of these groups to develop and refine new program concepts and then to introduce the new programs. MemberWorks believes this method of product development has allowed it to respond quickly and effectively to market demand for new programs.

MemberWorks possesses the in-house operational capabilities and expertise to perform most aspects of its business with minimal reliance upon third party outsourcing. For instance, MemberWorks generally creates most of its marketing, creative and fulfillment materials. MemberWorks also maintains in-house call center facilities in order to answer its members' phone calls. MemberWorks believes this in-house approach enables the Company to provide better customer service and market its products more efficiently.

MemberWorks believes that it was the first membership company to introduce aggregated discount services in the areas of healthcare, sports, shopping, financial and personal security. MemberWorks also believes that all of its programs are innovative with respect to the variety and quality of particular services, discounts and other features which those programs offer. By bundling and reconfiguring various features of its standard programs, MemberWorks can customize a program to the particular needs and demands of its clients.

In addition to marketing its programs directly to consumers either through lists provided by credit card issuers and other businesses and organizations or through MemberLinkSM, MemberWorks also delivers its membership service programs through its wholesale programs. MemberWorks works with a wholesale client to incorporate elements from one or more of its standard service programs and designs a custom program for the client. The client will then provide the membership in the customized format to its customers as a value-added feature or resell the product. The client pays MemberWorks the membership fees for the customers who receive the service program. Wholesale programs have substantially lower acquisition cost, which result in higher profit margins for MemberWorks. Accordingly, MemberWorks provides membership in the service program for fees which are less than the Company's standard fees for the program.

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### MEMBER SERVICE

MemberWorks believes that providing high quality service to its members is extremely important in order to encourage memberships and to strengthen the affinity of those members for the client that offered the service program. Currently, MemberWorks (including through its wholly-owned subsidiaries) maintains four call centers located in Omaha, Nebraska; Houston, Texas; Chicago, Illinois and Montreal, Canada with a total of almost 700 membership service representatives. All new membership service representatives are required to attend on-the-job training. Through its training programs, systems and software, MemberWorks seeks to provide members with friendly, rapid and effective answers to questions. MemberWorks also works closely with its clients' customer service staff to ensure that their representatives are knowledgeable in matters relating to membership service programs offered by MemberWorks.

### TECHNOLOGY

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MemberWorks has invested substantially in new technology, including a state-of-the-art fulfillment center, a sophisticated customer service CRM platform, data warehousing and mining capabilities and various Internet applications to allow it to effectively and efficiently service its members. MemberWorks receives new member information from its marketing partners daily, and that information is maintained on core infrastructure systems that drive information consistently to call center, fulfillment, billing and financial systems. This allows for rapid fulfillment of member information kits as well as other benefits. All membership information is maintained on a state-of-the-art CRM system, which allows extremely responsive call center interactions. MemberWorks receives confirmation of billing data from the Company's merchant processors on a regular basis, permitting MemberWorks to update the status of each member, including member profile information.

In providing quality service to its members, the Company's management information systems interact with the Company's advanced call routing system in order to display member profile information prior to receiving the call, allowing the Company's membership service representatives to have the best possible information prior to serving the members. The Company's telecommunications systems also monitor the performance quality of its membership service representatives and other aspects of its business through sophisticated reporting capabilities. In addition, the Company's marketing experts use proprietary systems in combination with advanced systems from outside vendors to review, analyze and model the demographics of lists of prospective members supplied by clients in order to determine which customers are most likely to respond to an offer and retain their membership.

### FULFILLMENT

In most cases, the products and services offered to members through the Company's programs are provided directly to members by independent benefit providers/vendors. MemberWorks evaluates and engages only those vendors who can cost-effectively deliver high quality products and services. Vendors generally benefit by gaining significant volume demand with minimal associated marketing expense. Accordingly, vendors gain access and marketing exposure to the Company's membership base and, pursuant to contractual arrangements with MemberWorks, generally quote a discounted price. MemberWorks generally does not receive any material payments from these vendors for rendering services to the Company's members and, in certain cases, MemberWorks pays its vendors a fee based on the volume of members in the Company's program or based on other agreed upon factors.

The Company's contracts with its vendors are generally for a one-year term, with subsequent one-year renewal terms at the option of MemberWorks. Vendors may cancel contracts with MemberWorks, but in most cases, only for cause and subject to notice provisions to provide MemberWorks time to locate a substitute vendor. Most vendor contracts are non-exclusive, but have requirements that the vendors maintain the confidentiality of the terms of the contract.

### SALES AND MARKETING

MemberWorks solicits members for its programs primarily by direct marketing methods, including telemarketing, which it outsources to third party contractors, and MemberLinkSM inbound call marketing. MemberWorks also solicits members through the use of direct mail which is mailed either at MemberWorks' own expense or at its client's expense. Most of the Company's individual memberships are also available on the Internet.

Under the Company's wholesale programs, MemberWorks does not pay for the marketing costs to solicit memberships. Instead, the client offering the memberships is responsible for marketing, usually with the assistance of MemberWorks. In some cases, the client may provide wholesale memberships to its customers free of charge and pay the periodic membership fee to MemberWorks for each customer membership. In other cases, the client may charge a reduced fee to

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its customer.

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MemberWorks continues to pursue its international expansion through the growth of its subsidiary located in Canada, MemberWorks Canada. MemberWorks Canada provides retail membership programs similar to those offered in the U.S. as well as credit card enhancement services to Canadian financial institutions through wholesale arrangements. The Company's revenues from international operations represented 3% of total revenues for the fiscal year ended June 30, 2002.

The Company's sales strategy is to establish and maintain long-term relationships with its clients. MemberWorks employs a consultative sales process to understand and define client needs and to determine how those needs can be addressed by the membership service programs offered by MemberWorks. MemberWorks seeks to build upon its existing customer relationships by integrating and cross-selling its different membership service programs.

### DISTRIBUTION

MemberWorks arranges with its client organizations to market membership programs to such clients' individual account holders and customers. Clients generally receive royalties on initial and renewal memberships. The Company's contracts with these clients typically grant MemberWorks the right to continue providing membership services directly to such clients' individual account holders even if the client terminates the contract, provided that the client continues to receive its royalties.

Substantially all of the information necessary for the Company's marketing efforts are supplied by its clients in accordance with strict consumer privacy safeguards. As a result, the Company's ability to market a new program to an existing customer base or an existing program to a new customer base is generally dependent upon first obtaining client approval.

Many client relationships are pursuant to contracts that may be terminated by the client upon 30 to 90 days notice without cause and without penalty. Upon such termination, MemberWorks generally has the right to continue its relationship with the client's customers that have become program members for a specified period to substantially the same extent as prior to the termination, but may not resolicit those members upon such member's cancellation or non-renewal of the member's membership.

MemberWorks distributes its programs through direct marketing efforts. The direct marketing techniques utilized include outbound telemarketing, inbound marketing, direct mail and internet marketing. All telemarketing is outsourced to third party contractors. In addition, MemberWorks distributes its products through wholesale arrangements where MemberWorks is not responsible for marketing to the customer.

Membership programs sponsored by the Company's largest client, Citibank, accounted for 16% of revenue for the fiscal year ended June 30, 2002.

### RESTRUCTURING

In October 2001, the Company announced the implementation of several cost saving initiatives due to a slowdown in consumer response rates and increased economic uncertainty in both the U.S. and abroad. This restructuring program was designed to improve organizational effectiveness and profitability and included a workforce reduction, the closing of the Company's United Kingdom operations and the downsizing of the operational infrastructure throughout the Company.



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### GOVERNMENT REGULATION

MemberWorks markets its membership programs through various distribution channels, including outbound telemarketing, inbound marketing, direct mail and internet marketing. These channels are regulated on both the state and federal levels and the Company believes that these marketing methods will increasingly be subject to such regulation, particularly in the area of consumer privacy. Such regulation may limit our ability to solicit new members or to offer one or more products or services to existing members. The telemarketing industry has become subject to an increasing amount of federal and state regulation as well as general public scrutiny in the past several years. For example, the Federal Telephone Consumer Protection Act of 1991 limits the hours during which telemarketers may call consumers and prohibits the use of automated telephone dialing equipment to call certain telephone numbers. Additionally, the Federal Telemarketing and Consumer Fraud and Abuse Prevention Act of 1994 and Federal Trade Commission ("FTC") regulations, including the Telemarketing Sales Rule, promulgated thereunder prohibit deceptive, unfair or abusive practices in telemarketing sales. Both the

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FTC and state attorneys general have authority to prevent telemarketing activities deemed by them to be "unfair or deceptive acts or practices." Further, some states have enacted laws and others are considering enacting laws targeted directly at regulating telemarketing practices, and there can be no assurance that any such laws, if enacted, will not adversely affect or limit the Company's current or future operations. Compliance with these regulations is generally the responsibility of the Company, and the Company could be subject to a variety of enforcement and/or private actions for any failure to comply with such regulations. The Company's provision of membership programs requires the Company to comply with certain state regulations, changes in which could materially increase the Company's operating costs associated with complying with such regulations. The risk of noncompliance by the Company with any rules and regulations enforced by a federal or state consumer protection authority may subject the Company or its management to fines or various forms of civil or criminal prosecution, any of which could materially adversely affect the Company's business, financial condition and results of operations. Also, the media often publicizes perceived noncompliance with consumer protection regulations and violations of notions of fair dealing with consumers, and the membership programs industry is susceptible to peremptory charges by the media of regulatory noncompliance and unfair dealing.

The Company currently maintains rigorous security and quality controls to ensure that all of its marketing practices meet or exceed industry standards and all applicable state and federal laws and regulations. The Company only collects and maintains customer data that is required to administer its business activities, such as a customer's name, address and billing information and only public information is used for marketing and modeling purposes, such as demographic, neighborhood and lifestyle data. The Company neither resells any confidential customer information that is obtained or derived in its marketing efforts nor purchases consumer information from financial institutions.

### COMPETITION

MemberWorks believes that the principal competitive factors in the membership services industry include the ability to identify, develop and offer innovative service programs, the quality and breadth of service programs offered, price and marketing expertise. The Company's competitors offer membership programs which provide services similar to, or which directly compete with, those provided by MemberWorks. Some of these competitors have substantially larger customer bases

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and greater financial and other resources than the Company's. To date, MemberWorks has effectively competed with such competitors. However, there can be no assurance that the Company's competitors will not increase their emphasis on programs similar to those offered by MemberWorks to more directly compete with MemberWorks; provide programs comparable or superior to those provided by MemberWorks at lower membership prices; adapt more quickly than MemberWorks to evolving industry trends or changing market requirements; or that new competitors will not enter the market or that other businesses will not themselves introduce competing programs. Such increased competition may result in price reductions, reduced gross margins and loss of market share, any of which could materially adversely affect the Company's business, financial condition and results of operations. Additionally, because contracts between clients and program providers are often exclusive with respect to a particular service, potential clients may be prohibited from contracting with MemberWorks to promote a program if the services provided by the Company's program are similar to, or merely overlap with, the services provided by an existing program of a competitor.

### EMPLOYEES

As of June 30, 2002, MemberWorks employed 1,075 persons on a full-time basis and 141 on a part-time basis. None of the Company's employees are represented by a labor union. MemberWorks believes that its employee relations are good.

### Item 2. Properties

A summary of key information with respect to the Company's leased facilities is as follows:

Location	Square Footage	Year of Lease Expiration
-----	-----	-----
Omaha, NE	93,123	2009 through 2015
Stamford, CT	98,947	2002 through 2006
Montreal, Canada	48,193	2003 through 2011
Houston, TX	41,591	2006
Atlanta, GA	16,122	2005
Chicago, IL	11,676	2005
White Plains, NY	4,193	2004

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The Stamford, Connecticut office serves as the Company's corporate headquarters. All other locations serve as the operational offices for MemberWorks.

### Item 3. Legal Proceedings

Except as set forth below, in management's opinion, there are no significant legal proceedings to which the Company or any of its subsidiaries is a party or to which any of their properties are subject. The Company is involved in other lawsuits and claims generally incidental to its business including, but not limited to, various suits, including previously disclosed suits, brought against the Company by individual consumers seeking monetary and/or injunctive relief relating to the marketing of the Company's programs. In addition, from time to time, and in the regular course of its business, the Company receives inquiries from various federal and/or state regulatory/enforcement authorities.

In March 2001, an action was instituted by plaintiff Teresa McClain against Coverdell & Company ("Coverdell"), a wholly-owned subsidiary of the Company,

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Monumental Life Insurance Company and other defendants in the United States District Court for the Eastern District of Michigan, Southern Division. The suit, which seeks unspecified monetary damages, alleges that Coverdell and the other defendants violated the Michigan Consumer Protection Act and other applicable Michigan laws in connection with the marketing of Monumental Life Insurance Company insurance products. The complaint includes a claim that the suit should be certified as a class action and the plaintiff has filed a motion for class certification to which all of the defendants have filed opposing papers regarding the same. The Court has announced that it will deny the motion for national class certification, but it has certified a class of Michigan residents. No order has been issued. The Company believes that the claims made against Coverdell are unfounded and Coverdell and the Company will vigorously defend their interests against this suit.

In March 2002, the Company and other plaintiffs filed suit against Homestore.com, Inc. in United States District Court for the District of Connecticut. The action has been transferred to the United States District Court for the Central District of California. The suit, seeking injunctive and other relief, alleges securities fraud, negligent misrepresentation, breach of contract and other grounds in connection with the Company's sale of its interest in iPlace, Inc. In response to plaintiffs' preliminary motions, the court ordered Homestore.com, Inc. to place \$58.0 million in a constructive trust pending resolution of the lawsuit or further order of the court. In August 2002, the Company announced that it, along with certain of the other former shareholders of iPlace, Inc., had settled their lawsuit against Homestore.com, Inc. The total settlement amount in favor of the plaintiffs is \$23.0 million of which the Company will receive approximately \$19.2 million.

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

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No matters were submitted to a vote of security holders during the quarter ended June 30, 2002.

