Table of Contents

an accounting policy to be critical if it is important to a company's financial condition and results of operations, and if it requires significant judgment and estimates on the part of management in its application. We have discussed the selection and development of the critical accounting policies with the audit committee of our board of directors, and the audit committee has reviewed our related disclosures in this prospectus. Although we believe that our judgments and estimates are appropriate and correct, actual results may differ from those estimates.

We believe the following to be our critical accounting policies because they are important to the portrayal of our financial condition and results of operations and they require critical management judgments and estimates about matters that are uncertain. If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operation for future periods could be materially affected.

- Revenue Recognition
- Allowance for Doubtful Accounts
- Accrued Liabilities
- Accounting for Income Taxes
- Stock-Based Compensation
- Legal Contingencies

Revenue Recognition

We generate revenue from the sale of our neutral tandem interconnection services. We maintain executed service agreements with each of our customers in which specific fees and rates are determined. Revenue is recorded each month on an accrual basis based upon documented minutes of use by each customer for which service is provided, when collection is probable. We provide service primarily to large, well-established competitive carriers.

Allowance for Doubtful Accounts

We make judgments as to our ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices. For those invoices not specifically reviewed, provisions are recorded at differing rates, based upon the age of the receivable. In determining these percentages, we analyze our historical collection experience and current economic trends. If the historical data we use to calculate the allowance for doubtful accounts does not reflect our future ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed and future results of operations could be materially affected. At September 30, 2006, our allowance for doubtful accounts is zero. We did not write-off any customer receivables throughout 2006.

Accrued Liabilities

The preparation of our consolidated financial statements, in conformity with GAAP, requires management to make estimates and assumptions that affect our reported amount of accrued liabilities at the date of the financial statements and the reported amount of expenses during the period.

Significant estimates may be required to determine the amount, if any, of charges for transport, signaling and other facility related expenses that may have been incurred but not yet invoiced. We have cutoff processes and controls in place to identify accrual amounts where invoices have been received after the period end. Where we believe products or services have been received, but no invoice has been received, we develop accrual estimates.

We may also develop, and report, significant estimates when our transport vendors invoice us for amounts that we dispute where (i) there is a high probability that the dispute will ultimately result in a payment by us and (ii) an amount can be reasonably estimated. At September 30, 2006, our disputed charges accrual is approximately $0.8 million. Of this amount, $0.4 million is related to one dispute. For more information, see "Business-Legal Proceedings."

Table of Contents

Accounting for Income Taxes

Deferred income tax assets and liabilities are recognized for future income tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and for net operating loss carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recorded in earnings in the period of enactment. A valuation allowance is provided for deferred income tax assets whenever it is more likely than not that future tax benefits will not be realized.

Stock-Based Compensation

We currently record stock-based compensation expense in connection with any grant of options to our employees.

We record stock-based compensation expense associated with our stock options in accordance with Statement of Financial Accounting Standards, or SFAS, No. 123(R), *Share Based Payments* which requires us to calculate the expense associated with our stock options by determining the fair value of the options. This expense is included in general and administrative expense.

We adopted SFAS 123(R) as of January 1, 2005, using the modified retrospective method. The modified retrospective method requires the prior period financial statements to be restated to recognize compensation cost in the amounts previously reported in the pro forma footnotes. We adjusted general and administrative expense in 2004 to include $10,000 of additional compensation expense.

We use the Black-Scholes valuation model to calculate the fair value of stock options. This model takes into account the exercise price of the stock option, the fair value of the common stock underlying the stock option as measured on the date of grant and an estimation of the volatility of the common stock underlying the stock option. Such value is recognized as expense over the service period, net of estimated forfeitures, using the accelerated method under SFAS 123(R). The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates. The following table provides the amount of share-based expense recorded as a result of adopting SFAS No. 123(R).

	Year Ended December 31,			Nine Months Ended September 30,	
	2003	2004	2005	2005	2006
				(Unaudited)	
	(In thousands)				
Share-based expense	$ —	$ 10	$ 29	$ 19	$ 198

Prior to 2005, we considered Neutral Tandem to be an illiquid start-up and developed a process for assessing the fair value of our common stock internally. This process was used for determining a reasonable estimate of the then current value of our common stock through 2005. Given an absence of an active market for our common stock, we determined the estimated fair value of our common stock on the grant date based on several factors, including:

- the grants involved private company securities that were not liquid;
- the price at which Series A, Series B-1, Series B-2 and Series C convertible preferred stock was issued by us to outside investors in arms-length transactions in November 2003, November 2004, June 2005 and February 2006, respectively, and the rights, preferences and privileges of the preferred stock relative to the common stock;

Table of Contents

- our stage of development, business forecast and present value of our projected future cash flows;
- important developments relating to our business strategy;
- the likelihood of achieving a liquidity event for the shares of common stock, such as an initial public offering or a sale of us, given prevailing market conditions;
- the state of the new issue market for similarly situated technology companies; and
- the market prices of various publicly held technology companies.

Beginning late 2005, to assist us in our analysis of the fair value of the stock options being granted, we engaged an independent valuation specialist to assist us in our determination of the fair value of our common stock at December 31, 2005, and at the end of each quarter in 2006.

These valuations were generally prepared soon after the end of our fiscal quarter preceding the grant date. The independent valuation specialist applied a number of different methodologies to assist us in our determination of fair value. The methodologies primarily employed were (i) an "income approach" and (ii) a "market approach."

The "income approach" estimates the fair value of our common stock based upon the present value of our projected future cash flows. The "market approach" estimates the fair value of our common stock based upon comparisons to publicly held companies whose stocks are actively traded and an analysis of the multiples at which those stocks are trading in the market. These factors were then analyzed and given the appropriate weight to determine a value for us. To establish the fair value of our common stock as a privately-held company on a per-share basis, appropriate adjustments were applied to account for the illiquid and noncontrolling nature of our common stock, the liquidation preference of the our preferred stock, and the number of common shares issued and outstanding as of each valuation date (incorporating, as appropriate, both (a) the number of issued and outstanding stock options and (b) the conversion rights of the preferred stock).

Each of the methodologies employed relies upon estimates that can evolve over a period of time. The "income approach", for example, relies upon projections of future cash flows and estimations of appropriate discount rates to determine present value. Throughout 2006, our actual operating results increased when compared to comparable prior periods, and correspondingly our projections of future revenues and expenses evolved as this information and other relevant factors were considered in our projections. Moreover, the perceived risk of our projected cash flows has changed over time as we have developed a track record of growing our business substantially consistent with our long-term plan.

The "market approach" relies upon market-based evidence of how the market values companies identified as comparable to ours. Over time, the observed market evidence with respect to these comparable companies has changed. In addition, our growth prospects, risk attributes, and other relevant factors have also changed, which affects the selection of an appropriate valuation multiple applicable to our business. These factors have been considered and reflected in the valuation analysis performed by our independent valuation specialist.

Finally, as we have moved closer toward the filing of an initial public offering, the perceived liquidity of our common stock has increased. In other words, although we are still a privately held company without an active market for our shares, the increased likelihood of a future event (i.e., the initial public offering) whereby our shareholders would achieve liquidity, decreases any appropriate discounts for lack of marketability that would otherwise apply absent a potential initial public offering.

Since December 2003, when we began to grant stock options, the fair value of our common stock has increased at each measurement date. As described above, these increases are a reflection of a number of factors

Table of Contents

that, generally, reflect (a) decreased risk with respect to the achievability of our future projected cash flows as we have achieved a track record of growing our business substantially in line with our long-term plan and (b) increased perceived liquidity in our common stock as the potential for an initial public offering becomes more likely.

We follow the fair-value method of accounting for stock options under SFAS No. 123(R) to account for the 2003 Stock Option and Stock Incentive Plan, or the 2003 Stock Incentive Plan. Stock-based employee compensation is reflected in the statement of operations. All options granted under the 2003 Stock Incentive Plan have an exercise price equal to the market value of the underlying common stock on the date of the grant. No stock options have been issued to contractors. The following table shows the fair value of one share of our common stock on each stock option grant date during the nine months ended September 30, 2006:

Grant Date	Number of Stock Options Issued	Weighted Average Fair Value of One Share of Common Stock
First Quarter 2006	920,825	$ 1.17
Second Quarter 2006	397,500	$ 1.33
Third Quarter 2006	258,650	$ 2.56
Total	1,576,975	

For purposes of this disclosure, the fair value of each option granted during the nine months ended September 30, 2006 is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Expected life	10 years
Risk-free interest rate range	4.7%–5.1%
Expected dividends	0.0 %
Volatility	34.4%–41.6%

Our volatility assumption has evolved over time. As a non-liquid start-up, we determined that the use of a broad index fund which included companies similar to us was acceptable. During this timeframe leading up to 2006, our volatility assumption was updated quarterly based upon historical prices of the Fidelity Select Telecommunications "FSTCX" index fund.

Beginning in 2006, as we began moving closer to an initial public offering, a new method for estimating volatility was adopted. This method focuses specifically on the simple average volatility of three telecommunication companies that share similar business characteristics. The simple average volatility of the three companies selected range from 34.4% at the beginning of 2006 to 41.6% at the end of the year.

Legal Contingencies

We are currently involved in various claims and legal proceedings. We review the status of each significant matter quarterly and assess our financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and may revise our estimates. Such revisions in the estimates of the potential liabilities could have a material impact on our results of operations and financial position.

See "Risk Factors" for certain matters that may bear on our future results of operations.

Table of Contents

Results of Operations

The following table sets forth our results of operations for the year ended December 31, 2003, 2004 and 2005 and for the nine months ended September 30, 2005 and 2006:

	Year Ended December 31,			Nine Months Ended September 30,	
	2003	2004	2005	2005 (unaudited)	2006 (unaudited)
			(In thousands)		
Statements of Operations					
Revenue	$ —	$ 3,439	$27,962	$ 18,177	$ 37,864
Operating Expense:					
Cost of revenue	13	2,027	11,349	7,467	14,621
Operations	155	2,704	8,189	5,868	8,150
Depreciation and amortization	2	655	3,141	2,011	4,464
Sales and marketing	69	775	1,360	991	1,149
General and administrative	449	2,310	3,053	2,361	2,785
Total operating expense	688	8,471	27,092	18,698	31,169
Income (Loss) From Operations:	(688)	(5,032)	870	(521)	6,695
Other (Income) Expense:					
Interest expense	8	276	843	594	849
Interest income	(6)	(69)	(170)	(140)	(556)
Other income	—	—	(11)	—	—
Total other expense	2	207	662	454	293
Income (Loss) Before Income Taxes	(690)	(5,239)	208	(975)	6,402
Provision For Income Taxes	—	—	—	—	157
Net Income (Loss)	$ (690)	$(5,239)	$ 208	$ (975)	$ 6,245

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Revenue. Revenue increased from $18.2 million in the nine months ended September 30, 2005 to $37.9 million in the nine months ended September 30, 2006, or an increase of 108.3%. The increase in revenue was due to an increase of minutes of use from 6.4 billion minutes of use in the nine months ended September 30, 2005 to 17.4 billion minutes of use in the nine months ended September 30, 2006, or an increase of 170.5%.

The number of markets in which we operate increased from ten in the nine months ended September 30, 2005 to 17 in the nine months ended September 30, 2006. The average fee per minute decreased from $0.0028 in the nine months ended September 30, 2005 to $0.0022 in the nine months ended September 30, 2006, or a decrease of 23.0%. The decrease resulted from us entering six new markets where the market rate offered by the ILECs were lower than our then average market rate, causing us to enter into contracts with our customers at competitively lower rates than in markets where we had already been in operation.

In early 2005, SBC Communications, Inc. or SBC, announced an agreement to acquire AT&T. As a result of this transaction, beginning in the second quarter of 2006, the combined SBC and AT&T entity began reducing the amount of minutes of use processed by us. Although we are not currently aware of any merger or acquisition agreements that may have a negative effect upon our future revenue, it is likely that industry consolidation will continue to occur. Our ability to grow in the future could be adversely affected by greater industry consolidation.

Operating Expenses. Operating expenses increased from $18.7 million in the nine months ended September 30, 2005 to $31.2 million in the nine months ended September 30, 2006, or 82.3% of revenue. The components making up operating expenses are discussed further below.

