LIBERTY ALL STAR EQUITY FUND
Form DEF 14A
January 15, 2016

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

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934
(Amendment No.___)

Filed by Registrant [X]
Filed by a Party other than the Registrant [ ]

Check the appropriate box:
[ ] Preliminary Proxy Statement
[ ] Confidential, for Use of the Commission Only (as permitted by Rule14a-6(e)(2))
[X] Definitive Proxy Statement
[ ] Definitive Additional Materials
[ ] Soliciting Material Pursuant to Sec. 240.14a-12

LIBERTY ALL-STAR EQUITY FUND

(name of Registrant as Specified in its Charter)

ALPS FUND SERVICES, INC.
1290 Broadway, Suite 1100
Denver, Colorado 80203

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

[X] No fee required

[ ] Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.
1) Title of each class of securities to which transaction applies:
2) Aggregate number of securities to which transaction applies:
3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11(set forth the amount on which the filing fee is calculated and state how it was determined):
4) Proposed maximum aggregate value of transaction:
5) Total fee paid:
[ ] Fee paid previously with preliminary materials.
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1) Amount Previously Paid:
2) Form, Schedule or Registration Statement No.:
3) Filing Party:
4) Date Filed:

LIBERTY ALL-STAR® EQUITY FUND
(the "Fund")

1290 Broadway, Suite 1100
Denver, Colorado 80203
(303) 623-2577

NOTICE OF SPECIAL MEETING OF SHAREHOLDERS
February 25, 2016

To the Shareholders of the Fund:

NOTICE IS HEREBY GIVEN that the Special Meeting of Shareholders of the Fund will be held at One Financial Center, 15th Floor, Boston, Massachusetts, 02111 on February 25, 2016 at 9:00 a.m. Eastern Time (the "Special Meeting"). The purpose of the Special Meeting is to consider and act upon the following matter, and to transact such other business, including adjournment of the Special Meeting, as may properly come before the Special Meeting or any adjournments thereof:

1. To approve a new Portfolio Management Agreement among the Fund, ALPS Advisors, Inc. and Aristotle Capital Management, LLC (the "Proposal").

The Board of Trustees has fixed the close of business on December 14, 2015 as the record date for the determination of the shareholders of the Fund entitled to notice of, and to vote at, the Special Meeting and any adjournments thereof.

YOUR BOARD OF TRUSTEES RECOMMENDS THAT YOU VOTE FOR THE PROPOSAL.

By order of the Board of Trustees of the Fund

William R. Parmentier, Jr.
President of the Fund

YOUR VOTE IS IMPORTANT - PLEASE SIGN, DATE AND RETURN YOUR PROXY CARD PROMPTLY.
You are cordially invited to attend the Special Meeting. We urge you, whether or not you expect to attend the Special Meeting in person, to vote your shares. Your vote is important no matter how many shares you own. Voting your shares early will avoid costly follow-up mail and telephone solicitation. After reviewing the enclosed materials, please complete, sign and date your proxy card and mail it promptly in the enclosed return envelope, or help save time and postage costs by calling the toll free number indicated on your proxy card and following the instructions. You may also vote via the internet by logging on to the website indicated on your proxy card and following the instructions that will appear. If we do not hear from you, our proxy solicitation firm, Boston Financial Data Services, Inc. ("BFDS"), may contact you. This will ensure that your vote is counted even if you cannot attend the meeting in person. If you have any questions about the proposal or the voting instructions, please call BFDS at 1-844-700-1419.

Important Notice Regarding the Availability of Proxy Materials for the Special Meeting to be held on February 25, 2016: An electronic copy of this proxy statement and the Fund's annual report are available at www.all-starfunds.com.

January 15, 2016

LIBERTY ALL-STAR® EQUITY FUND
(the "Fund")

PROXY STATEMENT
SPECIAL MEETING OF SHAREHOLDERS
February 25, 2016

This Proxy Statement is furnished in connection with the solicitation of proxies on behalf of the Board of Trustees of the Fund (the "Board") to be used at the Special Meeting of Shareholders of the Fund to be held at One Financial Center, 15th Floor, Boston, Massachusetts, 02111 at 9:00 a.m. Eastern Time and at any adjournments thereof (such meeting and any adjournment being referred to collectively as the "Special Meeting"). Shareholders of record on December 14, 2015 are eligible to vote at the Special Meeting.

The solicitation of proxies for use at the Special Meeting is being made by the Fund by the mailing on or about January 15, 2016, of the Notice of the Special Meeting of Shareholders. Supplementary solicitations may be made by mail, telephone or personal interview by officers and Trustees of the Fund and officers, employees and agents of the Fund's investment advisor, ALPS Advisors, Inc. ("AAI" or the "Fund Manager"), and/or its affiliates. Authorization to execute proxies may be obtained from shareholders through instructions transmitted by telephone, facsimile or other electronic means. The expenses in connection with preparing this Proxy Statement and of the solicitation of proxies for the Special Meeting will be paid by the Fund. The Fund will reimburse brokerage firms and others for their expenses in forwarding solicitation material to the beneficial owners of shares.

The Special Meeting is being held to vote on the following matter, and to transact such other business, including adjournment of the Special Meeting, as may properly come before the Special Meeting or any adjournments thereof:

1. Approve a new Portfolio Management Agreement among the Fund, AAI, and Aristotle Capital Management, LLC.

PROPOSAL. APPROVAL OF NEW PORTFOLIO MANAGEMENT AGREEMENT.

Shareholders of the Fund are being asked to approve a new Portfolio Management Agreement (included as Exhibit A) among the Fund, ALPS Advisors, Inc. (“AAI” or the “Fund Manager”) and Aristotle Capital Management, LLC (“Aristotle” or the “Portfolio Manager”).

The Multi-Manager Methodology

The Fund allocates its portfolio assets among a number of independent investment management firms (each a “Portfolio Manager” and, collectively, the “Portfolio Managers”) recommended by the Fund Manager and approved by the Board of Trustees (the “Board” or the “Trustees”), currently five for the Fund. Each Portfolio Manager employs a different investment style and/or strategy, and from time to time the Fund Manager rebalances the Fund’s assets among the Portfolio Managers. The Fund’s multi-manager methodology is based on the premise that most investment management firms consistently employ a distinct investment style that causes them to emphasize stocks with particular characteristics, and that, because of changing investor preferences, any given investment style will move into and out of market favor and will result in better performance under certain market conditions but poorer market performance under other conditions. The Fund’s multi-manager methodology seeks to achieve more consistent and less volatile performance over the long term than if a single Portfolio Manager was employed.

The Portfolio Managers recommended by AAI represent a blending of different styles which, in AAI’s opinion, is appropriate for the Fund’s investment objective. AAI continuously monitors and evaluates each Portfolio Manager on a quantitative and qualitative basis. The evaluation process focuses on, but is not limited to, the firm’s philosophy, investment process, personnel and performance. AAI regularly analyzes and evaluates the investment performance and portfolios of the Fund’s Portfolio Managers and from time to time recommends changes in the Portfolio Managers. Such recommendations could be based on factors such as a change in a Portfolio Manager’s investment style or a Portfolio Manager’s divergence from the investment style for which it was selected, changes deemed by AAI to be potentially adverse in a Portfolio Manager’s personnel or ownership or other structural or organizational changes affecting the Portfolio Manager, or a deterioration in a Portfolio Manager’s investment performance when compared to that of other investment management firms employing similar investment styles. Portfolio Manager changes may also be made to change the mix of investment styles employed by the Fund’s Portfolio Managers. Portfolio Manager changes, as well as the rebalancing of the Fund’s assets among the Portfolio Managers, may result in portfolio turnover in excess of what would otherwise be the case. Increased portfolio turnover results in increased brokerage commission and transaction costs, and may result in the recognition of additional capital gains.

Under the terms of an exemptive order issued to the Fund and AAI by the U.S. Securities and Exchange Commission (“SEC”), the Fund may enter into a portfolio management agreement with a new or additional Portfolio Manager recommended by AAI in advance of shareholder approval, provided that the new agreement is at a fee no higher than that provided in, and includes terms and conditions substantially similar to, the Fund’s agreements with its other existing Portfolio Managers, and that its continuance is subject to approval by shareholders no later than the Fund’s next scheduled meeting following the date of the portfolio management agreement with the new or additional Portfolio Manager.

New Portfolio Management Agreement with Aristotle

From February 17, 2004 to December 14, 2015, Matrix Asset Advisers, Inc. ("Matrix") managed a portion of the large cap value equity allocation of the Fund's portfolio. Consistent with the Fund's multi-manager methodology, including AAI's continuous evaluation of Portfolio Managers and consideration of potential new Portfolio Managers, after evaluating Matrix, AAI deemed it in the best interest of the Fund to recommend, and the Board approved, the reallocation to Aristotle of the large cap value equity portion of the Fund's portfolio that had been managed by Matrix. Accordingly, the Portfolio Management Agreement ("Old Agreement") with Matrix was terminated on December 14, 2015, and a new Portfolio Management Agreement with Aristotle commenced on December 14, 2015. Aristotle and

Matrix both manage large cap value equity portfolios and follow a fundamental, research driven investment process. AAI believes that Aristotle's investment philosophy of investing in high quality businesses trading at discounts to Aristotle's determination of their intrinsic values would complement the philosophies of Cornerstone Capital Management LLC, Pzena Investment Management, LLC, Delaware Investments and TCW Investment Management Company, the Fund's other current Portfolio Managers. AAI also believes that Aristotle's experienced investment team and favorable performance record would benefit the Fund. Based upon these factors, AAI recommended that the Board approve a Portfolio Management Agreement among the Fund, AAI and Aristotle.

Based upon the foregoing and on AAI's quantitative and qualitative analyses, AAI recommended, and, on December 3, 2015, subject to shareholder approval, the Fund's Board approved, the hiring of Aristotle, effective December 14, 2015. The Old Agreement with Matrix, dated November 1, 2011, among Matrix, AAI and the Fund, was last approved by shareholders on September 30, 2011. For the fiscal year ended December 31, 2014, the Fund paid AAI advisory fees equal to $8,553,568 and AAI paid Matrix advisory fees equal to $870,915. During the most recent fiscal year, no fees were paid to Aristotle by the Fund, its affiliated persons or any affiliated person of such persons because Aristotle was hired as a new Portfolio Manager on December 14, 2015.

Differences between the Old and New Portfolio Management Agreements

The new Portfolio Management Agreement with Aristotle ("New Agreement") is set forth in Exhibit A to this proxy statement. The terms of the New Agreement with Aristotle are materially the same as the terms of the Old Agreement with Matrix. The fee rate for Aristotle under the New Agreement is the same as the fee rate for Matrix under the Old Agreement, and is described below. In both cases, the sub-advisory fee is paid by AAI, not the Fund.

Services Provided by the Portfolio Manager

The New Agreement with Aristotle essentially provides that Aristotle, under the Board's and AAI's supervision and subject to the Fund's registration statement, will: (1) formulate and implement an investment program for the portion of the Fund's assets assigned to Aristotle; (2) decide what securities to buy and sell for the Fund's portfolio (or the portion of the Fund's portfolio managed by Aristotle); (3) select brokers and dealers to carry out portfolio transactions for the Fund (or the portion of the Fund's portfolio managed by Aristotle); and (4) report results to the Board of the Fund.

Term of the New Agreement

The New Agreement with Aristotle provides that it will continue in effect for an initial period of two years beginning on or about December 14, 2015. After that, it will continue in effect from year to year as long as its continuation is approved at least annually (i) by the Fund's Board or by vote of a majority of the outstanding voting securities of the Fund, and (ii) by vote of a majority of the Fund's Trustees who are not "interested persons" (as defined in the Investment Company Act of 1940, as amended (the "1940 Act")) of any party to the New Agreement ("Independent Trustees").

Compensation under the New Agreement

For services provided to the Fund, AAI will pay to Aristotle, on or before the 10th day of each calendar month, a fee calculated and accrued daily and payable monthly by AAI for the previous calendar month at the annual rate of:

(i) 0.40% of the amount obtained by multiplying the Portfolio Manager's Percentage ("Portfolio Manager's Percentage" means the percentage obtained by dividing (i) the average daily net asset values of the Portfolio Manager Account during the preceding calendar month, by (ii) the Average Total Fund Net Assets) times the Average Total Fund Net Assets ("Average Total Fund Net Assets" means the average daily net asset values of the Fund as a whole during the preceding calendar month) up to and including $400 million;

(ii) 0.36% of the amount obtained by multiplying the Portfolio Manager's Percentage times the Average Total Fund Net Assets exceeding $400 million up to and including $800 million;

(iii) 0.324% of the amount obtained by multiplying the Portfolio Manager's Percentage times the Average Total Fund Net Assets exceeding $800 million up to and including $1.2 billion; and

(iv) 0.292% of the amount obtained by multiplying the Portfolio Manager's Percentage times the Average Total Fund Net Assets exceeding $1.2 billion.

Termination of the New Agreement

The New Agreement for the Fund may be terminated without penalty (i) by vote of the Fund's Board or by vote of a majority of the outstanding voting securities of the Fund, on thirty days' written notice to Aristotle, (ii) by the Fund Manager upon thirty days' written notice to Aristotle, or (iii) by Aristotle upon ninety days' written notice to the Fund Manager and the Fund. The New Agreement terminates automatically in the event of its "assignment," as defined in the 1940 Act, or upon termination of the Fund Management Agreement between AAI and the Fund.

Liability of the Portfolio Manager

The New Agreement provides that the Aristotle will not be liable to AAI, the Fund or its shareholders, except for liability arising from Aristotle's willful misfeasance, bad faith, gross negligence or violation of the standard of care established by and applicable to Aristotle in its actions under the New Agreement or the breach of its duty or obligations under the New Agreement.

Board Evaluation and Recommendation

At its meeting on December 3, 2015, the Fund's Board, including all of the Independent Trustees, approved the New Agreement. Before approving the New Agreement, the Trustees considered management's recommendations as to the approval of the New Agreement. As part of the Board's approval process, legal counsel to the Independent Trustees requested certain information from Aristotle, and the Trustees received reports from Aristotle and AAI that addressed specific factors to be considered by the Board. The Board's counsel also provided the Trustees with a memorandum regarding their responsibilities in connection with the approval of the New Agreement.