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#### Executive Officers of the Registrant

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The executive officers of the registrant of MemberWorks and their respective ages as of July 31, 2002 are as follows:

Name	Age	Position
----	---	-----
Gary A. Johnson	47	President and Chief Executive Officer, Director
Vincent DiBenedetto	45	Executive Vice President, Sales and Client Services
James B. Duffy	48	Executive Vice President and Chief Financial Officer
Walter Kazmierczak	47	Executive Vice President, Marketing Services
William Olson	44	Executive Vice President, Sales and Client Services
David Schachne	41	Executive Vice President, Business Development
Dennis P. Walker	57	Executive Vice President and Director

GARY A. JOHNSON, a co-founder of MemberWorks, has served as President and

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Chief Executive Officer and a director of MemberWorks since its inception.

VINCENT DIBENEDETTO joined MemberWorks in October 2000 and currently serves as Executive Vice President, Sales and Client Services. Prior to joining MemberWorks, Mr. DiBenedetto was President of Discount Development Services, L.L.C., a subsidiary of MemberWorks which was acquired in October 2000.

JAMES B. DUFFY joined MemberWorks in 1996 and currently serves as Executive Vice President and Chief Financial Officer.

WALTER KAZMIERCZAK joined MemberWorks in May 2001 and currently serves as Executive Vice President, Marketing Services. Prior to joining MemberWorks, Mr. Kazmierczak was Senior Vice President and General Manager of Columbia House, Chief Internet Officer of Crown Book Corporation and Vice President and General Manager of Macmillan Publishing.

WILLIAM OLSON joined MemberWorks in March 2001 and currently serves as Executive Vice President, Sales and Client Services. Prior to joining MemberWorks, Mr. Olson served in various senior positions such as President & Chief Executive Officer of Dunlop/Maxfli Sports Corporation, President & Chief Executive Officer of Gold Coast Beverage Distributors and President & Chief Executive Officer of Guinness Brewing North America Corporation.

DAVID SCHACHNE joined MemberWorks in 1990 and currently serves as Executive Vice President, Business Development. He has held various senior management positions at MemberWorks in Marketing and Business Development.

DENNIS P. WALKER, a co-founder of MemberWorks, has served as Executive Vice President and a director of MemberWorks since its inception.

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### Part II

#### Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters

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The Company's Common Stock is listed on the NASDAQ National Market ("NASDAQ") under the symbol MBRS. The following table sets forth for the periods indicated the high and low closing sale prices per share as reported on the NASDAQ.

	High	Low
Fiscal Year Ended June 30, 2002:	----	---
First Quarter	\$25.00	\$17.90
Second Quarter	21.00	7.98
Third Quarter	18.93	14.26
Fourth Quarter	18.53	16.27
	High	Low
	----	---
Fiscal Year Ended June 30, 2001:		
First Quarter	\$37.06	\$25.56
Second Quarter	36.19	19.38
Third Quarter	27.94	18.69
Fourth Quarter	26.00	20.31

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As of August 5, 2002, there were 40,000,000 shares of the Company's Common Stock authorized of which 13,351,830 shares were outstanding, held by approximately 1,959 stockholders of record. MemberWorks has not declared or paid any cash dividends to date and anticipates that all of its earnings in the foreseeable future will be retained for use in its business and to repurchase its common stock under the stock repurchase program. The Company's future dividend policy will depend on the Company's earnings, capital requirements, financial condition, requirements of the financing agreements to which MemberWorks is a party and other factors considered relevant by the Board of Directors.

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### Item 6. Selected Financial Data

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The selected consolidated statements of operations data for each of the years ended June 30, 2002 through 1998 and the selected consolidated balance sheet data as of June 30, 2002 through 1998 set forth below are derived from the consolidated financial statements of MemberWorks which have been audited by PricewaterhouseCoopers LLP. The selected consolidated financial information of MemberWorks is qualified by reference to and should be read in conjunction with Item 8, "Consolidated Financial Statements and Supplementary Data," and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing elsewhere herein.

	Year Ended June 30		
	2002	2001	2000
	-----	-----	-----
	(In thousands, except per share)		
<b>CONSOLIDATED STATEMENTS OF OPERATIONS DATA:</b>			
Revenues	\$ 427,602	\$ 475,726	\$ 330,107
Total expenses	415,713	509,050	331,547
Operating income (loss)	11,889	(33,324)	(1,440)
Gain on sale of subsidiary	65,608	-	-
Net (loss) gain on investment	(33,628)	(2,172)	8,854
Other (expense) income, net	(401)	(450)	873
Income (loss) before equity in affiliate and minority interest	43,468	(35,946)	8,287
Equity in income (loss) of affiliate	-	83	19
Minority interest	450	9,106	2,027
Net income (loss) before cumulative effect of accounting change	43,918	(26,757)	10,333
Cumulative effect of accounting change	(5,907)	(25,730)	-
Net income (loss)	\$ 38,011	\$ (52,487)	\$ 10,333
	=====	=====	=====

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Basic earnings (loss) per share:

Income (loss) before cumulative effect of accounting change	\$ 3.03	\$ (1.75)	\$ 0.68
Cumulative effect of accounting change	(0.41)	(1.69)	-
	\$ 2.63	\$ (3.44)	\$ 0.68
Basic earnings (loss) per share	\$ 2.63	\$ (3.44)	\$ 0.68

Diluted earnings (loss) per share:

Income (loss) before cumulative effect of accounting change	\$ 2.95	\$ (1.75)	\$ 0.61
Cumulative effect of accounting change	(0.40)	(1.69)	-
	\$ 2.55	\$ (3.44)	\$ 0.61
Diluted earnings (loss) per share	\$ 2.55	\$ (3.44)	\$ 0.61

Weighted average common shares outstanding

Basic	14,477	15,248	15,162
	14,909	15,248	16,993
Diluted	14,909	15,248	16,993

June 30,

2002	2001	2000
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(In thousands)

CONSOLIDATED BALANCE SHEET DATA:

Cash and cash equivalents	\$ 51,185	\$ 22,736	\$ 30,169
Total assets	280,817	348,461	316,772
Long-term liabilities	3,627	3,057	1,083
Shareholders' (deficit) equity	(20,630)	(25,965)	19,021
Cash flow provided by operating activities	21,706	13,013	44,910

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

MemberWorks addresses the needs of organizations seeking to leverage the expertise of an outside provider in offering membership service programs. Membership service programs offer selected products and services from a variety of vendors for a monthly or annual fee. Membership service programs intend to enhance existing relationships between businesses and consumers. MemberWorks derives its revenues principally from annually renewable membership fees. The Company generally receives full payment of annual fees at or near the beginning of the membership period, but recognizes revenue as the member's refund privilege expires. Similarly, the costs associated with soliciting each new member, as well as the cost of royalties, are recognized as the related revenue is recognized. Profitability and cash flow generated from renewal memberships exceed that of new memberships due to the absence of solicitation costs associated with new member procurement.

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### CRITICAL ACCOUNTING POLICIES

On December 12, 2001, the Securities and Exchange Commission issued Financial Reporting Release ("FRR") No. 60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" ("FRR 60"), suggesting that companies provide additional disclosure on those accounting policies considered most critical to their organization. Critical accounting policies are those policies that are important to the Company's financial condition and results and involve subjective or complex judgments on the part of management, often as a result of the need to make estimates. The following areas all require the use of judgments and estimates: membership cancellation rates, deferred marketing costs, intangible assets and income taxes. Estimates in each of these areas are based on historical experience and various assumptions that MemberWorks believes are appropriate. Actual results may differ from these estimates. MemberWorks believes the following represent the critical accounting policies of the Company as contemplated by FRR 60. For a summary of all of the Company's significant accounting policies, see Note 2 of the Notes to the consolidated financial statements located in this 2002 Annual Report on Form 10-K.

#### Revenue recognition

Membership fees are billed through clients of the Company primarily through credit cards. During an initial annual membership term or renewal term, a member may cancel his or her membership in the program, either for a complete refund of the membership fee for that period or a prorata refund based on the remaining portion of the membership period depending upon the terms of the membership program. Deferred membership fees are recorded, net of estimated cancellations, after the trial period has expired, and are amortized as revenues from membership fees upon the expiration of membership refund privileges. An allowance for cancellations is established based on management's estimates and is updated regularly. In determining the estimate of allowance for cancellations, management analyzes historical cancellation experience, current economic trends and changes in customer demand for the Company's products. Actual membership cancellations are charged against the allowance for cancellations on a current basis. If actual cancellations differ from the estimate, the results of operations would be impacted. Accrued liabilities set forth in the accompanying consolidated balance sheets as of June 30, 2002 and 2001 include an allowance for membership cancellations of \$23.8 million and \$30.0 million, respectively.

#### Membership solicitation and other deferred costs

Membership solicitation costs include marketing and direct mail costs related directly to membership solicitation (i.e., direct response advertising costs). In accordance with the American Institute of Certified Public Accountants Statement of Position 93-7, "Reporting on Advertising Costs," direct response advertising costs are deferred and charged to operations as revenues from membership fees are recognized. Other deferred costs consist of royalties paid to clients, which relate to the same revenue streams as the direct response advertising costs and are also charged to income over the membership period. Membership solicitation costs incurred to obtain a new member generally are less than the estimated total membership fees. However, if membership solicitation costs were to exceed total estimated membership fees, an adjustment would be made to the extent of any impairment.

#### Goodwill and other intangibles

In connection with the implementation of Financial Accounting Standards Board ("FASB") Statement No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), MemberWorks reviewed the carrying value of its goodwill and other intangible assets by comparing such amounts to their fair values. The Company determined that at July 1, 2001, there was an impairment of goodwill of \$5.9 million at one

of its reporting units due to the change in methodology of calculating impairment under SFAS 142 concurrent with recent downward trends in the operations of that reporting unit (see Note 3 to the consolidated financial statements contained in this 2002 Annual Report on Form 10-K). This amount was recorded as a cumulative effect of accounting change in the statement of operations in the fiscal quarter ended September 30, 2001. MemberWorks is required to perform this comparison at least annually, or more frequently if circumstances indicate possible impairment. When determining fair value, the Company utilizes various assumptions, including projections of future cash flows. A change in these underlying assumptions will cause a change in the results of the tests and, as such, could cause fair value to be less than the carrying amounts. In such an event, MemberWorks would then be required to record a corresponding charge, which would impact earnings.

#### Income Taxes

Income taxes are determined in accordance with FASB Statement No. 109, "Accounting for Income Taxes" ("SFAS 109"), which requires recognition of deferred income tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred liabilities and assets are determined based on the difference between the financial statement basis and the tax basis of liabilities and assets using enacted tax rates in effect for the year in which the differences are expected to reverse. SFAS 109 also provides for the recognition of deferred tax assets if it is more likely than not that the assets will be realized in future years. A valuation allowance has been established for deferred tax assets for which realization may not be likely. As of June 30, 2002 and 2001, the deferred tax asset of \$6.6 million and \$22.7 million, respectively, has been fully reserved. In assessing the valuation allowance, MemberWorks has considered future taxable income and ongoing tax planning strategies.

#### FISCAL 2002 COMPARED TO FISCAL 2001

REVENUES. Revenues decreased 10% to \$427.6 million in 2002 from \$475.7 million in 2001 primarily due to the effect of the sale of iPlace, Inc. and the controlled slow down in new member marketing implemented in the beginning of the fiscal year. This controlled slow down was a reaction to decreased consumer response rates. Excluding iPlace, Inc. revenues of \$9.4 million and \$42.4 million in 2002 and 2001, respectively, revenues would have decreased 3%. Revenues before deferral, which are revenues before the application of Staff Accounting Bulletin 101, "Revenue Recognition in the Financial Statements" ("SAB 101"), decreased 15% to \$410.5 million in 2002 from \$485.0 million in 2001 due to the sale of iPlace, Inc., the controlled slow down in new member marketing implemented in the beginning of the fiscal year, and the closing of the United Kingdom operations. Excluding iPlace, Inc. revenues before deferral of \$11.0 million and \$53.7 million in 2002 and 2001, respectively, revenues before deferral would have decreased 7%. The Company's membership base decreased to approximately 6.6 million members at June 30, 2002 from 7.9 million members at June 30, 2001 due to the controlled slow down in new member marketing implemented in the beginning of the fiscal year, the sale of iPlace, Inc. and the closing of the United Kingdom operations. As a percentage of total revenues, annual renewal revenues were 48% in 2002 and 41% in 2001. As a percentage of total revenues before deferral, annual renewal revenues were 51% in 2002 and 44% in 2001. The increase in renewal revenues as a percentage of total revenues is due to the controlled slow down in new member marketing implemented in the beginning of the fiscal year. Revenue from members who are charged on a monthly payment program increased to \$41.3 million in 2002 from \$27.6 million in 2001.



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OPERATING EXPENSES. Operating expenses consist of member service call center costs, membership benefit costs and membership kit costs. Operating expenses decreased 13% to \$78.7 million in 2002 from \$90.4 million in 2001 primarily due to the sale of iPlace, Inc., the closing of the United Kingdom operations and lower revenues during the year. As a percentage of revenues before deferral, operating expenses increased to 19.2% in 2002 from 18.6% in 2001 primarily due to the effect of lower revenues reported in 2002.