Table of Contents

Costs of Revenue. Costs of revenue increased from $7.5 million in the nine months ended September 30, 2005, or 41.1% of revenue, to $14.6 million in the nine months ended September 30, 2006, or 38.6% of revenue. The increase in our costs of revenue resulted from an increase of $7.0 million in recurring network costs, due to the increase in the number of switch locations we connect, from 286 switch locations at September 30, 2005 to 473 switch locations at September 30, 2006, and a decrease of $0.2 million in non-recurring costs, as only 140 new switch locations were connected in the nine months ended September 30, 2006 compared with 187 new switch locations connected in the nine months ended September 30, 2005. Cost of revenue also increased due to an increase of $0.3 million in our switch related costs primarily made up of increased facility rent and utilities costs in our 14 locations at the end of September 30, 2006 compared to ten locations at September 30, 2005.

Operations Expenses. Operations expenses increased from $5.9 million in the nine months ended September 30, 2005, or 32.3% of revenue, to $8.2 million in the nine months ended September 30, 2006, or 21.5% of revenue. The increase in our operations expenses resulted from an increase in payroll and benefits of $1.2 million, due to an increase in the number of switch location personnel as well as individuals located at our corporate office who are directly responsible for maintaining and expanding our switch network and an increase of $1.1 million related to property tax, insurance, maintenance and supplies for the new switch locations.

Depreciation and Amortization Expense. Depreciation and amortization expense increased from $2.0 million in the nine months ended September 30, 2005, or 11.1% of revenue, to $4.5 million in the nine months ended September 30, 2006, or 11.8% of revenue. The increase in our depreciation and amortization expense resulted from capital expenditures of $10.7 million primarily related to the expansion of switch capacity in existing markets and the installation of switch capacity in new markets.

Sales and Marketing Expense. Sales and marketing expense increased from $1.0 million in the nine months ended September 30, 2005, or 5.5% of revenue, to $1.1 million in the nine months ended September 30, 2006, or 3.0% of revenue. The increase in our sales and marketing expense is due our hiring of an additional employee.

General and Administrative Expense. General and administrative expense increased from $2.4 million in the nine months ended September 30, 2005, or 13.0% of revenue, to $2.8 million in the nine months ended September 30, 2006, or 7.4% of revenue. The increase in our general and administrative expense is due to an increase in salaries and benefits resulting from hiring additional employees.

Other (Income) Expense. Other expense decreased from $0.5 million in the nine months ended September 30, 2005 to $0.3 million in the nine months ended September 30, 2006, or 0.8% of revenue. The decrease in our other expense resulted from a $0.3 million increase in our interest expense related to our increase in borrowings under our facility with an affiliate of Western Technology Investment, which was off-set by an increase of $0.4 million in interest income from higher average balances in our short term investments.

Provision for Income Taxes. Provision of income taxes increased from zero in the nine months ended September 30, 2005 to $0.2 million in the nine months ended September 30, 2006, or 0.4% of revenue.

Fiscal Year Ended December 31, 2005 Compared to the Fiscal Year Ended December 31, 2004

Revenue. Revenue increased from $3.4 million in the year ended December 31, 2004 to $28.0 million in the year ended December 31, 2005, or an increase of 713.1%. The increase in revenue was due to an increase of minutes of use from 1.0 billion minutes processed in the year ended December 31, 2004 to 10.4 billion minutes processed in the year ended December 31, 2005, or an increase of 920.4%.

The number of markets in which we operate increased from four in the year ended December 31, 2004 to 14 in the year ended December 31, 2005. The average fee per minute decreased from $0.0034 in the year ended

Table of Contents

December 31, 2004 to $0.0027 in the year ended December 31, 2005, or a decrease of 20%. The decrease resulted from us entering 10 new markets where the market rate offered by the ILECs were lower than our then average market rate causing us to enter into contracts with our customers at competitively lower rates.

In early 2005, the Michigan Public Service Commission revised the maximum allowable rate that an ILEC could charge for transit service based upon AT&T's (previously SBC Communications, Inc.) total element long run incremental cost, or TELRIC, which was significantly below the rate charged by AT&T. This decision decreased our average rate per minute in Michigan from $0.0035 at the beginning of the year to an average rate per minute of $0.0011 at the end of 2005. To the extent future ILEC transit rates may be reduced in our other switch locations, our revenues may be adversely affected.

Operating Expenses. Operating expenses increased from $8.5 million in the year ended December 31, 2004 to $27.1 million in the year ended December 31, 2005, or 96.9% of revenue. The components making up operating expenses are discussed further below.

Costs of Revenue. Costs of revenue increased from $2.0 million in the year ended December 31, 2004, or 58.9% of revenue, to $11.3 million in the year ended December 31, 2005, or 40.6% of revenue. The increase in our costs of revenue resulted from an increase of $6.8 million in recurring network costs, due to the increase in the number of switch locations we connect, from 99 switch locations at December 31, 2004 to 333 switch locations at December 31, 2005, and a increase of $0.9 million in non-recurring costs, as only 99 new switch locations were connected in the year ended December 31, 2004 compared with 234 new switch locations connected in the year ended December 31, 2005. Cost of revenue also increased due to an increase of $1.6 million in our switch related costs primarily made up of increased facility rent and utilities costs in our 14 locations at the end of December 31, 2005 compared to four locations at December 31, 2004.

Operations Expenses. Operations expenses increased from $2.7 million in the year ended December 31, 2004, or 78.6% of revenue, to $8.2 million in the year ended December 31, 2005, or 29.3% of revenue. The increase in our operations expenses resulted from an increase in payroll and benefits of $3.8 million, due to an increase in the number of switch location personnel as well as individuals located at our corporate office who are directly responsible for maintaining and expanding our switch network, an increase of $0.8 million associated with the implementation of new computer software and an increase of $0.9 million related to property tax, insurance, maintenance and supplies.

Depreciation and Amortization Expense. Depreciation and amortization expense increased from $0.1 million in the year ended December 31, 2004, or 19.0% of revenue, to $3.1 million in the year ended December 31, 2005, or 11.2% of revenue. The increase in our depreciation and amortization expense resulted from capital expenditures of $14.0 million primarily related to the expansion of switch capacity in existing markets and the installation of switch capacity in new markets.

Sales and Marketing Expense. Sales and marketing expense increased from $0.8 million in the year ended December 31, 2004, or 22.5% of revenue, to $1.4 million in the year ended December 31, 2005, or 4.9% of revenue. The increase in our sales and marketing expense is due to an increase in the size of our sales and marketing department with the addition of three individuals in the year ended December 31, 2005.

General and Administrative Expense. General and administrative expense increased from $2.3 million in the year ended December 31, 2004, or 67.2% of revenue, to $3.1 million in the year ended December 31, 2005, or 10.9% of revenue. The increase in our general and administrative expense is due to an increase in salaries and benefits from the addition of new employees and higher corporate facility rent as we moved to a larger corporate office in late 2004 to accommodate business growth.

Other (Income) Expense. Other expense increased from $0.2 million in the year ended December 31, 2004 to $0.7 million in the year ended December 31, 2005, or 2.4% of revenue. The increase in our other expense

Table of Contents

resulted from a $0.6 million increase in our interest expense related to increased borrowings under our facility with an affiliate of Western Technology Investment, which was partially off-set by $0.1 million in interest income from higher average balances in our short term investments.

Provision for Income Taxes. There were no income tax provisions in the years ended December 31, 2004 and 2005 as a result of our net operating losses.

Fiscal Year Ended December 31, 2004 Compared to the Fiscal Year Ended December 31, 2003

Revenue. Revenue increased from zero in the year ended December 31, 2003 to $3.4 million in the year ended December 31, 2004. The increase in revenue was due to the start up of our business in February 2004 which resulted in an increase of minutes processed from no minutes processed in the year ended December 31, 2003 to 1.0 billion minutes processed in the year ended December 31, 2004. We began processing minutes of use in February 2004 and at December 31, 2004 had four operating switch locations. The average fee per minute in the year ended December 31, 2004 was $0.0034.

Operating Expenses. Operating expenses increased from $0.7 million in the year ended December 31, 2003 to $8.5 million in the year ended December 31, 2004, or 246.3% of revenue. The components making up operating expenses are discussed further below.

Costs of Revenue. Costs of revenue increased from less than $0.1 million in the year ended December 31, 2003 to $2.0 million in the year ended December 31, 2004, or 58.9% of revenue. The increase in our costs of revenue resulted from an increase of $1.0 million in recurring network costs, due to the increase in the number of switch locations we connect, from zero switch locations at December 31, 2003 to 99 switch locations at December 31, 2004, and an increase of $0.3 million in non-recurring costs, as no new switch locations were connected in the year ended December 31, 2003 compared with 99 new switch locations connected in the year ended December 31, 2004. Cost of revenue also increased due to an increase of $0.7 million in our switch related costs primarily made up of increased facility rent and utilities costs in our one location at the end of December 31, 2003 compared to four locations at December 31, 2004.

Operations Expenses. Operations expenses increased from $0.2 million in the year ended December 31, 2003 to $2.7 million in the year ended December 31, 2004, or 78.6% of revenue. The increase in our operations expenses resulted from an increase in payroll and benefits of $1.8 million, due to an increase in the number of switch location personnel as well as individuals located at our corporate office who are directly responsible for maintaining and expanding our switch network, and an increase of $0.7 million in supplies, repairs and maintenance and temporary labor.

Depreciation and Amortization Expense. Depreciation and amortization expense increased from less than $0.1 million in the year ended December 31, 2003 to $0.7 million in the year ended December 31, 2004, or 19.0% of revenue. We did not have any significant fixed assets in the year ended December 31, 2003 and therefore the increase in our depreciation and amortization expense resulted primarily from $8.1 million in capital expenditures related to the addition of switch capacity in new markets.

Sales and Marketing Expense. Sales and marketing expense increased from less than $0.1 million in the year ended December 31, 2003 to $0.8 million in the year ended December 31, 2004, or 22.5% of revenue. The increase in our sales and marketing expense is due to an increase in the size of our sales and marketing department with the addition of four individuals in the year ended December 31, 2004.

General and Administrative Expense. General and administrative expense increased from $0.4 million in the year ended December 31, 2003 to $2.3 million in the year ended December 31, 2004, or 67.2% of revenue. The increase in our general and administrative expense is due to an increase in salaries and benefits from the addition of new management and administrative employees.

Table of Contents

Other (Income) Expense. Other expense increased from less than $0.1 million in the year ended December 31, 2003 to $0.2 million in the year ended December 31, 2004. The increase in our other expense resulted from a $0.3 million increase in our interest expense related to our increase in borrowings under our facility with an affiliate of Western Technology Investment, which was partially off-set by $0.1 million in interest income from higher average balances in our short term investments.

Provision for Income Taxes. There was no income tax provision in the years ended December 31, 2003 and 2004 as a result of our net operating losses.

Liquidity and Capital Resources

Our primary sources of liquidity have been cash provided by operations, the sale and issuance of equity, and borrowings under our credit facility. Our principal uses of cash have been capital expenditures for switch equipment, working capital and debt service requirements. We anticipate that our principal uses of cash in the future will be facility expansion, capital expenditures for switch equipment and working capital.

Our capital expenditures of $1.3 million, $8.1 million and $14.0 million in the years ended December 31, 2003, 2004 and 2005, respectively, and $12.5 million and $10.7 million in the nine month periods ended September 30, 2005 and 2006, respectively, related primarily to the installation of switching equipment in existing and new locations. We expect to incur approximately $21.4 million of capital expenditures related to the installation of switching equipment in 2007.

Working capital increased from $3.1 million at September 30, 2005 to $14.7 million at September 30, 2006. The increase in working capital at September 30, 2006 is due to the equity financing completed in February 2006 in which we received $12.0 million of proceeds and additional borrowings of $7.5 million under our credit facility with an affiliate of Western Technology Investment. We borrowed the remaining $2.5 million in December 2006 under our credit facility. Working capital decreased from $6.1 million at December 31, 2004 to $3.7 million at December 31, 2005. The decline in working capital in 2005 is primarily due to our investment in switch equipment and an increase in both accrued expenses and the current portion of long-term debt.

Cash, cash equivalents and short-term investments increased from $6.7 million at September 30, 2005 to $20.9 million at September 30, 2006. The increase in cash, cash equivalents and short-term investments at September 30, 2006 is due to the equity financing completed in February 2006, increased borrowings under our credit facility and cash flows from operations, partially offset by cash used to finance capital expenditures for switch equipment and reduce other debt obligations.

