

PEGASYSTEMS INC

FORM 10-K (Annual Report)

Filed 04/15/98 for the Period Ending 12/31/97

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Fiscal Year 12/31

PEGASYSTEMS INC

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Industry	Software & Programming
Sector	Technology
Fiscal Year	12/31

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

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

For the fiscal year ended December 31, 1997

Commission File No. 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts
(State or other jurisdiction of
incorporation or organization)

04-2787865
(IRS Employer Identification No.)

101 Main Street
Cambridge, MA
(Address of principal executive offices)

02142-1590
(zip code)

(617) 374-9600
(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: None **SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:**

Common Stock, \$.01 par value per share

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

As of March 20, 1998, the aggregate market value of the Registrant's voting stock held by non-affiliates of the Registrant was approximately \$487.1 million (without admitting that any person whose shares are not included in determining such value is an affiliate).

There were 28,545,100 shares of the Registrant's common stock, \$.01 par value per share, outstanding on March 20, 1998.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Definitive Proxy Statement for its 1998 Annual Meeting of Stockholders to be held on May 6, 1998 (the "1998 Proxy Statement") are incorporated by reference into Part III of this Form 10-K and portions of the Registrant's Annual Report to Stockholders for the Registrant's fiscal year ended December 31, 1997 (the "1997 Annual Report") are incorporated by reference into Part II and Part IV of this Form 10-K. With the exception of the portions of the 1998 Proxy Statement and the 1997 Annual Report expressly incorporated into this Form 10-K by reference, such documents shall not be deemed filed as part of this Form 10-K.

TABLE OF CONTENTS

PART 1

Item ----	Page ----
1 Business	3
2 Properties	16
3 Legal Proceedings	16
4 Submission of Matters to a Vote of Security Holders	16
Executive Officers of the Registrant	17
Certain Statements for Purposes of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995	18

PART II

5 Market for Registrant's Common Stock and Related Stockholder Matters	24
6 Selected Consolidated Financial Data	24
7 Management's Discussion and Analysis of Financial Condition and Results of Operations	24
7A Quantitative and Qualitative Disclosure About Market Risk	24
8 Financial Statements and Supplementary Data	25
9 Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	25

PART III

10 Directors and Executive Officers of the Registrant	25
11 Executive Compensation	25
12 Security Ownership of Certain Beneficial Owners and Management	25
13 Certain Relationships and Related Transactions	25

PART IV

14 Exhibits, Financial Statement Schedules, and Reports on Form 8-K	26
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PART I

Item 1 BUSINESS

Pegasystems develops customer relationship management software to automate customer interactions across transaction-intensive enterprises. Many of the world's largest organizations in banking, mutual funds and securities, mortgage services, card services, insurance, healthcare management, and telecommunications use the Company's solutions to integrate, automate, standardize, and manage a broad array of mission-critical customer interactions, including account set-up, record retrieval, correspondence, disputes, investigations, adjustments, and sales. The Company's solutions can be used by thousands of concurrent users to manage customer interactions and to generate billions of dollars a day in resulting transactions. Work processes initiated by the Company's solutions are driven by a highly adaptable "rule base" defined by the user-organization for its specific needs. The rule base facilitates a high level of consistency in customer interactions in call centers, over the Internet, and other delivery channels, yet drives different processes depending on the customer profile or the nature of the request. The Company's open, multi-tiered, client/server solutions operate on a broad variety of platforms, including UNIX, Windows/NT, and IBM/MVS. The Company offers consulting, training, and support services to facilitate the use of its solutions.

Industry Background

Intensifying competition is forcing businesses to reduce costs while focusing on customer relationship management as the most important means of differentiation. Many types of businesses are increasingly recognizing customer interactions as a critical opportunity to solidify and expand customer relationships. Due to the volume and precise nature of customer transactions, it is especially critical for organizations to implement cost-effective systems that manage customer interactions accurately and efficiently and capitalize on that interaction to cross sell and up sell additional products and services.

Providing high-quality, cost-effective customer relationship management is complex. Organizations with global operations must be able to manage customer interactions in different languages, time zones, currencies, and regulatory environments. The challenge is magnified as the product offerings of an organization increase and when organizations are combined. Work processes occasioned by a single customer interaction often involve multiple departments within an organization, which may have different priorities and service standards, and may involve a variety of different computer systems. Customers may contact an organization through various means, including telephone, facsimile, the Internet, or in person. The organization must be able to respond in a timely, accurate, and consistent fashion or risk customer defection.