MARKETING EXPENSES. Marketing expenses consist of direct solicitation costs incurred to obtain new members and royalties paid to clients, which are generally amortized in the same manner as the related revenue. Marketing expenses decreased 18% to \$249.0 million in 2002 from \$305.0 million in 2001 primarily due to the effect of the controlled slow down in new member marketing implemented in the beginning of the fiscal year and the effect of the sale of iPlace, Inc. As a percent of revenue, marketing expenses decreased to 58.2% in 2002 from 64.1% in 2001 primarily due to the increase in the mix of renewal revenue as a percent of total revenue. The lower level of new member marketing resulted in an increase in the ratio of renewal member revenues to total revenues. Marketing expenses related to renewal revenues are typically

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significantly lower than expenses related to new member revenues. Expenses related to new member marketing, as a percent of new member revenues, increased in 2002 compared to 2001 primarily due to a decrease in consumer response rates. Marketing expenses before deferral, which are marketing expenses before the application of SAB 101, decreased 19% to \$233.9 million in 2002 from \$287.9 million in 2001 and, as a percent of revenues before deferral, decreased to 57.0% in 2002 from 59.4% in 2001. The decrease in marketing expenses before deferral was due to a controlled slow down in new member marketing implemented in the beginning of fiscal 2002, the effect of the sale of iPlace, Inc. and the closing of the United Kingdom operations. The decrease in marketing expenses before deferral as a percent of revenue before deferral was due to an increase in the mix of renewal revenues.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses primarily include personnel-related costs, occupancy costs and other overhead costs. General and administrative expenses decreased 21% to \$79.2 million in 2002 from \$99.7 million in 2001, and as a percentage of revenues before deferral, decreased to 19.3% in 2002 from 20.6% in 2001. These decreases were primarily due to the sale of iPlace, Inc. and the effect of cost saving initiatives related to the restructuring, as described below.

RESTRUCTURING CHARGES. In October 2001, the Company implemented certain cost saving initiatives due to a slowdown in consumer response rates and increased economic uncertainty in both the U.S. and abroad. This restructuring program included a workforce reduction of approximately 190 employees, the closing of the Company's United Kingdom operations and the downsizing of the operational infrastructure throughout the Company. As a result of this restructuring program, the Company recorded restructuring charges of \$6.9 million during the second quarter ended December 31, 2001.

AMORTIZATION OF GOODWILL AND OTHER INTANGIBLES. Intangible amortization decreased to \$1.9 million in 2002 from \$10.9 million in 2001 due to the adoption of SFAS 142, which no longer requires the amortization of indefinite lived intangible assets, and the sale of iPlace, Inc. Excluding the amortization of indefinite lived intangible assets in 2001, amortization of goodwill and other intangibles would have been \$3.1 million.

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**GAIN ON SALE OF SUBSIDIARY.** In August 2001, the Company sold its investment in and advances to iPlace, Inc. in exchange for \$50.1 million in cash, including \$3.7 million held in escrow, and 1.6 million shares of Homestore.com, Inc. common stock, including 0.5 million shares held in escrow. The fair value of the Homestore.com, Inc. common stock as of the date of sale was \$34.5 million. The Homestore.com, Inc. common stock received is unregistered. Once the Homestore.com, Inc. stock is registered, MemberWorks may only sell 1/12th of the shares in any calendar month pursuant to the merger agreement. In connection with this sale, the Company recognized a gain of \$65.6 million before the write down of Homestore.com, Inc. stock described below.

**LOSS ON SALE OF INVESTMENT, NET.** The Company's investment in Homestore.com, Inc. declined in value during fiscal 2002 and management determined that the decline was other than temporary. As a result, the Company wrote down its investment in Homestore.com, Inc. to its fair market value and recognized a loss of \$33.6 million during fiscal 2002. As of June 30, 2002, the Company's investment in Homestore.com, Inc. is valued at \$0.9 million.

**OTHER EXPENSE, NET.** Other expense, net is primarily composed of interest income from cash and cash equivalents and interest expense on the Company's borrowings under its line of credit and notes payable. Other expense decreased to \$0.4 million in 2002 from \$0.5 million in 2001. The Company had no borrowings outstanding under its line of credit as of June 30, 2002.

**PROVISION FOR INCOME TAXES.** MemberWorks was not required to record a provision for income taxes for the year ended June 30, 2002 due to the ability to utilize net operating losses to offset taxable income. MemberWorks was not required to record a provision for income taxes for the year ended June 30, 2001 due to tax losses realized. As of June 30, 2002, MemberWorks had accumulated federal net operating loss carry forwards of \$68.7 million.

### FISCAL 2001 COMPARED TO FISCAL 2000

**REVENUES.** Revenues increased 44% to \$475.7 million in 2001 from \$330.1 million in 2000 due to an increase in the Company's membership base and an increase in the weighted average program fee. Excluding the effects of SAB 101, revenues would have increased 40% to \$462.3 million in 2001. Revenues before deferral increased 26% to \$485.0 million in 2001 from \$383.6 million in 2000 due to an increase in the Company's membership base and an increase in the weighted

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average program fee. The Company's membership base increased to 7.9 million members at June 30, 2001 from 6.9 million members at June 30, 2000. The increase in the Company's membership base was due to increased demand for the Company's existing programs, as well as the introduction of new programs in 2001 and the Company's expansion into international markets. The increase in the weighted average program fee was due to an increase in program pricing and introduction of new programs with higher fees. As a percentage of total revenues, annual renewal revenues were 41% in 2001 and 38% in 2000. As a percentage of total revenues before deferral, annual renewal revenues were 44% in 2001 and 38% in 2000.

**OPERATING EXPENSES.** Operating expenses increased 46% to \$90.4 million in 2001 from \$62.0 million in 2000 due to the servicing requirements of a larger membership base. As a percentage of revenues before deferral, operating expenses increased to 18.6% in 2001 from 16.2% in 2000 primarily due to an increase in

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the mix of revenue generated from our online business, which has a higher operating expense ratio than our other businesses.

**MARKETING EXPENSES.** Marketing expenses increased 56% to \$305.0 million in 2001 from \$195.3 million in 2000 due to increased expenses required to grow the membership base. As a percentage of revenues, marketing expenses increased to 64.1% in 2001 from 59.1% in 2000. Excluding the effect of SAB 101, marketing expenses would have been 62.3% of revenues in 2001. Marketing expenses, as a percentage of revenues, increased primarily due to a shift in the marketing mix and higher cancellation rates. Marketing expenses before deferral increased 17% to \$287.9 million in 2001 from \$245.7 million in 2000. As a percent of revenues before deferral, marketing expenses decreased to 59.4% in 2001 from 64.1% in 2000.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses increased 48% to \$99.7 million in 2001 from \$67.6 million in 2000 due to higher staff related expenses and occupancy costs required to support the Company's growth. As a percentage of revenues before deferral, general and administrative expenses increased to 20.6% in 2001 from 17.6% in 2000 primarily due to an increase in the mix of revenue generated from our online business, which has a higher general and administrative expense ratio than our other businesses.

**NON-RECURRING CHARGE.** In April 2001, the Company entered into a voluntary agreement with the State of California and Ventura and Orange Counties to implement certain marketing practices in the State of California. Pursuant to the agreement, the Company paid costs of investigation and certain penalties to be split between the state and the counties and established a reserve to cover specific future costs related to the agreement. As a result of the agreement, the Company recorded a non-recurring charge of \$3.0 million.

**AMORTIZATION OF GOODWILL AND OTHER INTANGIBLES.** Intangible amortization increased to \$10.9 million in 2001 from \$6.7 million in 2000 due to the acquisition of Discount Development Services, L.L.C. and its subsidiary, Uni-Care, Inc., (together "DDS") during fiscal 2001 and the effect of a full year of amortization related to the Company's acquisition of eNeighborhoods and Qspace, Inc. in February and April of 2000, respectively.

**GAIN ON SALE OF INVESTMENT, NET.** During fiscal 2001, the Company wrote down its investment in 24/7 Media, Inc. ("24/7") by \$1.8 million due to a decline in value which was determined to be other than temporary. In addition, during fiscal 2001, MemberWorks sold its remaining shares of 24/7 stock, received proceeds of \$4.1 million and recognized a loss of \$0.4 million. The financial impact of these transactions on fiscal 2001 is a net loss of \$2.2 million.

**OTHER EXPENSE/INCOME, NET.** Other expense/income, net is primarily composed of interest income from cash and cash equivalents and interest expense on the Company's borrowings under its line of credit. Other expense in 2001 was \$0.5 million compared to other income of \$0.9 million in 2000. Other expense in 2001 increased due to the Company's borrowings under its line of credit during the period.

**PROVISION FOR INCOME TAXES.** MemberWorks was not required to record a provision for income taxes for the years ended June 30, 2001 and 2000 due to tax losses realized. As of June 30, 2001, MemberWorks had accumulated federal net operating loss carry forwards of \$102.4 million.

### LIQUIDITY AND CAPITAL RESOURCES

Operating cash flow before changes in assets and liabilities was \$26.9 million, \$16.0 million and \$16.0 million for the years ended June 30, 2002, 2001 and 2000, respectively. The increase in operating cash flow before changes in assets

and liabilities in 2002 was primarily due to decreased losses incurred related to iPlace, Inc. and the United Kingdom operations, as well as the cost saving initiatives related to the restructuring plan.

Revenues before deferral were \$410.5 million, \$485.0 million and \$383.6 million for the years ended June 30, 2002, 2001 and 2000, respectively. The Company's membership base was 6.6 million, 7.9 million and 6.9 million members at June 30, 2002, 2001 and 2000, respectively. The decrease in the membership base in 2002 was due to a controlled slow down in new member marketing implemented in the beginning of the 2002 fiscal year, the sale of iPlace, Inc. and the closing of the United Kingdom operations.

Marketing expenses before deferral were \$233.9 million, \$287.9 million and \$245.7 million in 2002, 2001 and 2000, respectively. As a percent of revenues before deferral, marketing expenses before deferral were 57.0% in 2002, 59.4% in 2001 and 64.1% in 2000. The decrease in marketing expenses before deferral was due to a controlled slow down in new member marketing implemented in the beginning of fiscal 2002, the effect of the sale of iPlace, Inc. and the closing of the United Kingdom operations. The decrease in marketing expenses before deferral as a percent of revenue before deferral was due to an increase in the mix of renewal revenues. Marketing expenses related to renewal revenues are typically significantly lower than expenses related to new member revenues. Expenses related to new member marketing, as a percent of new member revenues, increased in 2002 compared to 2001 primarily due to a decrease in consumer response rates.

Changes in assets and liabilities decreased cash from operating activities by \$5.1 million in 2002, \$3.0 million in 2001 and increased cash by \$29.0 million in 2000. The negative effect of changes in assets and liabilities in 2002 was primarily due to the controlled slow down in new member marketing implemented in the beginning of fiscal 2002, as well as the effect of an increase in the members enrolled in a monthly versus annual payment plan. In total, cash provided by operations was \$21.7 million, \$13.0 million and \$44.9 million in 2002, 2001 and 2000, respectively.

Net cash provided by investing activities was \$40.2 million in 2002, while net cash used in investing activities was \$18.2 million in 2001 and \$34.2 million in 2000. Net cash provided by investing activities in 2002 reflected the receipt of \$46.0 million in net proceeds from the sale of iPlace, Inc. In fiscal 2001, MemberWorks paid \$8.2 million in cash to acquire the remaining 81% of DDS. In fiscal 2000, MemberWorks acquired ConsumerInfo.com for \$15.9 million in cash. In addition, during fiscal 2001 and 2000, MemberWorks received \$4.1 million and \$5.2 million, respectively, in proceeds from the sale of its investment in 24/7. Capital expenditures were \$5.8 million, \$15.1 million and \$20.3 million in 2002, 2001 and 2000, respectively.

Net cash used in financing activities was \$33.5 million, \$2.1 million and \$31.5 million in 2002, 2001 and 2000, respectively. The increase in cash used in financing activities was due to an increase in the number of treasury shares acquired under the Company's stock repurchase program. The Company purchased 2.2 million shares in 2002. Marketing, the Board and management have repeatedly ignored requests to define, monitor and communicate performance metrics.<sup>16</sup>

<sup>15</sup> Edwards, Jeremy, *Dating game: With increasing internet penetration, online dating is on the rise*, IBISWorld Inc., September, 2013.

- <sup>16</sup> Spark Networks, Inc., Form 10-K, filed with the SEC on March 14, 2014 and Spark Networks, Inc., Form 10-K, filed with the SEC on March 8, 2013.

***Action Plan Item 2: Ensure that management will be held accountable for delivering superior and sustainable corporate performance and tying compensation to both business results and share price performance.***

The current Board has rewarded management's underperformance with a generous compensation plan. Unlike stockholders, who have seen \$1.00 convert to \$0.79 over the last eight years, the Company Management and Board have collected salary, board fees and roughly 1.7 million shares of low-cost options equating to over \$18 million in total compensation.<sup>17</sup> Furthermore, management and the Board, have little skin in the game, owning only 43,600 shares or 0.2% of the Company's common stock outright (excluding options)<sup>8</sup>

To hold management accountable, our proposed Board would review all current compensation policies and ensure alignment with investors in a cost-appropriate manner. We are more than happy to reward management but only when we all benefit together.

***Action Plan Item 3: Carefully examine all aspects of the Company's user experience and appropriate service offerings with respect to competition. We will examine subscriber lifetime values and ensure a strong return on direct marketing investments in relation to subscriber acquisition cost. Our Board would focus on cash flow generation until acceptable and sustainable returns on directing marketing expenditures can be verified.***

The Company business is predicated upon balancing subscriber acquisition costs against lifetime value. As such, it is critical that the Company provide appropriate subscription offerings in relation to its competitors. In the last year, competitors have launched several important, new revenue streams, and the Company has failed to keep pace.

Management claims Christian Networks presents a market opportunity 30 times the size of Jewish Networks, implying an addressable market of roughly 2.5 million subscribers.<sup>19</sup> Christian Networks' current active paid subscriber base totals 192,349, or just 7.7% of this implied addressable market, and yet, on the March 5, 2014 conference call, management announced a sequential decline in its subscriber base and revenue.<sup>20</sup> Current and prospective stockholders are left with little more than a series of question marks, unable to determine if the current strategy is creating value for stockholders. This is critical because the Company corporate history is littered with failed ventures such as JPix, American Singles, and Kizmeet, as well as businesses that have little impact on value creation such as HurryDate.

***Action Plan Item 4: Provide visible metrics to allow all investors to judge the degree of the Company's progress and hold the Board accountable for results.***

While it is the role of management to run the Company, one of the Board's fundamental responsibilities is to ensure that capital allocation decisions reflect the long-term interests of its stockholders. If elected, our proposed nominees would undertake an immediate review of key investments to ensure that they are earning a return on investment appropriate to the risk of building a business alongside the stable cash flows of Jewish Networks. While analyzing these investments, our Directors would simultaneously work with management to design clear metrics to measure performance and share these appropriately with all stockholders to judge progress. Given the results to date, it is no longer acceptable to invest tens of millions of dollars in Christian Networks while asking stockholders to trust management and the Board.