We believe that cash flow from operating activities together with available borrowings under our credit agreement will be sufficient to fund our operations for the next twelve months. We regularly review acquisitions and additional strategic opportunities, which may require additional debt or equity financing. We currently do not have any pending agreements or understandings with respect to any acquisitions or strategic opportunities.

Discussion of Cash Flows

The following table sets forth components of our cash flow for the following periods:

	Year Ended December 31,			Nine Months Ended September 30,	
	2003	2004	2005	2005 (Unaudited)	2006 (Unaudited)
			(In thousands)		
Cash flows from operating activities	($ 623)	($ 4,572)	$ 2,147	$ 962	$ 8,969
Cash flows from investing activities	($7,886)	($10,030)	($10,240)	($10,379)	($ 6,328)
Cash flows from financing activities	$8,591	$14,719	$ 9,185	$ 9,774	$16,971

Table of Contents

Cash flows from operating activities

Our largest source of operating cash flows is payments from customers which are generally received between 45 to 50 days following the end of the billing month. Our primary uses of cash from operating activities are for personnel related expenditures, facility and switch maintenance costs.

Cash provided by operations for the nine months ended September 30, 2006 was attributable to net income of $6.2 million plus non-cash charges, primarily amortization and depreciation, of $4.8 million, and $2.9 million due to an increase in accounts payable and accrued liabilities, $3.8 million due to an increase in accounts receivable and $1.1 million due to an increase in other current assets. Cash provided by operations for the nine months ended September 30, 2005 was attributable to a net loss of $1.0 million, plus non-cash charges, primarily amortization and depreciation of $2.1 million, and $2.3 million due to an increase in accounts payable, accrued liabilities and noncurrent liabilities, less $2.4 million due to an increase in accounts receivable. Cash provided by operations for the year ended December 31, 2005 was attributable to net income of $0.2 million, plus non-cash charges, primarily amortization and depreciation, of $3.2 million, and an increase in accounts payable and accrued liabilities of $2.1 million, which was partially offset by an increase in accounts receivable of $3.6 million. Cash used by operating activities for the year ended December 31, 2004 was attributable to a net loss of $5.2 million, which reflected our start up of operations, plus $0.8 million of non-cash charges, primarily amortization and depreciation, an increase of $1.6 million in accounts payable and accrued liabilities, less an increase in accounts receivable of $1.0 million, due to increased monthly billings, an increase of $0.2 million in other assets and $0.5 million in noncurrent assets. For the year ended December 31, 2003, cash used by operating activities consisted of our net loss of $0.7 million, less a $0.1 million increase in accrued liabilities.

Cash flows from investing activities

The changes in cash flows from investing activities primarily relate to purchases of switch equipment and the timing of purchases and maturities of short-term investments. We also use cash to support letters of credit required by certain facility landlords and other vendors.

Cash used in investing activities for the nine months ended September 30, 2006 was $6.3 million. We invested $10.7 million in the purchase of switch equipment, offset by a decrease in short-term investments of $4.5 million. Cash used in investing activities for the nine months ended September 30, 2005 was $10.4 million. We invested $12.5 million in the purchase of switch equipment, offset by a decrease in short-term investments of $2.1 million. Cash used in investing activities for the year ended December 31, 2005 was $10.2 million. We invested $14.0 million in the purchase of switch equipment, offset by a decrease in short-term investments of $3.8 million. Cash used in investing activities for the year ended December 31, 2004 was $10.0 million. We invested $8.1 million in the purchase of switch equipment and supported $0.3 million of letters of credit, required to secure certain facility leases and other obligations, and increased our short-term investments by $1.6 million. Cash used in investing activities for the year ended December 31, 2003 was $7.9 million. We invested $1.3 million in the purchase of switch equipment in addition to increasing our short-term investments by $6.6 million.

Cash flows from financing activities

The changes in cash flows from financing activities primarily relate to equity financing, borrowings and payments under our debt obligations.

We generated cash flow from financing activities in the nine months ended September 30, 2006 of $17.0 million primarily as a result of $11.9 million in net proceeds from the issuance of preferred shares and $7.5 million in borrowing under our credit facility from an affiliate of Western Technology Investment. These proceeds were partially offset by our repayment of $2.5 million of principal on our outstanding debt. We generated cash flow from financing activities in the nine months ended September 30, 2005 of $9.8 million primarily as a result of $8.5 million in net proceeds from the issuance of preferred shares and $2.8 million in borrowing under our credit facility. These proceeds were partially offset by our repayment of $1.4 million of principal on our outstanding debt. We generated cash flow from financing activities in the year ended December 31, 2005 of $9.2 million primarily as a result of $8.5 million in net proceeds from the issuance of

Table of Contents

preferred shares and $2.8 million in borrowing under our credit facility. These proceeds were partially offset by our repayment of $2.0 million of principal on our outstanding debt. We generated cash flow from financing activities in the year ended December 31, 2004 of $14.7 million primarily as a result of $8.6 million in net proceeds from the issuance of preferred shares and $6.8 million in borrowing under our credit facility. These proceeds were partially offset by our repayment of $0.7 million of principal on our outstanding debt. We generated cash flow from financing activities in the year ended December 31, 2003 of $8.6 million as a result of net proceeds from the issuance of preferred shares.

Contractual Cash Obligations

The following table represents a summary of our estimated future payments under contractual cash obligations as of September 30, 2006. Changes in our business needs, cancellation provisions, changing interest rates and other factors may result in actual payments differing from these estimates. We cannot provide certainty regarding the timing and amounts of payments. There have been no significant developments with respect to our contractual cash obligations since September 30, 2006.

	Payments due by period				
Contractual Cash Obligations	Total	Current	2-3 years	4-5 years	More than 5 years
			(In thousands)		
Principal payments on long-term debt	$11,874	$6,071	$ 5,803	$ —	$ —
Interest payments on long-term debt	2,957	1,278	1,679	—	—
Operating leases	16,193	636	5,058	5,246	5,253
Total	$31,024	$7,985	$12,540	$5,246	$5,253

Debt and Credit Facilities

We have an equipment loan and security agreement with an affiliate of Western Technology Investment, which provides us with up to $19.5 million in available credit. This credit facility matures in several installments, beginning in May 2007 and ending in March 2010. As of September 30, 2006 we had approximately $11.6 million outstanding under this credit facility. Loans bear interest at prime plus between 1.25% and 3.005% and there is a terminal payment of between 8.14% and 9.6% of the original amount borrowed. The average interest rate of this credit facility, including all balloon payments, was 11.4%, 13.6% and 14.0% for the years ended December 31, 2004, 2005 and for the nine months ended September 30, 2006, respectively. Our obligations under the credit facility are secured by a lien on substantially all of our assets and specified equipment.

Under the terms of the credit facility, we must comply with certain negative covenants that limit our ability to declare or pay dividends, incur additional indebtedness, incur liens, dispose of significant assets, make acquisitions or significantly change the nature of our business without the permission of the lender. As of September 30, 2006, we were in compliance with all of the covenants under the agreement.

Additionally, in accordance with the terms of the credit facility, we issued warrants to the note holders to purchase 402,236 shares of our preferred stock for a weighted average price of $2.55 per share. The warrants are exercisable at any time up to eight years after their issuance. No warrants had been exercised at September 30, 2006. The fair value of these warrants, as calculated using the Black-Scholes method, was estimated at $182,000, $206,000 and $460,000 at December 31, 2004, 2005 and at September 30, 2006, respectively and has been reflected as a reduction of the carrying amount of the note and is being accreted over the term of the note. The charge to interest expense in the nine months ended September 30, 2005 and 2006 were $45,000 and $82,000 and for the years ended December 31, 2003, 2004 and 2005 were $0, $18,000 and $68,000, respectively.

Letters of Credit

We use cash collateralized letters of credit issued by LaSalle Bank N.A. to secure certain facility leases and other obligations. At September 30, 2006 there was $360,500 of restricted cash used as collateral for $305,000 in letters of credit outstanding.

Table of Contents

Effect of Inflation

Inflation generally affects us by increasing our cost of labor and equipment. We do not believe that inflation had any material effect on our results of operations during the nine month periods ended September 30, 2005 and September 30, 2006 or the years ended December 31, 2003, 2004 and 2005.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board, or FASB, issued SFAS 154, *Accounting Changes and Error Correction.* SFAS 154 requires retrospective application to prior-period financial statements of changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also redefines "restatement" as the revising of previously issued financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We will comply with the pronouncement as required.

In June 2006, the FASB issued FASB Interpretation, or FIN, No. 48, *Accounting for Uncertainty in Income Taxes.* FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109, *Accounting for Income Taxes,* and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We have not yet determined the impact, if any, that the adoption of FIN 48 will have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements.* The standard provides guidance for using fair value to measure assets and liabilities. The standard clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We have not yet determined the impact, if any, that the adoption of SFAS 157 will have on our consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin, or SAB, No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* SAB 108 provides guidance on how the effects of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for financial statements issued for fiscal years beginning after November 15, 2006. We are not aware of any misstatements that would have a material impact on our consolidated financial statements.

Qualitative and Quantitative Disclosure about Market Risk

Interest rate exposure

We invest our excess cash in short-term high-grade commercial paper whose carrying values approximate market. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value of our short-term investments as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates fell by 10% in the nine months ended September 30, 2006, our interest income would have declined by approximately $56,000. Assuming an average investment level in short-term interest bearing securities of $16.0 million, which approximates the average amount invested in these securities during the nine months ended September 30, 2006, a one-percentage point decrease in the applicable interest rate would result in a $120,000 decrease in interest income.

Table of Contents

BUSINESS

Our Company

We are a leading provider of tandem interconnection services to competitive carriers, including wireless, wireline, cable telephony and VoIP companies. Competitive carriers use tandem switches to interconnect and exchange traffic between their networks without the need to establish direct switch-to-switch connections. Prior to the introduction of our service, the principal method for competitive carriers to exchange traffic was through the use of the incumbent local exchange carriers', or ILECs, tandem switches. Under interpretations of the Telecommunications Act, ILECs are required to provide tandem switching to competitive carriers pursuant to prescribed rates established by regulatory authorities. Our solution enables competitive carriers to exchange traffic between their networks without using an ILEC tandem.

The proliferation of competitive carriers over the past decade and their capture of an increasing share of subscribers has shifted a greater amount of intercarrier traffic to ILEC tandem switches and amplified the complexity of carrier interconnections. This has resulted in additional traffic loading of ILEC tandems, lower service quality and substantial costs incurred by competitive carriers for interconnection. A loss of ILEC market share to competitive carriers has escalated competitive tensions and resulted in an increased demand for tandem switching.

We founded our company to solve these interconnection problems and better facilitate the exchange of traffic among competitive carriers. By utilizing our managed tandem solution, our customers benefit from a simplified interconnection network solution which reduces costs, increases network reliability, decreases competitive tension and adds network diversity and redundancy. Since the launch of our service in 2004, we believe we have established the largest network of tandem switches serving as neutral interconnection points for voice traffic between competitive carriers in the United States.

We have 56 signed agreements with major competitive carriers and operate in 33 markets. Currently, we provide service to leading competitive carriers in the United States, including wireless carriers such as Sprint Nextel Corp., T-Mobile USA, Inc., MetroPCS Wireless Inc., U.S. Cellular Corporation and Cingular Wireless LLC; cable companies such as Cablevision Systems Corporation, Comcast Cable Communications, Inc., RCN Corporation and Cox Communications Inc.; wireline carriers such as AT&T, McLeod USA Inc., MCI/Verizon Business, Level 3 Communications Inc. and XO Communications Inc.; and VoIP providers such as Vonage Holdings Corp., Broadvox Carrier Services, LLC, Voex Inc. and Reynwood Communications Inc. Our network currently carries approximately 2.5 billion minutes of traffic per month and is capable of terminating calls to over 151 million assigned telephone numbers. As the telecommunications market share continues to shift from traditional ILEC access lines to competitive carriers, we believe we will have access to an expanding market. We believe that our neutral tandem network and its size and scale will provide us with opportunities to enter new markets, increase market share with current customers and attract new customers.

Since commencing service in February 2004, we have grown rapidly, generating revenue of approximately $28.0 million in fiscal 2005. During the nine months ended September 30, 2006, we increased revenue to $37.9 million, an increase of 108% compared to the nine months ended September 30, 2005, and net income was approximately $6.2 million.

