

PRECISION OPTICS CORPORATION INC
Form DEF 14A
October 28, 2004

SCHEDULE 14A INFORMATION

**Proxy Statement Pursuant to Section 14 of
the Securities Exchange Act of 1934**

Filed by the Registrant

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 Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to §240.14a-12

Precision Optics Corporation, Inc.
(Name of Registrant as Specified In Its Charter)

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

Payment of Filing Fee (Check the appropriate box):

- 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: |
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| (2) | |

Aggregate number of securities to which transaction applies:

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(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

PRECISION OPTICS CORPORATION, INC.
22 East Broadway
Gardner, Massachusetts 01440

To the Stockholders:

The Board of Directors and Officers of Precision Optics Corporation, Inc. invite you to attend the 2004 Annual Meeting of Stockholders to be held Monday, November 29, 2004, at 10:00 a.m. at the offices of Ropes & Gray LLP, One International Place, Boston, Massachusetts.

A copy of the Proxy Statement and the Company's 2004 Annual Report to Stockholders are enclosed.

If you cannot be present at the meeting, please mark, date, and sign the enclosed proxy card and return it as soon as possible in the enclosed envelope.

Very truly yours,

/s/ Richard E. Forkey

RICHARD E. FORKEY
President

PRECISION OPTICS CORPORATION, INC.
22 East Broadway
Gardner, Massachusetts 01440

NOTICE OF 2004 ANNUAL MEETING OF STOCKHOLDERS

November 29, 2004

The 2004 Annual Meeting of Stockholders of Precision Optics Corporation, Inc. (the Company) will be held on Monday, November 29, 2004, at 10:00 a.m. at the offices of Ropes & Gray LLP, Boston, Massachusetts, for the following purposes:

1. To elect one Class II director to hold office for a three-year term and until his respective successor shall have been duly elected and qualified.
2. To consider and act on a proposal to approve an Amended and Restated 1997 Incentive Plan of the Company.
3. To transact any and all other business that may properly come before the meeting or any adjournment thereof.

All stockholders of record at the close of business on Thursday, September 30, 2004, are entitled to notice of and to vote at the meeting.

Stockholders are requested to sign and date the enclosed proxy and return it in the enclosed envelope. The envelope requires no postage if mailed in the United States.

By Order of the Board of Directors

/s/ Jack P. Dreimiller

Jack P. Dreimiller
Clerk

November 1, 2004

PRECISION OPTICS CORPORATION, INC.

**Annual Meeting of Stockholders
November 29, 2004
PROXY STATEMENT**

INFORMATION CONCERNING SOLICITATION AND VOTING

General

This Proxy Statement and form of proxy are furnished in connection with the solicitation of proxies by the Board of Directors of Precision Optics Corporation, Inc., a Massachusetts corporation (the Company), for the 2004 Annual Meeting of Stockholders of the Company to be held on November 29, 2004, at 10:00 a.m. at the offices of Ropes & Gray LLP, One International Place, Boston, Massachusetts, and any adjournments thereof, for the purposes set forth in the notice of meeting. The Company was incorporated in 1982, and its principal executive offices are at 22 East Broadway, Gardner, Massachusetts 01440 (telephone 978-630-1800). This Proxy Statement and form of proxy are first being distributed to stockholders on or about November 1, 2004.

Stockholders Entitled to Vote

As of September 30, 2004, the Company had outstanding 7,008,212 shares of Common Stock, \$0.01 par value per share (the Common Stock). Each share of Common Stock entitles the holder of record thereof at the close of business on September 30, 2004 to one vote, in person or by proxy, on the matters to be voted upon at the meeting.

Voting Procedures

Consistent with Massachusetts law and the Company's by-laws, the holders of a majority of the shares entitled to be cast on a particular matter, present in person or represented by proxy, constitutes a quorum as to such matter. Votes cast by proxy or in person at the annual meeting will be counted by persons appointed by the Company to act as election inspectors for the meeting.

If the enclosed form of proxy is properly signed and returned and not revoked, the shares represented thereby will be voted at the annual meeting. If the stockholder specifies in the proxy how the shares are to be voted, they will be voted as specified. If the stockholder does not specify how the shares are to be voted, such shares will be voted in favor of the proposals described in Proposal Number 1 and Proposal Number 2 below.

Any stockholder has the right to revoke his or her proxy at any time before it is voted by: (1) attending the meeting and voting in person, (2) by filing with the Clerk of the Company a written instrument revoking the proxy or (3) delivering to the Clerk another newly executed proxy bearing a later date.

Required Vote

The election of the Class II director described in Proposal Number 1 requires a plurality of votes cast. Should the person so named below as nominee for the Board of Directors be unable or unwilling to serve as director, the persons named in the form of proxy for the annual meeting may, in their discretion, vote for such other person or may vote to fix the number of directors at such number less than four, as the Board of Directors may recommend.

The approval of the Amended and Restated 1997 Incentive Plan of the Company described in Proposal Number 2 requires the affirmative vote of a majority of the shares represented and entitled to vote at the meeting.

Abstentions and broker non-votes are counted as present and entitled to vote for purposes of determining a quorum, but will not be counted as votes properly cast for purposes of determining the outcome of voting on any matter. A broker non-vote occurs when a nominee holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power for the particular item and has not received instructions from the beneficial owner. Under the rules of the New York Stock Exchange applicable to member firms, brokers (i) will have discretionary authority to vote shares held in their name for the election of directors even if they do not receive instructions from the beneficial owners, and (ii) will not have discretionary authority to vote shares held in their name for the approval of the Amended and Restated 1997 Incentive Plan.

Voting on Other Matters

At the date hereof, the Company's management has no knowledge of any business other than that described in the notice for the annual meeting which will be presented for consideration at such meeting. If any other business should come before such meeting, the persons appointed by the enclosed form of proxy may, in their discretion, vote all such proxies in accordance with their own judgment. The persons appointed by the enclosed form of proxy also may, in their discretion, vote all proxies with respect to matters incident to the conduct of the meeting.

Costs of Proxy Solicitation

The Company will bear all the costs of the solicitation of proxies. The Board of Directors may arrange with brokerage houses and other custodians, nominees, and fiduciaries to forward solicitation materials to the beneficial owners of the stock held of record by such persons, and the Company may reimburse them for the reasonable out-of-pocket expenses incurred in so doing. In addition to the solicitation of proxies by use of the mails, the Company may use the services of some of its directors, officers, and regular employees (who will receive no compensation therefrom in addition to their regular salaries) to solicit proxies personally or by mail or telephone.

PROPOSAL NUMBER 1. ELECTION OF DIRECTORS

The Company's Board of Directors is divided into three classes that are as nearly equal in number as possible, with staggered terms of office. Only one class is elected each year. Each director serves a three year term and until his or her successor has been duly elected and qualified. The Board of Directors has fixed the number of directors at four. At the annual meeting it is intended that the Company's Class II director (Joel R. Pitlor) be re-elected as a Class II director to hold office until the annual meeting of stockholders in 2007 and until his respective successor has been duly elected and qualified. The directors in Class I (Richard E. Forkey and Edward A. Benjamin) will hold office until the annual meeting of stockholders in 2006, and the director in Class III (Robert R. Shannon) will hold office until the annual meeting of stockholders in 2005 (and in each case, until their respective successors have been duly elected and qualified).