***Action Plan Item 5: Lead the Company to embrace best practices in corporate governance and remove stockholder unfriendly By-laws.***

In the past few months, we have become deeply concerned about a number of issues at Spark Networks. In order to address our concerns, we sought Board representation. After considerable thought, we decided the only path

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- <sup>17</sup> Spark Networks, Inc., Schedules 14A filed with the SEC on April 2, 2013, April 24, 2012, April 27, 2011, April 28, 2010, April 29, 2009, and November 25, 2008.
- <sup>18</sup> Spark Networks, Inc., Schedule 14A filed with the SEC on April 2, 2013.
- <sup>19</sup> Spark Networks, Inc., Investor Presentation Q3 2013: Page 14, via Spark Networks Investor Relations, accessed March 2014.
- <sup>20</sup> Spark Networks, Inc., Transcript of Q4 2013 Earnings Call March 05, 2014, via Capital IQ, Inc., accessed March 2014.

forward to realize stockholder value for all stockholders was to nominate four extremely qualified nominees for election at the Company's 2014 annual meeting.<sup>21</sup> To ensure proper corporate governance, we also proposed changes to the articles and Bylaws of the Company in our initial filing, two of which are included as Proposals before stockholders at the Company's 2014 Annual Meeting. If adopted, we believe these changes would ensure that management and the Board, including our Directors, if elected, would be more accountable to all stockholders.

***Action Plan Item 6: Evaluate all strategic alternatives to maximize stockholder value.***

We believe Spark Networks today trades at a fraction of what it is truly worth. Although it may be a challenge to value Spark Networks, sell-side analysts value Match.com's subscribers at \$930 to \$1,014 each.<sup>22</sup> In contrast, Spark Networks subscribers are currently being valued at only \$363 per subscriber.

Spark Networks' industry leading Jewish Networks brand has 87% contribution margins, which comes to \$267 in contribution per subscriber per year.<sup>23</sup> In the hands of a strategic buyer, we believe the vast majority of the contribution dollars would fall to EBITDA. Based on recent M&A activity and comparable transactions, we believe Christian Networks subscribers could be valued at \$650-750 per subscriber.<sup>24</sup> Therefore, it is our belief that it is not unreasonable to value Spark Networks at six times Jewish Networks contribution dollars, or \$1,560 per subscriber, plus Christian Networks at \$650-750 per subscriber, which would imply a sum-of-the-parts value in the \$10-12 per share range.

If properly led by a highly motivated Board of Directors, we believe Spark Networks can be worth much more than the current market price. We encourage all stockholders to vote for our nominees by voting the GOLD proxy card, to bring the change that we feel strongly that the Company needs.

### **BACKGROUND OF THE PROXY SOLICITATION**

The Osmium Parties first purchased Company Shares in 2008. In 2010, we publicly expressed our opposition to a going private transaction proposed by former Company majority stockholder Great Hill Partners for \$3.10 per Share. Over the years, as the Osmium Parties acquired more Shares, we have been in routine communication with Company management regarding our thoughts for the Company, particularly its strategic opportunities and its relationship with the investment community. We have routinely attended investor and industry conferences featuring the Company. We have made strategic introductions and we have provided repeated advice related to expanding the Company investor base. On November 22, 2013, representatives from Osmium Partners had a telephone conference with Mr. Liberman, the Company's Chairman and CEO, requesting one Board seat. We believed Board representation was appropriate given Great Hill Partners' significant decrease in ownership, which resulted in Osmium becoming the largest stockholder of Spark. Given a significant reinvestment of stockholder capital into new business initiatives, we believed it was important for stockholders to maintain Board representation, as had been the case throughout Great Hill Partners' tenure. During the course of the conversation, in an effort to hasten change within the Board, Osmium Partners amended its request to an immediate appointment. Over the next few weeks, these discussions continued.

On December 5, 2013, Osmium Partners spoke with representatives of the Company expressing the desire to add Mr. Lewis immediately to the Board, and on December 6, 2013, the Osmium Parties filed a Schedule 13D with the SEC disclosing this request. On December 11, 2013, the Company announced the resignation of the two Great Hill Partners appointees from the Board.

<sup>21</sup> Osmium Partners, Schedule 13D/A, filed with the SEC on February 24, 2014.

<sup>22</sup> Bank of America Merrill Lynch, *IAC InterActive Another Google hit to Ask but Match continues to shine*, October 30, 2013; Oppenheimer & Co. Inc., *IAC/InterActive Corp Structural Weakness in Search Should Be a*



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*Catalyst for Reorganization*, October 30, 2013.

- <sup>23</sup> Based on revenues, contribution and average paying subscribers reported for 2013 for Jewish Networks; Spark Networks, Inc., Fourth Quarter Earnings Release, Current Report on Form 8-K, filed with the SEC on March 5, 2014.
- <sup>24</sup> Based on Osmium estimates, Match.com's acquisition of Meetic (2011); Permira's acquisition of Ancestry.com (2012).

From December to February, Osmium Partners and the Company engaged in multiple discussions regarding a potential Board seat. In late December, the Company offered to discuss its strategic ideas. Without knowing that the Company would appoint Mr. Lewis to the Board, and given Osmium Partners' principal business of investing, we declined to execute a confidentiality agreement that would subject us to a contractual standstill provision or saddle us indefinitely with material non-public information. During this period, Mr. Lewis introduced Mr. Liberman to certain strategic contacts of Osmium Partners, for which Mr. Liberman expressed appreciation in an email communication dated January 30, 2014. Despite believing that the Company and its representatives were unnecessarily delaying the Board appointment process, Osmium Partners remained patient with the Company and its process. However, the Board appointment terms and proposed settlement agreement delivered by the Company to Osmium Partners on February 14, 2014 contained provisions that were not consistent with the parties' earlier discussions and were not market for such Board appointment arrangements. Additionally, Company Parties further expressed an interest in implementing a classified Board, a change Osmium did not support.

On February 21, 2014, prior to the Company's February 23, 2014 deadline for such nominations, the Osmium Parties, through stockholder of record Fund I, pursuant to Section 2.9 of the Bylaws, delivered a stockholder nomination letter containing advance notice of four stockholder nominations for the then-current full size of the Board and proposals to be brought before the Annual Meeting. This Nomination Letter submitted nominations for the four Stockholder Nominees, as well as three stockholder proposals (Proposals 3 and 4 of this Proxy Statement, and a third proposal relating to the ability of stockholders to act by written consent, which the Company has declined to include on the agenda of the Annual Meeting based on its view that it first requires Board approval). This letter, in addition to the nomination of the Stockholder Nominees and notice of the stockholder proposals, expressed dissatisfaction with the Company's delays in updating the Board following the departure of Great Hill Partners, and its two directors from the Company and the Board. Further, the letter criticized the Company's corporate governance regime for its impediments to stockholder democracy and demanded Board accountability to stockholders.

On March 2, 2014, John Lewis personally met with a member of the Company Board to discuss a settlement agreement. These parties reached an agreement in principal based on the immediate appointment of Mr. Lewis and another individual to the Board and a market settlement agreement. During the week of March 3, 2014, the Osmium Parties discussed the Stockholder Nominees and stockholder proposals with representatives of the Company, and representatives of the Osmium Parties prepared a settlement agreement for discussion. The Company invited Mr. Lewis to meet with Messrs. David Hughes and Vince Thompson regarding their appointment to the Board. On March 5, 2014, representatives from the Company responded with significant edits to the proposed settlement agreement. These changes were inconsistent with the agreement in principal reached on March 2, 2014 and included not making any changes consistent with the Osmium Parties' corporate governance stockholder proposals, not containing market recommendation/voting requirements, and requiring the Osmium Parties' nominee to tender his resignation in advance. On March 7, 2014, representatives from the Osmium Parties informed Company representatives that it was terminating settlement discussions.

On March 10, 2014, after the advance notice deadline for submission of stockholder proposals and nominations at the Annual Meeting, the Board announced that it had expanded the size of the Board from four to six members and appointed Messrs. Hughes and Thompson to the Board.

On March 10, 2014, the Osmium Parties issued a press release regarding the Company detailing its concerns and action plan for the Company, and amended its Schedule 13D filing.

On April [ ], 2014, the Osmium Parties filed a preliminary Proxy Statement, and amended its Schedule 13D filing.

## PROPOSAL 1

### ELECTION OF DIRECTORS

We are seeking your support at the Annual Meeting to elect our four independent Stockholder Nominees, Stephen J. Davis, John H. Lewis, Michael J. McConnell and Walter L. Turek.

According to the Company Statement, the Board currently consists of six authorized directors whose terms will expire at the Annual Meeting, and the Company has nominated these six directors for election at the Annual Meeting. Because the Board size increased to six directors subsequent to the deadline for the submission of director nominations by stockholders, we are seeking your support to elect our four Stockholder Nominees in opposition to the Company's nominees at the Annual Meeting. If elected, our four Stockholder Nominees would replace four of the Company's directors and would constitute a majority of the current Board.

By submitting the **GOLD** proxy card, you will not be able to vote for two director positions for which only the Company is soliciting proxies. However, because of the current six director Board size and the plurality voting standard set forth in the Company's Amended and Restated Bylaws, the six individuals receiving the highest number of FOR votes will be elected at the Annual Meeting. There is no assurance that any incumbent Company director will serve as a director if one or more of our Stockholder Nominees are elected to the Board. You should refer to the Company Statement for the names, background, qualifications and other information concerning the Company's nominees. The nominations of our Stockholder Nominees were made in a timely manner and in compliance with the Company's governing instruments.

#### *Stephen J. Davis, 49*

Mr. Davis is a Partner at Banneker Partners, a San Francisco-based private equity firm that focuses on investments in public and private software, internet and business services companies and has been an active investor in technology companies since 2000. Banneker Partners focuses on making investments in software, internet/digital media, SaaS and business services companies.

Prior to joining Banneker Partners, in 2000, Mr. Davis co-founded Vista Equity Partners, a private equity firm that grew to over \$2 billion in capital during his tenure. Mr. Davis served as Principal at Vista. Before joining Vista Equity Partners, he was a Vice President in the Leveraged Finance Group at Credit Suisse First Boston, where he was active in the structure, origination and syndication of bank debt, high yield securities and mezzanine debt capital principally for portfolio companies or acquisition targets of leading private equity firms. Prior to Credit Suisse First Boston, Mr. Davis practiced mergers and acquisitions and securities law in New York with Debevoise & Plimpton and Kirkland & Ellis.

Mr. Davis has served on the Board of Genesys Telecommunications Laboratories, Inc., a leading provider of customer experience and contact center solutions, since its acquisition from Alcatel Lucent in February 2012 by Permira Advisors, Technology Crossover Ventures, and Banneker Partners. Since 2014, he has served on the Board of StatusPath, an online SaaS company providing workflow automation to improve transparency and coordination between teams in the pursuit of business goals and performance objectives. Additionally, Mr. Davis has served on the Board of Advisors of Rocket Lawyer, the leading online company helping small businesses and consumers with their legal needs, since 2007. Mr. Davis has been a Board Observer to Ancestry.com, the leading provider of online genealogy and family history since December 2012, when it was acquired by Permira Advisors, Spectrum Ventures and Banneker Partners. Previously, he has served on the Boards of Applied Systems, BigMachines, Inc., Craig/is Ltd., Petroleum Place, SER, and Ventyx, Inc.

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In addition, Mr. Davis serves on the Board of Trustees of GLIDE, a non-profit organization dedicated to breaking the cycle of poverty and marginalization, as well as the Board of Directors at the Center for Investigative Reporting in Berkeley, California, and he works with M3 Foundation, a non-profit organization focused on providing education and life skills to youth in the East Bay. Mr. Davis received a B.A. in Economics from Carleton College and JD and MBA degrees from Columbia University, where he graduated with Beta Gamma Sigma honors.

The Osmium Parties have named Mr. Davis as a Stockholder Nominee because of his distinguished track record and deep experience focused on investing in software/SaaS, Internet and business services companies, all with a goal of driving top line growth organically and through acquisitions and operational improvement. In addition to his service as a board member, board observer and advisory board member, he has led the acquisitions of several software companies, including BigMachines, Applied Systems, Petroleum Place and Ventyx.

***John H. Lewis, 41***

Mr. Lewis a Founder and Managing Partner of Osmium Partners, a Greenbrae-based value investment firm. Prior to founding Osmium Partners in 2002, from 2001 to 2002, Mr. Lewis was Director of Research at Retzer Capital, a Wisconsin-based hedge fund. From 1999 to 2001, he was an Equity Research Analyst at Heartland Funds, a mutual fund with over \$2 billion under management and a 4-star Morningstar rating. At Heartland, Mr. Lewis covered nine sectors, which translated to 35-55 companies and typically over \$100 million in investments for three funds (Value, Value Plus, Select Value). Mr. Lewis received a BA from the University of Maryland (1996), and an MBA from the University of San Francisco (1999).

Mr. Lewis's extensive experience in capital allocation, finance, realizing value in publicly traded companies and knowledge of internet, consumer-based subscription businesses provide the requisite qualifications, skills, perspective and experience that make him well qualified to serve on the Board.

***Michael J. McConnell, 48***

In addition to being a private investor, Mr. McConnell served as the Interim Non-Executive Chairman of the Board of Directors of Redflex Holdings, Limited, an Australian Stock Exchange (ASX)-listed developer and manufacturer of digital photo enforcement solutions from February 2013 to February 2014 and has served on the Board since August 2011. Mr. McConnell also served as Redflex's Chairman of the Audit Committee, as well as a member of the Remuneration and Nominating & Governance Committees. From 2009 to 2012, Mr. McConnell served as the Chief Executive Officer of Collectors Universe, Inc., a NASDAQ-listed provider of third-party authentication and grading of high value collectibles. Mr. McConnell served on the Board of Collectors Universe, including on its Compensation and Nominating and Governance committees until December 2013. From 1994 to 2007, Mr. McConnell served as a Managing Director of Shamrock Capital Advisors, an investment manager of both domestic and international alternative asset funds in public equities, real estate and private equity, where he led a \$1.2 billion direct investment fund and was a member of the firm's Executive Committee.