The Board did not consider any single factor or particular information most relevant to its consideration to approve the New Agreement and each Trustee may have afforded different weight to the various factors. In voting to approve the New Agreement, the Board considered the overall fairness of the New Agreement and the factors it deemed relevant with respect to the Fund including, but not limited to: (1) the nature, extent and quality of the services to be provided to the Fund under the New Agreement; (2) Aristotle's investment performance; (3) the fees to be paid by the Fund and the fees charged by Aristotle to other clients, as applicable; (4) whether fee rate levels reflect economies of scale for the benefit of investors; (5) the costs of the services provided and profits to be realized by Aristotle from its relationship with the Fund; and (6) any other benefits to be derived by Aristotle as a result of its relationship with the Fund.

Nature, Extent and Quality of Services. The Board considered information regarding Aristotle's investment philosophy and investment style and the services to be provided by Aristotle. In addition, the Board reviewed information regarding Aristotle's financial condition and the background and experience of the personnel who would be responsible for managing the large cap value equity allocation of the Fund's portfolio pursuant to Aristotle's Value Equity strategy. The Board also considered information regarding Aristotle's compliance program and compliance record. The Board concluded that the nature, extent and quality of the services to be provided by Aristotle were consistent with the terms of the New Agreement and that the Fund was likely to benefit from services provided by Aristotle under the New Agreement.

Investment Performance. The Board considered the performance of Aristotle's Value Equity Composite ("Composite"), gross and net of fees, relative to the Russell 1000® Value Index ("Russell Index"), the S&P 500® Index ("S&P 500"), and the Evestment US Large Cap Value institutional peer group ("Peer Group"). The Composite includes all discretionary accounts managed in the Value Equity strategy. The objective of the Value Equity strategy is to optimize long-term returns and is benchmarked to the Russell Index and the S&P 500® with a focus on mitigating market risk. The Value Equity strategy focuses on high-quality U.S. businesses and ADRs which appear to be trading at a discount to fair value and have a minimum market capitalization of approximately $2 billion. The performance of the Composite is calculated in compliance with the Global Investment Performance Standards (GIPS®).

The Board considered the ranking of the Composite, gross-of-fees, relative to the Peer Group and that the ranking of the Composite relative to the Peer Group as of September 30, 2015 for the one-year, three-year and since-inception periods generally exceeded the calendar year ranking of the Composite relative to the Peer Group for 2014, 2013, 2012, 2011 and 2010. The Board also considered that the Composite outperformed the Russell Index and the Peer Group for the year-to-date, 1-year, 3-year, and since inception periods ended September 30, 2015, and that the Composite outperformed the S&P 500 for the year-to-date, 1-year, and 3-year periods, but underperformed for the since inception period. Therefore, the Board considered that the long-term performance of the Composite generally ranked favorably to the Peer Group. The Board concluded that the investment performance of Aristotle's Value Equity strategy has been good.

Fees and Expenses. In evaluating the New Agreement, the Board reviewed the proposed fee rate for services to be performed by Aristotle on behalf of the Fund. The Board considered that the fee rate under the New Agreement is the same as the fee rate paid to the Fund's prior subadviser. The Board also considered Aristotle's representation that the fee rate under the New Agreement represents a discount from Aristotle's published fee schedule for accounts managed pursuant to the Value Equity strategy. However, the Board also considered that Aristotle charges a lower fee to certain investment companies and institutional clients in the Value Equity strategy that have negotiated a lower fee rate and may have larger accounts or multiple accounts that are aggregated for purposes of determining the applicable fee rate. The Board also noted that the fee schedule for the New Agreement has breakpoints at which the fee rate declines as Fund assets allocated to Aristotle increase above a specific breakpoint. The Board concluded that the fees payable to Aristotle under the New Agreement were reasonable in relation to the nature and quality of the services expected to be provided, taking into account the fee rates that Aristotle charges to other clients.

Economies of Scale. The Board considered Aristotle's representation that, as assets increase, there may be economies of scale in the subadvisory fee rate. The Board took into consideration that there may be economies of scale in the future in the event that the Fund's assets increase.

Costs of Services. The Board considered that the fee under the New Agreement would be paid to Aristotle by AAI, not the Fund, and noted the arm's-length nature of the relationship between AAI and Aristotle with respect to the negotiation of the fee rate on behalf of the Fund. Accordingly, the Board determined that AAI's costs and profitability in providing services to the Fund were generally more relevant to the Board's evaluation of the fees and expenses paid by the Fund than Aristotle's costs and profitability. The Board also noted that it had considered AAI's costs and profitability in connection with its review of the Fund's Management Agreement in September 2015.

Other Benefits to be derived by Aristotle. The Board considered the potential "fall-out" benefits (including the receipt of proprietary research from unaffiliated brokers) that Aristotle might receive in connection with its association with the Fund. The Board also considered Aristotle's representation that serving as subadviser to the Fund may provide for better trade execution and greater access to research and company management. Based on the foregoing information, the Board concluded that the potential benefits accruing to Aristotle by virtue of its relationship with the Fund appear to be fair and reasonable.

Based on its evaluation, the Board unanimously concluded that the terms of the New Agreement were reasonable and fair and that the approval of the New Agreement was in the best interests of the Fund and its shareholders. The Board unanimously voted to approve and recommend to the shareholders of the Fund that they approve the New Agreement.

General Information Regarding Aristotle

Principal Executive Officers and Directors

The following are the principal executive officer, certain other officers and directors of Aristotle:

Name and Address[(1)]	Position with Aristotle and Principal Occupation
Richard Hollander	Chairman of the Board
Howard Gleicher	Chief Executive Officer, Chief Investment Officer
Gary Lisenbee	Co-Chief Executive Officer, Co-Chief Investment Officer
Steven Borowski	President
Richard Schweitzer	Chief Financial Officer, Chief Risk Officer
Michelle Gosom	Chief Compliance Officer
Robert Womack	Managing Director
Nancy Scarlett	Managing Director, Operations
Ranjit Sufi	Managing Director, Institutional Sales & Marketing
Matthew Schleichkorn	Managing Director, Retail Sales & Marketing
Sandy Incontro	Managing Director, Client Portfolio Manager

(1) The address of Aristotle is 11100 Santa Monica Boulevard, Los Angeles, CA 90025.

Beneficial Owners

The following are the 10% or more beneficial owners of voting shares of Aristotle:

Name and Address[1]	Position with Aristotle	Ownership Percentage
RCB Acquisition Company, LLC	Entity controlled by Richard Hollander, Chairman	27%
Gleicher Holdings, LLC	Entity controlled by Howard Gleicher, Chief Executive Officer, Chief Investment Officer	27%
Steven Borowski	President	12%

(1) The address of Aristotle is 11100 Santa Monica Boulevard, Los Angeles, CA 90025.

Other Funds Managed

In addition to the management services to be provided to the Fund, Aristotle also provides advisory and sub-advisory services to other investment companies. Information with respect to the assets of and sub-advisory fees payable to Aristotle by those funds having investment objectives similar to those of the Fund is set forth below:

Name of Fund	Total Assets Under Management at September 30, 2015	Annual Effective Management Fee as a % of Average Daily Net Assets	Waivers, Reductions or Agreements to Waive or Reduce Management Fee
Harbor Large Cap Value Fund	$269.7 million	0.60%	0.03%
Strategic Advisers Value Fund	$637.4 million	0.43%	0.25%
Strategic Advisers Value Multi-Manager Fund	$1.8 million	0.52%	0.28%
ABN AMRO Aristotle US Equities	$977.1 million	1.50%	N/A
St. James's Place North American Unit Trust	$959.4 million	1.55%	N/A

Required Vote

Approval of the New Agreement requires the affirmative vote of a "majority of the outstanding voting securities" of the Fund, which, under the 1940 Act, means the affirmative vote of the lesser of (a) 67% or more of the shares of the Fund present at the Special Meeting or represented by proxy if the holders of more than 50% of the outstanding shares are present or represented by proxy, or (b) more than 50% of the outstanding shares of the Fund.

In the event that the shareholders of the Fund fail to approve the New Agreement with Aristotle, the New Agreement will terminate and AAI will cause the portfolio assets under management by Aristotle to be reallocated to one or more of the other Portfolio Managers or invested in money market instruments or cash equivalent holdings pending the appointment of Aristotle or a new Portfolio Manager.

THE BOARD RECOMMENDS THAT SHAREHOLDERS OF THE FUND VOTE "FOR" THE PROPOSAL.

OTHER BUSINESS

The Board knows of no other business to be brought before the Special Meeting. However, if any other matters properly come before the Special Meeting, it is the intention of the Board that proxies that do not contain specific instructions to the contrary will be voted on such matters in accordance with the judgment of the persons designated therein as proxies.

OTHER INFORMATION

The December 31, 2014 Annual Report and the June 30, 2015 Semi-Annual Report for the Fund were mailed to shareholders prior to this proxy statement. You may obtain an additional copy of the Annual Report and/or the Semi-Annual Report for the Fund, free of charge, by writing to the Fund c/o ALPS Fund Services, Inc., 1290 Broadway, Suite 1100, Denver, CO 80203, or by calling 1-800-241-1850. An electronic copy of the Annual Report and the Semi-Annual Report for the Fund are available at www.all-starfunds.com.

MANAGEMENT

ALPS Advisors, Inc. (“AAI”), 1290 Broadway, Suite 1100, Denver, Colorado 80203, is the Fund’s investment advisor. Pursuant to the Fund Management Agreement, AAI implements and operates the Fund's multi-manager methodology and has overall supervisory responsibility for the general management and investment of the Fund's assets, subject to the Fund’s investment objectives and policies and any directions of the Trustees. AAI recommends to the Board the investment management firms (currently five for the Fund) for appointment as Portfolio Managers of the Fund. ALPS Fund Services, Inc., 1290 Broadway, Suite 1100, Denver, Colorado 80203, an affiliate of AAI, provides administrative services to the Fund under an Administration, Bookkeeping and Pricing Services Agreement with the Fund.

The names and addresses of the Fund’s current Portfolio Managers are as follows:

Aristotle Capital Management, LLC
11100 Santa Monica Boulevard
Los Angeles, CA 90025

Cornerstone Capital Management LLC
3600 Minnesota Drive
Edina, MN 55435

Delaware Investments
2005 Market Street
Philadelphia, PA 19103

Pzena Investment Management, LLC
320 Park Avenue
New York, NY 10022

TCW Investment Management Company
865 South Figueroa Street
Los Angeles, CA 90017

Portfolio Transactions and Brokerage

The Fund’s Portfolio Managers have discretion to select brokers and dealers to execute portfolio transactions initiated by that Portfolio Manager for the portion of the Fund's portfolio assets allocated to it, and to select the markets in which such transactions are to be executed. The portfolio management agreements with the Fund provide, in substance, that in executing portfolio transactions and selecting brokers or dealers, the primary responsibility of the Portfolio Managers is to seek to obtain best net price and execution for the Fund.

The Portfolio Managers are authorized to cause the Fund to pay a commission to a broker or dealer who provides research products and services to the Portfolio Manager for executing a portfolio transaction which is in excess of the amount of commission another broker or dealer would have charged for effecting the same transaction. The Portfolio Managers must determine in good faith, however, that such commission was reasonable in relation to the value of the research products and services provided to them, viewed in terms of that particular transaction or in terms of all the client accounts (including the Fund) over which the Portfolio Manager exercises investment discretion. It is possible that certain of the services received by a Portfolio Manager attributable to a particular transaction will primarily benefit one or more other accounts for which investment discretion is exercised by the Portfolio Manager.

In addition, under their portfolio management agreements with the Fund and AAI, the Portfolio Managers, in selecting brokers or dealers to execute portfolio transactions for the Fund, are authorized to consider (and AAI may request them to consider) brokers or dealers that provide to AAI, directly or through third parties, research products or services such as research reports; portfolio analyses; compilations of securities prices, earnings, dividends and other data; computer software, and services of one or more consultants. The commissions paid on such transactions may exceed the amount of commission another broker would have charged for effecting that transaction. Research products and services made available to AAI include performance and other qualitative and quantitative data relating to investment managers in general and the Portfolio Managers in particular; data relating to the historic performance of categories of securities associated with particular investment styles; fund portfolio and performance data; data relating to portfolio manager changes by pension plan fiduciaries; and related computer software, all of which are used by AAI in connection with its selection and monitoring of Portfolio Managers, the assembly of an appropriate mix of investment styles, and the determination of overall portfolio strategies for the Fund.

Although AAI currently is not receiving soft dollar research products and services from brokers and dealers in connection with portfolio transactions initiated by the Fund’s Portfolio Managers, the Fund’s Portfolio Managers may be receiving soft dollar research products and services in connection with such portfolio transactions. In each case, AAI will reach an understanding with a Portfolio Manager as to the amount of the Fund’s portfolio transactions to be directed to brokers and dealers that make research products and services available to AAI.

Although the Fund does not permit a Portfolio Manager to act or to have a broker-dealer affiliate act as broker for Fund portfolio transactions initiated by it, the Portfolio Managers are permitted to place Fund portfolio transactions initiated by them with another Portfolio Manager or its broker-dealer affiliate for execution on an agency basis, provided that the commission does not exceed the usual and customary broker's commission being paid to other brokers for comparable transactions and is otherwise in accordance with the Fund’s procedures adopted pursuant to Rule 17e-1 under the 1940 Act. For the fiscal year ended December 31, 2014, the Fund did not pay commissions to any affiliated broker.

On February 15, 2000, the SEC issued the Fund exemptive relief from Sections 10(f), 17(a) and 17(e) and Rule 17e-1 under the 1940 Act to permit (1) broker-dealers which are, or are affiliated with, Portfolio Managers of the Fund to engage in principal transactions with, and provide brokerage services to, portion(s) of the Fund advised by another Portfolio Manager, and (2) the Fund to purchase securities either directly from a principal underwriter which is an affiliate of a Portfolio Manager or from an underwriting syndicate of which a principal underwriter is affiliated with a Portfolio Manager of the Fund. The Fund currently relies on Rule 17a-10 under the 1940 Act rather than this exemptive relief.