The names, ages, principal occupations for at least the last five years, and certain other information regarding the directors, including the nominee, are as follows:

Name and Year First Elected Director	Age	Principal Occupation; Directorships of Other Public Companies
Richard E. Forkey (1982)*	64	President, Chief Executive Officer, Treasurer and a director of the Company since founding the Company in 1982; Clerk of the Company from May 1983 to June 1990.
Edward A Benjamin (1990)*	66	Clerk of the Company from June 1990 to January 1998. Mr. Benjamin is a Trustee of the Board of Trustees of CDC Nvest Funds, AEW Real Estate Income Fund, and Loomis Sayles Funds and a Director of Coal, Energy Investments & Management, LLC. Mr. Benjamin was a partner in the law firm of Ropes & Gray LLP, Boston, Massachusetts, from 1969 to 1998.
Joel R. Pitlor (1990)	65	Since 1979, Mr. Pitlor has been President of J.R. Pitlor, a management consulting firm that provides strategic business planning, which Mr. Pitlor founded. Mr. Pitlor has provided business planning consultation to the Company since 1983. Mr. Pitlor is also a director of Uroplasty, Inc.
Robert R. Shannon (1990)*	72	Since 1969, Mr. Shannon has been a Professor at the Optical Sciences Center of the University of Arizona and Director of the Center from 1983 to July 1992. Mr. Shannon is also a Director of Aerospace Corporation.

* Directors whose terms do not expire this year.

All of the stockholders holding shares of the Company's Common Stock are entitled to cast one vote in person or by proxy for each share standing in their names and are entitled to elect one Class II director at the 2004 Annual Meeting. If a nominee is not available as a candidate when the election occurs, the persons named in the proxy may, in their discretion, vote for the election of such other person as the Board of Directors may designate or to reduce the number of directors correspondingly. The Company has no reason to believe that the nominee will not be available for election.

Board of Directors

During the fiscal year ended June 30, 2004, the Company's Board of Directors held four meetings and acted by unanimous written consent on two occasions. Each director attended at least 75% of the meetings of the Board of Directors.

While the Company has no formal policy in place regarding board members' attendance at annual meetings of stockholders, the Company encourages their attendance at such annual meetings. There were two members of the Board in attendance at the Company's 2003 Annual Meeting of Stockholders.

Information as to ownership of the Company's securities by the nominee for director is included under the heading Security Ownership of Certain Beneficial Owners and Management.

While the Board does not have standing nominating or compensation committees, it does have a standing Audit Committee.

Audit Committee

The Audit Committee of the Board of Directors is composed of Messrs. Benjamin and Shannon. The function of the Audit Committee is to provide assistance to the board of Directors in fulfilling its responsibility to the stockholders, potential stockholders and the investment community in respect of corporate accounting, reporting practices of the Company, and the quality and integrity of the financial reports of the Company. The Audit Committee held five meetings during the fiscal year ended June 30, 2004 and acted by unanimous written consent on one occasion. Each of the Audit Committee members attended 100% of the meetings of the Audit Committee in the last year.

The Board of Directors has not made a determination as to whether any members of its Audit Committee qualify as an audit committee financial expert meeting the criteria set forth in Item 401(e) of Regulation S-B.

Director Nomination Procedures

The Company believes that it is appropriate not to have a standing nominating committee because of the small size of the Board of Directors. The Board of Directors as a whole identifies and evaluates nominees for election to the Board of Directors. By having the Board of Directors as a whole consider and evaluate nominees, the Board of Directors weighs the input of all directors. Of the members of the Board of Directors, Messrs. Benjamin, Pitlor and Shannon would be considered independent according to Nasdaq's listing standards governing nominating committees.

The process by which the Board of Directors considers nominees for membership on the Board of Directors is flexible and based, generally, on the directors' assessment of the needs of the Company and the extent to which existing directors meet those needs. Factors considered by the Board of Directors in evaluating the suitability of a potential nominee may include, but not be limited to: business and management experience, familiarity with the Company's industry and products, the ability to integrate with existing directors and management and the extent to which a potential nominee may satisfy applicable requirements such as independence or expertise requirements under the securities laws and Nasdaq Marketplace Rules.

The Board of Directors will consider director nominees recommended by stockholders. Such recommendations should include the name, age, address, telephone number, principal occupation, background and qualifications of the nominee and the name, address, and telephone number of and number of shares of Common Stock beneficially owned by the stockholder making the recommendation and should be sent to the Clerk of the Company at 22 East Broadway, Gardner, Massachusetts 01440. Such recommendations should be submitted to the Clerk of the Company prior to June 15 of the respective year in order to give the Company adequate time in order to consider the recommendations.

Director Compensation

The Company pays each director who is not also an employee of the Company \$250 per Board or Committee meeting that the director attends and reimburses the director for travel expenses.

During the fiscal year ended June 30, 2004, the Company also issued, pursuant to its Amended and Restated 1997 Incentive Plan, stock options exercisable for a total of 834 shares of the Company's Common Stock to each of Messrs. Benjamin, Pitlor, and Shannon. Each of these options is immediately exercisable at a price per share of \$1.95.

THE BOARD OF DIRECTORS RECOMMENDS THE ELECTION OF THE NOMINEE DESCRIBED IN PROPOSAL NUMBER 1.

PROPOSAL NUMBER 2. APPROVAL OF AMENDED AND RESTATED 1997 INCENTIVE PLAN

The Board of Directors has approved and proposes that stockholders approve certain amendments to the Precision Optics Corporation, Inc. Amended and Restated 1997 Incentive Plan (the "1997 Incentive Plan"). The primary purpose of further amending the 1997 Incentive Plan is to increase the total number of shares of Common Stock that may be issued under the 1997 Incentive Plan from 300,000 to 1,500,000. The proposed Amended and Restated 1997 Incentive Plan also changes the limit on the maximum number of shares that may be granted to any person from (a) 100,000 shares over the life of the Plan, to (b) 600,000 shares per year. The Board of Directors believes that approval of the 1997 Incentive Plan, as proposed to be amended, will advance the interests of the Company by continuing to provide eligible participants the opportunity to receive a broad variety of equity-based and cash incentives ("Awards"). As of November 1, 2004, 183,153 shares of Common Stock remained available for future Awards under the 1997 Incentive Plan.

Participation in Plan.

The grant of Awards under the Amended and Restated 1997 Incentive Plan to eligible participants is subject to the discretion of the plan administrator, which is currently the Board of Directors. The table below sets forth, as of the date of this proxy statement, the expectation of the Board with respect to the allocation of future awards under the 1997 Incentive Plan, including the grant to each non-employee director on the date of the 2004 Annual Meeting of stockholders of a stock option exercisable for 5,000 shares of Common Stock. Because the exercise price of each Award is determined at the time of grant, the dollar values of the potential Awards listed below are not determinable at this time. The following table sets forth information with respect to the potential allocation of options to purchase Common Stock to the executive officers named in the Summary Compensation Table, to all current executive officers as a group, to all non-executive directors as a group, and to all other employees as a group:

**Amended Plan Benefits
1997 Incentive Plan**

Name and Position	Number of Units	Dollar Value
Richard E. Forkey, President, Chief Executive Officer, and Treasurer	373,600(1)	n/a(2)
Jack P. Dreimiller, Senior Vice President, Finance, Chief Financial Officer and Clerk	0	n/a(2)
All current executive officers as a group	373,600(1)	n/a(2)
All non-executive directors as a group	15,000(3)	n/a(2)
All non-executive officer employees as a group	994,553(4)	n/a(2)

(1) Represents a future grant to Richard Forkey of options to purchase shares of Common Stock. The Board of Directors expects that up to approximately 30% of such options would vest immediately upon grant and that the remainder of such options would vest in increments based on the attainment by the Company of certain financial targets established by the independent members of the Board.

(2) The dollar value of such Award or Awards is not determinable at this time.

(3) Represents grants of Awards expected in connection with the 2004 Annual Meeting of Stockholders. Each non-employee director of the Company receives an option to purchase shares of Common Stock on the date of each annual meeting of stockholders.