Mr. McConnell has served on numerous public and private company boards in the USA, Australia, New Zealand and Ireland over his career. In March 2014, he joined the Board of Vitacost.com, Inc., a NASDAQ-listed leading online retailer of health and wellness products, including dietary supplements. From August 2011 to November 2012, Mr. McConnell served as Chairman of the Remuneration Committee of the Board, and Audit Committee member, of PaperlinX Limited, as ASX-listed international merchant of paper, communication materials and diversified products and services. From November 2009 to January 2012, Mr. McConnell was a member of the board of directors of MRV Communications, a worldwide supplier of communications equipment and services to carriers, governments and enterprise customers worldwide, where he also served on the Strategy and Compensation Committees. In addition, he has formerly served on the boards of Ansell Limited (October 2001 to November 2005), Nuplex Industries (December 2000 to March 2002), Force Corporation (March 1999 to May 2000), iPass Inc. (February 2007 to October 2008), Neo Technology Ventures (February 1999 to June 2004), Cosmoline Limited (March 1997 to May 1999) and Port-Link International (August 2000 to November 2005). Mr. McConnell received his BA in economics from Harvard University in 1988 and his MBA degree (Shermet Scholar) from the Darden School of the University of Virginia in 1994. Mr. McConnell is a member of the Board of Governors of the microfinance organization Opportunity International.

Because Mr. McConnell brings considerable experience as an operating executive, investment professional, public company board member and committee chairman, leader of C-suite executive searches, and speaker on corporate governance, the Osmium Parties believe Mr. McConnell has the requisite qualifications, skills, perspective and experience that make him well qualified to serve on the Board.

*Walter L. Turek*, 61

Mr. Turek has served as the Executive Chairman of Ascentis Corporation, a provider of human resources software, online payroll services, and SaaS Human Capital Management solutions since 2011. From 2005 until its sale to Vista Equity Partners in 2013, Mr. Turek served on the Board of Directors, including as Chairman of the Nominations and Governance Committee and a member of the Audit and Compensation Committees, of Greenway Medical Technologies (formerly NYSE: GWAY), a provider of information solutions to improve the financial performance of healthcare providers. During his tenure with Greenway Medical, revenues grew from approximately \$10 million to \$140 million. From 2009 to its sale in February 2012 to Juniper Networks, he served as Co-Founder and Director of Mykonos Software, a provider of security solutions for websites and web applications against hackers, fraud and theft. Since 1999, Mr. Turek has been a member of the Board of Directors of BlueTie.com, a leading provider of email hosting services and cloud based collaboration solutions.

Until June 2009, Mr. Turek served as an officer and Senior Vice President of Sales and Marketing for Paychex, Inc. (NASDAQ: PAYX), where he oversaw a sales force of over 2,000 people as well as the company's Marketing and International efforts. During the course of his twenty-five year tenure with Paychex, a leading provider of payroll and human resource services company revenues grew from \$10 million to \$2 billion, and the company's market cap expanded to \$13 billion. In addition, Mr. Turek also served as Corporate Director of Stromberg, a wholly owned subsidiary and a provider of time and attendance solutions.

The Osmium Parties have named Mr. Turek as a Stockholder Nominee due to his familiarity with all aspects of running an organization, including finance, technology, sales and operations. He has a long and distinguished career as both a high level sales and marketing executive officer of a large, international service provider, and a director and founder of numerous private and public solutions providers and software companies.

The business address of each of the Stockholder Nominees is c/o Osmium Partners, LLC, 300 Drakes Landing Rd #172, Greenbrae, CA 94904.

We believe that each of the Stockholder Nominees qualifies as an independent director under Section 803(A)(2) of the NYSE MKT Company Guide, and we have no knowledge of any facts that would prevent a determination that each of the Stockholder Nominees is independent.

The Stockholder Nominees have not received any compensation from the Osmium Parties for serving as nominees, and they will not receive any compensation from us for their services as directors of the Company if elected. Each of the Stockholder Nominees, if elected, will be entitled to receive from the Company compensation paid by the Company to its non-employee directors. The compensation currently paid by the Company to its non-employee directors is described in the Company Statement. Other than as stated in this Proxy Statement, there are no arrangements or understandings between the Osmium Parties and any of the Stockholder Nominees or any other person or persons pursuant to which the nomination of the Stockholder Nominees described herein is to be made. Each of the Stockholder Nominees has consented to being named as a nominee in this Proxy Statement and has confirmed his willingness to serve on the Board if elected.

The Osmium Parties do not expect that any of the Stockholder Nominees will be unable to stand for election, but in the event that a vacancy in the slate of Stockholder Nominees should occur unexpectedly, the shares of Common Stock represented by the **GOLD** proxy card will be voted for a substitute candidate selected by the Osmium Parties, to the extent permissible. The Osmium Parties specifically reserve the right to nominate additional persons, to the extent

permissible, including in the event that the Company increases the size of the Board above its existing size or makes changes to its Board by nominating individuals that are not presently serving as directors. If the Osmium Parties decide to add nominees, we will supplement this Proxy Statement. Additional nominations made pursuant to the preceding sentence are without prejudice to our position that any attempt to increase the size of the current Board or change its composition constitutes an unlawful manipulation of the Company's corporate machinery.

**WE URGE YOU TO VOTE YES TO THE ELECTION OF OUR NOMINEES PURSUANT TO PROPOSAL 1.**



## PROPOSAL 2

### **COMPANY PROPOSAL TO RATIFY APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

As discussed in further detail in the Company Statement, the Board has recommended the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2014. According to the Company Statement, stockholder ratification of the selection of Ernst & Young LLP as the Company's independent public accountants is not required by its Certificate of Incorporation nor its Bylaws. If the stockholders fail to ratify the appointment, the Audit Committee will reconsider whether or not to retain Ernst & Young LLP. Even if the selection is ratified, the Audit Committee in its discretion may direct the appointment of a different independent accounting firm at any time during the year, if it determines that such a change would be in the best interests of the Company and its stockholders.

**WE DO NOT OBJECT TO THE RATIFICATION OF THE APPOINTMENT OF ERNST & YOUNG LLP AS THE COMPANY'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE YEAR ENDING DECEMBER 31, 2014 AND INTEND TO VOTE OUR SHARES FOR THIS PROPOSAL.**

## PROPOSAL 3

### **STOCKHOLDER PROPOSAL REQUESTING THE BOARD ADOPT A RULE TO REDEEM ANY CURRENT OR FUTURE STOCKHOLDER RIGHTS PLAN OR AMENDMENT THERETO UNLESS SUCH PLAN IS SUBMITTED TO A STOCKHOLDER VOTE WITHIN 12 MONTHS**

As discussed in further detail in the Company Statement, Company stockholder Mr. Kenneth Steiner, has notified the Company that he intends to present a proposal at the Annual Meeting that the Board adopt a rule to redeem any current or future stockholder rights plan (also known as a "poison pill") or amendment thereto adopted by the Company, unless such a rights plan or amendment is submitted to stockholder vote, as a separate ballot item, within twelve months. In support of this proposal, as included in the Company Statement, Mr. Steiner appears to assert that the Company has a stockholder rights plan that expires in 2017, and that such a stockholder rights plan allows an entrenched management to further its own interests.

The Company opposes Mr. Steiner's proposal. According to the Company Statement, the rights under the Company's stockholder rights plan are only exercisable upon the acquisition by a third party of more than 30% of the Company's outstanding voting shares where the third party has not concurrently launched a tender offer to acquire all of the Company's outstanding common stock.

Generally, the Osmium Parties view stockholder rights plans, and other methods by which a public company board of directors could act out of self-interest to entrench themselves, with a critical eye. The Participants believe that it is important for the Board to periodically consider the Company's corporate governance regime and defensive profiles including the rights plan to determine whether the Company is availing itself of the appropriate protections in light of stockholder needs. However, given the 30% threshold needed to trigger the Company's rights plan, the Participants do not believe that it is presently necessary for the Company to adopt a rule to redeem any current or future stockholder rights plan or amendment thereto as described in Mr. Steiner's proposal.

**WE DO NOT OBJECT TO THE COMPANY'S OBJECTION TO THE ADOPTION OF A RULE THAT THE BOARD WILL REDEEM A CURRENT OR FUTURE STOCKHOLDER RIGHTS PLAN OR AMENDMENT THERETO UNLESS THE PLAN IS SUBMITTED TO A STOCKHOLDER VOTE WITHIN TWELVE MONTHS. WE INTEND TO VOTE OUR SHARES AGAINST THIS PROPOSAL.**



## PROPOSAL 4

### STOCKHOLDER PROPOSAL BY THE OSMIUM PARTIES TO AMEND

#### THE COMPANY'S AMENDED AND RESTATED BYLAWS TO PERMIT STOCKHOLDERS TO CALL SPECIAL MEETINGS OF STOCKHOLDERS

Currently, Company stockholders cannot call special meetings of stockholders under the Bylaws. Section 2.3 of the Bylaws only permits the Company's Board of Directors, Chairman, Chief Executive Officer or President to call special meetings of stockholders. This provision strictly limits the ability of Company stockholders to propose changes in the composition of the Board of Directors or act with respect to other Company initiatives or concerns at any time other than at the annual meeting of stockholders. Such a prohibition has the effect of limiting stockholders to only one stockholder forum per year and prohibits the stockholders from calling a meeting on a timely basis with a stockholder-driven agenda. The Participants believe that such a limit is too restrictive on the Company and its stockholders and creates too much separation between the Board and management, on the one hand, and the stockholders whom they are charged to serve. The ability to bring special meetings of stockholders is critical if stockholders are to be fully effective in advocating for their best interests.

Under this Proposal Three, Section 2.3 of the Bylaws would be deleted in its entirety and replaced with the following proposed language:

#### **Section 2.3 Special Meetings.**

Special meetings may be called at any time by the (i) Board of Directors, (ii) the Chairman, (iii) the Chief Executive Officer, (iv) the President or (v) stockholders owning not less than fifteen percent of the outstanding stock entitled to vote at such meeting by delivering a written request to the Secretary of the Corporation, which request shall set forth the purpose or purposes for which the special meeting is called. Upon receipt of any such stockholder request, it shall be the duty of the Secretary to fix the date and time of the meeting, to be held not more than 75 days following receipt of the request, and to give notice thereof. If the Secretary shall neglect to refuse to fix the date and time of the meeting, the person or persons calling the meeting may do so.

**WE BELIEVE IT IS IMPORTANT TO AMEND THE BYLAWS TO ALLOW BENEFICIAL STOCKHOLDERS TO BE ABLE TO CALL SPECIAL MEETINGS OF STOCKHOLDERS, AND WE INTEND TO VOTE OUR SHARES FOR THIS PROPOSAL.**

## PROPOSAL 5

### STOCKHOLDER PROPOSAL BY THE OSMIUM PARTIES TO AMEND

#### THE COMPANY'S AMENDED AND RESTATED BYLAWS TO ALLOW BENEFICIAL STOCKHOLDERS TO SUBMIT PROPOSALS AND NOMINATIONS FOR DIRECTORS UNDER THE COMPANY'S AMENDED AND RESTATED BYLAWS

Currently, Section 2.9 of the Bylaws only permit a stockholder who is a holder of record (i.e., a stockholder whose name appears directly on the books of the Company's transfer agent) to make stockholder proposals or nominate directors at the Company's annual meetings of stockholders. The Participants believe that modern markets, including the NYSE MKT on which the Company's Common Stock is listed, depend on the quick transfer of shares allowed by the use of the Depository Trust Company (DTC) system. The vast majority of shares held by investors in public companies are held through DTC. Investors, however, hold these shares in street name, only as beneficial owners, not record holders.

As a result, we believe that the requirement of Section 2.9 of the Bylaws that stockholder nominations for directors and stockholder proposals must be submitted by a record holder on behalf of beneficial holders at best poses significant barriers for, and at worst disenfranchises, a significant percentage of the Company's investor base.

The provision prevents Company stockholders whose shares were purchased entirely on the NYSE MKT, and other beneficial holder stockholders, from making nominations or other proposals on their own behalf. Concerned stockholders must take considerable extra effort to make nominations or proposals through DTC or transfer some or all of their shares to a registered holding.

A requirement that only a record holder can submit a stockholder nomination or proposal, in our view, is arcane in the modern market and penalizes the majority of the Company's stockholders for acquiring and holding shares in the most common and convenient form of stock ownership. Further, it is clearly in the best interests of stockholders to have the ability to make timely proposals or nominate directors that would be responsive to stockholder concerns.

Therefore, we call for the Company's stockholder nomination and proposal process to apply equally to beneficial stockholders and stockholders of record. It is our proposal that Sections 2.9(A) and 2.9(B) of the Bylaws should be deleted in their entirety and replaced with the following proposed language:

(A) Except for (1) any directors entitled to be elected by the holders of preferred stock, (2) any directors elected in accordance with Section 3.6 hereof by the Board of Directors to fill a vacancy or newly-created directorships or (3) as otherwise required by applicable law or stock market regulation, only persons who are nominated in accordance with the procedures in this Section 2.9 shall be eligible for election as directors. Nomination for election to the Board of Directors at a meeting of stockholders may be made (i) by or at the direction of the Board of Directors or (ii) by any stockholder of the Corporation who complies with the notice procedures set forth in Section 2.9(B). At any annual meeting of the stockholders, only such business shall be conducted as shall have been properly brought before the meeting. To be properly brought before an annual meeting, business must be (1) specified in the notice of meeting (or any supplement thereto) given by or at the direction of the Board of Directors, (2) otherwise properly brought before the meeting by or at the direction of the Board of Directors, or (3) properly brought before the meeting by a stockholder. For business to be properly brought before an annual meeting by a stockholder, the business must constitute a proper matter under Delaware law for stockholder action and the stockholder must have given timely notice thereof in writing to the Secretary in accordance with the procedures set forth in the Section 2.9(B).