INFORMATION ABOUT THE MEETING

Solicitation of Proxies

The solicitation of proxies for use at the Special Meeting is being made primarily by the Fund by the mailing on or about January 15, 2016 of the Notice of Special Meeting of Shareholders, this Proxy Statement and the accompanying proxy card. Supplementary solicitations may be made by mail, telephone or personal interview by officers and Trustees of the Fund and officers, employees and agents of AAI, and/or its affiliates and by Boston Financial Data Services, Inc. (“BFDS”), the firm that has been engaged to assist in the solicitation of proxies. Authorization to execute proxies may be obtained from shareholders through instructions transmitted by telephone, facsimile or other electronic means.

The Board has set the close of business on December 14, 2015 as the record date (“Record Date”), and only shareholders of record on the Record Date will be entitled to vote on the Proposal and any other matters at the Special Meeting. Additional information regarding outstanding shares and voting your proxy is included at the end of this Proxy Statement in the sections entitled “General Information” and “Voting Information.”

The Fund has engaged BFDS to assist in the solicitation of proxies with regard to the Proposal. The estimated cost of this solicitation, to be borne by the Fund, is $60,000.

Voting Rights

Only shareholders of record of the Fund on the Record Date may vote. Shareholders of record on the Record Date are entitled to be present and to vote at the Special Meeting. Each share or fractional share is entitled to one vote or fraction thereof. Each proxy solicited by the Board which is properly executed and returned in time to be voted at the Special Meeting will be voted at the Special Meeting in accordance with the instructions on the proxy. Any proxy may be revoked at any time prior to its use by written notification received by the Fund's Secretary, by the execution and delivery of a later-dated proxy, or by attending the Special Meeting and voting in person. Any letter of revocation or later-dated proxy must be received by the Fund prior to the Special Meeting and must indicate your name and account number to be effective. Proxies voted by telephone or Internet may be revoked at any time before they are voted at the Special Meeting in the same manner that proxies voted by mail may be revoked.

The Fund understands that the New York Stock Exchange ("NYSE") has taken the position that broker-dealers that are members of the NYSE and that have not received instructions from a customer prior to the date specified in the broker-dealer firm's request for voting instructions may not vote such customer's shares on a new investment advisory contract or certain other types of proposals. Therefore, NYSE broker-dealers that have not received customer instructions will not be permitted to vote customer shares with respect to the Proposal. A signed proxy card or other authorization by a beneficial owner of Fund shares that does not specify how the beneficial owner's shares are to be voted on a proposal may be deemed to be an instruction to vote such shares in favor of the applicable proposal.

Abstentions and broker non-votes will be counted as present for purposes of determining whether a quorum is present; however, for purposes of the Proposal, abstentions and broker non-votes will have the effect of a vote against the Proposal (because an absolute percentage of affirmative votes is required, regardless of the number of votes cast, and neither an abstention nor a broker non-vote is an affirmative vote). "Broker non-votes" occur where: (i) shares represented at the Meeting are held by brokers or nominees, typically in "street name"; (ii) instructions have not been received from the beneficial owners or persons entitled to vote the shares; and (iii) the broker or nominee does not have discretionary voting power on a particular matter.

Quorum; Adjournment

For the Fund, a majority of the shares outstanding on the Record Date and entitled to vote, present and in person or represented by proxy, constitutes a quorum for the transaction of business by the shareholders of the Fund at the Special Meeting. A shareholder vote may be taken on one or more proposals prior to adjournment if sufficient votes have been received and it is otherwise appropriate. In the event of an adjournment, no notice is required other than an announcement at the meeting at which adjournment is taken.

Additional Solicitation. If there are not enough shares represented at the Special Meeting for a quorum or votes to approve the proposal at the Special Meeting, the Chairman of the Special Meeting may adjourn the Special Meeting to permit the further solicitation of proxies.

Share Ownership

All shareholders of record of the Fund on the Record Date (December 14, 2015) are entitled to one vote for each share held. As of the Record Date, there were 182,754,403 outstanding shares of beneficial interest of the Fund. To the knowledge of the Fund, on the Record Date for the Special Meeting, the following persons were known to own more than 5% of the outstanding securities of the Fund:

Name and Address of Owner	# of Shares Owned	% of Shares Owned	Type of Ownership
First Trust Portfolios L.P. 120 E. Liberty Dr., Suite 400	12,322,410*	6.88%*	Beneficial

Wheaton, IL. 60187

*Based on SC13G filing made with the SEC on January 21, 2015.

To the knowledge of the Fund, on the Record Date for the Special Meeting, the following Trustees and executive officers were known to own the following shares of the Fund:

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Name of Trustees and Officers	# of Shares Owned	Type of Ownership
Independent Trustees		
John A. Benning	33,678.53	Direct and Indirect
Thomas W. Brock	23,484.00	Direct
George R. Gaspari	1,259.00	Direct
John J. Neuhauser	156.32	Direct
Richard C. Rantzow	3,000.00	Direct
Interested Trustee		
Edmund J. Burke	None	N/A
Executive Officers		
William Parmentier, Jr.	54,379.00	Direct
Kimberly R. Storms	None	N/A
All Trustees and Executive Officers as a Group	115,956.85	Direct and Indirect

As of the Record Date, the Trustees and officers of the Fund, in the aggregate, owned less than 1% of each class of the Fund’s outstanding shares of beneficial interest.

Since the beginning of the Fund’s most recently completed fiscal year, no Trustee purchased or sold securities exceeding 1% of the outstanding securities of any class of AAI or any Portfolio Manager or of such entity’s parents or subsidiaries.

SUBMISSION OF CERTAIN SHAREHOLDER PROPOSALS FOR 2016 ANNUAL MEETING OF SHAREHOLDERS

Under the SEC's proxy rules, shareholder proposals meeting tests contained in those rules may, under certain conditions, be included in the Fund’s proxy material for a particular annual shareholders meeting (each, an “Annual Meeting”). Under the foregoing proxy rules, proposals submitted for inclusion in the proxy material for the 2016 Annual Meeting must be received by the Fund on or before March 8, 2016. The fact that the Fund receives a shareholder proposal in a timely manner does not ensure its inclusion in its proxy material, since there are other requirements in the proxy rules relating to such inclusion.

Shareholders who wish to make a proposal that would not be included in the Fund’s proxy materials or to nominate a person or persons as Trustee at the Fund’s 2016 Annual Meeting must ensure that the proposal or nomination is delivered to the Secretary of the Fund no earlier than February 7, 2016 and no later than March 8, 2016. If the date of the 2016 Annual Meeting is before July 28, 2016 or after September 26, 2016, then the proposal or nomination must be received by the later of 120 days prior to the annual meeting or the tenth day following the date that a public announcement of the annual meeting is first made. The proposal or nomination must be in good order and in compliance with all applicable legal requirements and the requirements set forth in the Fund’s Restated By laws. The chairperson of the Annual Meeting may refuse to acknowledge any proposal or nomination that does not meet the legal and By-law requirements. These dates do not apply to any special meeting of shareholders.

You must submit any shareholder proposals and nominations to the Secretary of the Fund, 1290 Broadway, Suite 1100, Denver, Colorado 80203.

The persons named as proxies for the 2016 Annual Meeting will have discretionary authority to vote on all matters presented at the meeting consistent with SEC's proxy rules.

HOUSEHOLDING OF PROXY MATERIALS

Only one copy of this Proxy Statement may be mailed to households, even if more than one person in a household is a shareholder of record, unless the Fund has received instructions to the contrary. If a shareholder needs an additional copy of an Annual Report or Semi-Annual Report or this Proxy Statement, please contact the Fund at 1-800-241-1850. If any shareholder does not want the mailing of this Proxy Statement to be combined with those for other household members, please contact the Fund in writing at: 1290 Broadway, Suite 1100, Denver, CO 80203 or call the Fund at 1-800-241-1850.

EXHIBIT A

LIBERTY ALL-STAR® EQUITY FUND
PORTFOLIO MANAGEMENT AGREEMENT
ARISTOTLE CAPITAL MANAGEMENT, LLC

December 14, 2015

Re: Portfolio Management Agreement

Ladies and Gentlemen:

Liberty All-Star Equity Fund (the "Fund") is a diversified closed-end investment company registered under the Investment Company Act of 1940, as amended (the "Act"), and is subject to the rules and regulations promulgated thereunder.

ALPS Advisors, Inc. (the "Fund Manager") evaluates and recommends portfolio managers for the assets of the Fund, and the Fund Manager or an affiliate of the Fund Manager is responsible for the day-to-day Fund administration of the Fund.

1. Employment as a Portfolio Manager. The Fund, being duly authorized, hereby employs Aristotle Capital Management, LLC ("Portfolio Manager"), as a discretionary portfolio manager, on the terms and conditions set forth herein, of that portion of the Fund's assets which the Fund Manager determines to assign to the Portfolio Manager (those assets being referred to as the "Portfolio Manager Account"). The Fund Manager may, from time to time, allocate and reallocate the Fund's assets among the Portfolio Manager and the other portfolio managers of the Fund's assets. The Portfolio Manager will be an independent contractor and will have no authority to act for or represent the Fund or the Fund Manager in any way or otherwise be deemed to be an agent of the Fund or the Fund Manager except as expressly authorized in this Agreement or in another writing by the Fund Manager and the Portfolio Manager. The Portfolio Manager's responsibilities for providing portfolio management services to the Fund shall be limited to the Portfolio Manager Account.

2. Acceptance of Employment; Standard of Performance. The Portfolio Manager accepts its employment as a discretionary portfolio manager and agrees to use its best professional judgment to make timely investment decisions for the Portfolio Manager Account in accordance with the provisions of this Agreement.

3. Portfolio Management Services of Portfolio Manager.

A. In providing portfolio management services to the Portfolio Manager Account, the Portfolio Manager shall be subject to the Fund's Declaration of Trust and By-Laws, as amended from time to time, investment objectives, policies and restrictions of the Fund as set forth in its Prospectus and Statement of Additional Information, as the same may be modified from time to time (together, the "Prospectus"), the investment objectives, policies and restrictions of the Fund as determined from time to time by the Board of Trustees, and the investment and other restrictions set forth in the Act and the rules and regulations thereunder, to the supervision and control of the Board of Trustees of the Fund, and to instructions from the Fund Manager. The Portfolio Manager shall not, without the prior approval of the Fund or the Fund Manager, effect any transactions that would cause the Portfolio Manager Account, treated as a separate fund, to be out of compliance with any of such restrictions or policies. The Portfolio Manager shall not consult with any other portfolio manager of the Fund concerning transactions for the Fund in securities or other assets.

B. As part of the services it will provide hereunder, the Portfolio Manager will:

(i) formulate and implement a continuous investment program for the Portfolio Manager Account;

(ii) take whatever steps are necessary to implement the investment program for the Portfolio Manager Account by arranging for the purchase and sale of securities and other investments;

(iii) keep the Fund Manager and the Board of Trustees of the Fund fully informed in writing on an ongoing basis, as agreed by the Fund Manager and the Portfolio Manager, of all material facts concerning the investment and reinvestment of the assets in the Portfolio Manager Account, the Portfolio Manager and its key investment personnel and operations relating to its provisions of services to the Fund; make regular and periodic special written reports of such additional information concerning the same as may reasonably be requested from time to time by the Fund Manager or the Trustees of the Fund; attend meetings with the Fund Manager and/or Trustees, as reasonably requested, the United States of America. The results for the interim periods are not necessarily indicative of results to be expected for the full year. Certain amounts previously reported have been reclassified to conform with the 2008 presentation.

The condensed consolidated financial statements of the Company include the accounts of the Company s subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities (e.g., bad debt reserves and inventory reserves), disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 Sales Concentration

As shown in the table below, customer concentrations of accounts receivable and revenues of greater than 10% were as follows:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2008		2007		2008		2007	
	Accounts Receivable	Revenues	Accounts Receivable	Revenues	Accounts Receivable	Revenues	Accounts Receivable	Revenues
Customer A	38%	37%	46%	52%	38%	41%	46%	52%
Customer B	16%	12%	*	*	16%	*	*	*
Customer C	*	11%	*	*	*	14%	*	*

* Less than 10%

For each of the three months ended September 30, 2008 and 2007, international sales, which are derived from billings to foreign customers, comprised 29% and 19%, respectively, of the Company s revenues. For each of the nine months ended September 30, 2008 and 2007, international sales comprised 22% and 20%, respectively, of the Company s revenues. During the three months ended September 30, 2008, 13% of our revenues were derived from billings to customers in Singapore. No single foreign country accounted for more than 10% of revenues during the three months ended September 30, 2007 and each of the nine months ended September 30, 2008 and 2007. Substantially all of the Company s international sales are export sales, which are shipped from the Company s domestic facility to foreign customers. In the future, we expect substantially all of our foreign sales to originate internationally as our operations in Malaysia become established.

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Note 3 Discontinued Operations

On February 9, 2007, the Company entered into an Asset Purchase Agreement (Purchase Agreement) with Fabrik, Inc. (Fabrik) and Fabrik Acquisition Corp. (together with Fabrik, the Purchasers) for the sale of assets relating to a portion of the Company s business which was engaged in the designing, final assembling, selling, marketing and distributing consumer-oriented products based on Flash memory, DRAM technologies and external storage solutions known as the Consumer Division of the Company. The consideration paid to the Company pursuant to the Purchase Agreement consisted of cash in the amount of approximately $43.0 million. The purchase price was subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivables and overhead capitalization of the Consumer Division (Purchase Price Adjustment). Subsequent to the closing of the sale, the Purchasers disputed certain amounts calculated by the Company in regards to the Purchase Price Adjustment. The original claim amount was approximately $6.7 million. In accordance with the Purchase Agreement, both parties agreed to resolve their Purchase Price Adjustment disputes through a third party arbitrator. During the arbitration proceeding, the Purchasers conceded approximately $4.0 million of their original disputed amounts. In January 2008, the arbitrator rejected substantially all of the Purchasers claims. As of September 30, 2008, no amounts have been recorded in the condensed consolidated financial statements for this matter as the Company is still in the process of enforcing the arbitrator s decision and resolving other post-closing items with the Purchasers.