(4) Includes a future grant to Joseph Forkey of options to purchase 560,400 shares of Common Stock. The Board of Directors expects that up to approximately 30% of the options to be granted to Joseph Forkey would vest immediately upon grant and that the remainder of such options would vest in increments based on the attainment by the Company of certain financial targets established by the independent members of the Board. The Board of Directors expects that options granted to other employees would vest automatically in equal annual installments over four years.

Summary of the 1997 Incentive Plan.

The following summary is a description of the 1997 Incentive Plan, as proposed to be amended, and is qualified in its entirety by reference to the full text of the 1997 Incentive Plan attached to this proxy statement as *Appendix A*. Terms used but not otherwise defined herein shall have the meanings ascribed to such terms in the 1997 Incentive Plan.

Administration. Subject to the terms of the 1997 Incentive Plan, the Administrator has authority to interpret the 1997 Incentive Plan; determine eligibility for and grant Awards; determine, modify or waive the terms and conditions of any Award; and otherwise do all things necessary to carry out the purposes of the 1997 Incentive Plan. In the case of any Award intended to be eligible for the performance-based compensation exception under Section 162(m), the Administrator shall exercise its discretion consistent with qualifying the Award for such exception.

Eligibility and Participation. In general, the Administrator will select participants in the 1997 Incentive Plan from among key employees of the Company and its affiliates who, in the opinion of the Administrator, are in a position to make a significant contribution to the success of the Company or its affiliates. The Administrator also has discretion to include as participants in the 1997 Incentive Plan members of the Company's Board of Directors and other persons who provide services to the Company or its affiliates. As of September 30, 2004, approximately 40 persons were eligible to receive Awards under the 1997 Incentive Plan, including the Company's two executive officers and three non-employee directors. The maximum number of shares for which stock options may be granted to any person, the maximum number of shares subject to stock appreciation rights granted to any person, and the aggregate maximum number of shares of Stock which may be delivered to any person pursuant to Awards that are not stock options or stock appreciation rights are each limited to 600,000 shares per year under the 1997 Incentive Plan. In addition, no more than \$2 million may be paid to any individual with respect to any annual cash performance-based bonuses and no more than \$2 million in cash performance-based bonuses may be paid to any individual with respect to multi-year performance periods ending in the same year. No Award constituting an incentive stock option within the meaning of Section 422 of the Internal Revenue Code (an "ISO") may be granted under the 1997 Incentive Plan after September 15, 2007, but ISO Awards previously granted may extend beyond such date.

Types of Awards. The Administrator, in its discretion, may award (i) options to purchase Common Stock, (ii) stock appreciation rights, (iii) restricted or unrestricted Stock, (iv) promises to deliver Common Stock or other securities in the future, (v) convertible securities, (vi) cash bonuses, and (vii) cash bonuses or loans to help defray the costs of the foregoing Awards.

Performance Criteria. Awards under the 1997 Incentive Plan may be conditioned upon satisfaction of specified performance criteria. In the case of any such Award that is intended to qualify for exemption from the deduction limitation rules of Section 162(m) of the Internal Revenue Code (an "Exempt Award"), the criteria used in connection with the Award shall be one or any combination of the following (determined either on a consolidated basis or, as the context permits, on a divisional, subsidiary, line of business or geographical basis or in combinations thereof): (i) sales; revenues; assets; expenses; earnings before or after deduction for all or any portion of interest, taxes, depreciation or amortization, whether or not on a continuing operations or an aggregate or per share basis; return on equity, investment, capital or assets; gross margin; inventory level or turns; one or more operating ratios; borrowing levels, leverage ratios or credit rating; market share; capital expenditures; cash flow; stock price; stockholder return; or other objective operating contributions; or (ii) acquisitions or divestitures (in whole or in part); joint ventures and strategic alliances; spin-offs, split-ups and the like; reorganizations; recapitalizations, restructurings, financings (issuance of debt or equity) and refinancings; or other transactions that involve a change in the equity ownership of the Company. A Performance Criterion measure and any targets with respect thereto determined by the Administrator need not be based upon an increase, a positive or improved result or avoidance of loss. In the case of an Exempt Award, the administrator will preestablish the particular performance goals in writing no later than 90 days after the commencement of the period of service to which the performance relates (or earlier if so required under applicable regulations) and will certify prior to payment whether the performance goal or goals have been attained. If the performance goal with respect to an Exempt Award is not attained, no other Award shall be provided in substitution. To date, the Company has not granted any Exempt Awards.

Rules Applicable to Awards. Neither ISOs nor, except as the Administrator otherwise expressly provides, other Awards may be transferred other than by will or by the laws of descent and distribution, and during a Participant's lifetime ISOs (and, except as the Administrator otherwise expressly provides, other non-transferable Awards requiring exercise) may be exercised only by the Participant. The Administrator may determine the time or times at which an Award will vest or become exercisable. Without limiting the foregoing, the Administrator may at any time accelerate the vesting or exercisability of an Award, regardless of any adverse or potentially adverse tax consequences resulting from such acceleration. Unless the Administrator expressly provides otherwise, immediately upon the cessation of the Participant's Employment, an Award requiring exercise will cease to be exercisable and will terminate, and all other Awards to the extent not already vested will be forfeited with certain exceptions, which are enumerated in the 1997 Incentive Plan.

Stock Options. The Administrator will determine the exercise price, if any, of each Award requiring exercise. Unless the Administrator determines otherwise, each stock option will have an exercise price not less than the fair market value of the Stock subject to the stock option, determined as of the date of grant. A stock option intended to be an ISO granted to a person who owns (or by application of attribution rules is deemed to own) more than 10% of the total combined voting power of all classes of stock of the Company will have an exercise price equal to 110% of such fair market value. Options awarded under the 1997 Incentive Plan will not be ISOs except as expressly provided otherwise.

Effect of Certain Transactions. In the event of a consolidation or merger in which the Company is not the surviving corporation or which results in the acquisition of a majority of the Company's outstanding Stock by a single person or entity or by a group of persons and/or entities acting in concert, or in the event of the sale or transfer of all or substantially all of the Company's assets or a dissolution or liquidation of the Company, all outstanding Awards requiring exercise will cease to be exercisable, and all other Awards to the extent not fully vested (including Awards subject to performance conditions not yet satisfied or determined) will be forfeited, as of the effective time of such transaction; provided, however, that immediately prior to the consummation of such a transaction, the vesting or exercisability of Awards shall be accelerated unless, in the case of any Award, the Administrator provides for one or more substitute or replacement awards from, or the assumption of existing Awards by, the acquiring entity (if any) or its affiliates.

Equitable Adjustment. In the event of a stock dividend, stock split or combination of shares, recapitalization or other change in the Company's capital structure, the Administrator will make appropriate adjustments to the maximum number of shares that may be delivered under the 1997 Incentive Plan, to the maximum share limits under the 1997 Incentive Plan, to the number and kind of shares of stock or securities subject to Awards then outstanding or subsequently granted, to any exercise prices relating to Awards, and to any other provision of Awards affected by such change. In connection with the one-for-six reverse split of the Company's Common Stock that was consummated on January 29, 2003, the Administrator made such adjustments accordingly. The Administrator also may make such adjustments to take into account other distributions or events, if the Administrator determines that adjustments are appropriate to avoid distortion in the operation of the 1997 Incentive Plan and to preserve the value of Awards; provided, however, that no such adjustment shall be made to the maximum share limits, or otherwise to an Award intended to be eligible for the performance-based exception under Section 162(m), except to the extent consistent with that exception.