(B) To be timely, a stockholder's notice shall be delivered to the secretary at the principal executive offices of the Corporation not later than the close of business on the ninetieth (90th) day nor earlier than the close of business on the one hundred twentieth (120th) day prior to the first anniversary of the preceding year's annual meeting; provided, however, that in the event that the date of the annual meeting differs by more than thirty (30) days from such anniversary date or if the Corporation has not previously held an annual meeting, notice by the stockholder to be timely must be so delivered not earlier than the close of business on the one hundred twentieth (120th) day prior to such annual meeting and not later than the close of business on the later of the ninetieth (90th) day prior to such annual meeting or the tenth day following the day on which public announcement of the date of such meeting is first made by the Corporation. In the case of an election of directors at a special meeting of stockholders, provided that the Board of Directors has determined that directors shall be elected at such meeting, a stockholder's notice shall be delivered to the secretary at the principal executive offices of the Corporation not earlier than the one hundred twentieth (120th) day prior to such special meeting and not later than the close of business on the later of (x) the ninetieth (90th) day prior to such special meeting and (y) the tenth (10th) day following the day on which notice of the date of such special meeting was mailed or public disclosure of the date of such special meeting was made, whichever first occurs. In no event shall the adjournment or postponement of an annual meeting (or the public announcement thereof) commence a new time period (or extend any time period) for the giving of a stockholder's notice.

Such stockholder's notice shall set forth (I) as to each person whom the stockholder proposes to nominate for election or reelection as a director (a) all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended (or any successor thereto) and Rule 14a-11 thereunder (or any successor



thereto) (including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected); (b) the name and address of the stockholder who intends to make the nomination and of the person or persons to be nominated (in the event the stockholder is a holder of record, as such name and address appear on the books of the Corporation); (c) a representation that the stockholder is either a holder of record or beneficial owner of stock of the Corporation entitled to vote at such meeting and intends to appear in person or by proxy at the meeting and nominate the person or persons specified in the notice, and evidence of such beneficial ownership of stock; (d) a description of all arrangements or understandings between the stockholder and each nominee and any other person or persons (naming such person or persons) pursuant to which the nomination or nominations are to be made by the stockholder; and (e) such other information regarding each nominee proposed by such stockholder as would be required to be included in a proxy statement filed pursuant to the proxy rules of the United States Securities and Exchange Commission had the nominee been nominated, or intended to be nominated, by the Board, (II) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the text relating to the business (including the text of any resolutions proposed for consideration and in the event that such business includes a proposal to amend the Bylaws, the language of the proposed amendment), the reasons for conducting such business at the meeting, and any material interest in such business of such stockholder on whose behalf the proposal is made; and (III) as to the stockholder giving the notice on whose behalf the nomination or proposal is made (a) the name and address of the stockholder who intends to submit the proposal (in the event the stockholder is a holder of record, as such name and address appear on the books of the Corporation); (b) the class and number of shares of the Corporation which are owned beneficially and of record by such stockholder, and evidence of such beneficial ownership of stock; (c) a description of all arrangements or understandings between such stockholder any other person or persons (including their names) in connection with the proposal of such business by such stockholder; (d) a representation that such stockholder intends to appear in person or by proxy at the meeting to bring such business before the meeting; and (e) a representation whether the stockholder intends or is part of a group which intends (x) to deliver a proxy statement and/or form of proxy to holders of at least the percentage of the Corporation's outstanding capital stock required to approve or adopt the proposal and/or (y) otherwise to solicit proxies from stockholders in support of such proposal. In addition, the stockholder making such proposal shall promptly provide any other information reasonably requested by the Corporation. In addition, with regards to any director-nominee, the stockholder's notice must be accompanied by the written consent of the proposed nominee to serve as a director if elected. The Corporation may require any proposed nominee to furnish such other information as may reasonably be required to determine the eligibility of such proposed nominee to serve as a director of the Corporation.

Notwithstanding anything in these Bylaws to the contrary, no business shall be conducted at any meeting of stockholders except in accordance with the procedures set forth in this Section 2.9; provided that any stockholder proposal which complies with Rule 14a-8 of the proxy rules (or any successor provision) promulgated under the Securities Exchange Act of 1934, as amended, and is to be included in the Corporation's proxy statement for an annual meeting of stockholders shall be deemed to comply with the requirements of this Section 2.9. A stockholder shall not have complied with this Section 2.9(B) if the stockholder solicits or does not solicit, as the case may be, proxies in support of such stockholder's proposal or director-nominee in contravention of the representations with respect thereto required by this Section 2.9.

**WE BELIEVE IT IS IMPORTANT TO AMEND THE BYLAWS TO ALLOW BENEFICIAL STOCKHOLDERS TO SUBMIT STOCKHOLDER NOMINATIONS AND PROPOSALS IN THE SAME MANNER AS STOCKHOLDERS OF RECORD, AND WE INTEND TO VOTE OUR SHARES FOR THIS PROPOSAL.**

## VOTING AND PROXY PROCEDURES

Only stockholders of record at the close of business on the Record Date will be entitled to notice of and to vote at the Annual Meeting. Each share of the Company's Common Stock is entitled to one vote. Stockholders are not entitled to cumulative voting rights. Based on publicly available information, we believe that the only outstanding class of securities of the Company entitled to vote at the Annual Meeting is the Common Stock.

According to the Company Statement, stockholders of record as of the Record Date will be allowed to vote their Shares in person by ballot at the Annual Meeting. Stockholders holding shares through a brokerage firm, bank or other custodian will not be able to vote in person by ballot at the Annual Meeting unless they vote a legal proxy at the Annual Meeting obtained in advance from such brokerage firm, bank or other custodian. The Annual Meeting will be held at 11355 W. Olympic Blvd., Los Angeles, California 90064, and directions to the Annual Meeting are available by contacting Okapi Partners toll-free at (855) 305-0856.

Shares represented by properly executed **GOLD** Proxy Cards will be voted at the Annual Meeting as marked and, in the absence of specific instructions, will be voted **FOR** the election of the four Stockholder Nominees, **FOR** the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the year ending December 31, 2014, **AGAINST** the stockholder proposal regarding poison pills, **FOR** the amendment to the Company's Amended and Restated Bylaws to permit stockholders to call special meetings of stockholders, and **FOR** the amendment to the Company's Amended and Restated Bylaws to allow beneficial stockholders to submit proposals and nominations for directors, as described herein and in the discretion of the persons named as proxies on all other matters as may properly come before the Annual Meeting.

The Board is currently composed of six directors, whose terms expire at the Annual Meeting. According to the Company Statement, the Company has nominated these six directors for election at the Annual Meeting. The Board size increased to six directors subsequent to the deadline for the submission of director nominations by stockholders. This Proxy Statement is soliciting votes to elect only our four Stockholder Nominees. If elected, our four Stockholder Nominees would replace four of the Company's directors and would constitute a majority of the Board.

The enclosed **GOLD** Proxy Card enables you only to vote for our Stockholder Nominees and does not confer voting power with respect to the Company's nominees. You can only vote for the Company's nominees by signing and returning a proxy card provided by the Company. The names, backgrounds and qualifications of the Company's nominees, and other information about them, can be found in the Company Statement. The Participants intend to vote all of their Shares in favor of the Stockholder Nominees. There is no assurance that any of the Company's nominees will serve as directors if any or all of our Stockholder Nominees are elected.

## QUORUM; ABSTENTIONS; BROKER NON-VOTES

According to the Company Statement, the presence of the holders of a majority of the Shares entitled to vote at the Annual Meeting, either in person or by proxy, is necessary to constitute a quorum at the Annual Meeting.

Stockholders who hold Shares in street name are not stockholders of record, but rather holders who hold their Shares through accounts with brokerage firms, banks or other custodians. In the absence of specific voting instructions from the beneficial stockholders, these brokerage firms, banks and other custodians generally lack the discretion to submit votes on behalf of such beneficial stockholders for matters considered to be non-routine under applicable exchange rules, including, according to the Company Statement, all proposals at the Annual Meeting, due to the contested solicitation. A broker non-vote is a proxy submitted by a custodian that does not indicate a vote for some or all of the proposals because the custodian lacks discretionary voting authority on non-routine matters.



According to the Company Statement, abstentions will count towards the presence of a quorum, but broker non-votes will not. The Company has indicated in the Company Statement that if a quorum is not present at the Annual Meeting, the Company expects to adjourn the Annual Meeting in order to solicit additional proxies.

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## VOTES REQUIRED FOR APPROVAL

*Election of Directors (Proposal 1)* According to the Company Statement, in a contested election, the six nominees for director receiving the highest vote totals will be elected as directors of the Company. Withheld votes, or votes against, will have no impact on the election of directors. Stockholders will not be able to abstain from voting in the election of directors.

*Other Proposals (Proposals 2, 3, 4 and 5)* According to the Company Statement, the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the year ending December 31, 2014, the stockholder proposal regarding poison pills, our proposed amendment to the Company's Amended and Restated Bylaws to permit stockholders to call special meetings of stockholders, and our proposed amendment to the Company's Amended and Restated Bylaws to allow beneficial stockholders to submit proposals and nominations for directors each requires the affirmative vote of holders of a majority of the Shares present or represented by proxy at the meeting and entitled to vote on the proposals. Abstentions will have the same effect as a vote against the proposal. Broker non-votes will not be counted in determining the outcome of any of the Proposals, and because of the contested solicitation, according to the Company Statement, they will not be counted for purposes of determining whether a quorum exists.

## REVOCAION OF PROXIES

Stockholders of the Company may revoke their proxies at any time prior to exercise by attending the Annual Meeting and voting in person (although attendance at the Annual Meeting will not in and of itself constitute revocation of a proxy) or by delivering a written notice of revocation. The delivery of a subsequently dated proxy that is properly completed will constitute a revocation of any earlier proxy. The revocation may be delivered to the Company or Osmium Partners, LLC, c/o Okapi Partners, 437 Madison Avenue, 28th Floor, New York, N.Y. 10022.

Although a revocation is effective if delivered to the Company, we request that either the original or xerox copies of all revocations be mailed to Osmium Partners, LLC, c/o Okapi Partners, 437 Madison Avenue, 28th Floor, New York, N.Y. 10022 so that we will be aware of all revocations and can more accurately determine if and when proxies have been received from the holders of record of a majority of the outstanding Shares of the Company's common stock on the Record Date. Additionally, Okapi Partners may use this information to contact stockholders who have revoked their proxies in order to solicit later dated proxies for the election of the Stockholder Nominees.

If your Shares are registered in your own name, please sign, date and mail the enclosed **GOLD** Proxy Card to Okapi Partners in the postage-paid envelope provided. If any of your Shares are held in the name of a brokerage firm, bank, custodian or other institution, only the brokerage firm, bank, custodian or other institution can execute a Proxy Card for such Shares and will do so only upon receipt of specific instructions from you. Accordingly, for those Shares you own through a brokerage firm, bank, bank nominee or other institution, you must contact the person responsible for your account at the brokerage firm, bank, custodian or other institution and advise that person to execute and return the accompanying **GOLD** Proxy Card. We urge you to confirm in writing your instructions to the person responsible for your account and to provide a copy of such instructions to Osmium Partners, LLC, c/o Okapi Partners, 437 Madison Avenue, 28th Floor, New York, N.Y. 10022, so that we will be aware of all instructions given and can attempt to ensure that such instructions are followed.

**Your Proxy Card is important, no matter how many or how few Shares you own. Please complete, sign and return the enclosed GOLD Proxy Card as promptly as possible.**

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**If you have any questions about executing or delivering your GOLD Proxy Card, need additional copies of the Participants proxy materials, or require assistance, please contact:**

**437 Madison Avenue, 28th Floor**

**New York, N.Y. 10022**

**(212) 297-0720**

**Stockholders Call Toll-Free at: (855) 305-0856**

**IMPORTANT NOTICE REGARDING THE AVAILABILITY OF THIS PROXY STATEMENT**

This Proxy Statement, the GOLD Proxy Card and other materials we have filed in connection with this Proxy Statement are available at: [\[www.okapivote.com/osmium.\]](http://www.okapivote.com/osmium)

**SOLICITATION OF REQUESTS; EXPENSES**

The solicitation of proxies pursuant to this Proxy Solicitation is being made by the Participants. Proxies may be solicited by mail, facsimile, telephone, telegraph, Internet, in person and by advertisements. The Participants will bear the entire expense of preparing and mailing this Proxy Statement and any other soliciting material, including, without limitation, the costs, if any, related to advertising, printing, public relations, transportation, litigation and the fees of attorneys, financial advisors, solicitors and accountants. We may solicit Proxies by telephone, email, telegram, and personal solicitation, in addition to the mail. We will reimburse the reasonable out-of-pocket expenses of banks, brokerage houses, and other custodians, nominees, and fiduciaries in connection with the forwarding of solicitation material to the beneficial owners of Common Stock that such institutions hold.

The Osmium Parties have retained Okapi Partners to provide solicitation and advisory services in connection with this solicitation. Okapi Partners will receive a fee not to exceed \$[ ], together with reimbursement for its reasonable out-of-pocket expenses, and will be indemnified by the Osmium Parties against certain liabilities and expenses, including certain liabilities under the federal securities laws. Okapi Partners will solicit proxies from individuals, brokers, banks, custodian and other institutional holders. It is anticipated that Okapi Partners will employ approximately [ ] persons to solicit the Company's stockholders as part of this solicitation. Okapi Partners does not believe that any of its directors, officers, employees, affiliates or controlling persons, if any, is a participant in this Proxy Solicitation.