Operating results of the Consumer Division as discontinued operations for the three and nine months ended September 30, 2008 and 2007 are summarized as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenues	$	$	$	$ 28,693
Gain on disposition of Consumer Division	$	$	$	$ 8,005
Income (loss) from discontinued operations	80	308	229	(430)
Provision for income taxes	(33)	16	(91)	(2,945)
Income from discontinued operations	$ 47	$ 324	$ 138	$ 4,630

The income from discontinued operations in the third quarter and the first nine months of 2008 is due primarily to cash settlements received and the reduction of the potential rebate liability recorded as of December 31, 2007 related to the Hard Drive Class Action Lawsuit discussed in Note 7.

Assets and liabilities of the discontinued operation included in the consolidated balance sheets as of September 30, 2008 and December 31, 2007 are as follows (in thousands):

	September 30, 2008	December 31, 2007
Other current assets	$	$ 197
Current assets of discontinued operations	$	$ 197
Accrued and other liabilities	$ 10	$ 483
Current liabilities of discontinued operations	$ 10	$ 483

Note 4 Income Taxes

The Company s effective tax rates were 54.1% and 44.7% for the nine months ended September 30, 2008 and September 30, 2007, respectively. The difference between the Company s effective tax rates and the 35% federal statutory rate resulted primarily from foreign losses in tax-free jurisdictions that are not tax-benefited. The increase in foreign losses that are not tax benefited is due to the short-term impact of the new global tax structure that the Company is in the process of implementing.

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Note 5 Net Income Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect the potentially dilutive securities. Options to purchase 4,695,416 and 5,301,182 shares of common stock were outstanding at September 30, 2008 and 2007, respectively. In addition, 296,000 and 457,750 restricted stock units payable in shares of common stock were outstanding at September 30, 2008 and 2007, respectively. For each of the three months ended September 30, 2008 and 2007, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 1,337,631 and 1,772,707, respectively. For each of the nine months ended September 30, 2008 and 2007, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 1,427,717 and 2,102,814, respectively.

Note 6 Supplemental Balance Sheet Information

Inventory consists of the following (in thousands):

	September 30, 2008	December 31, 2007
Raw materials	$ 66,487	$ 20,105
Work-in-progress	466	772
Finished goods	13,295	10,679
	$ 80,248	$ 31,556

Accrued and other liabilities consisted of the following (in thousands):

	September 30, 2008	December 31, 2007
Payroll costs	$ 6,659	$ 5,165
Marketing	504	439
Other	2,439	565
Total	$ 9,602	$ 6,169

Note 7 Commitments and Contingencies

Lemelson Medical, Education & Research Foundation, LLP Patent Infringement

The Company received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP (Lemelson Foundation) filed a complaint on November 13, 2001 against the Company and other defendants. The complaint was filed in the District Court of Arizona and alleges that the Company s manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, the Company was served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Based on the U.S. Court of Appeal s affirmance, the Lemelson Foundation moved to dismiss with prejudice all claims against the Company and certain other defendants, and that request for dismissal was granted by the court. In July 2008, following the dismissal of the last remaining defendant in the case, the court ruled that this case was terminated.

Hard Drive Class Action Lawsuit

On October 6, 2006, an individual, Boris Brand, filed a purported nationwide class action lawsuit against the Company in the Superior Court for the State of California, County of Los Angeles, alleging that the Company s description of the capacity of its hard drive products constitutes fraudulent, unfair, deceptive and false advertising under California Business and Professions Code Sections 17200 and 17500 and violates the California Consumers Legal Remedies Act. In particular, the lawsuit alleges that the Company s description of the storage capacity on its hard drives uses a decimal basis for measuring gigabytes which results in a lower storage capacity when the hard drives are incorporated into an operating system that uses a binary basis for measurement. Although the Company believes this lawsuit is without merit, it has agreed to provide qualifying class members the means to claim a rebate of 6% of the purchase price of the storage device for a period of three months from the announcement of the program. In addition, the Company will pay a portion of the plaintiff s legal fees as determined by an arbitration proceeding which concluded on March 10, 2008. The court granted preliminary approval of the settlement on May 30, 2008 and the Company launched its 6% rebate program on June 9, 2008. The court approved the terms of the settlement on September 23, 2008. The submission period for the 6% rebate program ended in September 2008 and the Company is in the process of validating the limited number of claims it received. During the nine months ended September 30, 2008, the Company reduced the previous accrual for potential rebate claims by $114,000, which is included as a component of discontinued operations since the related products were sold by the Company s former Consumer Division. The remaining accrual as of September 30, 2008 is immaterial. The Company is also pursuing claims against its former insurance provider and some of the suppliers who have supplied it with the hard drives involved since the Company believes that those suppliers have a legal duty to indemnify it for any damages. There can be no assurance, however, that the Company will be successful in its claims against its former insurance provider or the suppliers. During the nine months ended September 30, 2008, the Company received cash settlements from certain former suppliers of hard drive products to the Company s former Consumer Division totaling $152,000, which were recorded as income from discontinued operations.

Seagate Patent Infringement Lawsuit

On April 14, 2008, a patent infringement lawsuit was filed in the United States District Court, Northern District of California by Seagate Technology LLC, Seagate Technology International, Seagate Singapore International Headquarters Pte. Ltd. and Maxtor Corporation (collectively, Seagate) alleging that the Company infringes four of Seagate s patents U.S. Patent Nos. 6,404,647, 6,849,480, 6,336,174 and 7,042,664. On May 1, 2008, Seagate filed an amended complaint asserting that the Company infringes an additional Seagate patent U.S. Patent No. 5,261,058. The lawsuit seeks injunctive relief and unspecified compensatory and treble damages and attorneys fees for the alleged patent infringement. The Company filed its answer on May 15, 2008 asserting affirmative defenses of non-infringement, invalidity, failure to mark or give notice, unenforceability, and adequate remedy other than injunctive relief. Further, in the answer the Company counter-claimed for a declaratory judgment of non-infringement, invalidity, and unenforceability of all 5 Seagate patents, and all legal fees and costs. On November 7, 2008, we filed our amended answer to add counter-claims against Seagate and Seagate CEO William D. Watkins for intentional interference with contractual relations, intentional interference with prospective economic advantage, defamation (libel per se), trade libel, unfair competition (Cal. Bus. & Prof. Code § 17200), false advertising / unfair competition (Lanham Act 15 U.S.C. § 1125(a)), and slander of title. The Company believes Seagate s allegations are without merit and intends to vigorously defend itself in the lawsuit. As of September 30, 2008, no amounts have been recorded in the consolidated financial statements for this matter as management believes it is too early in the proceedings to determine an outcome.

Other Legal Proceedings

The Company is currently not a party to any other material legal proceedings. However, the Company is involved in other suits and claims in the ordinary course of business, and the Company may from time to time become a party to other legal proceedings arising in the ordinary course of business.

As is common in the industry, the Company currently has in effect a number of agreements in which the Company has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company s products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. The Company s insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2008.

Note 8 Intangible Assets and Goodwill

The following table presents detail of the Company s intangible assets, related accumulated amortization and goodwill (in thousands):

	As of September 30, 2008			As of December 31, 2007		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	$ 1,070	$ 584	$ 486	$ 1,070	$ 423	$ 647
Customer relationships (five years)	900	611	289	900	487	413
Total intangible assets	$ 1,970	$ 1,195	$ 775	$ 1,970	$ 910	$ 1,060
Goodwill	$ 1,682	$	$ 1,682	$ 1,682	$	$ 1,682

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Company recorded amortization expense of $95,000 for the three months ended September 30, 2008 and 2007 and $285,000 for the nine months ended September 30, 2008 and 2007. Estimated intangible asset amortization expense (based on existing intangible assets) for the remainder of the year ending December 31, 2008 and the years ending December 31, 2009, 2010 and 2011 is $94,000, $352,000,

$217,000, and $112,000, respectively. Amortization will be completed as of the end of 2011.

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Note 9 Shareholders Equity

The 2000 Stock Incentive Plan (the Plan) was adopted by the Company s board of directors and approved by its shareholders in June 2000. On April 17, 2006, the Plan was amended and restated by the Board and approved by the Company s shareholders on May 25, 2006. The Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company s common stock to officers and other employees, non-employee board members and consultants. Under the Plan, eligible participants may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. In addition, the Plan as amended and restated, allows for the issuance of restricted stock units to officers and other employees, non-employee board members and consultants. Restricted stock units are share awards that entitle the holder to receive shares of the Company s common stock upon vesting. The Company s board of directors, its compensation committee or its equity awards committee determines eligibility and vesting schedules for options and restricted stock units granted under the Plan. Options expire within a period of not more than ten years from the date of grant.

At September 30, 2008, the Plan provided for the issuance of up to 21,191,104 shares of common stock. The number of shares of common stock reserved for issuance under the Plan will automatically increase on the first trading day in January in each calendar year by an amount equal to 4% of the total number of shares of common stock outstanding on the last trading day in December of the prior calendar year, but in no event will exceed 2,500,000 shares.

During the nine months ended September 30, 2008, options for the purchase of 1,146,000 shares at a weighted-average option price of $10.76 per share, with annual vesting of 25%, were awarded. The contractual lives of 2008 awards are consistent with those of prior years.

At September 30, 2008, 5,660,805 shares of common stock were available for grant under the Plan.

During the nine months ended September 30, 2008, the Company repurchased 1,669,208 shares of common stock at an average share price of $7.79, including commissions. Repurchased shares were returned to the status of authorized but unissued shares of common stock and may be reissued by the Company in the future.

During the nine months ended September 30, 2008, the Company received $5.9 million in cash proceeds for the exercise of 1,266,480 options with a $2.9 million tax benefit for disqualifying dispositions of incentive stock options and vesting of restricted stock units.

Note 10 New Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141(R), Business Combinations , and SFAS No. 160, Accounting and Reporting of Noncontrolling interest in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS No. 160). These new standards will significantly change the financial accounting and reporting of business combination transactions and noncontrolling (or minority) interests in consolidated financial statements. The Company will be required to adopt SFAS No. 141(R) and SFAS No. 160 on or after December 15, 2008. Accordingly, any business combinations the Company engages in will be recorded and disclosed following existing accounting principles until December 31, 2008.

Effective January 1, 2008, the Company adopted the provisions of SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. The Company chose not to elect the fair value option for its financial assets and liabilities existing at January 1, 2008, and did not elect the fair value option on financial assets and liabilities transacted in the nine months ended September 30, 2008. Therefore, the adoption of SFAS No. 159 had no impact on the Company s consolidated financial statements.

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Effective January 1, 2008, the Company adopted the provisions of SFAS No. 157, Fair Value Measurement, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. Relative to SFAS No. 157, the FASB issued FASB Staff Positions (FSP) 157-1 and 157-2. FSP 157-1 amends SFAS No. 157 to exclude SFAS No. 13, Accounting for Leases, and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of the application of SFAS No. 157 to fiscal years beginning after November 15, 2008 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company elected the one-year deferral and thus will not apply the provisions of SFAS No. 157 to nonfinancial assets and nonfinancial liabilities that are recognized at fair value in the financial statements on a nonrecurring basis until the fiscal year beginning January 1, 2009. Non-recurring nonfinancial assets and nonfinancial liabilities for which the Company has not applied the provisions of SFAS No. 157 include those measured at fair value in goodwill impairment testing and those initially measured at fair value in a business combination. The Company s adoption of SFAS No. 157 did not have a material effect on the Company s consolidated financial statements for financial assets and liabilities and any other assets and liabilities carried at fair value.

In April 2008, the FASB issued FASB Staff Position (FSP) SFAS No. 142-3, Determination of the Useful Life of Intangible Assets. FSP SFAS No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The intent of FSP SFAS No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) and other applicable accounting literature. FSP SFAS No. 142-3 is effective for the Company beginning January 1, 2009. The Company does not anticipate that the adoption of FSP SFAS No. 142-3 will have an impact on its consolidated financial statements.

The Company has implemented all new accounting pronouncements that are in effect and that may impact its consolidated financial statements and does not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on its consolidated financial statements.

Note 11 Credit Facility

On July 30, 2008, the Company entered into an agreement for a $35 million two-year senior unsecured revolving credit facility (the Credit Facility) with Wachovia Bank, National Association (Wachovia). The Credit Facility will bear interest at a floating rate equivalent to, at the option of the Company, either (i) LIBOR plus 0.70% - 1.20% depending on the Company s leverage ratio at each quarter end or (ii) Wachovia s prime rate, announced from time to time, less 1.00% - 1.50% depending on the Company s leverage ratio at each quarter end. The Credit Facility is guarantied by certain domestic subsidiaries of the Company. In addition, in the event the Company makes a loan to any of its foreign subsidiaries, the Company has agreed to pledge to Wachovia the Company s intercompany note from such foreign subsidiary. The Credit Facility agreement contains customary affirmative and negative covenants, some of which require the maintenance of specified financial ratios. The Credit Facility matures on July 30, 2010.

As of September 30, 2008, there were no borrowings outstanding. In order to ensure the preservation of this additional liquidity amid the adverse credit market conditions, the Company borrowed $35 million under the Credit Facility in October 2008. In November 2008, after passage of the Emergency Economic Stabilization Act of 2008 and some stabilization of the credit markets, the Company elected to repay $25 million of the amount borrowed. Proceeds from the Credit Facility will be used to maintain liquidity and fund working capital requirements, on an as needed basis.

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

Cautionary Statement

Certain statements in this report, including statements regarding our strategy, financial performance and revenue sources, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and are subject to the safe harbors created by those sections. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management s beliefs, and certain assumptions made by us. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. We undertake no obligation to revise or update any forward-looking statements for any reason. The section entitled Risk Factors set forth in this Form 10-Q and similar discussions in filings with the Securities and Exchange Commission made from time to time, including other quarterly reports on Form 10-Q, our Annual Reports on Form 10-K, and in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition.