Amendment. Subject to the Administrator's obligation to exercise its discretion consistent with qualifying Awards for the performance-based exception under Section 162(m) if such Awards are intended to so qualify, the Administrator may at any time or times amend the 1997 Incentive Plan or any outstanding Award for any purpose which may at the time be permitted by law, or may at any time terminate the 1997 Incentive Plan as to any further grants of Awards, provided that, except to the extent expressly required or permitted by the 1997 Incentive Plan, no such amendment will, without the approval of the stockholders of the Company, effectuate a change for which stockholder approval is required in order for the 1997 Incentive Plan to continue to qualify under Section 422 of the Internal Revenue Code or for Awards to be eligible for the performance-based exception under Section 162(m).

Other Compensation. The existence of the 1997 Incentive Plan and the grant of Awards will not affect the Company's right to pay other bonuses or compensation in addition to Awards under the 1997 Incentive Plan.

Price of Common Stock. The closing price of the Company's Common Stock on the NASDAQ SmallCap Market on October 26, 2004 was \$0.78.

Certain Federal Income Tax Consequences.

The following discussion summarizes certain federal income tax consequences of the issuance and exercise of stock options awarded under the 1997 Incentive Plan and is based on the law as in effect on September 30, 2004. The summary does not address all federal tax consequences, nor does it cover state, local or non-U.S. tax consequences.

In general, a participant realizes no taxable income on either the grant or the vesting of a stock option. The exercise of an option that does not qualify as an ISO results in ordinary income (generally subject to withholding if the option was awarded to an Employee) equal to the difference (the "Option Spread") between the value of the stock purchased and the option exercise price. A corresponding deduction is available to the Company. In general, the ordinary income associated with the exercise is measured and taken into account at the time of exercise. Any subsequent sale of stock purchased under a nonstatutory option may result in a capital gain or loss.

The exercise of an ISO does not produce ordinary taxable income. However, because the Option Spread constitutes "alternative minimum taxable income" (measured and taken into account, in general, at the time of exercise), exercise of an ISO may result in an alternative minimum tax liability. In addition, shares purchased under an ISO ("ISO Shares") are subject to special tax holding rules. If a participant holds on to ISO Shares for at least two years from the date of the ISO grant and at least one year after exercise, any gain or loss recognized for tax purposes upon a subsequent sale of the shares will be a long-term capital gain or loss. However, a disposition of ISO Shares by the participant within either of these special holding periods (a so-called "disqualifying disposition") results in ordinary compensation income in the year of the disposition equal, in general, to the Option Spread at the time the option was exercised. The ordinary income realized upon a disqualifying disposition of ISO Shares is deductible to the Company but is not subject to withholding. Any additional gain recognized for tax purposes in a disqualifying disposition will be taxed as short-term or long-term capital gain.

- (3) The Company's Inducement Equity Incentive Plan (the Inducement Plan), which was in effect as of December 31, 2005, and was the only equity compensation plan not approved by security holders, was adopted by the Board in 2005 in connection with an acquisition. A total of 87,500 restricted shares of Company stock were initially reserved for issuance under the Inducement Plan. In December 2005, the Company issued 63,750 shares under the Inducement Plan, subject to vesting. In January 2006, the Company issued the remaining 23,750 shares, also subject to vesting. In accordance

with applicable rules, no stockholder
approval was required for the
Inducement Plan.

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COMPENSATION OF DIRECTORS

In 2005, non-employee directors received cash compensation of \$2,500 for each regular board meeting they attended in person, which compensation decreased to \$1,000 if the meeting was attended telephonically. In addition, each non-employee director received an annual option to purchase 10,000 shares of the Company's Common Stock, which vested quarterly over a three-year period, and a second option to purchase an additional 10,000 shares of the Company's Common Stock, which becomes 100% exercisable if and only if the non-employee director continued to hold the shares underlying the first option for the full three-year vesting period. This structure is designed to further align the directors' interests with the interests of the Company's stockholders and to provide incentives for the directors to make a long-term investment in and retain their equity holdings in the Company.

In addition to the aforementioned option grants, which were made to all non-employee directors, in 2005, the chairmen of the Compensation and Finance Committees and the Board's Lead Director, received additional option grants of 5,000 shares; the chairman of the Audit Committee received an additional option to purchase 12,500 shares; and each member of the Audit Committee (other than the chairman) received an annual option to purchase another 5,000 shares of Common Stock. All of these options vest quarterly over a three-year period beginning on the date of grant. No options were granted in 2005 to the members of the Nominating and Corporate Governance Committee for services on that committee.

In February 2006, the Board of Directors of the Company approved modifications to the compensation program for the Company's non-employee directors. Under the program, non-employee directors will continue to receive cash compensation in the amount of \$2,500 for each regular meeting of the Board they attend in person, which compensation decreases to \$1,000 if the meeting is attended telephonically. In addition, each non-employee director will now receive an annual retainer in the amount of \$15,000, payable quarterly. Further, each non-employee director will receive an annual restricted stock grant of 5,000 shares of the Company's Common Stock, which will vest annually, one-third per year, over a three-year period. This structure is designed to further align the directors' interests with the interests of the Company's stockholders and to provide the directors with an incentive to maximize long-term stockholder value.

In addition to the aforementioned restricted stock grants, which will be made to all non-employee directors, the chairmen of the Compensation, Nominating and Corporate Governance and Finance Committees will each receive an additional annual restricted stock grant of 1,000 shares; the chairman of the Audit Committee will receive an additional annual restricted stock grant of 2,000 shares; and members of the Audit Committee (other than the chairman) and the Board's Lead Director will each receive an annual restricted stock grant of 500 shares. All of these restricted stock grants will vest annually, one-third per year, over a three year period. The Board of Directors will annually evaluate and consider whether to maintain or modify the compensation program for the non-employee directors.

Table of Contents**COMPENSATION OF EXECUTIVE OFFICERS****Summary of Compensation**

The following table shows for the fiscal years ended December 31, 2005, 2004 and 2003, compensation awarded or paid to, or earned by, the Company's Chief Executive Officer and its other most highly compensated executive officers at December 31, 2005, who received compensation in excess of \$100,000 in fiscal year 2005 (the Named Executive Officers). At December 31, 2005, the Company had only one such other executive officer.

Summary Compensation Table

Name and Principal Position	Year	Annual Compensation			Long Term Compensation Awards	All Other Compensation
		Salary (\$)	Bonus (\$)	Other Annual Compensation (\$)	Securities Underlying Options (#)	
Joel A. Ronning Chief Executive Officer	2005	\$ 250,000	\$ 1,000,000(2)			\$ 18,150(5)
	2004	250,000	1,000,000(3)		200,000	6,500
	2003	250,000	600,000(4)		200,000	5,300
Thomas M. Donnelly(6) Chief Financial Officer	2005	\$ 193,558	\$ 100,000(2)		125,000	\$ 7,000
	2004					
	2003					
Carter D. Hicks(7) Former Chief Financial Officer	2005	\$ 147,808				\$ 7,000
	2003	250,000			50,000	6,500
	2002	241,730			50,000	5,300

(1) Represents amounts attributable to each of Messrs. Ronning, Donnelly and Hicks for 401(k) matching contributions by the Company.

(2) Paid in March 2006 for performance in 2005.

(3) Paid in March 2005 for performance in 2004.

(4) Paid in March 2004 for performance in 2003.

(5) Includes \$11,150 in life insurance premiums paid by the Company for Mr. Ronning.

(6) Represents partial year salary. Mr. Donnelly joined us as Vice President Finance in February 2005 and was elected to the position of Chief Financial Officer in July 2005. His annual salary is \$250,000.

(7) Mr. Hicks retired as Chief Financial Officer in July 2005 and remained with the Company as a non-executive employee through the remainder of 2005.