Our Industry

In recent years, a wide array of new services and technologies has emerged as competitive alternatives to ILEC services for consumer and enterprise telephony. The increasingly diverse market now includes wireless, cable telephony, wireline and VoIP companies. As these competitive carriers have expanded their customer base, the amount of traffic exchanged between them has also increased and is expected to grow in the future. For example:

- IDC Research estimates that the number of wireless subscribers in the U.S. is expected to grow from 203.9 million as of year end 2005 to over 262.5 million as of year end 2010, representing a compounded annual growth rate, or CAGR, of 5.2% (IDC, March 2006, *U.S. Wireless Consumer 2006-2010 Forecast: Ways Around the Walls Ahead*).

Table of Contents

- CTIA reported that U.S. wireless minutes of use exceeded 850 billion in the first half of 2006, representing a 27% increase compared to the same period in 2005 (CTIA, 2006, *CTIA's Semi-Annual Wireless Industry Survey*).
- IDC Research estimates that the number of cable telephony and VoIP subscribers in the U.S. is expected to grow from 4.2 million as of year-end 2005 to approximately 44.0 million by the end of 2010, representing a CAGR of approximately 60% (IDC, May 2006, *U.S. Residential VoIP Services 2006-2010 Forecast and Analysis: Where There Is Smoke, Is There Fire?*).
- Total ILEC access lines declined by 6.2 million to 160.9 million during the 2005 calendar year, representing a 3.7% decrease from access lines at year-end 2004 (FCC, *Local Telephone Competition: Status as of December 31, 2005*).

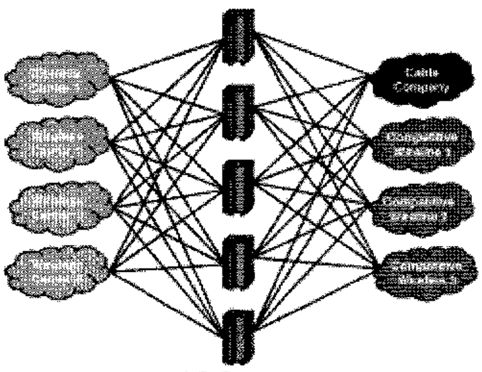
According to the Local Exchange Routing Guide, or LERG, an industry standard guide used by carriers, there are approximately 1.4 billion telephone numbers assigned to carriers in North America. Our services are principally targeted to address the estimated 722 million, or 52% of the total 1.4 billion, telephone numbers assigned to competitive carriers.

Prior to the introduction of our services, competitive carriers had two alternatives for exchanging traffic between their networks. The two alternatives were interconnecting to the ILEC tandems or directly connecting individual switches, commonly referred to as "direct connects." Given the cost and complexity of establishing direct connects, competitive carriers resorted to utilizing the ILEC tandem as the primary method of exchanging traffic. The ILECs often required competitive carriers to interconnect to multiple ILEC tandems with each tandem serving a restricted geographic area. In addition, as the competitive telecommunications market grew, the process of establishing interconnections at multiple ILEC tandems became increasingly difficult to manage and maintain, causing delays and inhibiting competitive carrier growth and the purchase of ILEC tandem services became an increasingly significant component of a competitive carrier's costs.

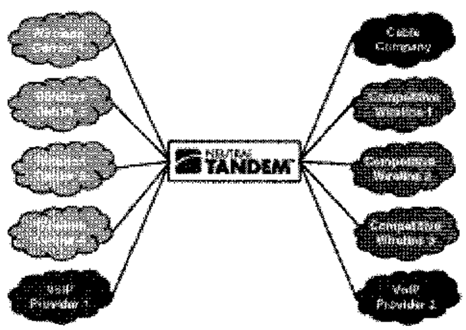
Growth in intercarrier traffic switched through ILEC tandems has created switch capacity shortages known in the industry as ILEC "tandem exhaust," where overloaded ILEC tandems become a bottleneck for competitive carriers. This has increased call blocking and given rise to service quality issues for competitive carriers. With the introduction of our services, we believe we became the first carrier to provide alternative tandem services capable of alleviating the ILEC tandem exhaust problem.

The following diagrams illustrate interconnecting via the ILEC tandem networks and an example of interconnecting via our managed tandem network.

Interconnecting via the ILEC Tandem Network within a Market



Interconnecting via Neutral Tandem Network within a Market



The second alternative exchanging traffic, prior to us, was by directly connecting competitive carrier switches to each other. Implementing direct switch-to-switch network connections between all competitive switches in a market is very challenging. For example, in order to completely bypass the ILEC tandem network, a market with 100 competitive switches would require 9,900 direct one-way switch-to- switch connections. The capital and operating expense requirements, complexity and management challenges of establishing and maintaining direct connections generally makes them uneconomical for all but the highest traffic switch combinations and an impractical network-wide solution.

Table of Contents

Competitive carriers are also interested in ways to reduce the risk of network failure. The *Recommendations of the Independent Panel Reviewing the Impact of Hurricane Katrina on Communications Networks*, which was prepared for the FCC, noted the need for tandem diversity. The panel highlighted that the impact of an ILEC tandem failure due to the failure of routing paths into tandems in New Orleans in August 2005 led to the inability of local carriers to exchange and complete calls and the inability of long distance calls to enter or leave areas served by the tandem.

Our solutions help minimize these network failures and interconnection problems by offering physically diverse tandem switching facilities and transmission paths that increase network reliability. We also simplify the ordering, provisioning and capacity management requirements of our customers, and seek to leverage our extensive interconnection network and proprietary technology to capitalize on the growth of intercarrier traffic.

Our Services

Our services allow competitive carriers to exchange traffic between their networks without using an ILEC tandem or establishing direct connections. Each competitive carrier that connects to our network generally gains access to all other competitive carriers' switches connected to our network.

Once connected to our network, carriers can route their traffic to other destinations (telephone numbers) that are addressable by our network. We charge on a per-minute basis for traffic switched by our network. We have an established system for monitoring and tracking customer traffic volumes, and have historically been able to predict these volumes with relative accuracy. Our customers typically use our services for all, or the majority of, their tandem switching needs if our network connects to the desired final destination. In addition, our customers provide us with forecasts of future traffic levels. Together, this system of predicting traffic volumes for both existing and new customers allows us to reasonably estimate future revenue streams.

As a core component of our service offering, we actively manage network capacity between our tandem switches and customers' switches, which results in improved network quality and reduced call blocking. By constantly monitoring traffic levels and projecting anticipated growth in traffic, we are generally able to provide on a timely basis additional circuits between customer switches and our network to meet increased demand. This feature saves competitive carriers substantial time and effort in managing their interconnection network, improves their customers' experience, reduces trouble tickets and allows them to focus more on their core business. We are not aware of any other company that provides a managed tandem service which includes active management of capacity to and from the tandem.

We use proprietary software tools (many of which are patent-pending) to manage and track routing combinations associated with hundreds of millions of telephone numbers. Our services include ongoing customer notification of new routing options that become available as we add new customers to our network or enter new markets. We also provide our customers with invoices, management reports and call detail records in paper and electronic formats along with monthly savings summary reports. ILECs do not currently provide customers with many of these value-added services.

Our managed tandem network includes technologically advanced IP and Time Division Multiplexing, or TDM, switching platforms linked together by an IP backbone. Our network is capable of automatically switching IP-originated or conventional TDM traffic to terminating carriers using either protocol. We support IP-to-IP, IP-to-TDM, TDM-to-IP and TDM-to-TDM traffic with appropriate protocol conversion and gateway functionality.

Our network currently connects 580 unique competitive carrier switches, creating up to 335,820 unique switch-to-switch routes serving 151 million telephone numbers assigned to these carriers. In the quarter ended September 30, 2006, our network carried approximately 2.5 billion minutes of traffic per month.

Table of Contents

Our Strengths

We believe the following strengths differentiate us and position us for continued growth.

- *Market Leading Position.* We believe we have built the largest neutral tandem network in the United States. By being "first-to-market" in the metropolitan areas we serve, we have built significant scale for carrier interconnections and access to terminating telephone numbers. We provide service in 33 markets and have become an integral part of many of our customers' networks, gaining significant industry knowledge of how they manage and engineer interconnections.
- *Strong "Network Effect."* The value of our service offering increases with the number of carriers connected to our network. The addition of each new customer to our network allows the new customer to route traffic to all of our existing customers and allows all of our existing customers to route traffic to the new customer. The "network effect" of adding an additional customer to our platform creates a significant opportunity for existing customers to realize incremental savings by increasing the volume of traffic switched by our tandem network.

  According to Metcalf's law, the "value" or "power" of a network increases in proportion to the square of the number of nodes (interconnected switches) on the network. For example, we currently interconnect 580 competitive switches, which provides a possible 335,820 revenue opportunities for us and savings opportunities for our customers. The 581st interconnection will potentially add up to 1,160 new revenue opportunities for us and savings opportunities for our existing customers.
- *Network-Neutral Position.* Unlike the ILECs, we are positioned as a neutral, third party tandem service provider and generally do not directly compete with our customers. Therefore, we do not have the competitive tensions and conflicts of interest of an ILEC in providing tandem interconnection services. We believe any new entrant would need to match our position of neutrality in order to compete effectively with us.
- *Large and Growing Market.* The continuing shift of telecommunications traffic away from conventional ILEC phone lines to the wireless, VoIP, cable telephony and other wireline segments, provides opportunities for us to continue to expand our business. ILEC access lines declined by 6.2 million to 160.9 million during the 2005 calendar year, representing a 3.7% decrease from access lines at year-end 2004 (FCC, Local Telephone Connection status as of December 21, 2005). During the same period, wireless subscribers grew by 22.6 million and VoIP and cable telephony lines grew by an estimated 3.6 million. Our tandem network was designed to serve the interconnection needs of these rapidly growing segments of the communications market, and since the initiation of our service in 2004, we feel we have built strong relationships with a majority of the leading carriers in these segments, which we believe provides opportunities for us to grow with our customers.
- *Adaptable Technology and Proprietary Software Tools.* Our switching architecture utilizes platforms manufactured by Sonus Networks, Inc. and Nortel Networks Corp. We have deployed a full suite of Sonus Networks' IMS (IP Multimedia Subsystem)-ready solutions which enables us to interconnect to customers on either a TDM or IP interface. In addition, we support both conventional SS7 and Session Initiation Protocol, or SIP, call routing.

  Patent-pending proprietary software tools help us to manage the complicated routing scenarios required to terminate traffic to hundreds of millions of telephone numbers and support our network. The software allows us to quickly identify new routing opportunities between carriers and to help optimize our customers' interconnection costs, which leads to improved customer service.

  We believe the adaptability and flexibility of our technology enables us to provide more robust service offerings, to interconnect a wider range of traffic types and to adapt our service offerings more efficiently than the ILECs, which predominantly employ legacy Class 4 TDM-only circuit switching technology for tandem switching.
- *Experienced Management Team.* We have an experienced management team committed to expanding our position as a leading provider of neutral tandem services. Our senior management has an average of

Table of Contents

20 years of industry experience at companies such as AT&T, Comcast Cable Communications, Inc., Focal Communications Corporation (now part of Level 3 Communications Inc.) and MCI (now part of Verizon).

Our Strategy

Our strategy is focused on expanding our business by increasing the share of telecommunications traffic that our tandem network can serve. Expanding our share of telecommunications traffic increases the value of our network to our customers and enables us to capture a larger share of total telecommunications revenue. Key elements of our expansion strategy include:

- *Broaden our geographic presence.* Our managed tandem services are currently available in 33 markets, serving 151 million assigned telephone numbers out of a potential addressable market of 322 million telephone numbers assigned to competitive carriers in these 33 markets. We plan to broaden our geographic presence in 2007 to include an additional 18 markets. After completing the planned expansion, we estimate that, based upon information published in the LERG, our potential addressable market opportunity will include over 400 million telephone numbers assigned to competitive carriers in those markets. Many of our existing customers provide service in one or more of these new markets. We intend to market our services to our customers in these new markets.
- *Expand our customer base.* As our network expands, our market opportunity will include additional competitive carriers (particularly regional wireless carriers and cable companies) that are not in the markets we currently serve. Many of these potential customers are among the fastest growing carriers in their service areas. In selecting new markets into which we plan to expand, our sales and marketing organization reviews each new market to identify possible new customers.
- *Grow customer traffic.* Three factors principally drive traffic growth from customers: routing opportunities to new customers, routing opportunities in new markets and growth in our customers' traffic volumes. As we add new customers to our network, we receive incremental revenue from the new customer and from all existing customers terminating traffic to the new customer. This "network effect," our expansion strategy and focus on serving the fastest growing segments of the competitive telephony industry positions us well to grow customer traffic.
- *Increase the types of traffic we exchange.* Our business originally connected only local traffic among carriers within a single metropolitan market. In 2006, we installed a national IP backbone network connecting our major local markets. As a result, our service offerings now include the capability of switching and carrying traffic between multiple markets. With one point of access, our customers are able to increase the number of minutes that are switched by our network. We believe that this significant base of interconnected customers and future access to more markets will provide opportunities for further growth in our business.