The following discussion should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Form 10-Q.

Discontinued Operations of Consumer Division

On February 9, 2007, we entered into an Asset Purchase Agreement (Purchase Agreement) with Fabrik, Inc. (Fabrik) and Fabrik Acquisition Corp. (together with Fabrik, the Purchasers) for the sale of assets relating to a portion of our business which was engaged in the designing, final assembling, selling, marketing and distributing consumer-oriented products based on Flash memory, DRAM technologies and external storage solutions known as the Consumer Division. The consideration paid to us pursuant to the Purchase Agreement consisted of cash in the amount of approximately $43.0 million. The purchase price was subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivables and overhead capitalization of the Consumer Division (Purchase Price Adjustment). Subsequent to the closing of the sale, the Purchasers disputed certain amounts calculated by us in regards to the Purchase Price Adjustment. The original claim amount was approximately $6.7 million. In accordance with the Purchase Agreement, both parties agreed to resolve their Purchase Price Adjustment disputes through a third party arbitrator. During the arbitration proceeding, the Purchasers conceded approximately $4.0 million of their original disputed amounts. In January 2008, the arbitrator rejected substantially all of the Purchasers claims. As of September 30, 2008, no amounts have been recorded in the condensed consolidated financial statements for this matter as we are still in the process of enforcing the arbitrator s decision and resolving other post-closing items with the Purchasers.

The sale of the assets of the Consumer Division meets the criteria defined in Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets as a discontinued operation and is presented herein as such. The results of operations and gain on the sale of the assets of the Consumer Division are reported in income (loss) from discontinued operations in the Consolidated Financial Statements for all periods presented. Assets and liabilities sold are classified as assets and liabilities of discontinued operations in the Consolidated Balance Sheet as of September 30, 2008 and December 31, 2007. As a result of the sale of the assets of the Consumer Division, which was previously reported as a separate operating segment, we now operate as a single reportable segment. The discussion of our financial condition and results of operations contained in this Form 10-Q include the operating results of our OEM business with our former Consumer Division being accounted for as a discontinued operation.

Overview

STEC, Inc. designs, develops, manufactures and markets custom memory solutions based on Flash memory and DRAM technologies. Headquartered in Santa Ana, California, we specialize in developing high-speed, high-capacity Flash solid-state drives (SSDs) and memory cards, used in sensitive and highly-volatile environments, and high-density DRAM modules.

We market our products to OEMs, leveraging our custom design capabilities to offer custom memory solutions to address their specific needs.

We are focusing on several revenue growth initiatives, including:

- Continuing to develop and qualify customized Flash-based products, including our Zeus^{IOPS}, Mach8^{IOPS} and Mach8/MLC product lines, for the enterprise storage, enterprise server, notebook and ultra-mobile notebook applications, respectively;
- Targeting new customers for our value-add DRAM solutions; and
- Expanding our international business in Asia and Europe.

Over the past several years we have expanded our custom design capabilities of Flash products for OEM applications. We have invested significantly in the design and development of customized Flash controllers, firmware and hardware form factors and made strategic acquisitions that have expanded our Flash design capabilities and sales and marketing infrastructure. We believe that our continued investment in our Flash capabilities will positively impact the future growth of our Flash revenues.

A major area of our Flash-based product investment has been focused on solid-state drive technology. We believe the advantages of SSD technology are currently being defined in several distinct market segments: a) enterprise storage and video-on-demand (VoD) applications, b) servers and c) PC, mobile computing and consumer-related markets and d) military and industrial applications. We see opportunities to leverage our SSD expertise across each of these markets where we believe our technology can outperform existing solutions. In addition, we believe the SSD market will continue to expand over the next few years, aided by the continuation of the decline in Flash component pricing, with the overall unit volumes continuing to grow over the next several years.

In the third quarter of 2008, we received notice of design wins from one of the largest Enterprise Storage and Server OEMs confirming our qualification across multiple platforms using our Zeus^{IOPS} and Mach8^{IOPS} SSDs. We are in the later stages of qualification for our Zeus^{IOPS} SSDs with several other key Enterprise-Storage customers. In addition, we are in the later stages of qualification with several leading Enterprise-Server OEMs for our Mach8^{IOPS} SSD products.

Our MLC-based products for client applications are now shipping in volume. We believe the general environment of falling NAND Flash prices will help to further reduce the price of SSDs to the end-customer and stimulate demand in both of these markets. We started shipping production units into these markets in the third quarter of 2008.

Flash product revenue increased 45% from $27.9 million in the third quarter of 2007 to $40.5 million in the third quarter of 2008, and 31% from $77.5 million in the first nine months of 2007 to $101.9 million in the first nine months of 2008. We expect our continued investments in Flash custom design and controller development to result in sustained revenue growth from our Flash product line in the fourth quarter of 2008. Flash product gross margins were significantly higher than DRAM product gross margins in the third quarters of 2008 and 2007.

We offer both monolithic DRAM modules and DRAM modules based on our stacking technology. DRAM product revenue increased 56% from $14.0 million in the third quarter of 2007 to $21.8 million in the third quarter of 2008, and 21% from $52.4 million in the first nine months of 2007 to $63.2 million in the first nine months of 2008.

We continue to make progress toward one of our long-term revenue growth initiatives to expand of our international business in Asia and Europe. Since the beginning of 2004, we have opened sales, marketing, procurement and engineering offices in Austria, China, Germany, Hong Kong, Italy, Japan, Malaysia, Taiwan and the United Kingdom in order to build the necessary infrastructure to support product development and revenue growth in those geographic regions. We completed construction of a 210,000 square foot manufacturing facility in Malaysia, which we expect will reduce average production and administrative labor costs, provide better access to growing markets internationally, improve supply chain efficiency, reduce lead times, increase manufacturing efficiency through investments in new state-of-the-art equipment, and lower our overall long-term effective income tax rate. However, we anticipate transition-related costs for our Malaysia manufacturing facility to negatively impact our earnings in the short-term.

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During the third quarter of 2008, we incurred approximately $3.0 million of expenses related to our Malaysia operations. Of the $3.0 million, approximately $1.1 million represents general, administrative and other expenses, $470,000 represents research and development expenses, $130,000 represents sales and marketing expenses and $1.3 million relates to manufacturing overhead.

Historically, a limited number of customers have accounted for a significant percentage of our revenue. Our ten largest customers accounted for an aggregate of 78.4% of our revenues in the first nine months of 2008, compared to 73.5% of our total revenues in the first nine months of 2007, and 82.2% of our revenues in the third quarter of 2008, compared to 76.3% of our total revenues in the third quarter of 2007. We had two customers account for more than 10.0% of our revenues, at 40.9% and 13.7%, for the nine months ended September 30, 2008, compared to one customer, which accounted for more than 10.0% of our revenues, at 52.1%, for the same period in 2007. We had three customers account for more than 10.0% of our revenues, at 36.5%, 12.3% and 10.7%, in the third quarter of 2008, compared to one customer, which accounted for more than 10.0% of our revenues, at 52.4%, for the same period in 2007.

The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by, any of our major customers would harm our business, financial condition and results of operations. See Risk Factors Sales to a limited number of customers represent a significant portion of our revenues and the loss of any key customer would materially reduce our revenues.

Revenues derived from billings to foreign customers accounted for 21.8% of our revenues in the first nine months of 2008, compared to 20.0% of our revenues in the first nine months of 2007, and 29.3% of our revenues in the third quarter of 2008, compared to 18.8% of our revenues in the third quarter of 2007. During the third quarter of 2008, 12.6% of our revenues were derived from billings to customers in Singapore. No single foreign country accounted for more than 10% of revenues during the third quarter of 2007. Substantially all of the Company s international sales are export sales, which are shipped from the Company s domestic facility to foreign customers. Going forward, we expect substantially all of our foreign sales to originate internationally as our operations in Malaysia become established. For the nine months ended September 30, 2008 and 2007, more than 95.0% of our international sales were denominated in U.S. dollars. In addition, our purchases of DRAM and Flash components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries. See Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

In the past, we have been and expect to continue to experience some seasonality in our business resulting in higher sales generally in the fourth quarter of each year due to corporate customers spending to their full capital budgets before the end of each year.

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Results of Operations

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	67.9	71.0	67.6	69.7
Gross profit	32.1	29.0	32.4	30.3
Operating expenses:				
Sales and marketing	8.1	8.9	8.4	9.4
General and administrative	11.2	11.2	10.6	9.5
Research and development	9.0	7.6	8.7	7.8
Total operating expenses	28.3	27.7	27.7	26.7
Operating income	3.8	1.3	4.7	3.6
Interest income	0.4	2.4	0.8	2.1
Income from continuing operations before provision for income taxes	4.2	3.7	5.5	5.7

Comparison of Three Months Ended September 30, 2008 to Three Months Ended September 30, 2007

Net Revenues. Our revenues were $63.7 million in the third quarter of 2008, compared to $44.7 million in the same period in 2007. Revenues increased 42.5% in the third quarter of 2008 due primarily to a 24.9% increase in unit shipments and a 20.0% increase in average sales price, or ASP, from $30 in the third quarter of 2007 to $36 in the third quarter of 2008. The increase in unit shipments resulted primarily from an increase in orders from new and existing customers in the third quarter of 2008. The increase in our ASP resulted primarily from a 30.8% increase in Flash ASP as the result of increased sales of higher-ASP Zeus^{IOPS} products in the third quarter of 2008 compared to the same period in 2007.

Sales of our products are generally made under short-term cancelable purchase orders. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter.

Gross Profit. Our gross profit was $20.4 million in the third quarter of 2008, compared to $13.0 million in the same period in 2007. Gross profit as a percentage of revenues was 32.1% in the third quarter of 2008, compared to 29.0% in the third quarter of 2007. The increase in gross profit in absolute dollars was due primarily to increased revenues and unit shipments for Flash products. Gross profit as a percentage of revenue in the third quarter of 2008 increased due primarily to a shift in product mix toward higher value-added Flash products and improvements in gross profit margin for DRAM products, partially offset by an increase in production and labor overhead due to ramp-up costs related to our Malaysia facility.

Sales and Marketing. Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $5.1 million in the third quarter of 2008, compared to $4.0 million in the third quarter of 2007. Sales and marketing expenses as a percentage of revenue were 8.1% in the third quarter of 2008, compared to 8.9% in the third quarter of 2007. The increase in sales and marketing expenses in absolute dollars was due to increases in revenues, units shipped, and the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, such as expansion in Asia and Europe, and to support the continued revenue expansion of our Flash products. The decrease in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of some of these expenses and as a result of lower commissions paid to independent manufacturers representatives, which resulted from revised agreements with those representatives during the third quarter of 2007. Additionally, we utilized fewer manufacturers representatives during the third quarter of 2008 compared to the third quarter of 2007. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $7.2 million in the third quarter of 2008, compared to $5.0 million in the third quarter of 2007.

General and administrative expenses as a percentage of revenues were 11.2% in the third quarters of 2008 and 2007. The increase in general and administrative expenses in absolute dollars was due primarily to a $920,000 increase in costs related to our new facility in Malaysia, a $550,000 increase in payroll and payroll-related costs, a $220,000 increase in depreciation expense, and a $150,000 increase in global tax structuring costs. Payroll and payroll-related costs increased due to an increase in employee headcount, higher stock-based compensation and bonuses. Malaysia costs have increased as the result of the facility continuing to ramp-up operations in 2008. Depreciation expense increased due to increased investments in computer software applications to support worldwide growth.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were $5.7 million in the third quarter of 2008, compared to $3.4 million in the third quarter of 2007. Research and development expenses as a percentage of revenues were 9.0% in the third quarter of 2008 compared to 7.6% in the third quarter of 2007. Research and development expenses increased in absolute dollars and as a percentage of revenues due primarily to increases in payroll costs and new product design costs from our expanding global research and development efforts predominantly related to our SSD Flash product lines which includes the advancement of high performance solid state drives.

Interest Income. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. Interest income was $241,000 in the third quarter of 2008 and $1.1 million in the third quarter of 2007. The decrease in interest income resulted primarily from lower interest rates and a lower average cash balance in 2008 compared to 2007. The average cash balance during the third quarter of 2008 compared to the third quarter of 2007 decreased due primarily to working capital requirements

Provision for Income Taxes. The provision for income taxes was $1.5 million and $1.2 million in the third quarters of 2008 and 2007, respectively. Our effective tax rate decreased from 69.8% in the third quarter of 2007 to 56.1% in the third quarter of 2008 due primarily to higher than anticipated foreign losses in tax-free jurisdictions that were not tax-benefited in the third quarter of 2007. We expect to receive significant long-term tax benefits after the implementation of our new global tax structure.

Income from Continuing Operations. Income from continuing operations was $1.2 million and $506,000 in the third quarters of 2008 and 2007, respectively. The increase in income from continuing operations was due primarily to a $7.4 million increase in gross profit offset by a $5.6 million increase in operating expenses, an $833,000 decrease in interest income and an $309,000 increase in the provision for income taxes in the third quarter of 2008 compared to the third quarter of 2007. The increase in gross profit is due primarily to an increase in Flash and DRAM revenues as the result of an increase in unit sales in 2008. The increase in operating expenses is due primarily to expansion efforts in Asia and Europe, an increase in employee compensation costs, higher professional fees, an increase in capital expenditures and increased investments in research and development for new Flash products to support the increase in revenue.

Income from Discontinued Operations. As previously mentioned above, we sold the assets of our Consumer Division on February 9, 2007. Income from discontinued operations was $47,000 and $324,000 in the third quarters of 2008 and 2007, respectively. The income in the third quarter of 2008 is due primarily to a cash settlement on a lawsuit received from a former supplier of hard drive products to our former Consumer Division.

Comparison of Nine Months Ended September 30, 2008 to Nine Months Ended September 30, 2007

Net Revenues. Our revenues were $170.5 million in the first nine months of 2008, compared to $135.6 million in the same period in 2007. Revenues increased 25.7% in the first nine months of 2008 due primarily to an 18.0% increase in unit shipments, and a 9.1% increase in ASP from $33 in first nine months of 2007 to $36 in the first nine months of 2008. The increase in unit shipments resulted primarily from an increase in orders from new and existing customers in the first nine months of 2008. The increase in our ASP resulted primarily from an increase in higher-ASP SSD product sales in the first nine months of 2008 compared to the first nine months of 2007.