Stock Option Grants and Exercises

The Company grants options to its executive officers under its 1998 Plan. At last year's annual meeting, stockholders of the Company approved an amendment and restatement of the Company's 1998 Stock Option Plan that combined the 1998 Stock Option Plan with the Company's 1999 Stock Option Plan and gave the Company the flexibility to grant restricted stock awards, restricted stock unit awards and performance shares, in addition to incentive and nonstatutory stock options, to the directors, employees and consultants of the Company and its subsidiaries under the combined plan. As part of the amendment and restatement of the 1998 Stock Option Plan approved by the stockholders, the 1999 Stock Option Plan was suspended so that no new stock options would be granted thereunder and the shares of Common Stock that were available for issuance under the 1999 Stock Option Plan are now available for issuance under the 1998 Plan and any shares of Common Stock underlying stock options outstanding under the 1999 Stock Option Plan that terminate unexercised will be available for issuance under the 1998 Plan.

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As of April 1, 2006, options to purchase a total of 4,400,003 shares were outstanding under the 1998 Plan and options to purchase 1,611,016 shares remained available for grant thereunder.

The following tables show for the fiscal year ended December 31, 2005, certain information regarding options granted to, exercised by, and held at year end by, the Named Executive Officers:

Option Grants in Last Fiscal Year

Name	Individual Grants				Potential Realizable	
	Number of Securities Underlying Options Granted (#)	% of Total Options Granted to Employees in Fiscal Year(2)	Exercise or Base Price (\$/Sh)(3)	Expiration Date	Value at Assumed Annual Rates of Stock Price Appreciation for Option Term(4)	
					5% (\$)	10% (\$)
Joel A. Ronning						
Thomas M. Donnelly(1)	50,000	5.90%	\$ 30.69	02/10/2015	\$ 965,000	\$ 2,446,000
	50,000	5.90%	\$ 25.23	05/10/2015	\$ 793,000	\$ 2,011,000
	25,000	2.95%	\$ 28.75	06/15/2015	\$ 452,000	\$ 1,146,000
Carter D. Hicks(5)						

- (1) Stock options vest over four years with respect to 25% on the first year anniversary and 6.25% each three months thereafter and expire ten years from the date of grant, or earlier upon termination of employment.
- (2) Based on options to purchase 846,678 shares of the Company's Common Stock granted in the fiscal year ended December 31, 2005.
- (3) All options were granted at the fair market value of the Company's Common Stock on the date of grant.
- (4) The potential realizable value is calculated based on the term of the option at its time of grant. It is calculated by assuming that the stock price on the date of grant appreciates at the indicated annual rate, compounded annually for the entire term of the option and that the option is exercised and sold on the last day of its term for the appreciated stock price. No gain to the option holder is possible unless the stock price increases over the option term. The 5% and 10% assumed rates of appreciation are derived from the rules of the SEC and do not represent the Company's estimate or projection of the future Common Stock price.
- (5) Mr. Hicks retired as Chief Financial Officer in July 2005 and remained with the Company as a non-executive employee through the remainder of 2005.

Aggregated Option Exercises in Last Fiscal Year, and Fiscal Year-end Option Values

Number of Securities Underlying Unexercised Options at	Value of Unexercised In-the-Money Options at
--	--

Name	Shares Acquired on Exercise (#)	Value Realized \$(1)	December 31, 2005		December 31, 2005(2)	
			Exercisable (#)	Unexercisable (#)	Exercisable (\$)	Unexercisable (\$)
Joel A. Ronning	445,000	\$ 14,910,000	1,154,582	187,500	\$ 24,623,000	\$ 2,161,000
Thomas M. Donnelly			0	125,000	\$ 0	\$ 250,000
Carter D. Hicks(3)	78,338	\$ 2,004,000	8,333	51,459	\$ 76,000	\$ 867,000

- (1) The value realized is based on the fair market value of the Company's Common Stock on the date of exercise minus the exercise price.
- (2) The valuations are based on the fair market value of the Company's Common Stock on December 31, 2005, of \$29.74 minus the exercise price of the options.
- (3) Mr. Hicks retired as Chief Financial Officer in July 2005 and remained with the Company as a non-executive employee through the remainder of 2005.

Table of Contents**Employment Agreements*****Employment Agreement with Joel A. Ronning***

Effective August 8, 2005, the Company entered into an employment agreement with Joel A. Ronning, the Company's Chief Executive Officer, which superseded the prior employment agreement between the parties. The term of the employment agreement is for a period of two years (the Expiration Date) with automatic one-year renewals if not terminated prior to the Expiration Date (as extended in connection with any renewed term). Mr. Ronning's compensation pursuant to the employment agreement consists of a base salary of \$250,000. In 2005, Mr. Ronning's compensation also included a cash bonus of \$1,000,000 based on his and the Company's performance, which was paid in early 2006. In addition, in February 2006 Mr. Ronning was granted stock options to purchase an aggregate of 200,000 shares of the Company's Common Stock as part of his compensation. Future annual bonuses will be determined at the discretion of the Compensation Committee and approved by the Board. The Company may grant stock options, restricted stock, stock appreciation rights, or other incentive equity (Incentive Equity) to Mr. Ronning in the future at the discretion of the Board or a committee of the Board. In the event of Mr. Ronning's termination under certain circumstances, including upon a change in control of the Company, he will be entitled to termination payments equal to his base salary at the time of termination plus a weighted three year average of his annual bonus amount, as well as a continuation of certain employee benefits for a period of 12 months. In the event of a change of control, any unvested Incentive Equity held by Mr. Ronning will immediately vest and become exercisable. The acceleration of Incentive Equity in the event of an acquisition or similar corporate event may be viewed as an anti-takeover provision, which may have the effect of discouraging a proposal to acquire or otherwise obtain control of the Company. In the event of a change of control, such payments and benefits may be reduced if any payment or benefit would be subject to the excise tax imposed by Section 4999 of the Internal Revenue Code. Mr. Ronning also has agreed not to compete with the Company in countries or territories where the Company conducts business for a period of 12 months following termination under certain circumstances.

Employment Offer Letter with Thomas M. Donnelly

Effective July 1, 2005, the Company entered into an employment offer letter with Thomas M. Donnelly, the Company's Chief Financial Officer. Pursuant to this letter, Mr. Donnelly's annual base compensation will be \$250,000. Mr. Donnelly is eligible to participate in the Company's employee benefits and equity incentive plans and had previously been granted options to purchase 125,000 shares of Common Stock.

Employment Agreement with Carter D. Hicks

Effective July 1, 2005, the Company entered into an employment agreement with Carter D. Hicks, in connection with his retirement from the position of the Company's Chief Financial Officer. Under the terms of the agreement, Mr. Hicks will continue as a non-executive employee of the Company until June 30, 2006 unless Mr. Hicks accepts other employment. From July 1, 2005 until June 30, 2006 (unless earlier terminated), Mr. Hicks will receive a monthly salary of \$3,000 and his stock options will continue to vest as scheduled. In connection with this employment agreement, Mr. Hicks also entered into a release, a non-solicitation and a non-competition agreement with the Company.

Compensation Committee Interlocks and Insider Participation

The Company's Compensation Committee is composed of three non-employee directors: Messrs. Lansing, Madison and Seegal. No current member of the Compensation Committee is or has ever been an officer or employee of the Company, or has had any relationship with the Company that is required to be disclosed under Item 404 of Regulation S-K. No executive officer of the Company serves on the board of directors or as a member of a compensation committee of any entity that has or has had one or more executive officers serving as a member of the Company's Board of Directors or Compensation Committee.