Our Customers

As of January 9, 2007, we have agreements with 56 competitive carriers to exchange traffic and 48 of these carriers are already connected to our network. Our contracts with our top five customers represented approximately 61% of our expected total revenue in 2006. Two customers, Sprint Nextel and T-Mobile, each represented over 10% of our expected total revenue in 2006. Our contracts with customers do not contain volume commitments, are not exclusive, and could be terminated or modified in ways that are not favorable to us. However, while we have lost customers' traffic in specific routes, since initiating service we have not had any significant customer cease using our services completely. We generate revenue for our managed tandem services by charging tandem transit fees to the originating carrier of the call on a minutes of use basis. Wireless and cable companies represent approximately 26% of our customer base and account for approximately 69% of our revenue.

Since our customers typically interconnect with us in all of their markets where we have a presence, by entering new markets, we have the ability to increase our revenues. In addition, we expect to broaden our customer base by targeting competitive carriers that are not current customers or that operate in markets that we

Table of Contents

do not yet serve. Approximately 67% of our 48 interconnected carriers currently use our services in more than one market.

Our principal customers include:

Wireless Carriers	Cable Companies	VoIP Providers	Wireline
Sprint/Nextel	Cablevision	Vonage	AT&T
T-Mobile	Comcast	Broadvox	McLeod
MetroPCS	RCN	Voex	MCI/Verizon Business
U.S. Cellular	Cox	Reynwood	Level 3/Broadwing
Cingular			XO

Our Markets

Our managed tandem services are currently available in the following 33 markets:

New York, NY	Los Angeles, CA	Chicago, IL	Miami, FL
Washington, D.C.	Atlanta, GA	Detroit, MI	Boston, MA
Minneapolis, MN	Tampa, FL	N. New Jersey	Cleveland, OH
Cincinnati, OH	Orlando, FL	Columbus, OH	Indianapolis, IN
Milwaukee, WI	Jacksonville, FL	Hartford, CT	Buffalo, NY
Rochester, NY	Albany, NY	Dayton, OH	Akron, OH
Toledo, OH	Syracuse, NY	Youngstown, OH	Fort Myers, FL
Madison, WI	Peoria, IL	Green Bay, WI	Champaign, IL
Rockford, IL			

Our expected 2007 market expansion plan includes 18 markets, including Philadelphia, San Francisco, Phoenix, Seattle and Denver. The new markets increase our potential addressable market coverage opportunity to over 400 million assigned telephone numbers to competitive carriers.

Sales and Marketing

Our sales and marketing organization divides accounts by wireless, cable, wireline and VoIP companies and seeks to develop solutions for our customers. Dividing customers in this way allows us to develop unique industry knowledge about each carrier and a more value-added sales force. Our sales team works closely with our customers to identify and address their needs. We seek to expand the use of our service offerings by our current customers through account managers who are dedicated to specific customer accounts. The sales team conducts weekly meetings to discuss customer activity, best practices and industry trends. In addition to a base salary, the compensation package for the members of our sales team includes incentive arrangements, including quarterly target incentives based on our performance and the individual's performance, tiered payment structures and negative incentives. The members of our sales organization have an average of 19 years of sales experience and in-depth knowledge of the telecommunications industry.

Our marketing team works closely with the sales team to deliver comprehensive services, develop a clear and consistent corporate image and offer a full range of product offerings. Our marketing efforts are designed to drive awareness of our service offerings. Our marketing activities include direct sales programs, website programs and targeted public relations. We are also engaged in an on-going effort to maintain relationships with key communications industry analysts.

Our Customer Support

Our ordering and provisioning groups form the core of our customer support team. Each group works closely with the different vendor and customer organizations responsible for establishing service. We assign an implementation manager to each account that is responsible for the end-to-end delivery of our services. These managers make daily contact with their customer and help coordinate our local operations teams during

Table of Contents

implementation. This process helps to improve customer satisfaction, increase customer implementation and promote our revenue realization.

Our network operations center monitors and supports our tandem network 24 hours a day, 365 days a year. The network operations center is responsible for troubleshooting any potential network problems.

Competition

Our primary competition comes from the traditional ILECs (AT&T, Verizon and Qwest) who are generally required to provide tandem switching services pursuant to interpretations of the Telecommunications Act. The ILECs generally set prices for per minute transit charges and port charges according to mandated rate schedules with varying rate caps set by state public utility commissions.

We also face indirect competition from carriers that directly connect their switches. When there is a significant amount of traffic between two switches, there is an economic incentive to establish such direct connection to remove intermediate switching. As our customers grow, the amount of traffic exchanged between them grows, thus leading to the increased risk that they will direct connect switches exchanging significant traffic and remove that traffic from our tandems. The risk of direct connections is increased as more carriers move to an IP based interface, because direct connecting between two IP based carriers is less complex, thus enabling more direct connections. Maintaining and coordinating direct connects, however, has proven to be expensive, difficult to manage and time consuming.

Additionally, other companies may be focusing resources on developing and marketing services that may compete with our services. Potential competitors face barriers to entry due to the network effect associated with our large customer base, switch port availability provided by customers and our growing operational and network scale economies.

The ILECs that provide tandem switching in competition with us have significantly more employees and greater financial, technical, marketing and other resources than we have. Our ability to compete successfully depends on numerous factors, both inside and outside our control, including:

- tandem switching rates charged by the ILECs;
- our responsiveness to customer needs;
- our ability to support existing and new industry standards and protocols;
- our ability to continue development of technical innovations; and
- the quality, reliability, security and price-competitiveness of our services.

Barriers to Entry

- *Difficulty for New Entrants to Overcome Strong Network Effect.* We believe our three year head-start in establishing our network and interconnecting 580 competitive switches gives us a significant advantage over new entrants. Our value proposition to customers is based on lower cost of transit, superior service quality and neutrality. We believe that any network with fewer interconnections than ours has proportionately less value.
- *Inability to Replicate Shelf Space within a Customer's Switch.* Obtaining interconnections from competitive carriers may also be difficult for new entrants. Each interconnection requires the use of switch ports from the competitive carrier. Switch ports are capital intensive and are purchased on a just-in-time basis. Competitive carriers may be unwilling to provide switch ports without significant traffic or savings opportunities.
- *Our Established Relationships with Most Major Carriers.* Since our inception, we have built strong relationships with most of the leading cable telephony, wireless, wireline and VoIP providers in the markets we serve. We feel it would be difficult for a new entrant to readily displace our interconnection network.

Table of Contents

Our Employees

As of December 31, 2006, we had 110 employees. No labor union represents our employees. We have not experienced any work stoppages and consider our relations with our employees to be good.

Regulation

Overview

Our communications services business is subject to varying degrees of federal and state regulation. We have chosen to operate as a common carrier and therefore are voluntarily subject to the jurisdiction of both federal and state regulatory agencies, which have the authority to review our prices, terms and conditions of service. We operate as a facilities-based carrier and have received all necessary state and FCC authorizations to do so. The regulatory agencies exercise minimal control over our prices and services, but do impose various obligations such as reporting, payment of fees and compliance with consumer protection and public safety requirements.

By operating as a common carrier, we also benefit from certain legal rights established by federal legislation, especially the Telecommunications Act, which gives us and other competitive entrants the right to interconnect to the networks of incumbent telephone companies and access to elements of their networks on an unbundled basis. We have used these rights to gain interconnection with the incumbent telephone companies and to purchase selected services at wholesale prices that extend our ability to terminate traffic. We have also used these rights to request interconnection with competitive carriers for the termination of transit traffic to carriers that decide for whatever reason not to utilize our transit service. While our experience has been that competitive carriers usually accommodate such requests, and indeed frequently becomes users of our transit service as well, we are pursuing an FCC proceeding against Verizon Wireless related to its refusal of such a request. See "Legal Proceedings."

The FCC and state regulators are considering a variety of issues that may result in changes in the regulatory environment in which we operate our business. Most importantly, many state and federal proceedings have considered issues related to the ILECs' pricing of services competitive with our service. To the extent that the regulatory commissions maintain or impose pricing restrictions on the transit rates charged by the ILEC, then the price we compete with is likely to be lower. The trend has generally been to remove pricing restrictions on the ILECs' rates, thus allowing the prices we compete against to reach a market level, which is often higher than the previous regulated price, but there can be no guarantee that the trend will continue. In addition, the FCC is conducting an extensive proceeding involving intercarrier compensation. One of the issues in the proceeding involves the pricing and regulation of ILEC tandem services, with which we compete. To the extent that the FCC limits or regulates the rates the ILECs' charge for tandem services, it could have a materially adverse impact on our rates and operations.

Although the nature and effects of governmental regulation are not predictable with certainty, we believe that the FCC is unlikely to enact rules that extinguish our basic right or ability to compete in telecommunications markets. The following sections describe in more detail the regulatory developments described above and other regulatory matters that may affect our business. While many of the regulatory developments do not directly affect our operations, to the extent that they limit our customers' ability to compete effectively against the ILEC, we are indirectly impacted.

Regulatory Framework

The Telecommunications Act

The Telecommunications Act, which substantially revised the Communications Act of 1934, established the regulatory framework for the introduction of competition for local communications services throughout the United States by new competitive entrants such as us. Before the passage of the Telecommunications Act, states typically granted an exclusive franchise in each local service area to a single dominant carrier, often a former

Table of Contents

subsidiary of AT&T known as a Regional Bell Operating Company, or RBOC, which owned the entire local exchange network and operated a virtual monopoly in the provision of most local exchange services in most locations in the United States. The RBOCs, following some recent consolidation, now consist of Verizon, Qwest Communications and AT&T.

Among other things, the Telecommunications Act preempts state and local governments from prohibiting any entity from providing communications service, which has the effect of eliminating prohibitions on entry that existed in almost half of the states at the time the Telecommunications Act was enacted. Nonetheless, the Telecommunications Act preserved state and local jurisdiction over many aspects of local telephone service and, as a result, we are subject to varying degrees of federal, state and local regulation.

We believe that the Telecommunications Act provided the opportunity to accelerate the development of competition at the local level by, among other things, requiring the incumbent carriers to cooperate with competitors' entry into the local exchange market. To that end, incumbent local exchange carriers are required to allow interconnection of their network with competitive networks. Incumbent local exchange carriers are further required by the Telecommunications Act to provide access to certain elements of their network to competitive local exchange carriers. These rules have helped the development of competitive telecommunications carriers, many of which have become our customers.

We have developed our business, including being designated as a common carrier, and designed and constructed our networks to take advantage of the features of the Telecommunications Act. There have been numerous attempts to revise or eliminate the basic framework for competition in the local exchange services market through a combination of federal legislation, adoption of new rules by the FCC, and challenges to existing and proposed regulations by the incumbent carriers. We anticipate that Congress will consider a range of proposals to modify the Telecommunications Act over the next few years, including some proposals that could restrict or eliminate our access to elements of the incumbent local exchange carriers' network. Although we consider it unlikely, based on statements of both telecommunications analysts and Congressional leaders, that Congress would reverse the fundamental policy of encouraging competition in communications markets, we cannot predict whether future legislation may adversely affect our business in other ways.

Federal Regulation

The FCC regulates interstate and international communications services, including access to local communications networks for the origination and termination of these services. We provide services on a common carrier basis and the FCC has jurisdiction over our services to the extent they are used as part of the origination or termination of interstate or international calls. However, the FCC only has limited jurisdiction over transit services that we provide for delivery of local and intra-state calls.