We estimate that our total expenditures relating to the solicitation of proxies will be approximately \$[ ] (including, without limitation, costs, if any, related to advertising, printing, fees of attorneys, financial advisors, solicitors and accountants, public relations, transportation, and litigation). Our total expenditures to date relating to these solicitations have been approximately \$[ ]. We intend to seek reimbursement of these costs from the Company. In the event that we seek reimbursement of our expenses, we do not intend to submit the matter to a vote of the Company's stockholders. The Board would be required to evaluate the requested reimbursement consistent with their fiduciary duties to the Company and its stockholders. Costs related to the solicitation of proxies include expenditures for attorneys, advisors, printing, advertising, postage and related expenses and fees.

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## INFORMATION ON THE PARTICIPANTS

The Participants in the solicitation of proxies from stockholders of Spark Networks, Inc. include the following: (1) Osmium Capital, LP, a Delaware limited partnership ( Fund I ); (2) Osmium Capital II, LP, a Delaware limited partnership ( Fund II ); (3) Osmium Spartan, LP, a Delaware limited partnership ( Fund III ); (4) Osmium Diamond, LP ( Fund IV ), and collectively with Fund I, Fund II, and Fund III, the Funds ); (5) Osmium Partners, LLC, a Delaware limited liability company ( Osmium Partners ); (6) John H. Lewis, a United States citizen (Mr. Lewis, Osmium Partners and the Funds, collectively, the Osmium Parties ); (7) Stephen J. Davis, a United States citizen; (8) Michael J. McConnell, a United States citizen; and (9) Walter L. Turek, a United States citizen. Messrs. Davis, McConnell and Turek (collectively, the Stockholder Nominees ) are the director nominees to the Board of Directors of Spark Networks nominated by Mr. Lewis and Osmium Partners in the Nomination Letter dated February 21, 2014, as filed as Exhibit 2 to Schedule 13D/A Amendment No. 2 as filed with the SEC by Osmium Partners, LLC on February 24, 2014.

The principal business address of each of the Participants is c/o Osmium Partners, LLC, 300 Drakes Landing Road #172, Greenbrae, CA 94904.

Osmium Partners serves as the general partner of Fund I, Fund II, Fund III and Fund IV. Mr. Lewis is the controlling member of Osmium Partners. Osmium Partners and Mr. Lewis may be deemed to share with Fund I, Fund II, Fund III and Fund IV (and not with any third party) the power to vote or direct the voting of and to dispose or direct the disposition of the 3,479,309 Shares collectively owned by the Funds, as set forth in more detail below. Mr. Lewis, individually, has the power to vote or direct the voting of and to dispose or direct the disposition of 143,564 Shares individually owned by him.

The Osmium Parties beneficially own:

- (i) Fund I directly owns 1,255,468 shares of Common Stock representing [ ]% of all of the outstanding shares of Common Stock of the Company.
- (ii) Fund II directly owns 1,197,699 shares of Common Stock representing [ ]% of all of the outstanding shares of Common Stock of the Company.
- (iii) Fund III directly owns 327,743 shares of Common Stock representing [ ]% of all of the outstanding shares of Common Stock of the Company.
- (iv) Fund IV directly owns 269,300 shares of Common Stock representing [ ]% of all of the outstanding shares of Common Stock of the Company.
- (v) Osmium Partners, as the general partner of each of the Funds, may be deemed to beneficially own the 3,050,210 shares of Common Stock held by them, representing [ ]% of all of the outstanding shares of Common Stock of the Company.
- (vi) Mr. Lewis individually owns 325,352 shares of Common Stock representing less than [ ]% of all of the outstanding shares of Common Stock of the Company. Mr. Lewis may also be deemed to be the beneficial

owner of the shares of Common Stock beneficially owned by Osmium Partners.

(vii) Collectively, the Osmium Parties beneficially own 3,375,562 shares of Common Stock representing [ ]% of all of the outstanding shares of Common Stock of the Company.

The Stockholder Nominees, other than Mr. Lewis, beneficially own:

(i) Mr. McConnell directly owns 135,021 shares of Common Stock representing less than [ ]% of all of the outstanding shares of Common Stock of the Company.

(ii) Mr. Turek directly owns 111,750 shares of Common Stock representing less than [ ]% of all of the outstanding shares of Common Stock of the Company.

(iii) Mr. Davis does not directly own any shares of Common Stock of the Company.

Collectively, the Participants own 3,622,324 shares, or [ ]% of the outstanding Common Stock of the Company.

The percentages set forth above are based on the 24,001,937 shares of Common Stock outstanding as of December 31, 2013, as reported by the Company in its Press Release filed as Exhibit 99.1 to its Current Report on Form 8-K filed with the SEC on March 5, 2014.

While each of the Stockholder Nominees is a limited partner in one or more of Funds I, II and IV, each of the Stockholder Nominees, other than Mr. Lewis, disclaims beneficial ownership of, and may not be deemed to share with any other Stockholder Nominee or any other Participant, the power to vote or direct the voting of and to dispose or direct the disposition of the Shares held by any other Stockholder Nominee or Participant.

None of the Participants share beneficial ownership of any Shares beneficially owned by any of the Stockholder Nominees (other than Mr. Lewis). Despite beneficial ownership of Shares and being a limited partner in one or more of Funds I, II and Fund IV, each of the Stockholder Nominees (excluding Mr. Lewis) disclaims any membership in any group for Section 13 purposes with any of the Reporting Persons.

The principal business of the Funds is to invest in securities and the principal business of Osmium Partners is investment management. The principal business of each Stockholder Nominee is disclosed in the section titled PROPOSAL 1 ELECTION OF DIRECTORS on page [ ].

The principal business address of Osmium Partners, LLC is 300 Drakes Landing Road #172, Greenbrae, CA 94904.

Except as set forth in this Proxy Statement (including the Annexes hereto), (i) during the past ten years, no Participant has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors); (ii) no Participant in this Proxy Solicitation directly or indirectly beneficially owns any securities of the Company; (iii) no Participant owns any securities of the Company which are owned of record but not beneficially; (iv) no Participant has purchased or sold any securities of the Company during the past two years; (v) no part of the purchase price or market value of the securities of the Company owned by any Participant is represented by funds borrowed or otherwise obtained for the purpose of acquiring or holding such securities; (vi) no Participant is, or within the past year was, a party to any contract, arrangements or understandings with any person with respect to any securities of the Company, including, but not limited to, joint ventures, loan or option arrangements, puts or calls, guarantees against loss or guarantees of profit, division of losses or profits, or the giving or withholding of proxies; (vii) no associate of any Participant owns beneficially, directly or indirectly, any securities of the Company; (viii) no Participant owns beneficially, directly or indirectly, any securities of any parent or subsidiary of the Company; (ix) no Participant or any of his or its associates was a party to any transaction, or series of similar transactions, since the beginning of the Company's last fiscal year, or is a party to any currently proposed transaction, or series of similar transactions, to which the Company or any of its subsidiaries was or is to be a party, in which the amount involved exceeds \$120,000; (x) no Participant or any of his or its associates has any arrangement or understanding with any person with respect to any future employment by the Company or its affiliates, or with respect to any future transactions to which the Company or any of its affiliates will or may be a party; and (xi) no person, including any of the Participants, who is a party to an arrangement or understanding pursuant to which the Stockholder Nominees are proposed to be elected has a substantial interest, direct or indirect, by security holdings or otherwise in any matter to be acted on as set forth in this Proxy Statement. There are no material proceedings to which any Participant or any of his or its associates is a party adverse to the Company or any of its subsidiaries or has a material interest adverse to the Company or any of its subsidiaries. With respect to each of the Participants, except as set forth in this Proxy Statement (including the Annexes hereto), none of the events enumerated in Item 401(f)(1)-(8) of Regulation S-K of the Exchange Act occurred during the past ten years and which must be disclosed as material for purposes of an evaluation of the integrity or ability of any person nominated to become a director under the federal securities laws. None of the Stockholder Nominees has carried on an occupation or employment, during the past five years, with the Company or any corporation or organization which is or was a parent, subsidiary or other affiliate of the Company, and none of the Stockholder Nominees has ever served on the

Company's Board. No family relationships exist between any Stockholder Nominee and any director or executive officer of the Company.

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## CERTAIN INFORMATION REGARDING THE COMPANY

The Company is a Delaware corporation with its principal executive offices at 11150 Santa Monica Blvd., Los Angeles, California 90025.

The Company is subject to the informational filing requirements of the Exchange Act and in accordance therewith it files periodic reports, proxy statements and other information with the SEC. Reports, proxy statements and other information filed by the Company with the SEC can be inspected and copied at the public reference facilities maintained by the SEC at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. Information regarding the public reference facilities may be obtained from the SEC by telephoning (202) 551-8090. The Company's filings with the SEC are also available to the public without charge on the SEC's website (<http://www.sec.gov>).

Except as otherwise noted herein, the information concerning the Company contained in this Proxy Statement has been taken from or based upon publicly available documents and records on file with the SEC and other public sources. Although we do not have any knowledge that would indicate that any statement contained herein based upon such documents and records is untrue, we have not independently verified the accuracy or completeness of such information and do not take any responsibility for the accuracy or completeness of the information contained in such documents and records, or for any failure by the Company to disclose events that may affect the significance or accuracy of such information.

### STOCKHOLDER PROPOSALS TO BE PRESENTED AT THE NEXT ANNUAL MEETING

Any stockholder wishing to submit a proposal to be included in the Company's 2015 proxy statement pursuant to Rule 14a-8 of the Exchange Act must submit such a written proposal that complies with Rule 14a-8 to the Company's Secretary. The Company must receive such a proposal no later than the close of business on [ ], 2014, the date that is 120 calendar days before the anniversary of the release date of the proxy statement relating to this year's Annual Meeting. If the date of the 2015 annual meeting of stockholders is changed by more than 30 days from the anniversary of this year's Annual Meeting, then the deadline is a reasonable time before the Company begins to print and mail proxy materials.

Stockholder nominations for the election of directors and stockholder proposals not made pursuant to Rule 14a-8 must comply with the advance notice provisions contained in the Bylaws, which provide that such proposals (i) may only be submitted by stockholders of record (or if Proposal 5 is approved, also by stockholders beneficially owning Shares) on the date of giving the advance notice and on the record date for the determination of stockholders entitled to notice of and to vote at stockholder meetings; (ii) must be submitted in writing to, and received by, the Company's Secretary at the Company's principal executive offices no later than the close of business on [ ], the date that is 90 days prior to the first anniversary of the preceding year's annual meeting, and no earlier than [ ], the date that is 120 days prior to the first anniversary of the preceding year's annual meeting.

If the date of the annual meeting differs by more than 30 days from the first anniversary of preceding year's annual meeting, then the deadline for stockholder notice of nominations and proposals not made pursuant to Rule 14a-8 is not earlier than the close of business on the date that is 120 days prior to the annual meeting and not later than the close of business on the date that is 90 days prior to the annual meeting, or the tenth day following the day the Company's first public announcement of the date of the annual meeting. Adjournments or postponements of an annual meeting do not extend or commence new time periods for the giving of stockholder notice. To be considered at the annual meeting, stockholder proposals must be presented in person by the stockholder (or qualified representative described in the Bylaws) at the annual meeting.

All proposals must be delivered to Joshua Kreinberg, Corporate Secretary, at Spark Networks, Inc., 11150 Santa Monica Blvd., Los Angeles, California 90025, and the Company recommends delivery by certified mail, return receipt



requested.

The information set forth above regarding the procedures for submitting stockholder proposals and nominations for the election of directors for consideration at the 2015 annual meeting of stockholders is based solely on information contained in the Company Statement. The incorporation of this information in this Proxy Statement should not be construed as an admission by the Participants that such procedures are legal, valid or binding.

**YOUR SUPPORT IS IMPORTANT**

NO MATTER HOW MANY OR HOW FEW SHARES YOU OWN, WE ARE SEEKING YOUR SUPPORT. PLEASE SIGN, DATE, AND MAIL IN THE ENCLOSED POSTAGE-PAID ENVELOPE THE ENCLOSED **GOLD** PROXY CARD AS SOON AS POSSIBLE.

IF YOUR SHARES ARE HELD IN THE NAME OF A BROKERAGE FIRM, BANK, BANK NOMINEE OR OTHER INSTITUTION, ONLY IT CAN SIGN A WRITTEN PROXY CARD WITH RESPECT TO YOUR SHARES. ACCORDINGLY, PLEASE CONTACT THE PERSON RESPONSIBLE FOR YOUR ACCOUNT AND GIVE INSTRUCTIONS FOR A PROXY CARD TO BE SIGNED REPRESENTING YOUR SHARES.

**WHOM YOU CAN CALL IF YOU HAVE QUESTIONS**

If you have any questions, need to request additional copies of the Participants proxy materials, or require any other assistance, please contact Okapi Partners, proxy solicitors for the Participants, at the following address and toll free telephone number:

**437 Madison Avenue, 28th Floor**

**New York, N.Y. 10022**

**(212) 297-0720**

**Stockholders Call Toll-Free at: (855) 305-0856**

**E-mail: [info@okapipartners.com](mailto:info@okapipartners.com)**

**This Proxy Statement and GOLD Proxy Card are Available at:**

**[www.okapivote.com/osmium](http://www.okapivote.com/osmium)**

**IT IS IMPORTANT THAT YOU SIGN AND DATE YOUR GOLD PROXY CARD AND RETURN IT PROMPTLY IN THE ENCLOSED ENVELOPE TO AVOID UNNECESSARY EXPENSE AND DELAY. NO POSTAGE IS NECESSARY.**

**INCORPORATION BY REFERENCE**

WE HAVE OMITTED FROM THIS PROXY STATEMENT CERTAIN DISCLOSURE REQUIRED BY APPLICABLE LAW TO BE INCLUDED IN THE COMPANY'S PROXY STATEMENT. SUCH DISCLOSURES INCLUDE, AMONG OTHER THINGS:

INFORMATION REGARDING SECURITIES OF THE COMPANY BENEFICIALLY OWNED BY THE COMPANY'S DIRECTORS, NOMINEES AND MANAGEMENT;

CERTAIN BENEFICIAL OWNERSHIP OF MORE THAN 5% OF THE COMPANY'S VOTING SECURITIES;

CURRENT BIOGRAPHICAL INFORMATION ON THE COMPANY'S DIRECTORS; AND

INFORMATION CONCERNING THE COMPENSATION OF THE COMPANY'S DIRECTORS AND EXECUTIVE OFFICERS, INCLUDING THE COMPANY'S COMPENSATION DISCUSSION AND ANALYSIS.