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**REPORT OF THE COMPENSATION COMMITTEE OF THE BOARD OF DIRECTORS
ON EXECUTIVE COMPENSATION²**

Introduction

The Company's executive compensation policies and practices are approved by the Compensation Committee of the Board of Directors (the "Committee"). The Committee consists of three independent directors who are not, and have never been, employees or officers of the Company. The Committee is responsible for the design, administration and oversight of the compensation and benefits programs for the Company's executive officers, including the Chief Executive Officer, and the Committee's determinations are reviewed with all of the non-employee directors of the Company.

Philosophy

The Committee has implemented compensation policies, plans and programs that seek to enhance stockholder value by aligning the financial interests of the executive officers with those of the Company and its stockholders. Annual base salaries are generally set at market-based competitive median levels. The Company relies on annual incentive compensation and equity incentives to attract, retain, motivate and reward executive officers and other key employees. Incentive compensation is variable and tied to corporate and individual performance. The policies, plans and programs are designed to provide an incentive to management to grow revenues, provide quality returns on investment, enhance stockholder value and contribute to the long-term growth of the Company. All policies, plans and programs are reviewed at least annually to ensure that they meet the current strategies and needs of the business. In 2006, the Committee plans to retain an independent consulting firm as an advisor and resource to assist the Committee in further developing and executing the Company's total compensation strategy.

Compensation Plans

The Company's executive compensation is based on three components, each of which is intended to support the overall compensation philosophy.

Base Salary

Base salary is the fixed portion of executive compensation targeted at the median level for technology companies with similar characteristics such as sales volume, capitalization and financial performance. Salaries for executive officers are reviewed by the Committee on an annual basis and may be changed based on the individual's performance or a change in competitive pay levels in the marketplace.

The Committee reviews with the Chief Executive Officer an annual salary plan for the Company's executive officers (other than the Chief Executive Officer). The salary plan is modified as deemed appropriate and approved by the Committee. The annual salary plan is developed by the Company's Chief Executive Officer based on publicly available competitive compensation information on organizations with similar characteristics, such as size, scope of operations, revenue growth and business focus, and on performance judgments as to the past and expected future contributions of the individual executives. Additional factors include levels of responsibility, breadth of knowledge and expertise and prior experience. The Committee reviews and establishes the base salary of the Chief Executive Officer based on similar competitive compensation data and the Committee's assessment of his past performance and its expectation as to his future contributions in directing the long-term success of the Company.

² This Section is not soliciting material, is not deemed filed with the SEC and is not to be incorporated by reference in any filing of the Company under the Securities Act or the Exchange Act whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

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Annual Incentives

The variable portion of executive compensation is paid pursuant to annual bonus plans agreed to by the Committee and the executive at or near the beginning of the year. The Committee believes that the annual bonus of key employees, including executive officers, should be based on optimizing revenues while maintaining prudent management of gross margins and operating expenses. Accordingly, the bonus plan for 2005 was based on achieving certain revenue and earnings levels. The Committee believes these goals are the strongest drivers of long-term value for the Company. The bonus payable to the Chief Executive Officer was based on the pre-established performance goals related to exceeding revenue and earnings targets and the Company's overall performance during the year as described.

Equity Incentives

Long-term equity incentives are provided through grants of stock options, restricted stock and performance shares to executive officers and other key employees pursuant to the Company's 1998 Plan. The stock component of compensation is intended to retain and motivate employees to grow long-term stockholder value. Initial grants of stock options are generally made to eligible employees upon commencement of employment. Following the initial hire, additional equity incentive grants may be made to participants pursuant to a periodic grant program or following a significant change in job responsibilities, scope or title. Stock options under the 1998 Plan generally vest over a four-year period and expire ten years from the date of grant. Stock options are granted at fair market value and have value only if the Company's stock price increases. The Committee believes this element of the total compensation program directly links the executive's interests with those of the stockholders and the long-term performance of the Company.

The Committee establishes the number and terms of options and restricted stock granted under the 1998 Plan to the executive officers. The Committee encourages executives to build a substantial ownership investment in the Company's Common Stock. Outstanding performance by an individual executive officer is recognized through larger equity grants.

The Committee has delegated authority to the Company's Chief Executive Officer for granting certain options to employees. All options granted by the Chief Executive Officer require acknowledgement by the Board of Directors. The Compensation Committee retains the authority to approve equity grants to executive officers and directors of the Company.

Out of a total of 846,678 options granted in 2005, executive officers of the Company received grants for 125,000 shares, or approximately 14.8% of the total options granted in 2005.

As an integral component of its long-term strategic planning process, the Committee evaluates a number of factors impacting its employee compensation philosophy, including the Company's stage of growth, competitive environment, business complexity and market opportunity. One of the key conclusions from this analysis was that Digital River continues to operate in a high growth environment that is subject to rapid change, complexity and a multitude of business risks. To continue its record of success in this challenging environment, the Company believes that its compensation practices must remain competitive with practices of peer group companies with similar growth rates and long-term opportunities.

Compensation of Chief Executive Officer

The compensation of Mr. Ronning, the Company's Chief Executive Officer, consists of all three of the above-described components. The Committee believes that the compensation awarded to Mr. Ronning should reflect the Company's overall performance and, accordingly, for the year ended December 31, 2005, the Committee used a number of factors and criteria to determine Mr. Ronning's compensation, including the Company's ability to achieve a full year of profitability, penetrate new markets, complete strategic acquisitions, and manage operating expenses.

The Committee did not increase Mr. Ronning's base salary in 2005 from the prior year. This reflected the Committee's belief that Mr. Ronning's base salary is at a competitive level for similar technology

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companies. However, based upon the Company's overall performance in 2005 and the achievement of pre-established performance goals, as well as Mr. Ronning's leadership of the Company's management throughout the year, a bonus of \$1,000,000 was paid to Mr. Ronning.

The Committee reviewed market data for similar technology companies to determine whether to grant Mr. Ronning equity incentives. Based on Mr. Ronning's 2005 performance, in February 2006 the Committee determined to grant him an option to acquire 200,000 shares of the Company's Common Stock. The Committee believes that Mr. Ronning's compensation is comparable to that received by the chief executive officers of similar technology companies.

Section 162(m)

Digital River is limited by Section 162(m) of the Code to a deduction for federal income tax purposes of up to \$1,000,000 of compensation paid to certain Named Executive Officers in a taxable year. Compensation above \$1,000,000 may be deducted if it meets certain technical requirements to be classified as performance-based compensation. Although the Committee uses the requirements of Section 162(m) as a guideline, deductibility is not the sole factor it considers in assessing the appropriate levels and types of executive compensation and it will elect to forego deductibility when the Committee believes it to be in the best interests of the Company and its stockholders.

The Committee believes that the programs described above provide compensation that is competitive with comparable high growth technology companies, link executive and stockholder interests, and provide the basis for the Company to attract and retain qualified executives. The Committee will continue to monitor the relationship among executive compensation, the Company's performance and stockholder value as a basis for determining the Company's ongoing compensation policies and practices.

COMPENSATION COMMITTEE

William J. Lansing, Chairman

Thomas F. Madison

Frederic M. Seegal

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PERFORMANCE MEASUREMENT COMPARISON³

The SEC requires a comparison on an indexed basis of cumulative total stockholder return for the Company, a relevant broad equity market index and a published industry line-of-business index. The following graph shows a total stockholder return of an investment of \$100 in cash on December 31, 2000 for (i) the Company's Common Stock; (ii) the CRSP Total Return Index for the Nasdaq Stock Market (U.S. companies) (the Nasdaq Composite Index); and (iii) the RDG Technology Composite Index. The RDG Technology Composite Index is composed of approximately 500 technology companies in the semiconductor, electronics, medical and related technology industries. Historic stock price performance is not necessarily indicative of future stock price performance. All values assume reinvestment of the full amount of all dividends.