The FCC imposes extensive economic regulations on incumbent local exchange carriers due to their ability to exercise market power. The FCC imposes less regulation on common carriers without market power including, to date, competitive local exchange carriers. Unlike incumbent carriers, we are not currently subject to price cap or rate of return regulation, but we are subject to the general federal guidelines that our charges for interstate and international services be just, reasonable and non-discriminatory. The rates we can charge for interstate access, unlike our transit services, are limited by FCC rules. We are also required to file periodic reports, to pay regulatory fees based on our interstate revenues, and to comply with FCC regulations concerning the content and format of our bills, the process for changing a customer's subscribed carrier, and other consumer protection matters. Because we do not directly serve consumers, many of these regulations have no practical effect on our business. The FCC has authority to impose monetary forfeitures and to condition or revoke a carrier's operating authority for violations of its requirements. Our operating costs are increased by the need to assure compliance with regulatory obligations.

The Telecommunications Act is intended to increase competition. Specifically, the Telecommunications Act opens the local services market by (i) requiring incumbent local exchange carriers to permit interconnection to

Table of Contents

their networks, (ii) by establishing incumbent local exchange carrier obligations with respect to interconnection with the networks of other carriers, (iii) provision of services for resale, (iv) unbundled access to elements of the local network, (v) arrangements for local traffic exchange between both incumbent and competitive carriers, (vi) number portability, (vii) access to phone numbers, (viii) access to rights-of-way, (ix) dialing parity and (x) collocation of communications equipment in incumbent central offices. Incumbent local exchange carriers are required to negotiate in good faith with carriers requesting any or all of these arrangements. If the negotiating carriers cannot reach agreement within a prescribed time, either carrier may request binding arbitration of the disputed issues by the state regulatory commission. Where an agreement has not been reached, incumbent local exchange carriers remain subject to interconnection obligations established by the FCC and state communications regulatory commissions.

The Telecommunications Act also eliminated provisions of prior law restricting the RBOCs from providing long distance services and engaging in communications equipment manufacturing. The Telecommunications Act permitted the RBOCs to provide long distance service to customers outside of states in which the RBOC provides local telephone service, immediately upon its enactment. It also permitted a RBOC to enter the long distance market within its local telephone service area upon showing that certain statutory conditions have been met and obtaining FCC approval. The FCC has approved RBOC petitions for in-region long-distance for every state in which these companies operate, and each RBOC is now permitted to offer long-distance service to its local telephone customers. This development has led to increased concentration in the telecommunications industry, which may affect our addressable market. See "Risk Factors—Consolidation in the industry, such as AT&T-BellSouth-Cingular, Verizon-MCI and SBC-AT&T, reduces the need for intercarrier transit service and may limit our growth opportunities," above. RBOCs have recently petitioned the FCC to remove some of the conditions they had to meet to obtain long-distance approval, including in particular conditions that impose obligations to provide access to RBOC broadband network elements.

Triennial Review Order and Appeals. As discussed above, the Telecommunications Act requires the incumbent local exchange carriers to provide competitors access to elements of their local network on an unbundled basis, known as UNEs. The Telecommunications Act requires that the FCC consider whether competing carriers would be impaired in their ability to offer telecommunications services without access to particular UNEs. If the FCC requires access to particular UNEs, the incumbent local exchange carriers are required to make available access to these network elements at prices based on TELRIC computed in accordance with FCC guidelines. If the FCC finds that UNE access is not required, the incumbent LEC may still be required to offer access to the element, but not at TELRIC-based prices.

The FCC's Triennial Review Order of August 2003, substantially revised its rules interpreting and enforcing these requirements. However, a March 2004 court decision required the FCC to reconsider portions of its Triennial Review Order, and as a result the FCC further revised the rules in a Remand Order adopted in late 2004, effective March 11, 2005. The Triennial Review Order denied competitors access to incumbent local exchange carrier packet switching capabilities provided over some fiber loop facilities and severely restricted their access to fiber loops to homes and other "primarily residential" locations such as apartment buildings. The Remand Order stated that incumbent local exchange carriers will no longer be required to provide access to unbundled circuit switching capabilities, which previously allowed carriers the opportunity to resell ILEC services or UNE-P, at incremental cost-based rates. These resale carriers have had to either convert their customers to other arrangements, which may include contractual resale arrangements with the incumbent local exchange carriers, or discontinue serving them.

The FCC Remand Order also required that incumbent local exchange carriers continue to make access available to competitors for high capacity loop and transport UNEs. However, the new rules placed new conditions and limitations on the incumbent local exchange carriers' obligation to unbundle these elements.

Incumbent local exchange carriers no longer have to provide T-1 and DS-3 UNE transport circuits on routes connecting certain high-traffic central offices. For T-1 transport (including transport as a component of a T-1 EEL), the exception applies if both central offices serve at least 38,000 business lines or have four or more fiber-based colocators. For DS-3 transport, the exception applies if both central offices serve at least 24,000 business

Table of Contents

access lines or have three or more colocators. There is also a cap of 12 DS-3 transport circuits available on an unbundled basis from an incumbent local exchange carrier on any given route, even where the high-traffic exception does not apply. Similarly, incumbent local exchange carriers no longer have to provide T-1 or DS-3 UNE loops to premises served by certain high-traffic central offices.

These changes in the FCC rules have had several effects on the competitive telecommunications carriers who are our prospective customers. First, the elimination of UNE-P has reduced the market share of resellers and led some former resellers to convert to facilities-based service. This development is positive for us because resellers generally are not potential users of our transit services. Second, the restrictions on the availability of loop and transport UNEs may have contributed to accelerated consolidation among competitive carriers, such as the recent acquisitions of TelCove and Broadwing by Level 3, the acquisition of US LEC by PaeTec, and the merger of CTC Communications, Choice One Communications and Conversent Communications to form One Communications. This development may have a negative impact on us because our business model is based on the existence of many independent carriers who need to exchange traffic with each other. It is difficult to predict the overall effect of these countervailing trends on our future business opportunities.

The new FCC rules are subject to ongoing court challenges. We cannot predict the results of future court rulings, or how the FCC may respond to any such rulings, or any changes in the availability of UNEs as the result of future legislative or regulatory decisions.

TELRIC Proceeding. In late 2003, the FCC initiated a proceeding to address the methodology used to price UNEs and to determine whether the current methodology, TELRIC, should be modified. Specifically, the FCC is evaluating whether adjustments should be made to permit incumbent local exchange carriers to recover their actual embedded costs and whether to change the time horizon used to project the forward looking costs. The FCC has taken no action in this proceeding during the past three years and is unlikely to adopt any changes to its rules within the next year, but we cannot be certain as to either the timing or the result of the agency's action.

Intercarrier Compensation. In 2001, the FCC initiated a proceeding to address rules that require one carrier to make payment to another carrier for access to the other's network, or intercarrier compensation. In its notice of proposed rulemaking, the FCC sought comment on some possible advantages of moving from the current rules to a bill and keep structure for all traffic types in which carriers would recover costs primarily from their own customers, not from other carriers. In February 2005, the FCC requested further comments on these issues and on several specific proposed plans for restructuring intercarrier compensation. In addition, from time to time, carriers that we connect with have requested that we pay them to terminate traffic, and this proceeding will likely address those rights or obligations. As part of that docket, on July 24, 2006, a group of large and rural ILECs filed a proposal for intercarrier compensation reform at the FCC called the Missoula Plan, which primarily benefits the ILECs. The Missoula Plan includes provisions regarding tandem transit services. Under the Missoula Plan a carrier may satisfy its transport obligations by a direct interconnection (by using its owns facilities or facilities obtained from another carrier) or by indirect interconnection through a third party tandem transit service. Under the Missoula Plan, tandem transit service would be provided at a rate not to exceed $0.0025 per minute of use for non-access traffic with exceptions for high-volume interconnections and premium or enhanced services. The FCC currently is considering public comments on the Missoula Plan. Independently or in combination with the Missoula Plan, the FCC could make significant changes in the ILEC's pricing of transit traffic, including lowering the rate, freezing the rate or establishing uniform rates.

We currently generally have no revenue exposure associated with reciprocal compensation for local traffic because our customers are primarily carrier customers, who are responsible for any compensation. We do, however, collect revenue for transit and access charges relating to the termination of local and long distance traffic with other carriers. If the FCC were to reduce what the ILEC can charge for the transiting of local traffic, our revenues would be reduced. We cannot predict either the timing or the result of this FCC rulemaking.

Regulatory Treatment of VoIP. In February 2004, the FCC initiated a proceeding to address the appropriate regulatory framework for VoIP providers. Currently, the status of VoIP providers is not clear,

Table of Contents

although a report issued by the FCC in 1998 suggests that some forms of VoIP may constitute "telecommunications services" that are subject to regulation as common carriers under federal law. The 1998 report also suggested, however, that this regulatory treatment would not apply until after the FCC determined which specific services were subject to regulation. The new FCC proceeding will attempt to determine what, if any, regulation is appropriate for VoIP providers and whether the traffic carried by these providers will be subject to access charges. The principal focus of this rulemaking is on whether VoIP providers should be subject to some or all of the regulatory obligations of common carriers.

The FCC is continuing to consider whether to impose various obligations on VoIP providers. It recently voted to impose requirements to provide access to 911 emergency services, to permit duly authorized law enforcement officials to monitor communications and to require VoIP providers to contribute to the cost of the FCC's universal service program. These obligations are likely to increase the cost of providing VoIP service and slow the growth of VoIP providers. Because VoIP providers are potential users of our services, this trend may affect demand for our services.

State Regulation

State agencies exercise jurisdiction over intrastate telecommunications services, including local telephone service and in-state toll calls. To date, we are authorized to provide intrastate local telephone and long-distance telephone services in twenty states. As a condition to providing intrastate telecommunications services, we are required, among other things, to:

- file and maintain intrastate tariffs or price lists describing the rates, terms and conditions of our services;
- comply with state regulatory reporting, tax and fee obligations, including contributions to intrastate universal service funds; and
- comply with, and to submit to, state regulatory jurisdiction over consumer protection policies (including regulations governing customer privacy, changing of service providers and content of customer bills), complaints, transfers of control and certain financing transactions.

Generally, state regulatory authorities can condition, modify, cancel, terminate or revoke certificates of authority to operate in a state for failure to comply with state laws or the rules, regulations and policies of the state regulatory authority. Fines and other penalties may also be imposed for such violations. As we expand our operations, the requirements specific to any individual state will be evaluated to ensure compliance with the rules and regulations of each state.

In addition, the states have authority under the Telecommunications Act to approve or (in limited circumstances) reject agreements for the interconnection of telecommunications carriers' facilities with those of the incumbent local exchange carrier, to arbitrate disputes arising in negotiations for interconnection and to interpret and enforce interconnection agreements. In exercising this authority, the states determine the rates, terms and conditions under which we can obtain collocation in ILEC central offices and interconnection trunks for termination of local traffic to ILEC customers, under the FCC rules. The states may re-examine these rates, terms and conditions from time to time.

State governments and their regulatory authorities may also assert jurisdiction over the provision of transit services, particularly the ILECs' provision of the service. Various state regulatory authorities have initiated proceedings to examine the regulatory status of transit services. Some states have taken the position that transit service is an element of the "transport and termination of traffic" services that incumbent ILECs are required to provide at TELRIC rates under the Telecommunications Act, while other states have ruled that the Telecommunications Act does not apply to these services. To date, the FCC has not resolved this dispute over interpretation of the Telecommunications Act, resulting in disparate pricing of these services among the states. The trend has been to reduce the state regulation of transit service, although there are exceptions and there can be no assurance that the trend will continue. Like the FCC, most states have the power to order interconnection in the event that we have traffic that we need to terminate directly to a carrier not on the tandem.

Table of Contents

Intellectual Property

Our success is dependent in part upon our proprietary technology. We rely principally upon trade secret and copyright law to protect our technology, including our software, network design, and subject matter expertise. We enter into confidentiality or license agreements with our employees, distributors, customers and potential customers and limit access to and distribution of our software, documentation and other proprietary information. We believe, however, that because of the rapid pace of technological change in the communications industry, the legal protections for our services are less significant factors in our success than the knowledge, ability and experience of our employees and the timeliness and quality of our services.

We have been granted one patent and have two additional patents pending with the U.S. Patent and Trademark Office. The granted patent addresses our core business, the operation of a neutral tandem network. One of the pending patents addresses a series of unique traffic routing designs developed by us to assist our customers in reducing their internal network operating costs. The second pending patent covers a set of proprietary operating systems and software developed by us to manage our network. There can be no assurance regarding how, whether or when these additional patents may be granted.