Gross Profit. Our gross profit was $55.2 million in the first nine months of 2008, compared to $41.1 million in the same period in 2007. Gross profit as a percentage of revenues was 32.4% in the first nine months of 2008, compared to 30.3% in the first nine months of 2007. The increase in gross profit in absolute dollars was due primarily to increased revenues and unit shipments for Flash and DRAM products. Gross profit as a percentage of revenue in the first nine months of 2008 increased due primarily to an increase in gross profit margin for DRAM products.

Sales and Marketing. Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $14.2 million in the first nine months of 2008, compared to $12.7 million in the first nine months of 2007. Sales and marketing expenses as a percentage of revenue were 8.4% in the first nine months of 2008, compared to 9.4% in the first nine months of 2007. The increase in sales and marketing expenses in absolute dollars was due to increases in revenues, units shipped, and the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, including expansion in Asia and Europe, and to support the continued revenue growth of our Flash products, partially offset by lower commissions paid to independent manufacturers representatives. The decrease in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of some of these expenses and as a result of lower commissions paid to independent manufacturers representatives, which resulted from revised agreements with those representatives during the third quarter of 2007. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $18.1 million in the first nine months of 2008, compared to $12.9 million in the first nine months of 2007. General and administrative expenses as a percentage of revenues were 10.6% in the first nine months of 2008, compared to 9.5% in the first nine months of 2007. The increase in general and administrative expenses in absolute dollars and as a percentage of revenues was due primarily to a $1.5 million increase in payroll and payroll-related costs, a $1.7 million increase in costs related to our new facility in Malaysia, an $890,000 increase in legal expenses, a $540,000 increase in global tax structuring costs and a $520,000 increase in depreciation expense. Payroll and payroll-related costs increased due to higher stock-based compensation and bonuses and an increase in employee headcount. Malaysia costs have increased as the result of the facility continuing to ramp-up operations in 2008. Legal expenses have increased as the result of an IP litigation matter which began in 2008. Depreciation expense increased due to increased investments in computer software applications to support worldwide growth.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were $14.9 million in the first nine months of 2008, compared to $10.6 million in the first nine months of 2007. Research and development expenses as a percentage of revenues were 8.7% in the first nine months of 2008 compared to 7.8% in first nine months of 2007. Research and development expenses increased in absolute dollars and as a percentage of revenues due primarily to increases in payroll costs and new product design costs from our expanding global research and development efforts predominantly related to our SSD Flash product lines which includes the advancement of high performance solid state drives.

Interest Income. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. Interest income was $1.4 million in the first nine months of 2008 and $2.8 million in the first nine months of 2007. The decrease in interest income resulted primarily from lower interest rates and a lower average cash balance in 2008 compared to 2007. The average cash balance decreased in the first nine months of 2008 compared to the first nine months of 2007 due primarily to working capital requirements and $15.5 million of cash used to repurchase shares of our common stock during the last three months of 2007 and first nine months of 2008.

Provision for Income Taxes. The provision for income taxes increased from $3.5 million in the first nine months of 2007 to $5.1 million in the first nine months of 2008 due primarily to the increase in income from continuing operations before income taxes from $7.7 million in the first nine months of 2007 to $9.4 million in the first nine months of 2008. Our effective tax rate increased from 44.7% in the first nine months of 2007 to 54.2% in the first nine months of 2008 due primarily to higher than anticipated foreign losses in tax-free jurisdictions.

Income from Continuing Operations. Income from continuing operations remained consistent from $4.3 million in the first nine months of 2007 to $4.3 million in the first nine months of 2008. Income from continuing operations was comprised of a $14.1 million increase in gross profit, offset by an $11.0 million increase in operating expenses, a $1.7 million increase in the provision for income taxes and a $1.4 million decrease in interest income in the first nine months of 2008. The increase in gross profit is due primarily to an increase in Flash and DRAM revenues as the result of an increase in unit sales in 2008. The increase in operating expenses is due primarily to expansion efforts in Asia and Europe, an increase in employee compensation costs, higher professional fees, an increase in capital expenditures and increased investments in research and development for new Flash products.

Income from Discontinued Operations. As previously mentioned above, we sold the assets of our Consumer Division on February 9, 2007. As a result of the sale, the Consumer Division is now reflected as discontinued operations in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Income from discontinued operations decreased from $4.6 million in the first nine months of 2007 to $138,000 in the first nine months of 2008 due primarily to substantially no activity taking place in 2008 related to the former Consumer Division, other than cash settlements received and the reduction of the potential rebate liability recorded as of December 31, 2007 related to the Hard Drive Class Action Lawsuit, discussed in Legal Proceedings contained in Part II, Item 1 of the Report.

Liquidity and Capital Resources

Working Capital, Cash and Marketable Securities

As of September 30, 2008, we had working capital of $133.0 million, including $29.4 million of cash and cash equivalents, compared to working capital of $141.1 million, including $94.3 million of cash and cash equivalents as of December 31, 2007 and working capital of $144.7 million, including $105.2 million of cash and cash equivalents as of September 30, 2007. Current assets were 5.1 times current liabilities at September 30, 2008, compared to 7.1 times current liabilities at December 31, 2007, and 7.3 times current liabilities at September 30, 2007.

Cash Used in Operating Activities in the Nine Months Ended September 30, 2008

Net cash used in operating activities was $45.1 million for the nine months ended September 30, 2008 and resulted primarily from a $48.7 million increase in inventory and a $15.8 million increase in accounts receivable, partially offset by a $5.4 million increase in accounts payable, a $3.7 million increase in accrued and other liabilities, net income of $4.5 million and non-cash depreciation and amortization of $6.5 million. Inventory increased primarily due to an increase in purchases of Flash inventory in 2008 in anticipation of increased production volumes for SSD products based on customer forecast and orders related to new product launches set for the second half of 2008 and the first quarter of 2009. Accounts receivable increased primarily due to an increase in sales. Accounts payable increased as a result of higher inventory purchases in the three months ended September 30, 2008 compared to the three months ended December 31, 2007. Accrued and other liabilities increased primarily due to a $1.5 million increase in payroll and payroll-related liabilities as a result of higher employee headcount and a $1.4 million increase in income taxes payable.

Cash Used in Investing Activities for the Nine Months Ended September 30, 2008

Net cash used in investing activities was $15.7 million for the nine months ended September 30, 2008 resulting primarily from $16.0 million in purchases of property, plant and equipment related to production equipment for the United States and Malaysia locations. During the nine months ended September 30, 2008, we had purchases and sales of marketable securities of $47.8 million.

As of September 30, 2008, we have made capital expenditures of approximately $30.8 million for our Malaysia facility primarily related to building construction costs, acquisition of land and purchases of production equipment. We estimate that total investments in land, facilities and capital equipment will be approximately $8.0 million over the next five years ending September 30, 2013. We expect that the substantial majority of these estimated investments will relate to our Malaysia facility.

Cash Used in Financing Activities for the Nine Months Ended September 30, 2008

Net cash used in financing activities was $4.1 million for the nine months ended September 30, 2008 and resulted from a $13.0 million repurchase of our common stock under our share repurchase program, partially offset by $5.9 million in proceeds realized from the exercise of stock options and a $2.9 million tax benefit from employee stock option exercises and vestings of restricted stock units. In July 2006, our board of directors authorized a share repurchase program enabling us to repurchase up to $10 million of our common stock over an 18-month period expiring on February 14, 2008. In May 2007, our board of directors authorized the expansion of the existing repurchase program enabling us to repurchase up to $60.0 million of our common stock over an 18-month period expiring on November 18, 2008. We repurchased 1,669,208 shares of common stock at an average share price of $7.79, including commissions during the nine months ended September 30, 2008. Repurchased shares were returned to the status of authorized but unissued shares of common stock and may be reissued by us in the future.

On July 30, 2008, we entered into an agreement for a $35 million two-year senior unsecured revolving credit facility (the Credit Facility) with Wachovia Bank, National Association (Wachovia). The Credit Facility will bear interest at a floating rate equivalent to, at our option, either (i) LIBOR plus 0.70% - 1.20% depending on our leverage ratio at each quarter end or (ii) Wachovia s prime rate, announced from time to time, less 1.00% - 1.50% depending on our leverage ratio at each quarter end. The Credit Facility is guarantied by certain of our domestic subsidiaries. In addition, in the event we make a loan to any of our foreign subsidiaries, we have agreed to pledge to Wachovia our intercompany note from such foreign subsidiary. The Credit Facility agreement contains customary affirmative and negative covenants, some of which require the maintenance of specified financial ratios. The Credit Facility matures on July 30, 2010. As of September 30, 2008, there were no borrowings outstanding. In order to ensure the preservation of this additional liquidity amid the adverse credit market conditions, we borrowed $35 million under the Credit Facility in October 2008. In November 2008, after passage of the Emergency Economic Stabilization Act of 2008 and some stabilization of the credit markets, we elected to repay $25 million of the amount borrowed. Proceeds from the Credit Facility will be used to maintain liquidity and fund working capital requirements, on an as needed basis.

We believe that our existing assets, cash, cash equivalents and investments on hand, together with the $35 million credit facility with Wachovia and cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year to provide additional working capital if our revenues increase substantially, to expand our international operations or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain additional credit facilities for other reasons. There can be no assurance that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

- whether our revenues increase substantially;
- our relationships with suppliers and customers;
- the market acceptance of our products;
- expansion of our international business, including the opening of offices and facilities in foreign countries;
- price discounts on our products to our customers;
- our pursuit of strategic transactions, including acquisitions, joint ventures and capital investments;
- our business, product, capital expenditure and research and development plans and product and technology roadmaps;
- the levels of inventory and accounts receivable that we maintain;

our entrance into new markets;

capital improvements to new and existing facilities;

technological advances; and

competitors responses to our products.

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Contractual Obligations and Off Balance Sheet Arrangements

Other than lease commitments incurred in the normal course of business (see Contractual Obligation table below), we do not have any material off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in the consolidated financial statements. Additionally, we do not have any interest in, or relationship with, any special purpose entities.

In the ordinary course of business, we may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of such agreements, services to be provided by us, or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We maintain director and officer insurance, which may cover certain liabilities arising from our obligation to indemnify our directors and officers in certain circumstances. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements.

Set forth in the table below is our estimate of our significant contractual obligations at September 30, 2008.

		Payment due by period			
Contractual Obligation	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Operating Lease Obligations	$ 6,117	$ 909	$ 1,436	$ 1,312	$ 2,460
Non-cancelable capital equipment purchase commitments	2,582	2,582			
Non-cancelable inventory purchase commitments	6,756	6,756			
Other non-cancelable purchase commitments	2,302	2,302			
Total	$ 17,757	$ 12,549	$ 1,436	$ 1,312	$ 2,460

Inflation

Inflation was not a material factor in either revenue or operating expenses during each of the first nine months ended September 30, 2008 and 2007.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. Information with respect to our critical accounting policies which we believe could have the most significant effect on our reported results and require subjective or complex judgments is contained in the notes to the consolidated financial statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2007. There have been no significant changes in our critical accounting policies and estimates during the nine months ended September 30, 2008 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

New Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, and SFAS No. 160, Accounting and Reporting of Noncontrolling interest in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS No. 160). These new standards will significantly change the financial accounting and reporting of business combination transactions and noncontrolling (or minority) interests in consolidated financial statements. We will be required to adopt SFAS No. 141(R) and SFAS No. 160 on or after December 15, 2008.

Accordingly, any business combinations the Company engages in will be recorded and disclosed following existing accounting principles until December 31, 2008. Effective January 1, 2008, we adopted the provisions of SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. We chose not to elect the fair value option for our financial assets and liabilities existing at January 1, 2008, and did not elect the fair value option on financial assets and liabilities transacted in the nine months ended September 30, 2008. Therefore, the adoption of SFAS No. 159 had no impact on our consolidated financial statements.

Effective January 1, 2008, we adopted the provisions of SFAS No. 157, Fair Value Measurement, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. Relative to SFAS No. 157, the FASB issued FASB Staff Positions (FSP) 157-1 and 157-2. FSP 157-1 amends SFAS No. 157 to exclude SFAS No. 13, Accounting for Leases, and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of the application of SFAS No. 157 to fiscal years beginning after November 15, 2008 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We elected the one-year deferral and thus will not apply the provisions of SFAS No. 157 to nonfinancial assets and nonfinancial liabilities that are recognized at fair value in the financial statements on a nonrecurring basis until the fiscal year beginning January 1, 2009. Non-recurring nonfinancial assets and nonfinancial liabilities for which we have not applied the provisions of SFAS No. 157 include those measured at fair value in goodwill impairment testing and those initially measured at fair value in a business combination. Our adoption of SFAS No. 157 did not have a material effect on our consolidated financial statements for financial assets and liabilities and any other assets and liabilities carried at fair value.

In April 2008, the FASB issued FASB Staff Position (FSP) SFAS No. 142-3, Determination of the Useful Life of Intangible Assets. FSP SFAS No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The intent of FSP SFAS No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) and other applicable accounting literature. FSP SFAS No. 142-3 is effective for us beginning January 1, 2009. We do not anticipate that the adoption of FSP SFAS No. 142-3 will have an impact on our consolidated financial statements.

We have implemented all new accounting pronouncements that are in effect and that may impact our consolidated financial statements and do not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

At any time, fluctuations in interest rates could affect interest earnings on our cash and cash equivalents and marketable securities. We periodically invest in marketable securities as part of our investment strategy. At September 30, 2008, our cash and cash equivalents were $29.4 million invested in money market and other interest bearing accounts. At September 30, 2008, we had no investments in marketable securities.

We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. The primary objective of our investment activities is to preserve capital. We have not used derivative financial instruments in our investment portfolio.

If interest rates were to decrease 1%, the result would be an annual decrease in our interest income related to our cash and cash equivalents and marketable securities of approximately $294,000. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such action. Further, this analysis does not consider the effect of the change in the level of overall economic activity that could exist in such an environment.