**Comparison of Five Year cumulative total return
among Digital River, Inc., the Nasdaq Stock Market (U.S.) Index,
and the RDG Technology Composite Index**

* \$100 invested on 12/31/00 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

³This Section is not soliciting material, is not deemed filed with the SEC and is not to be incorporated by reference in any filing of the Company under the Securities Act or the Exchange Act whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

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HOUSEHOLDING OF PROXY MATERIALS

The SEC has adopted rules that permit companies and intermediaries (e.g., brokers) to satisfy the delivery requirements for proxy statements and annual reports with respect to two or more stockholders sharing the same address by delivering a single proxy statement addressed to those stockholders. This process, which is commonly referred to as householding, potentially means extra convenience for stockholders and cost savings for companies.

This year, a number of brokers with account holders who are Digital River stockholders will be householding the Company's proxy materials. A single proxy statement will be delivered to multiple stockholders sharing an address unless contrary instructions have been received from the affected stockholders. Once you have received notice from your broker that they will be householding communications to your address, householding will continue until you are notified otherwise or until you revoke your consent. If, at any time, you no longer wish to participate in householding and would prefer to receive a separate proxy statement and annual report, please notify your broker or direct your written request to: Investor Relations, Digital River, Inc., 9625 West 76th Street, Eden Prairie, Minnesota 55344 or contact our Investor Relations department at (952) 253-1234. The Company will promptly deliver upon written or oral request a separate copy of the annual report or proxy statement to a security holder at a shared address to which a single copy of the document was delivered. Stockholders who currently receive multiple copies of the proxy statement at their addresses and would like to request householding of their communications should contact their broker.

OTHER MATTERS

The Board of Directors knows of no other matters that will be presented for consideration at the Annual Meeting. If any other matters are properly brought before the meeting, it is the intention of the persons named in the accompanying proxy to vote on such matters in accordance with their best judgment.

By Order of the Board of Directors

/s/ Kevin L. Crudden

Kevin L. Crudden
Secretary

Eden Prairie, Minnesota
April 28, 2006

A copy of the 2004 Annual Report to Stockholders accompanies this Proxy Statement. The Company's annual report on Form 10-K for the year ended December 31, 2005, as filed with the SEC, is available at no charge to stockholders upon written request to the Company at Investor Relations, Digital River, Inc., 9625 West 76th Street, Eden Prairie, Minnesota 55344. Copies also may be obtained without charge through Digital River's website at www.digitalriver.com, as well as the SEC's website at www.sec.gov.

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APPENDIX A

**DIGITAL RIVER, INC.
CHARTER OF THE AUDIT COMMITTEE
OF THE BOARD OF DIRECTORS**

STATEMENT OF POLICY

The primary purpose of the Audit Committee shall be to act on behalf of the Company's Board of Directors in fulfilling the Board's oversight responsibilities with respect to the Company's corporate accounting and reporting practices and the quality and integrity of the Company's financial statements and reports, as well as the qualifications, independence and performance of the certified public accountants engaged as the Company's independent outside auditors. The operation of the Committee shall be subject to the Bylaws of the Company as in effect from time to time and Section 141 of the Delaware General Corporation Law.

The policy of the Audit Committee, in discharging these obligations, shall be to maintain and foster an open avenue of communication between the Committee, the auditors and the Company's financial management.

COMPOSITION

The Audit Committee shall consist of at least three members of the Board of Directors. The members of the Audit Committee shall satisfy the independence and experience requirements of the Nasdaq National Market applicable to Audit Committee members. To the extent mandated by the requirements of the Nasdaq National Market, at least one member of the Audit Committee shall be a financial expert within the meaning of such requirements. The members of the Audit Committee shall be appointed by and serve at the discretion of the Board. Vacancies occurring on the Audit Committee shall be filled by the Board. The Committee's chairperson shall be designated by the Board or, if it does not do so, the Audit Committee members shall elect a chairperson by vote of a majority of the full Audit Committee.

MEETINGS AND MINUTES

The Audit Committee shall hold such regular or special meetings as its members shall deem necessary or appropriate. Minutes of each meeting will be prepared and distributed to each member of the Audit Committee, members of the Board who are not members of the Audit Committee and the Secretary of the Company. The Chairperson of the Audit Committee will report to the Board from time to time, or whenever so requested by the Board.

AUTHORITY

The Audit Committee shall have full access to all books, records, facilities and personnel of the Company as deemed necessary or appropriate by any member of the Committee to discharge his or her responsibilities hereunder. The Audit Committee shall have authority to retain, at the Company's expense, special legal, accounting or other advisors or consultants as it deems necessary or appropriate in the performance of its duties. The Audit Committee shall have authority to request that any of the Company's outside counsel, outside auditors or investment bankers, or any other consultant or advisor to the Company attend any meeting of the Audit Committee or meet with any member of the Audit Committee or any of its special legal, accounting or other advisors and consultants.

RESPONSIBILITIES

The primary responsibility of the Audit Committee shall be to oversee the Company's financial reporting process (including direct oversight of the auditors) on behalf of the Board and to report the results of these activities to the Board. The Audit Committee's functions and procedures should remain flexible to address changing circumstances most effectively. To implement the Audit Committee's purpose and policy, the Committee shall be charged with the following functions and processes, with the understanding, however,

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that the Audit Committee may supplement or (except as otherwise required by law or the applicable rules of Nasdaq) deviate from these activities as appropriate under the circumstances:

1. To evaluate the performance of the Company's outside auditors, to consider their qualifications and to determine whether to retain or to terminate the firm of certified public accountants employed by the Company as its outside auditors, which retention shall be subject only to ratification by the Company's stockholders.
2. To review and approve the engagement of the outside auditors, including the scope of and plans for the audit, the adequacy of staffing and the compensation to be paid to the auditors.
3. To review and approve the retention of the Company's outside auditors to perform any proposed permissible non-audit services, including the compensation to be paid therefor, authority for which may be delegated to one or more Committee members, provided that all approvals of non-audit services pursuant to this delegated authority be presented to the full Committee at its next meeting.
4. To monitor the rotation of the outside audit partner with primary responsibility for the audit and the outside audit partner responsible for review of the audit as required by applicable law.
5. At least annually, to receive and review written statements from the outside auditors delineating all relationships between the auditors and the Company consistent with Independence Standards Board Standard No. 1, to consider and discuss with the auditors any disclosed relationships or services that could affect the auditors' objectivity and independence, and to assess and otherwise take appropriate action to oversee the independence of the auditors.
6. To review, upon completion of the audit, the financial statements to be included in the Company's Annual Report on Form 10-K.
7. To discuss with the outside auditors and management, as appropriate, the results of the annual audit, including the auditors' assessment of the quality, not just acceptability, of accounting principles, the reasonableness of significant judgments and estimates (including material changes in estimates), any audit adjustments noted or proposed by the outside auditors (whether passed or implemented in the financial statements), the adequacy of the disclosures in the financial statements and any other matters required to be communicated to the Committee by the outside auditors under Statement on Auditing Standards No. 61.
8. To discuss with management and the outside auditors the results of the auditors' review of the Company's quarterly financial statements, prior to public disclosure of quarterly financial information, if practicable, or filing with the Securities and Exchange Commission of the Company's Quarterly Report on Form 10-Q, and any other matters required to be communicated to the Committee by the outside auditors under Statement on Auditing Standards No. 61. A member of the Committee may represent the entire Committee for purposes of this discussion.
9. To discuss with management and the outside auditors, as appropriate, the Company's disclosures contained in earnings press releases and under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in its periodic reports to be filed with the Securities and Exchange Commission.
10. To review with management and the outside auditors major issues that arise regarding accounting principles and financial statement presentations, including the adoption of new, or material changes to existing, critical accounting policies or to the application of those policies, the potential effect of alternative accounting policies available under GAAP, the potential impact of regulatory and accounting initiatives and any other

significant reporting issues and judgments.