Our Properties and Facilities

Our headquarters is located at One South Wacker Drive, Suite 200, Chicago, Illinois, where we lease approximately 15,000 square feet of office space. Our leased properties are described below:

Property Location	Approximate Square Feet	Use	Lease Expiration Date
Chicago, IL	15,423	Administrative Office	October 31, 2011
New York, NY	16,532	Switch site	August 31, 2014
Detroit, MI	10,800	Switch site	February 28, 2010
Indianapolis, IN	9,577	Switch site	April 30, 2012
Los Angeles, CA	6,857	Switch site	October 31, 2011
Cleveland, OH	6,000	Switch site	October 31, 2011
Atlanta, GA	5,861	Switch site	May 31, 2015
Minneapolis, MN	5,808	Switch site	February 28, 2012
Chicago, IL	5.263	Switch site	March 31, 2009
Miami, FL	5,176	Switch site	December 31, 2011
Chicago, IL	4,347	Switch site	May 31, 2011
San Francisco, CA	3,922	Switch site	April 30, 2014
Cincinnati, OH	3,369	Switch site	September 30, 2015
Boston, MA	2.416	Switch site	June 11, 2016
Orlando, FL	2,092	Switch site	May 31, 2011
Columbus, OH	2,026	Switch site	February 28, 2011
Milwaukee, WI	1,703	Switch site	November 30, 2014
Phoenix, AZ	1,652	Switch site	March 31, 2012
Tampa, FL	1,048	Switch site	January 31, 2016

We believe our existing facilities are adequate for our current needs in our existing markets and that suitable additional or alternative space will be available in the future on commercially reasonable terms as needed.

Legal Proceedings

From time to time, we are a party to legal or regulatory proceedings arising in the normal course of our business. Aside from the matter discussed below, we do not believe that we are party to any pending legal action that could reasonably be expected to have a material adverse effect on our business or operating results.

Table of Contents

Verizon Wireless. In July 2006, Verizon Wireless notified us that it wished to terminate its existing Master Service Agreement. As a consequence of this notification, we potentially would be unable to terminate traffic to Verizon Wireless customers in the three markets in which we are directly connected with Verizon Wireless. In response to the notification, in August 2006, we filed a petition for interconnection with the FCC. The petition argues that direct connection with Verizon Wireless is in the public interest because it furthers competitive choices in tandem services and strengthens the network reliability of the public switched telephone network. We have written submissions supporting our petition for interconnection from various sources, including the New York Department of Public Services, the cities of New York and Chicago, AT&T and others. To our knowledge, the FCC has never ordered a wireless carrier to provide interconnection. Therefore, there can be no assurance that our petition for interconnection will be successful or how, whether, or when this matter will be resolved.

Verizon. We are considering initiating an arbitration proceedings against Verizon regarding a billing dispute of approximately $1.3 million. The dispute originates from an accounts payable which we feel is not owed under the Verizon tariff. There can be no assurance regarding how, whether or when this matter will be resolved.

Table of Contents

MANAGEMENT

Executive Officers and Directors

The names, ages and positions of our executive officers and directors, as of January 15, 2007, are set forth below:

Name	Age	Position(s)
Rian J. Wren	50	President, Chief Executive Officer and Director
Robert Junkroski	42	Chief Financial Officer
Surendra Saboo	47	Chief Operating Officer and Executive Vice President
Ronald Gavillet	47	General Counsel and Executive Vice President, External Affairs
David Lopez	42	Senior Vice President of Sales
James P. Hynes	59	Director, Chairman
Dixon R. Doll	64	Director
Peter J. Barris	55	Director
Robert C. Hawk	67	Director
Lawrence M. Ingeneri	48	Director

Rian J. Wren. Mr. Wren joined us in February 2006 and has served as our President, Chief Executive Officer and Director since that time. Prior to joining us, Mr. Wren was Senior Vice President and General Manager of Telephony for Comcast Cable from November 1999 to August 2005. Mr. Wren joined Comcast in 1999 and was named CEO of Broadnet, Comcast's international wireless company located in Brussels, Belgium in 2000. After returning to the United States, he served as the Senior Vice President and General Manager of Telephony for Comcast Cable Division. Prior to joining Comcast, Mr. Wren held several senior management positions at AT&T from 1978 to 1999, including President of the Southwest Region, and worked in the Consumer, Business, Network Services, and Network Systems Manufacturing divisions for more than 20 years. Mr. Wren serves as a Director of Accessline Communications, Inc.

Robert Junkroski. Mr. Junkroski has been with the Company since it commenced services, and has served as our Chief Financial Officer since that time. Prior to joining us, Mr. Junkroski held the position of Vice President of Finance with Focal Communications Corporation, or Focal (now part of Level 3 Communications Inc.), from 1999 to 2002. Mr. Junkroski previously served as Focal's Treasurer and Controller from 1997 to 2001. On December 19, 2002, subsequent to Mr. Junkroski's departure, Focal filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. Before joining Focal, Mr. Junkroski was Controller for Brambles Equipment Services, Inc. and Focus Leasing Corporation.

Surendra Saboo. Dr. Saboo joined us in May 2006 as our Chief Operating Officer and Executive Vice President. Prior to joining us, Dr. Saboo was the Vice President of Product Development and Operations for Voice Services at Comcast Corporation from January 2002 to March 2006. From June 2000 to December 2001, Dr. Saboo served as Executive Vice President and Chief Operating Officer of Broadnet Europe, SPRL, a pan-European subsidiary of Comcast Corporation. Prior to joining Comcast Corporation, Dr. Saboo was the Chairman, Chief Executive Officer and founder of Teledigm, an e-CRM software product company in Dallas, Texas. Prior to starting Teledigm, Dr. Saboo spent 14 years at AT&T in a variety of operating areas including research and development, engineering, product management, strategy, systems development and operations. Dr. Saboo began his career with AT&T in 1986 as a Member of Technical Staff at Bell Laboratories in Holmdel, NJ. Dr. Saboo holds a B.S.M.E. degree from Birla Institute of Technology, India as well as M.S. and Ph.D. degrees in Operations Research from Ohio State University.

Ronald Gavillet. Mr. Gavillet has been with the Company since it commenced services, and has served as General Counsel and Executive Vice President, External Affairs since that time. Mr. Gavillet has over 20 years of diversified telecommunications experience. Previously, Mr. Gavillet served as Executive Vice President and General Counsel for MCG Capital's Cleartel Communications from 2002 to 2003. In addition to five years in private practice with the law firms of Skadden, Arps, Slate, Meagher & Flom and Hopkins & Sutter, Mr. Gavillet

Table of Contents

held senior legal and strategic positions with several competitive carriers, including MCI, USN Communications and Universal Access between 1985 and 2002. Mr. Gavillet was the founder and co-chair of the Federal Communications Bar Association Midwest Chapter and has authored several articles on the telecommunications industry.

David Lopez. Mr. Lopez joined us in 2003 and has served as our Senior Vice President of Sales since that time. For nearly 20 years, Mr. Lopez has provided account management responsibilities at Centel, Sprint, and Focal Communications Corporation. In his most recent position, Mr. Lopez provided sales management for Focal's largest and most successful market from 1997 to 2003. During his tenures at Centel and Sprint from 1992 to 1997, Mr. Lopez held national account positions with responsibility for local service, Centrex, and PBX equipment to Fortune 500 companies.

James P. Hynes. Mr. Hynes co-founded the Company in 2001, and served as Chief Executive Officer until February 2006, after which he became Executive Chairman. In December 2006 Mr. Hynes stepped down as Executive Chairman and assumed the title of Chairman of the Board, a position he holds today. Active in the industry for 30 years, Mr. Hynes personally directed the establishment of COLT Telecommunications in Europe as their first CEO in 1992. As Chairman of the Board, he led COLT's initial public offering in 1996. Mr. Hynes established MetroRED Telecom in South America and Mexico, as well as KVH Telecom in Tokyo. Concurrent with taking on these operating roles, he was Group Managing Director at Fidelity Capital for 10 years. His career has included senior positions with Chase Manhattan, Continental Corporation, Bache & Co. and New York Telephone. Mr. Hynes is a Vice Chairman of the Board of Trustees of Iona College and is also on the North American Board of the SMURFIT Graduate School of Business, University College Dublin in Ireland.

Dixon R. Doll. Dr. Doll has served as a Director of ours since 2003. Dr. Doll is the co-founder of DCM, an early stage technology venture capital firm which currently has more than $1.5 billion under management, headquartered in Menlo Park, California. In the mid-1980's, Dr. Doll co-founded the venture capital industry's first fund focused exclusively on telecommunications opportunities. He is the Chairman of the Board of Network Equipment Technologies and numerous private companies. Since 2004, he has been a director of the U.S. National Venture Capital Association in Washington D.C. where he also serves on the Executive Committee. Additionally, he also serves on the Stanford Institute for Economic Policy Research Advisory Board and is the Chairman of the San Francisco Asian Art Museum Board. Dr. Doll received his B.S.E.E. degree (cum laude) from Kansas State University as well as M.S. and Ph.D. degrees in Electrical Engineering from the University of Michigan, where he was a National Science Foundation scholar.

Peter J. Barris. Mr. Barris has served as a Director since 2003. Mr. Barris is currently the Managing General Partner of NEA where he specializes in information technology investing. Mr. Barris has been with NEA since 1992, and he serves as either an executive officer or general partner of various NEA entities. From 1988 to 1990, Mr. Barris was President and Chief Operating Officer at LEGENT Corporation. From 1986 to 1988, Mr. Barris served as Senior Vice President and General Manager of the Systems Software Division and from 1985-1985 as the Vice President of Corporate Development at UCCEL Corporation. Prior to that, Mr. Barris also held various management positions between 1977 and 1985 at the General Electric Company, including Vice President and General Manager at GE Information Services, Inc. Mr. Barris serves or has served as a member of the Boards of Directors of InnerWorkings, Inc., where he also served as a member of the audit, compensation and corporate governance committees, Vonage Holdings Corp., where he also served as a member of the compensation committee, ProtoStar, Boingo Wireless and Hillcrest, as well as several other private companies in the NEA portfolio. Mr. Barris serves on the Executive Committee of the National Venture Capital Association and is a member of the Board of Trustees of Northwestern University and the Board of Overseers of Tuck School at Dartmouth College.

Robert C. Hawk. Mr. Hawk has served as a Director since January 2004. Mr. Hawk has served as President of Hawk Communications since 1996 and is a Venture Partner of DCM. Prior to this, Mr. Hawk served

Table of Contents

as President and Chief Executive Officer of US West Multimedia Communications, Inc. From 1986 until 1995, Mr. Hawk was President of the Carrier Division of US West Communications, Inc. Prior to such position, Mr. Hawk was Vice President, Marketing and Strategic Planning for CXC Corporation, and Director of Advanced Systems Development for American Bell. From 1997 to 2002, Mr. Hawk served as a Special Limited Partner of Crosspoint Venture Partners. During that time he served on the boards of directors or advisory boards of fifteen companies that went public. Mr. Hawk previously served as a Director of Covad Communications and is a current Director for Centillium Communications and several private high technology companies.

Lawrence M. Ingeneri. Mr. Ingeneri has served as a Director since October 2006. Mr. Ingeneri is currently the Chief Financial Officer and a member of the Board of Directors of mindSHIFT Technologies, Inc., an IT managed services provider which he joined in October 2003. Prior to that time, Mr. Ingeneri was employed by COLT Telecom Group plc, or COLT, a European telecommunications services company from July 1996 to December 2002. Mr. Ingeneri was the Chief Financial Officer of COLT from July 1996 to June 2002 and a member of the Board of Directors of COLT from June 2001 to June 2002.

Our Board of Directors

Our board of directors has the power to appoint our officers. Each officer will hold office for the term determined by the board of directors and until such person's successor is chosen and qualified or until such persons resignation, removal or death. Our board currently consists of six persons. Within one year of the consummation of this offering, a majority of the board of directors will satisfy the independence requirements of the NASDAQ Stock Market.

So long as a combined total of at least 1,842,000 shares of Series A preferred stock, Series B-1 preferred stock, Series B-2 preferred stock and Series C preferred stock are outstanding (as adjusted for stock split, stock dividend, combination, reclassification of shares or similar event), the holders of the shares of Series A preferred stock, Series B preferred stock and Series C preferred stock (voting together as a single class and not as separate series, and on an as-converted basis) are entitled to elect two of our directors at any election of directors. The holders of outstanding common stock are entitled to elect two of our directors at any election of directors. The holders of preferred stock and common stock (voting together as a single class and not as separate series, and on an as-converted basis) are entitled to elect any of our remaining directors.