Historically, in attempting to meet demand for new customer management software systems, organizations have faced a choice between building custom systems or purchasing third-party systems. Building custom systems or modifying third-party systems can be slow and costly and has often led to isolated, departmentalized solutions. Traditional third-party systems are often inflexible, requiring organizations to conform their work processes to the system, rather than vice versa. Neither custom nor third-party solutions have generally accommodated an organization's need to evolve or expand operations without significant programming effort. Moreover, neither has had the high-volume transaction processing or integration capabilities necessary to support the comprehensive customer interaction requirements of large organizations. Today, organizations need flexible, scalable customer

relationship management solutions that can be implemented on an enterprise-wide basis to facilitate consistent, cost-effective customer relationship management.

The Pegasystems Solution

The Company's solutions integrate, automate, standardize, and manage on an enterprise-wide basis a broad array of mission-critical customer interactions for organizations, including account set-up, record retrieval, correspondence, disputes, investigations, adjustments, and sales. Pegasystems' solutions provide an architecture that drives intelligent processing and seamlessly integrates an organization's geographically dispersed and product specific service operations and isolated computer systems. By bridging these "islands of automation" within large organizations, the Company's solutions increase the efficiency of sales and service representatives and enable organizations to address multiple customer needs during a single contact.

The Company's customer service management solutions offer the following advantages:

Flexibility and Consistency. The Company's solutions are based on rules defined by the user-organization which drive various types of processing depending on such factors as the content of the customer request, the profile of the customer, the organization's policies and procedures, and the authority or qualifications of the customer sales and service representatives. By modifying its rule base, an organization can evolve its processing to address the competitive requirements of its business without costly and time consuming reprogramming. Significantly, the rule base feature of the Company's systems permits an organization to establish consistent standards yet interact differently with different segments of its customer base and thereby "mass personalize" its services.

Scalability and Robust Functionality. The scalability of the Company's multi-tiered client/server architecture allows an organization to add departments easily to new or existing servers without performance degradation. Organizations currently entrust the Company's systems with the storage and management of data relating to hundreds of millions of financial transactions. The Company's systems can be used by several thousand concurrent users to manage customer interactions and to process accurately and securely transactions involving billions of dollars a day that result from those interactions.

Ease-of-Use. The Company's client software applications increase the effectiveness and productivity of customer sales and service representatives by providing them with a flexible graphical user interface and processing capabilities that leverage the power of client/server desktop computers or the Internet/intranet. The Company's solutions allow customer sales and service representatives to focus on delivering superior customer management, rather than on mastering the protocols and procedures of multiple applications.

Integration Capabilities. The Company's open architecture permits its solutions to be integrated with a wide variety of other applications and technologies, including industry-standard relational database management systems, advanced telephony equipment, and diverse storage media (including magnetic, optical, tape, and microfilm). The Company's solutions also support the message formats of major financial transaction networks such as the SWIFT international funds network, the Federal Reserve's Fedwire system, and the VISA and MasterCard networks.

Multi-Platform Server Support. The Company's solutions feature a common software code base which, in addition to facilitating maintenance and enhancement development efforts, simplifies the support of multiple platforms. The Company's solutions are designed to run on a broad range of computer operating systems including IBM's MVS/CICS and AIX/UNIX systems, Digital Equipment Corporation's VMS system, Microsoft's Windows/NT system, Sun Microsystems' Solaris UNIX system, and Hewlett-Packard Corporation's HP-UX UNIX system.

Improved Efficiency of Customer Management. Pegasystems' solutions actually perform work, rather than simply track a customer management professional's tasks. Variable data elements (e.g., date, amount, customer, account) automatically route service requests and invoke system processes, depending on an organization's rule base. This feature allows customer sales and service representatives to focus on revenue enhancing opportunities, such as cross selling, and other matters requiring personal attention. During a customer interaction, the Company's solutions provide pertinent, consolidated information to guide the service representative. Savings are realized through reduced talk time, fewer manual processes, and less rework.

Business Strategy

Pegasystems' objective is to become the leading provider of mission-critical client/server customer relationship management software to organizations performing a high volume of complex interactions with demanding customers. To achieve this objective, the Company is pursuing the following strategies:

Leverage Strength in Financial Services Market. Pegasystems provides customer relationship management solutions to many of the largest financial services organizations in the world. The Company is seeking to expand its business with these organizations through sales efforts focused on marketing the Company's products and services to other business operations of these organizations. The Company is also leveraging its relationships and expertise with large financial services organizations to penetrate the medium-sized financial services market.