11. To review and discuss with management and the outside auditors, as appropriate, the Company's guidelines and policies with respect to risk assessment and risk management, including the Company's major financial risk exposures and the steps taken by management to monitor and control these exposures.

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12. To evaluate the cooperation received by the outside auditors during their audit examination, including any restrictions on the scope of their activities or access to required records, data and information.

13. To review with the outside auditors any management letter provided by the auditors and management's response, if any, to such letter.

14. To review with the outside auditors any communications between the audit team and the firm's national office with respect to issues presented by the engagement and to resolve any conflicts or disagreements between management and the outside auditors regarding financial reporting, accounting practices or policies and to resolve any conflicts regarding financial reporting.

15. To confer with the outside auditors and with the senior management of the Company regarding the scope, adequacy and effectiveness of financial reporting controls in effect (including any special audit steps taken in the event of material control deficiencies).

16. Periodically, to meet in separate sessions with the outside auditors and senior management to discuss any matters that the Audit Committee, the outside auditors or senior management believe should be discussed privately with the Audit Committee.

17. To consider and review with management, the outside auditors, outside counsel, as appropriate, and, in the judgment of the Committee, such special counsel, separate accounting firm and other consultants and advisors as the Committee deems appropriate, any correspondence with regulators or governmental agencies and any published reports that raise material issues regarding the Company's financial statements and accounting policies.

18. To establish procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, including the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

19. To review with counsel, the outside auditors and management, as appropriate, any significant regulatory or other legal or accounting matters that could have a material impact on the Company's financial statements, compliance programs and policies.

20. To investigate any matter brought to the attention of the Audit Committee within the scope of its duties if, in the judgment of the Audit Committee, such investigation is necessary or appropriate.

21. To prepare the report required by the rules of the Securities and Exchange Commission to be included in the Company's annual proxy statement.

22. To review and assess the adequacy of this charter annually and recommend any proposed changes to the Board for approval.

23. To report to the Board of Directors with respect to material issues that arise regarding the quality or integrity of the Company's financial statements, the performance or independence of the Company's independent auditors or such other matters as the Committee deems appropriate from time to time or whenever it shall be called upon to do so.

24. To perform such other functions and to have such powers as may be necessary or appropriate in the efficient and lawful discharge of the foregoing.

It shall be the responsibility of management to prepare the financial statements and the responsibility of the outside auditors to audit those financial statements. These functions shall not be the responsibility of the Audit Committee, nor shall it be the Committee's responsibility to ensure that the financial statements are complete and accurate, conform to generally accepted accounting principles or otherwise comply with applicable laws.

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**DIGITAL RIVER, INC.
PROXY SOLICITED BY THE BOARD OF DIRECTORS FOR
THE ANNUAL MEETING OF STOCKHOLDERS**

Wednesday, May 31, 2006

3:30 p.m.

**Radisson Plaza Hotel
35 South 7th Street
Minneapolis, Minnesota 55402**

**DIGITAL RIVER, INC.
9625 West 76th Street,
Eden Prairie, MN 55344**

proxy

TO THE STOCKHOLDERS OF DIGITAL RIVER, INC.:

NOTICE IS HEREBY GIVEN that the Annual Meeting of Stockholders of **DIGITAL RIVER, INC.**, a Delaware corporation (the Company), will be held on Wednesday, May 31, 2006, at 3:30 p.m. local time at the Radisson Plaza Hotel, 35 South 7th Street, Minneapolis, Minnesota, 55402 for the purposes stated on the reverse.

By signing the proxy, you revoke all prior proxies and appoint **Joel A. Ronning** and **Thomas M. Donnelly**, and each of them, with full power of substitution, to vote your shares on the matters shown on the reverse side and any other matters which may come before the Annual Meeting and all adjournments.

All stockholders are cordially invited to attend the meeting in person. Whether or not you expect to attend the meeting, please complete, date, sign and return the enclosed proxy as promptly as possible. In order to ensure your representation at the meeting, a return envelope (which is postage prepaid if mailed in the United States) is enclosed for that purpose. Even if you have given your proxy, you may still vote in person if you attend the meeting. Please note, however, that if your shares are held of record by a broker, bank or other nominee and you wish to vote at the meeting, you must obtain from the record holder a proxy issued in your name.

The foregoing items of business are more fully described in the Proxy Statement accompanying this Notice. The Board of Directors has fixed the close of business on April 12, 2006, as the record date for the determination of stockholders entitled to notice of and to vote at this Annual Meeting and at any adjournment or postponement thereof.

See reverse for voting instructions.

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COMPANY #

There are three ways to vote your Proxy

Your telephone or Internet vote authorizes the Named Proxies to vote your shares in the same manner as if you marked, signed and returned your proxy card.

VOTE BY PHONE TOLL FREE 1-800-560-1965 QUICK <<<< EASY <<<< IMMEDIATE

Use any touch-tone telephone to vote your proxy 24 hours a day, 7 days a week, until 12:00 p.m. (CT) on May 30, 2006.

Please have your proxy card and the last four digits of your Social Security Number available. Follow the simple instructions the voice provides you.

VOTE BY INTERNET <http://www.eproxy.com/driv/> QUICK <<<< EASY <<<< IMMEDIATE

Use the Internet to vote your proxy 24 hours a day, 7 days a week until 12:00 p.m. (CT) on May 30, 2006.

Please have your proxy card and the last four digits of your Social Security Number available. Follow the simple instructions to obtain your records and create an electronic ballot.

VOTE BY MAIL

Mark, sign and date your proxy card and return it in the postage-paid envelope we have provided or return it to **Digital River, Inc.,** c/o Shareowner ServicesSM, P.O. Box 64873, St. Paul, MN 55164-0873.

If you vote by Phone or Internet, please do not mail your Proxy Card

ò Please detach here ò

The Board of Directors Recommends a Vote FOR all Proposals

- | | | | |
|---------------------------|--|--|--------------------------------------|
| 1. Election of directors: | 01 William J. Lansing
02 Frederic M. Seegal | o Vote FOR
all nominees
(except as marked) | o Vote WITHHELD
from all nominees |
|---------------------------|--|--|--------------------------------------|

(Instructions: To withhold authority to vote for any indicated nominee, write the number(s) of the nominee(s) in the box provided to the right.)

- | | | | |
|---|-------|-----------|-----------|
| 2. To approve an amendment to the Company s Amended and Restated Certificate of Incorporation to increase the authorized number of shares of Common Stock, par value, \$.01 per share, from 60,000,000 shares to 120,000,000 shares | o For | o Against | o Abstain |
| 3. To ratify the selection by the Audit Committee of the Board of Directors of Ernst & Young LLP as independent auditors of the Company for its fiscal year ending December 31, 2006. | o For | o Against | o Abstain |

THIS PROXY WHEN PROPERLY EXECUTED WILL BE VOTED AS DIRECTED OR, IF NO DIRECTION IS GIVEN, WILL BE VOTED FOR ALL PROPOSALS.

Address Change? Mark Box o Indicate changes below:

Date

Signature(s) in Box

Please sign exactly as your name(s) appears on Proxy. If held in joint tenancy, all persons must sign. Trustees, administrators, etc., should include title and authority. Corporations should provide full name of corporation and title of authorized officer signing the proxy.