ALTHOUGH WE DO NOT HAVE ANY KNOWLEDGE INDICATING THAT ANY STATEMENT MADE BY IT HEREIN IS UNTRUE, WE DO NOT TAKE ANY RESPONSIBILITY FOR THE ACCURACY OR COMPLETENESS OF STATEMENTS TAKEN FROM PUBLIC DOCUMENTS AND RECORDS THAT WERE NOT PREPARED BY US OR ON OUR BEHALF, OR FOR ANY FAILURE BY THE COMPANY TO DISCLOSE EVENTS THAT MAY AFFECT THE SIGNIFICANCE OR ACCURACY OF SUCH INFORMATION.

**CONCLUSION**

We urge you to carefully consider the information contained in this Proxy Statement and then support our efforts by signing, dating and returning the enclosed **GOLD** proxy card today.

Thank you for your support,

**JOHN H. LEWIS**

**OSMIUM PARTNERS, LLC**

**OSMIUM CAPITAL, LP**

**OSMIUM CAPITAL II, LP**

**OSMIUM SPARTAN, LP**

**OSMIUM DIAMOND, LP**

**STEPHEN J. DAVIS**

**MICHAEL J. MCCONNELL**

**WALTER L. TUREK**

[            ], 2014

## ANNEX I

**TRANSACTIONS BY THE PARTICIPANTS IN THE SECURITIES OF SPARK NETWORKS, INC.  
DURING THE PAST TWO YEARS**

The following tables set forth all transactions effected during the past two years by the Participants with respect to securities of the Company. As of the date of hereof, all of the Participants that own of record or beneficially securities of the Company are listed below. The Shares reported herein are held in either cash accounts or margin accounts in the ordinary course of business.

**Osmium Capital (Fund I)**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
5/2/13	220,000	\$ 6.25	Purchase
11/22/13	57,270	\$ 5.40	Purchase
11/25/13	25,230	\$ 5.44	Purchase
11/26/13	13,200	\$ 5.70	Purchase

**Osmium Capital II (Fund II)**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
12/11/12	38,000	\$ 6.33	Purchase
12/12/12	11,544	\$ 6.46	Purchase
12/13/12	10,849	\$ 6.46	Purchase
12/14/12	6,158	\$ 6.67	Purchase
12/17/12	7,518	\$ 7.10	Purchase
12/18/12	8,000	\$ 7.33	Purchase
12/19/12	5,000	\$ 7.36	Purchase
12/20/12	2,583	\$ 7.35	Purchase
11/7/13	120,000	\$ 7.17	Sale
12/2/13	100,000	\$ 5.61	Sale*

**Osmium Spartan (Fund III)**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
12/3/12	75,000	\$ 6.11	Purchase
12/5/12	15,200	\$ 6.35	Purchase

**Osmium Diamond (Fund IV)**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
11/7/13	120,000	\$ 7.17	Purchase
11/22/13	29,503	\$ 5.40	Purchase
11/25/13	12,997	\$ 5.44	Purchase
11/26/13	6,800	\$ 5.70	Purchase
12/2/13	100,000	\$ 5.61	Purchase*

\* Cross-trade between Osmium Capital II (Fund II) and Osmium Diamond (Fund IV)

**John H. Lewis, Individually**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
1/8/14	1,200	\$ 6.27	Purchase
1/9/14	23,900	\$ 6.33	Purchase
1/10/14	60,538	\$ 6.24	Purchase
1/10/14	13,000	\$ 6.21	Purchase
1/13/14	48,200	\$ 6.13	Purchase
1/14/14	19,950	\$ 6.11	Purchase
1/15/14	15,000	\$ 6.17	Purchase

**Michael J. McConnell, Individually**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
6/28/13	5,000	\$ 8.35	Sale
3/13/14	7,500	\$ 4.95	Purchase
3/13/14	1,433	\$ 4.95	Purchase
3/13/14	8,567	\$ 5.00	Purchase
3/13/14	5,000	\$ 4.95	Purchase
3/24/14	2,500	\$ 4.95	Purchase
4/14/14	21	\$ 5.00	Purchase
4/15/14	5,000	\$ 4.96	Purchase
4/15/14	5,000	\$ 4.95	Purchase
4/15/14	5,000	\$ 4.96	Purchase

**Walter L. Turek, Individually**

	<b>Number of Shares</b>	<b>Price Per Share</b>	<b>Type of Transaction</b>
7/12/12	10,000	\$ 5.05	Purchase
8/16/13	10,000	\$ 7.24	Purchase
8/19/13	5,000	\$ 6.98	Purchase
11/14/13	15,000	\$ 6.75	Purchase
1/17/14	10,000	\$ 6.00	Purchase

While an investor in certain of the Funds, Stephen J. Davis does not own Shares individually.

## ANNEX II

## SECURITY OWNERSHIP OF THE PARTICIPANTS

Security Ownership of the Participants

The following table sets forth information regarding the beneficial ownership of the Company's common stock as of April [15], 2014, in each case including shares of common stock which such persons have the right to acquire within 60 days of April [15], 2014, by:

each of the Participants; and

all of the Participants as a group.

Name of Beneficial Owner	Number of Shares	Percent**
Osmium Partners	3,050,210	[12.8]%
Osmium Capital (Fund I)	1,255,468	[5.2]%
Osmium Capital II (Fund II)	1,197,699	[5.0]%
Osmium Spartan (Fund III)	327,743	[1.4]%
Osmium Diamond (Fund IV)	269,300	[1.1]%
Stephen J. Davis	0	0%
John H. Lewis	3,375,562 <sup>1</sup>	[14.1]%
Michael J. McConnell	135,021	*
Walter L. Turek	111,750	*
All participants together	3,622,324	[15.0]%

\* Less than 1%

\*\* Based on [ ] shares of common stock outstanding as of [ ], 2014, as reported by the Company in its [ ] as filed with the Securities and Exchange Commission on [ ], 2014.

(1) Includes 325,352 shares of Common Stock for which Mr. Lewis has sole voting and dispositive power, and 3,050,210 shares of Common Stock which Mr. Lewis may be deemed the beneficial owner, as Managing Member of Osmium Partners, the general partner of each of Fund I, Fund II, Fund III and Fund IV.



**IMPORTANT**

Tell your Board what you think! Your vote is important. No matter how many shares of the Common Stock you own, please give Osmium Partners your proxy FOR the election of the Stockholder Nominees by taking the following four steps:

COMPLETING the enclosed **GOLD** Proxy Card,

SIGNING the enclosed **GOLD** Proxy Card,

DATING the enclosed **GOLD** Proxy Card, and

MAILING the enclosed **GOLD** Proxy Card TODAY in the envelope provided (no postage is required if mailed in the United States).

**If any of your Shares are held in the name of a brokerage firm, bank, custodian or other institution, only it can vote such Shares and only upon receipt of your specific instructions.** Depending upon your broker or custodian, you may be able to vote either by toll-free telephone or by the Internet. Please refer to the enclosed Proxy Card for instructions on how to vote electronically. You may also vote by signing, dating and returning the enclosed **GOLD** Proxy Card.

If you have any questions or require any additional information concerning this Proxy Statement, please contact Okapi Partners at the address set forth below.

**437 Madison Avenue, 28th Floor**

**New York, N.Y. 10022**

**(212) 297-0720**

**Stockholders Call Toll-Free at: (855) 305-0856**

**E-mail: [info@okapipartners.com](mailto:info@okapipartners.com)**

**This Proxy Statement and GOLD Proxy Card are Available at:**

**[[www.okapivote.com/osmium](http://www.okapivote.com/osmium)]**

**PRELIMINARY COPY SUBJECT TO COMPLETION**  
**EVERY STOCKHOLDER'S VOTE IS IMPORTANT**

<b>VOTE BY PHONE</b>	<b>EASY VOTING OPTIONS: VOTE BY MAIL</b>	<b>VOTE ON THE INTERNET</b>
<b>Call:</b>	<b>Vote, sign and date this Proxy</b>	<b>Log on to:</b>
<b>[telephone number]</b>	<b>Card and return in the</b>	<b>[website address]</b>
<b>Follow the recorded instructions</b>	<b>postage-paid envelope</b>	<b>Follow the on-screen instructions</b>
<i>available 24 hours</i>		<i>available 24 hours</i>

Please detach at perforation before mailing.

**GOLD PROXY CARD**                      **SPARK NETWORKS, INC.**                      **GOLD PROXY CARD**

**ANNUAL MEETING OF  
STOCKHOLDERS**

**TO BE HELD ON JUNE 18, 2014**

**THIS PROXY SOLICITATION IS BEING MADE BY OSMIUM CAPITAL I, LP; OSMIUM CAPITAL II, LP; OSMIUM SPARTAN, LP; OSMIUM DIAMOND, LP; OSMIUM PARTNERS, LLC; AND JOHN H. LEWIS (COLLECTIVELY, OSMIUM PARTNERS ) STEPHEN J. DAVIS, MICHAEL J. MCCONNELL, AND WALTER J. TUREK (TOGETHER WITH JOHN H. LEWIS THE STOCKHOLDER NOMINEES AND COLLECTIVELY WITH OSMIUM PARTNERS THE PARTICIPANTS )**

**THE BOARD OF DIRECTORS OF SPARK NETWORKS, INC. IS NOT SOLICITING THIS PROXY**

The undersigned hereby appoint(s) [ ] and [ ] as proxies, and hereby authorizes them to represent and to vote, as designated herein, all of the shares of common stock of Spark Networks, Inc. (the Company ) that the undersigned is entitled to vote at the Annual Meeting of Stockholders to be held on June 18, 2014 at 9:00 a.m. Pacific Daylight Time at 11355 West Olympic Boulevard, Los Angeles, CA 90064, and at any adjournment or postponement thereof (the Annual Meeting ).

The undersigned hereby revoke(s) any other proxy or proxies heretofore given to vote or act with respect to the shares of common stock of the Company held by the undersigned, and hereby ratifies and confirms all action the herein named attorneys and proxies, their substitutes, or any of them may lawfully take by virtue hereof. If properly executed, this Proxy will be voted as directed on the reverse and in the discretion of the herein named attorney and proxy or his substitutes with respect to any other matters as may properly come before the Annual Meeting that are unknown to Osmium Partners a reasonable time before this solicitation.

**THIS PROXY WILL BE VOTED IN THE MANNER DIRECTED HEREIN AND UNLESS OTHERWISE DIRECTED, WILL BE VOTED FOR ALL THE NOMINEES NAMED IN PROPOSAL 1; FOR PROPOSAL 2; AGAINST PROPOSAL 3; FOR PROPOSAL 4; AND FOR PROPOSAL 5.**

**VOTE VIA THE INTERNET: [website]**

**VOTE VIA THE TELEPHONE: [phone number]**

**Note:** Please sign exactly as your name(s) appear(s) on this Proxy. Joint owners should each sign personally. When signing as attorney, executor, administrator, trustee, officer of corporation or other entity or in another representative capacity, please give the full title under the signature.

Signature and Title, if applicable

Signature (if held jointly)

Date

**EVERY STOCKHOLDER S VOTE IS IMPORTANT**

**Important Notice Regarding the Availability of Proxy Materials for the**

**Annual Stockholders Meeting to Be Held on June 18, 2014.**

**Osmium Partners Proxy Statement and this GOLD Proxy Card are available at:**

**[[www.okapivote.com/osmium](http://www.okapivote.com/osmium)]**

**IF YOU VOTE ON THE INTERNET OR BY TELEPHONE,**

**YOU NEED NOT RETURN THIS PROXY CARD**

Please detach at perforation before mailing.

**TO VOTE, MARK BLOCKS BELOW IN BLUE OR BLACK INK. Example: ¢**

**WE RECOMMEND A VOTE FOR THE NOMINEES LISTED IN PROPOSAL 1 BELOW.**

1 To elect the Osmium Parties four independent director nominees, Stephen J. Davis, John H. Lewis, Michael J. McConnell and Walter L. Turek, to serve as directors on the Board until the 2015 annual meeting of stockholders and until their respective successors are duly elected

01. Stephen J. Davis	02. John H. Lewis	03. Michael J. McConnell	04. Walter L. Turek
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<b>FOR</b>	<b>WITHHOLD</b>	<b>FOR ALL</b>
<b>ALL</b>	<b>ALL</b>	<b>EXCEPT</b>
..	..	..

**INSTRUCTIONS:** To withhold authority to vote for any individual nominee(s), mark the box **FOR ALL EXCEPT** and write the nominee s number on the line provided below.

The Osmium Parties intend to use this proxy to vote (i) **FOR ALL** Nominees. There is no assurance than any of the Company s nominees will serve as a director if any or all of our Nominees are elected to the Board.

**WE RECOMMEND A VOTE FOR PROPOSALS 2, 4 AND 5 AND A VOTE AGAINST PROPOSAL 3 BELOW.**

2 To ratify the appointment of Ernst & Young LLP as the independent registered public accounting firm of the Company for the year ending December 31, 2014

3 To consider and act upon a stockholder proposal regarding poison pills, if properly presented at the Annual Meeting

4 To consider a stockholder proposal to amend the Company s Amended and Restated Bylaws to permit stockholders to call

<b>FOR</b>	<b>AGAINST</b>	<b>ABSTAIN</b>
..	..	..
..	..	..
..	..	..

special meetings of stockholders, if properly presented at the Annual Meeting

- 5 To consider a stockholder proposal to amend the Company's Amended and Restated Bylaws to allow beneficial stockholders to submit proposals and nominations for director under the Company's Amended and Restated Bylaws, if properly presented at the Annual Meeting

**PLEASE SIGN AND DATE ON THE REVERSE SIDE**