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The carrying amount, principal maturity and estimated fair value of our cash and cash equivalents and marketable securities as of September 30, 2008 were as follows:

	Expected Maturity Date Before October 1, 2009	Thereafter	Total	Fair Value 9/30/2008
Cash and cash equivalents:				
Money market funds	$ 29,359,000	$	$ 29,359,000	$ 29,359,000
Weighted average interest rate	2.72%		2.72%	2.72%

Foreign Currency Exchange Rate Risk

More than 95.0% of our international sales are denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive. In addition, we purchase substantially all of our IC components from local distributors of Japanese, Korean and Taiwanese suppliers. Fluctuations in the currencies of Japan, Korea or Taiwan could have an adverse impact on the cost of our raw materials. To date, we have not entered any derivative instruments to manage risks related to interest rate or foreign currency exchange rates.

ITEM 4. CONTROLS AND PROCEDURES

Inherent Limitations on Effectiveness of Controls. Our management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

Evaluation of Disclosure Controls and Procedures. An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report to ensure that we record, process, summarize, and report information required to be disclosed by us in our reports filed under the Exchange Act within the time periods specified by the Securities and Exchange Commission s (SEC) rules and forms.

Changes in Internal Control Over Financial Reporting. During the three months ended September 30, 2008, there have not been any changes in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Lemelson Medical, Education & Research Foundation, LLP Patent Infringement

We received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP filed a complaint on November 13, 2001 against us and other defendants. The complaint was filed in the District Court of Arizona and alleges that our manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, we were served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Based on the U.S. Court of Appeal s affirmance, the Lemelson Foundation moved to dismiss with prejudice all claims against us and certain other defendants, and that request for dismissal was granted by the court. In July 2008, following the dismissal of the last remaining defendant in the case, the court ruled that this case was terminated.

Hard Drive Class Action Lawsuit

On October 6, 2006, an individual, Boris Brand, filed a purported nationwide class action lawsuit against us in the Superior Court for the State of California, County of Los Angeles, alleging that our description of the capacity of our hard drive products constitutes fraudulent, unfair, deceptive and false advertising under California Business and Professions Code Sections 17200 and 17500 and violates the California Consumers Legal Remedies Act. In particular, the lawsuit alleges that our description of the storage capacity on our hard drives uses a decimal basis for measuring gigabytes which results in a lower storage capacity when the hard drives are incorporated into an operating system that uses a binary basis for measurement. Although we believe this lawsuit is without merit, we have agreed to provide qualifying class members the means to claim a rebate of 6% of the purchase price of the storage device for a period of three months from the announcement of the program. In addition, we will pay a portion of the plaintiff s legal fees as determined by an arbitration proceeding which concluded on March 10, 2008. The court granted preliminary approval of the settlement on May 30, 2008 and we launched our 6% rebate program on June 9, 2008. The court approved the terms of the settlement on September 23, 2008. The submission period for the 6% rebate program ended in September 2008 and we are in the process of validating the limited number of claims we received. During the nine months ended September 30, 2008, we reduced our previous accrual for potential rebate claims by $114,000, which is included as a component of discontinued operations since the related products were sold by our former Consumer Division. The remaining accrual as of September 30, 2008 is immaterial. We are also pursuing claims against our former insurance provider and some of the suppliers who have supplied us with the hard drives involved since we believe that those suppliers have a legal duty to indemnify us for any damages. There can be no assurance, however, that we will be successful in our claims against our former insurance provider or the suppliers. During the nine months ended September 30, 2008, we received cash settlements from certain former suppliers of hard drive products to our former Consumer Division, totaling $152,000, which were recorded as income from discontinued operations.

Seagate Patent Infringement Lawsuit

On April 14, 2008, a patent infringement lawsuit was filed in the United States District Court, Northern District of California by Seagate Technology LLC, Seagate Technology International, Seagate Singapore International Headquarters Pte. Ltd. and Maxtor Corporation (collectively, Seagate) alleging that we infringe four of Seagate s patents U.S. Patent Nos. 6,404,647, 6,849,480, 6,336,174 and 7,042,664. On May 1, 2008, Seagate filed an amended complaint asserting that we infringe an additional Seagate patent U.S. Patent No. 5,261,058. The lawsuit seeks injunctive relief and unspecified compensatory and treble damages and attorneys fees for the alleged patent infringement. We filed our answer on May 15, 2008 asserting affirmative defenses of non-infringement, invalidity, failure to mark or give notice, unenforceability, and adequate remedy other than injunctive relief. Further, in the answer we counter-claimed for a declaratory judgment of non-infringement, invalidity, and unenforceability of all 5 Seagate patents, and all legal fees and costs. On November 7, 2008, we filed our amended answer to add counter-claims against Seagate and Seagate CEO William D. Watkins for intentional interference with contractual relations, intentional interference with prospective economic advantage, defamation (libel per se), trade libel, unfair competition (Cal. Bus. & Prof. Code § 17200), false advertising / unfair competition (Lanham Act 15 U.S.C. § 1125(a)), and slander of title. We believe Seagate s allegations are without merit and intend to vigorously defend ourselves in the lawsuit. As of September 30, 2008, no amounts have been recorded in the consolidated financial statements for this matter as we believe it is too early in the proceedings to determine an outcome.

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We are not currently involved in any other material legal proceedings. However, we are involved in other suits and claims in the ordinary course of business, and, from time to time, we may become subject to additional legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes. In addition, in the past we have received, and we may continue to receive in the future, letters alleging infringement of patent or other intellectual property rights. Our management believes that these letters generally are without merit and we intend to contest them vigorously.

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ITEM 1A. RISK FACTORS

This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about our industry and us. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. You should carefully consider these risks before you decide to buy shares of our common stock. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties, including those risks set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations above, may also adversely impact and impair our business. If any of these risks actually occur, our business, results of operations or financial condition would likely suffer. In such case, the trading price of our common stock could decline, and you may lose all or part of the money you paid to buy our stock. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

We expect our quarterly operating results to fluctuate in future periods, causing our stock price to fluctuate or decline.

Our quarterly operating results have fluctuated in the past, and we believe they will continue to do so in the future. Our future results of operations will depend on many factors including:

- Our suppliers production levels for the components used in our products;
- Our ability to procure required components;
- Market acceptance of new and enhanced versions of our products;
- Expansion of our international business, including the opening of offices and facilities in foreign countries;
- The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;
- Fluctuations in the cost of components and changes in the average sales prices of our products;
- Fluctuating market demand for our products;
- Changes in our customer and product revenue mix;
- The effects of litigation, including costs and expenses and diversion of management resources;
- Our ability to successfully integrate any acquired businesses or assets;
- Expenses associated with the start up of new operations or divisions.

Order cancellations, product returns, inventory buildups by customers and inventory write-downs;

Manufacturing inefficiencies associated with the start-up of new products and volume production;

Expenses associated with strategic transactions, including acquisitions, joint ventures and capital investments;

Our ability to adequately support potential future rapid growth;

Our ability to absorb manufacturing overhead if revenues decline; and

Increases in our sales and marketing expenses in connection with decisions to pursue new product initiatives.

Due to the above and other factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance. In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock would likely decline. In addition, the trading price of our common stock may fluctuate or decline regardless of our operating performance.

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Our dependence on a small number of suppliers for integrated circuit, or IC, devices and inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.

Typically, IC devices represent more than 80% of the component costs of our manufactured Flash products and DRAM modules. We are dependent on a small number of suppliers that supply key components used in the manufacture of our products. Since we have no long-term supply contracts, there is no assurance that our suppliers will agree to supply the quantities of components we may need to meet our production goals. Samsung currently supplies substantially all of the IC devices used in our Flash memory products. Micron, Qimonda and Samsung currently supply substantially all of the DRAM IC devices used in our DRAM products. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including the inability to obtain an adequate supply of components, price increases, late deliveries and poor component quality. A disruption in or termination of our supply relationship with any of our significant suppliers, or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers, could increase our costs or the prices of our products and adversely affect our revenues and business.

Our customers qualify specific Flash and DRAM ICs that are components in our products as part of the product qualification process. If any of our suppliers experience quality control problems, our products that utilize that supplier s IC may be disqualified by one or more of our customers. This would disrupt our supply of ICs, reduce the number of suppliers available to us and adversely affect our ability to fulfill our customers product orders. Further, we may be required to qualify a new supplier s IC, which could negatively impact our revenues during the new qualification process. There can be no assurance that we would be able to find and successfully qualify new suppliers in a timely manner or obtain ICs from new suppliers on commercially reasonable terms.

Moreover, from time to time, our industry experiences shortages in Flash and DRAM IC devices which have driven up the price of those components and required some vendors to place their customers, ourselves included, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. As a result, our reputation could be harmed, we may lose business from our customers, our revenues may decline, and we may lose market share to our competitors.

We have a less diversified customer base and our future success will be dependent on our ability to grow our business.

As a result of the divestiture of our Consumer Division in February 2007, we have a less diversified customer base and our future success will be dependent on our ability to grow our business with new customers. There can be no assurance that we will be successful in growing our business with new customers. Our failure to grow our business with new customers will hurt our reputation and harm our business, financial condition and results of operations.

Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues.

Historically, a limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 78.4% of our revenues in the first nine months of 2008, compared to 73.5% of our total revenues in the first nine months of 2007, and 82.2% of our revenues in the third quarter of 2008, compared to 76.3% of our total revenues in the third quarter of 2007. We had two customers account for more than 10.0% of our revenues, at 40.9% and 13.7%, for the nine months ended September 30, 2008, compared to one customer, which accounted for more than 10.0% of our revenues, at 52.1%, for the same period in 2007. We had three customers account for more than 10.0% of our revenues, at 36.5%, 12.3% and 10.7%, in the third quarter of 2008, compared to one customer, which accounted for more than 10.0% of our revenues, at 52.4%, for the same period in 2007. Consolidation in some of our customers industries may result in increased customer concentration and the potential loss of customers as a result of acquisitions. In addition, the composition of our major customer base changes from quarter to quarter as the market demand for our customers products changes, and we expect this variability to continue in the future. We expect that sales of our products to a limited number of customers will continue to contribute materially to our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by, any of our major customers could harm our business, financial condition and results of operations.

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Ineffective management of inventory levels or product mix, order cancellations, product returns and inventory write-downs could adversely affect our results of operations.

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products with our customers, we may incur increased and unexpected costs associated with this inventory. For example, if we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. As a result, we could incur increased expenses associated with writing off excess or obsolete inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error. We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were $2.6 million and $2.2 million during the nine months ended September 30, 2008 and 2007, respectively.

We have no long-term volume commitments from our customers. Sales of our products are made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships. Customers may change, cancel or delay orders with limited or no penalties. We have experienced cancellations of orders and fluctuations in order levels from period-to-period and we expect to continue to experience similar cancellations and fluctuations in the future, which could result in fluctuations in our revenues.

We may be less competitive if we fail to develop new and enhanced products and introduce them in a timely manner.

The enterprise storage, enterprise server, notebook, high-performance computing and networking and communications markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

We have experienced, and may in the future experience, delays in the development and introduction of new products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments could result in delays in market acceptance of these products. New products, even if first introduced by us, may not gain market acceptance or result in future profitability. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations.

We may also seek to develop products with new standards for our industry. It will take time for these new standards and products to be adopted, for customers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by customers may reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. We cannot assure you that any new products or standards we develop will be commercially successful.

We may not be able to maintain or improve our competitive position because of the intense competition in the memory industry.

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We conduct business in an industry characterized by intense competition, rapid technological change, evolving industry standards, declining average sales prices and rapid product obsolescence. Our primary competitors for SSD/Flash products include: Seagate, SanDisk, Toshiba, Western Digital, Intel and Samsung; and for DRAM products include: SMART Modular and Micron. Our competitors include many large domestic and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be in a better position to influence or respond to new or emerging technologies or standards and to changes in customer requirements than us. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

In addition, some of our significant suppliers, including Micron, Qimonda and Samsung Semiconductor, are also our competitors, many of whom have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise from new and emerging companies or due to the development of cooperative relationships among our current and potential competitors or third parties to increase the ability of their products to address the needs of our prospective customers. We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance, improved pricing or render our technology or products uncompetitive, any of which could cause a decline in sales or loss of market acceptance of our products.

Current economic conditions and the global financial crisis may have an impact on our business and financial condition in ways that we currently cannot predict.

Our operations and performance depend on worldwide economic conditions and their impact on levels of business spending, which have deteriorated significantly in many countries and regions, including without limitation the United States, and may remain depressed for the foreseeable future. Uncertainties in the financial and credit markets have caused our customers to postpone purchases, and continued uncertainties may reduce future sales of our products and services. While we believe we have a strong customer base and have experienced strong collections in the past, if the current market conditions continue to deteriorate we may experience increased collection times or greater write-offs, which could have a material adverse effect on our cash flow. Finally, our ability to access the capital markets may be restricted at a time when we would like, or need, to do so, which could have an impact on our flexibility to pursue additional expansion opportunities and maintain our desired level of revenue growth in the future. These and other economic factors could have a material adverse effect on demand for our products and services and on the our financial condition and operating results.

Our stock price is likely to be volatile and could drop unexpectedly.

Our common stock has been publicly traded since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive and diverts management s attention and resources.

Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States, which in turn could cause our business and operating results to suffer.

We sell our products to customers in foreign countries and seek to increase our level of international business activity through the expansion of our operations into select international markets, including Asia and Europe. Such strategy may include opening sales offices in foreign countries, the outsourcing of manufacturing operations to third party contract manufacturers, establishing joint ventures with foreign partners, and the establishment of manufacturing operations in foreign countries.

We completed the construction of our 210,000 square foot manufacturing facility in Malaysia in January 2008 that is expected, over time, to serve as a major hub for our Asia operational activities including manufacturing, sales and marketing, procurement, and logistics. A failure to successfully and timely integrate these operations into our global infrastructure will have a negative impact on our overall operations, cause us to delay or forego some of the original perceived benefits of operating internationally such as lower average production and engineering labor costs, better access to growing markets in Asia, improved supply chain efficiency, reduced lead times, increased manufacturing efficiency through investments in new state-of-the-art equipment and a lower overall long-term effective tax rate.