There are no family relationships among any of our directors or executive officers.

Our amended and restated certificate of incorporation, which will become effective prior to completion of this offering, may provide that our board of directors will be divided into three classes. If applicable, the term of office of directors assigned to Class I will expire at the annual meeting of shareholders in 2007 and at each third succeeding year thereafter, the term of office of directors assigned to Class II will expire at the annual meeting of shareholders in 2008 and at each third succeeding annual meeting thereafter, and the term of office of directors assigned to Class III will expire at the annual meeting of shareholders in 2009 and at each third succeeding annual meeting thereafter. If applicable, our board resolved that , and will serve as Class I directors, , and will serve as Class II directors and , and will serve as Class III directors.

If applicable, this classification of the board of directors may delay or prevent a change of control of us or in our management. See "Description of Capital Stock—Anti-Takeover Effects of Certain Provisions of Delaware Law and Our Amended and Restated Certificate of Incorporation and Restated Bylaws."

Committees of the Board of Directors

We currently have an audit committee, compensation committee and a nominating and corporate governance committee. Each such committee has three or more members, who serve at the pleasure of the board

Table of Contents

of directors. At the time of the offering, each committee will consist of three persons, at least one of whom is not employed by us, and is "independent" as defined under the rules of the NASDAQ Stock Market. Within one year of the consummation of this offering, all of the members of these committees will be independent.

Compensation Committee. The Compensation Committee is responsible for reviewing and making recommendations to the Board of Directors with respect to compensation of executive officers and other related compensation matters. Currently, Dr. Doll, Mr. Hynes and Mr. Barris serve on the Compensation Committee. Dr. Doll is chairman of the committee.

Our board of directors will adopt a written charter for this committee, which will be available on our website after completion of the offering.

Audit Committee. The Audit Committee is responsible for reviewing our financial statements, audit reports, internal financial controls, and for making recommendations with respect to those matters to the Board of Directors. Currently, Mr. Ingeneri, Mr. Hawk and Mr. Hynes serve on the Audit Committee. The board has determined that Mr. Ingeneri, the current chairman of the committee, qualifies as an "audit committee financial expert" within the meaning of the regulations of the SEC.

Our board of directors will adopt a written charter for this committee, which will be available on our website after completion of the offering.

Nominating and Corporate Governance Committee. The Nominating and Corporate Governance Committee will be responsible for the oversight of and assist our board of directors in developing and recommending governance practices and selecting the director nominees to stand for election at annual meetings of our shareholders. Currently, Mr. Hawk, Mr. Barris and Mr. Ingeneri serve on the Nominating and Corporate Governance Committee.

Our board of directors will adopt a written charter for this committee, which will be available on our website after completion of the offering.

Code of Conduct

Prior to this offering, we will adopt a finance code of professional conduct for our chief executive officer, chief financial officer and other key employees of the finance organization.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee is currently comprised of three directors, Messrs. Doll, Barris and Hynes. Dr. Doll serves as Chairman of the Compensation Committee. Shortly after the completion of this offering, each member of the Compensation Committee will meet the definition of independence under our corporate governance guidelines and further qualifies as a non-employee director for purposes of Rule16b-3 under the Securities Exchange Act of 1934. None of the current members of the Compensation Committee are current or, other than Mr. Hynes, former employees of ours nor are any members eligible to participate in any of our executive compensation programs. Additionally, the Compensation Committee operates in a manner designed to meet the tax deductibility criteria included in Section 162(m) of the Internal Revenue Code. See "—Committees of the Board of Directors" for a further description of the Compensation Committee. As discussed in "Certain Relationships and Related Transactions," Dr. Doll is co-founder of DCM and Mr. Barris is Managing General Partner of NEA, each of which are affiliates of certain of our stockholders.

Table of Contents

COMPENSATION DISCUSSION AND ANALYSIS

Overview

We were incorporated on April 19, 2001, commenced operations in November 2003 and began generating revenue with the launch of our service in February 2004. The material principles underlying our executive compensation policies and decisions are intended to:

- implement compensation packages which are competitive with comparable organizations and allow us to attract and retain the best possible executive talent;
- relate annual and long-term cash and stock incentives to achievement of measurable corporate and individual performance objectives;
- appropriately balance the mix of cash and non-cash short and long-term compensation;
- encourage integrity in business dealings through the discretionary portion of our compensation package; and
- align executives' incentives with long-term stockholder value creation.

To implement these principles, the Compensation Committee, which is responsible for approving and administering the compensation program for executive officers and certain senior employees, expects to maintain compensation plans that tie a substantial portion of executives' overall compensation to key strategic goals such as the development of our network, the establishment and maintenance of key strategic relationships and the growth of our customer base as well as our financial and operational performance, as measured by metrics such as revenue, customer growth, churn and markets launched. As executives assume greater responsibility inside Neutral Tandem, a larger portion of their total compensation is expected to be "at risk" and thus subject to corporate and individual performance.

Our Compensation Methodology

To assist the Compensation Committee in discharging its responsibilities, in 2005, the Compensation Committee retained an independent compensation consultant, Human Capital Solution, to evaluate certain aspects of our compensation practices and to assist in developing and implementing our executive compensation program. Human Capital Solution also provides outsourced human resources management services to us. Human Capital Solution developed a competitive peer group and performed benchmarking analyses of competitive compensation levels. With this information, our management developed recommendations that were reviewed and approved by the Compensation Committee in connection with developing and approving compensation awards.

Other than our retention of Human Capital Solution in 2005, we have not retained any other compensation consultant to review our policies and procedures relating to executive compensation. Our Compensation Committee does however informally consider competitive market practices by speaking to recruitment agencies and reviewing publicly available information relating to compensation of executive officers at other comparable telecommunications companies.

Our Compensation Committee reviews and approves all of our compensation policies.

Elements of Compensation

The principal elements of our compensation package are as follows:

- base salary;
- annual cash incentive bonuses;
- long-term incentive plan awards;

Table of Contents

- severance benefits;
- change in control benefits;
- perquisites and other compensation; and
- retirement benefits.

Base Salary

Base salary is used to recognize the experience, skills, knowledge and responsibilities required of all our employees, including our named executive officers. When establishing base salaries for 2006, the Compensation Committee and management considered a number of factors, including the seniority of the individual, the functional role of the position, the level of the individual's responsibility, the ability to replace the individual, the base salary of the individual at their prior employment and the number of well qualified candidates to assume the individual's role. Generally, we believe that executive base salaries should be targeted near the median of the range of salaries for executives in similar positions at comparable companies.

Base salaries are reviewed at a minimum annually by our Compensation Committee during our performance review, and adjusted from time to time to realign salaries with market levels after taking into account individual responsibilities, performance and experience.

Annual Cash Incentive Bonus

We have an annual cash incentive bonus plan for nearly all employees, including our named executive officers. The annual cash incentive bonuses are intended to compensate for the achievement of both our annual financial goals and individual annual performance objectives. Amounts payable under the annual cash incentive bonus plan are calculated as a percentage of the applicable officer's base salary, with higher ranked executive officers being compensated at a higher percentage of base salary. The corporate targets and the individual objectives are given roughly equal weight in the bonus analysis. The corporate targets generally conform to the financial metrics contained in the internal business plan adopted by the board of directors, including revenue, EBITDA and net income. Individual objectives are necessarily tied to the particular area of expertise of the employee and their performance in attaining those objectives relative to external forces, internal resources utilized and overall individual effort. The Compensation Committee approves the annual cash incentive award for the Chief Executive Officer and each other named executive officer. The Compensation Committee's determination, other than with respect to the Chief Executive Officer, is generally based upon the Chief Executive Officer's recommendations.

The bonus awards for 2006 and the expected target bonus awards for 2007 (each as a percentage of annual base salary) for the named executive officers are:

Category	2006 Target Bonus as a % of Annual Base Salary	2007 Target Bonus as a % of Annual Base Salary
Rian Wren	40%	40%
Robert Junkroski	40%	40%
Ronald Gavillet	40%	40%
Surendra Saboo	40%	40%
James Hynes	0%	0%

David Lopez, our Senior Vice President—Sales, is compensated quarterly based upon achievement of certain of our financial goals and individual performance objectives. During the first year of the named executives' employment agreements (other than Mr. Lopez), however, the maximum annual cash incentive bonus was capped at 40% of base salary. Depending on the achievement of the predetermined targets, the annual bonus for the other named executives may be less than or greater than the target bonus. The maximum annual cash incentive bonus is determined by the Compensation Committee based upon the principles underlying our executive compensation program. See "—Overview" above. The annual cash incentive bonus for the named executive officers is normally paid in a single installment in the first quarter following any given fiscal year.

Table of Contents

Long-Term Incentive Plan Awards

We believe that our long-term performance is fostered by a compensation methodology which compensates executive officers through the use of stock-based awards, such as stock options, restricted stock awards, and other rights to receive compensation based on the value of our stock. Therefore, our executive officers have a continuing stake in our long-term success.

Our 2003 Stock Incentive Plan was adopted on November 24, 2003 to provide certain of our employees, including our executive officers, with incentives to help align those employees' interests with the interests of our stockholders. Recently, our 2003 Stock Incentive Plan has been the principal method for our executive officers to acquire equity interests in us. We believe that the annual aggregate value of these awards should be set near competitive median levels for comparable companies. However, due to the early stage of our business, we expect to provide a greater portion of total compensation to our executives through our stock compensation than through cash based compensation.

The Compensation Committee administers the 2003 Stock Incentive Plan and determines the type and amount of awards to be granted to eligible employees, directors and consultants based upon the principles underlying our executive compensation program. See "—Overview" above. Awards under our 2003 Stock Incentive Plan are made throughout the year and are generally tied to Compensation Committee meetings. A total of 4,650,000 shares of our common stock are currently authorized for issuance under the 2003 Stock Incentive Plan. Shares subject to awards which expire or are cancelled or forfeited will again become available for issuance under the 2003 Stock Incentive Plan. As of January 15, 2007, there were 3,580,250 shares reserved for issuance under the 2003 Stock Incentive Plan and 1,069,750 shares available for future awards.

Stock Options. Stock option grants are typically made at the commencement of employment and generally thereafter by the Compensation Committee upon achievement of key strategic goals and on the anniversary of previous grants. Periodic stock option grants are made at the discretion of the Compensation Committee, and in appropriate circumstances the Compensation Committee may consider the recommendation of members of management. In 2006, certain named executive officers were awarded stock options in the amounts reflected in the following "Grants of Plan Based Awards" table. The Compensation Committee determines the exercise price of options awards granted under our 2003 Stock Incentive Plan, but with respect to incentive stock options intended to qualify as "performance-based compensation" within the meaning of Section 162(m) of the Internal Revenue Code, the exercise price must at least be equal to the fair market value of our common stock on the date of grant. In setting the fair market value of the common stock for the stock option, the Compensation Committee has engaged and relied upon an independent third party to perform appraisals of the fair market value of the common stock, which was last performed during the third quarter of 2006. The Compensation Committee determines the term of all options. Generally, the option awards vest 25% per year. Upon termination of a participant's service with us or with a subsidiary of ours, he or she may exercise his or her vested options for the period of 90 days from the termination of employment; provided, if termination is due to death or disability, the option will remain exercisable for 12 months after such termination. However, an option may never be exercised later than the expiration of its term. The terms of option awards under the 2003 Stock Incentive Plan are generally 10 years. Option holders are also generally allowed to exercise a stock option and at any time convert it into restricted stock.

Restricted Stock. Restricted stock awards are shares of our common stock that vest in accordance with terms and conditions established by the Compensation Committee. Holders of restricted stock have all the rights of a Neutral Tandem stockholder. Until adoption of the 2003 Stock Incentive Plan, it was more common for us to award shares of restricted stock than options. Since adoption of that plan, however, our compensation practice generally has been to award options rather than shares of restricted stock. The change was largely based upon the increased appreciation in the stock value, which would require employees to pay significant sums to purchase the restricted stock at the fair market value at the time of the grant. Shares of restricted stock that do not vest are subject to our right of repurchase or forfeiture.

Unless otherwise determined by the Compensation Committee, the 2003 Stock Incentive Plan does not allow for the sale or transfer of awards under the plan other than by will or the laws of descent and distribution,