Establishing operations in any other foreign country or region presents numerous risks, including:

- difficulties and costs of staffing and managing operations in certain foreign countries;
- foreign laws and regulations, which may vary country by country, may impact how we conduct our business;
- higher costs of doing business in certain foreign countries, including different employment laws;
- difficulty protecting our intellectual property rights from misappropriation or infringement;

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- political or economic instability;
- changes in import/export duties;
- necessity of obtaining government approvals;
- trade restrictions;
- work stoppages or other changes in labor conditions;
- difficulties in collecting of accounts receivables on a timely basis or at all;
- taxes;
- longer payment cycles and foreign currency fluctuations; and
- seasonal reductions in business activity in some parts of the world, such as Europe.

In addition, changes in policies and/or laws of the United States or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. We may also encounter potential adverse tax consequences if taxing authorities in different jurisdictions worldwide disagree with our interpretation of various tax laws or our determinations as to the income and expenses attributable to specific jurisdictions, which could result in our paying additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

We expect that our strategy to expand our international operations will require the expenditure of significant resources and involve the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third-party could claim that our products infringe a patent or other proprietary right. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties proprietary rights. Any of the foregoing events or claims could result in litigation. Such litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers and licensors obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation. A license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

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We are currently involved in one lawsuit regarding intellectual property infringement as further described under Legal Proceedings. In this lawsuit, Seagate alleges that we infringe five of its patents, including one related to solid state drive (SSD) technology and another related to stacking technology. Because litigation is inherently uncertain, we cannot predict the outcome of this lawsuit. We expect litigation will likely divert the efforts and attention of our key management and technical personnel. In addition, we expect to incur substantial legal fees and expenses in connection with this lawsuit. As a result, our defense of this lawsuit, regardless of its eventual outcome, is expected to be costly and time consuming.

Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages that may result in a material adverse effect on our business and results of operations.

Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

Our intellectual property may not be adequately protected, which could harm our competitive position.

Our intellectual property is critical to our success. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

- Prevent the challenge, invalidation or circumvention of our existing patents;
- Result in patents that lead to commercially viable products or provide competitive advantages for our products;
- Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;
- Prevent third-party patents from having an adverse effect on our ability to do business;
- Provide adequate protection for our intellectual property rights;
- Prevent disputes with third parties regarding ownership of our intellectual property rights;

Prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

Result in patents from any of our pending applications.

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In addition, despite our efforts to protect or intellectual property rights and confidential information, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies. In addition, if any of our patents are challenged and found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products related to such patents would cease. We have on at least one occasion applied for and may in the future apply for patent protection in foreign countries**.** The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

Declines in our average sales prices may result in declines in our revenues and gross profit.

Our industry is competitive and characterized by historical declines in average sales prices. Our average sales prices may decline due to several factors, including overcapacity in the worldwide supply of DRAM and Flash memory component as a result of increased manufacturing efficiencies, new manufacturing processes and manufacturing capacity expansions by component suppliers. In the past, overcapacity has resulted in significant declines in component prices, which has negatively impacted our average sales prices, revenues and gross profit. In addition, our competitors and customers also impose significant pricing pressures on us. Since a large percentage of our sales are to a small number of customers that are primarily distributors and large OEMs, these customers have exerted, and we expect they will continue to exert, pressure on us to make price concessions. If not offset by increases in demand for our products, decreases in average sales prices would likely have a material adverse effect on our business and operating results.

We are subject to the cyclical nature of the semiconductor industry and any future downturn could adversely affect our business.

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices. Prior downturns in the semiconductor industry negatively impacted our average sales prices, revenues and earnings. Any future downturns could have a material adverse effect on our business and results of operations.

Our level of indebtedness could adversely affect our cash flow and prevent us from fulfilling our financial obligations.

On July 30, 2008, we entered into a credit agreement for a $35 million revolving credit facility. Our debt could have important consequences, such as:

- requiring us to dedicate a portion of our cash flow from operations and other capital resources to debt service, thereby reducing our ability to fund working capital, capital expenditures, and other cash requirements;
- increasing our vulnerability to adverse economic and industry conditions;
- limiting our flexibility in planning for, or reacting to, changes and opportunities in, our business and industry, which may place us at a competitive disadvantage; and
- limiting our ability to incur additional debt on acceptable terms, if at all.

Additionally, if we were to default under our credit agreement and were unable to obtain a waiver for such a default, interest on the obligations would accrue at an increased rate and the lenders could accelerate our obligations under the credit agreement; however that acceleration will be automatic in the case of bankruptcy and insolvency events of default.

Additionally, to the extent we have made intercompany loans to our subsidiaries that have required us to pledge such loans to the lenders under the credit agreement, our subsidiaries would be required to pay the amount of the intercompany loans to the lenders in the event we are in default under the credit agreement. Any actions taken by the lenders against us in the event we are in default under the credit agreement could harm our financial condition.

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Failure to maintain effective internal control over financial reporting could result in a negative market reaction.

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we undertake a thorough examination of our internal control systems and procedures for financial reporting. We also are required to completely document and test those systems. Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in our annual reports. Section 404, as updated, also requires our independent registered public accounting firm to annually attest to, and report on, the effectiveness of our internal control over financial reporting.

Although our management has determined, and our independent registered public accounting firm has attested, that our internal control over financial reporting was effective as of December 31, 2007, we cannot assure you that we or our independent registered public accounting firm will not identify a material weakness in our internal controls in the future. If our internal control over financial reporting is not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price. Further, our Malaysia facility will become a significant subsidiary subject to Section 404 in 2008. Since 2008 is the first year that our Malaysia subsidiary will undertake a thorough examination of its internal control systems and procedures for financial reporting, there can be no assurance that we or our independent registered public accounting firm will not identify a material weakness in this entity s internal controls.

Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq rules, have required most public companies, including us, to devote additional internal and external resources to various governance and compliance matters. Because we have a relatively small corporate staff, we have incurred significant costs on outside professional advisers to assist us with these efforts. These costs have included increased accounting related fees associated with preparing the attestation report on our internal controls over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002. In addition, these new or changed laws, regulations and standards are subject to varying interpretations, as well as modifications by the government and Nasdaq. The way in which they are applied and implemented may change over time, which could result in even higher costs to address and implement revisions to compliance (including disclosure) and governance practices. We intend to invest the necessary resources to comply with evolving laws, regulations and standards. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed and we will be required to incur additional expenses.

We may make acquisitions that are dilutive to existing shareholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations.

We intend to grow our business through business combinations or other acquisitions of businesses, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. If we make any future acquisitions, we could issue stock that would dilute our shareholders percentage ownership, incur substantial debt, reduce our cash reserves or assume contingent liabilities. Furthermore, acquisitions may require material infrequent charges and could result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred compensation and identifiable purchased intangible assets or impairment of goodwill, any of which could negatively impact our results of operations.

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Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.

We continually evaluate and explore strategic opportunities as they arise, including business combinations, strategic partnerships, capital investments and the purchase, licensing or sale of assets. Our experience in acquiring other businesses, product lines and technologies is limited. The attention of our small management team may be diverted from our core business if we undertake any future acquisitions. Any potential future acquisition involves numerous risks, including, among others:

- Problems and delays in successfully assimilating and integrating the purchased operations, personnel, technologies, products and information systems;
- Unanticipated costs and expenditures associated with the acquisition, including any need to infuse significant capital into the acquired operations;
- Adverse effects on existing business relationships with suppliers, customers and strategic partners;
- Risks associated with entering markets and foreign countries in which we have no or limited prior experience;
- Contractual, intellectual property or employment issues;
- Potential loss of key employees of purchased organizations; and
- Potential litigation arising from the acquired company s operations before the acquisition.

These risks could disrupt our ongoing business, distract our management and employees, harm our reputation and increase our expenses. Our inability to overcome problems encountered in connection with any acquisitions could divert the attention of management, utilize scarce corporate resources and otherwise harm our business. These challenges are magnified as the size of an acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition. For example, in June 2004 we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of technology for networked storage applications. We were unable to successfully bring the Xiran Division products to market after funding its operations for over two years. In connection with the discontinued operation, we recorded a non-cash charge of approximately $3.0 million in the second quarter of 2004.

We are unable to predict whether or when any prospective acquisition candidate will become available or the likelihood that any acquisition will be completed. Even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

Three of our beneficial shareholders have substantial influence over our operations and could control all matters requiring shareholder approval.

Our founders, Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, are brothers and beneficially own approximately 50% of our outstanding common stock at September 30, 2008 (assuming the inclusion of shares of common stock subject to options that are presently exercisable or will become exercisable within 60 days of such date). In addition, Manouch Moshayedi and Mark Moshayedi are executive officers and directors. As a result, they potentially have the ability to control or influence all matters requiring approval by our shareholders, including the election and removal of directors, approval of significant corporate transactions and the decision of whether a change in control will occur. This potential control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

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We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. For each of the nine months ended September 30, 2008 and 2007, international sales, which are derived from billings to foreign customers, comprised 22% and 20%, respectively, of our revenues. For each of the nine months ended September 30, 2008 and 2007, more than 95.0% of our international sales were denominated in U.S. dollars. However, if there is a significant devaluation of the currency in a specific country, the prices of our products will increase relative to that country s currency and our products may be less competitive in that country. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

We purchase a majority of the DRAM and Flash components used in our products from local distributors of foreign suppliers. Although our purchases of DRAM and Flash components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of DRAM and Flash components.

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the United States or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

The manufacturing of our products is complex and subject to yield problems, which could decrease available supply and increase costs.

The manufacture of our Flash memory products, stacked DRAM products and Flash controllers is a complex process, and it is often difficult for companies to achieve acceptable product yields. Reduced yields could decrease available supply and increase costs. Flash controller yields depend on both our product design and the manufacturing process technology unique to our semiconductor foundry partners. Because low yields may result from either design defects or process difficulties, we may not identify yield problems until well into the production cycle, when an actual product defect exists and can be analyzed and tested. In addition, many of these yield problems are difficult to diagnose and time consuming or expensive to remedy.

Disruption of our operations in manufacturing facilities would substantially harm our business.

Our manufacturing operations are located in our facilities in Santa Ana, California and Penang, Malaysia. Due to this geographic concentration, a disruption of our manufacturing operations, resulting from sustained process abnormalities, human error, government intervention or natural disasters, including earthquakes, power failures, fires or floods, could cause us to cease or limit our manufacturing operations and consequently harm our business, financial condition and results of operations.

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Our Penang operation, which has recently begun to produce significant volumes, will continue to ramp production in subsequent quarters. While our management team is overseeing this transition, the operation itself has a limited operating history and we have limited experience operating in foreign countries. As a result, a disruption of our manufacturing operations resulting from ramp-up related challenges such as obtaining sufficient raw materials, hiring of qualified factory personnel, installation and efficient operation of new equipment, and management and coordination of a new logistics network within our global operations could cause us to cease, delay, or limit our manufacturing operations and consequently harm our business, financial condition and results of operations.

The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our growth. The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer, and Mark Moshayedi, our President, Chief Operating Officer, Chief Technical Officer and Secretary. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would prevent us from executing our growth strategy.

Failure to comply with governmental laws and regulations could harm our business.

Our business is subject to regulation by various federal and state governmental agencies. Such regulation includes employment and labor laws, workplace safety, product safety, environmental laws, consumer protection laws, import/export controls and tax. We are also subject to regulation in other countries where we conduct business. In certain jurisdictions, such regulatory requirements may be more stringent than in the United States. Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. These enforcement actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management s attention and resources and an increase in professional fees.

In addition from time to time we have received, and expect to continue to receive, correspondence from former employees terminated by us who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances the former employee has brought claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys fees and costs.

Anti-takeover provisions in our charter documents and stock option plan could prevent or delay a change in control and, as a result, negatively impact our shareholders.

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our articles of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

These provisions include:

- limitations on who may call special meetings of shareholders;
- advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;

elimination of cumulative voting in the election of directors;

the right of a majority of directors in office to fill vacancies on the board of directors;

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the ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.

Provisions of our 2000 Stock Incentive Plan allow for the automatic vesting of all outstanding equity awards granted under the 2000 Stock Incentive Plan upon a change in control under certain circumstances. Such provisions may have the effect of discouraging a third party from acquiring us, even if doing so would be beneficial to our shareholders.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities

The following is a summary of our stock repurchasing activity during the third quarter of 2008:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares as Part of Publicly Announced Program (1)	Maximum Dollar Value that May Yet be Purchased Under the Program
As of June 30, 2008	1,669,208	$ 7.79	2,005,055	$ 44,484,139
July 1 through July 31				$ 44,484,139
August 1 through August 31				$ 44,484,139
September 1 through September 30				$ 44,484,139
Total		$ 7.79	2,005,055	$ 44,484,139

(1) In July 2006, our board of directors authorized a share repurchase program enabling us to repurchase up to $10 million of our common stock over an 18-month period expiring on February 14, 2008. On May 22, 2007 we announced that our board of directors had authorized the expansion of the existing share repurchase program enabling us to repurchase up to $60 million of our common stock over an 18-month period expiring on November 18, 2008. Repurchases under our share repurchase program were and will be made in open market or privately negotiated transactions in compliance with Rule 10b-18 promulgated under the Securities Exchange Act of 1934, as amended. There is no guarantee as to the exact number of shares that will be repurchased by us, and we may discontinue purchases at any time that management determines that additional purchases are not warranted. Repurchased shares were returned to the status of authorized but unissued shares of common stock and may be reissued by us in the future. All shares were purchased pursuant to our existing share repurchase program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

Exhibit Number	Description
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless STEC, Inc. specifically incorporates the foregoing information into those documents by reference.

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SIGNATURES

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

	STEC, INC.,
	a California corporation
Date: November 10, 2008	/s/ DAN MOSES Dan Moses
	Executive Vice President and Chief Financial Officer
	(Principal Financial Officer and Duly Authorized Signatory)

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STEC, INC.

Index to Exhibits

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