Leverage Early Endorsement in Other Markets. In 1997, Pegasystems successfully penetrated and delivered its solutions to the insurance, telecommunications, healthcare management, and public utilities markets. Like the financial services industry, these markets have customer relationship management needs, and the Company's core technology is readily adaptable to these markets. During 1997, the Company hired personnel with expertise in these markets.

Increase Sales and Support Efforts. Pegasystems intends to establish additional sales and support offices, increase significantly its domestic and international direct sales forces, and provide enhanced service to customers. In addition, the Company plans to develop further its relationships with technology partners and consulting firms to gain introduction into significant business opportunities.

Develop Standard Product Templates. The Company commenced licensing standard product templates that give organizations an advanced starting point for configuring their work processes.

The Company intends to continue to develop and market standard product templates. The Company believes that these templates will facilitate more rapid implementation of the Company's solutions and will be a cost-effective way to address the needs of smaller organizations.

Reduce Implementation Time. The Company is continuing to refine its PegaSTAR consulting methodology, an approach to the reengineering of an organization's work processes that facilitates more rapid implementation of the Company's customer management systems and continued evolution of such systems by an organization's personnel after initial implementation. This methodology complements the Company's standard product templates in reducing the time required to implement the Company's systems.

Strategic Relationships. The Company has actively developed a partner strategy to increase market penetration at several levels. It has developed a formal PegaCSP (Pegasystems' Certified Solutions Provider) program to recruit Systems Integrators to allow and enable them to develop active Pegasystems practices. The Company is continuing with its strategy of leveraging dominant players in certain markets to sell and support its products. Financial transaction processors such as First Data Resources, for example, provide access to key customers and significant insight into the product requirements of the card market. The Company also continues to leverage relationships with technology companies to jointly bring best-of-breed solutions to market in a timely fashion.

Maintain Technological Leadership Position. Pegasystems is continuing to develop and invest in its technology. Current development efforts include the development of tools to facilitate the use of its customer management system, the integration of the Company's products with additional databases, interoperability with Internet and intranet systems, and support of emerging technical and workflow standards.

Technology

The Company's technology is designed to provide Technology Enabled Relationship Management (TERM) over a variety of delivery channels including call centers, branch offices, and the Internet. Pegasystems' solutions have the following key technological attributes:

Information Management. Effective customer response requires up-to-date information about the customer relationship, regardless of how, why, when, or where the customer contacts the organization. Pegasystems' customer relationship management solutions organize core customer information to facilitate global access.

Multi-tiered, Dynamic Distributed Processing. The Company's systems are designed to run in an advanced, highly scalable multi-tiered environment. In traditional three-tiered client/server environments, the user interface, the application code, and the data are segregated onto separate tiers. In the Pegasystems three-tiered client/server environment, the application code, the rule base, and selected data are replicated on both the central and satellite tiers so that processing may occur on either the central server or the distributed satellite servers to minimize network traffic and enhance performance. The rule base determines the optimal location for processing to occur based on the nature of the work required and the data involved. Rule base changes are replicated across the organization's central and satellite servers to facilitate consistent processing by all parts of the organization.

Inherited Workflow. Pegasystems solutions maintain organizational consistency while providing the flexibility needed for mass personalization. The rule base of the Company's systems may be defined so that certain processes are standardized across an organization while others may be superseded or supplemented by "local" rules tailored to the specific requirements of groups within the organization.

Platform Independence. Recognizing that organizations often use a variety of computer platforms, Pegasystems provides technology alternatives by supporting a range of mainframes, minicomputers, PC networks, and interface devices. While the Company offers an advanced 32-bit Windows-PegaREACH application for the desktop, the Company's server applications can also drive "dumb terminals," allowing organizations to preserve their investments in legacy networks.

Internet and Intranet Access. Pegasystems' solution PegaREACH uses the Internet-based HTML (Hypertext Markup Language) to define display attributes for its graphical user interface, leveraging logic and presentation rules between PegaReach and Internet/intranet workflows. With PegaWEB, these workflows can be accessed over the Internet or intranet using standard web browsers with no change to core application rules. Pegasystems' rules dynamically create HTML forms, menus, and displays, thereby facilitating interaction with the Internet.

Interfacing With Other Systems. Pegasystems' open architecture permits integration with a wide variety of other applications and networks, including relational databases, legacy systems accessed through IBM 3270 emulation, and messaging protocols. The Company offers a Universal Application Programming Interface (API) that allows an organization's custom software to be integrated with the Company's applications without the need to modify the Company's core application code. Pegasystems' PegaCONNECT components also support interfaces to IBM's MQSeries, CORBA, 3270-based mainframe applications, and major relational database systems. Pegasystems' solutions also integrate with other applications, accounting systems, and imaging products

Storage Options. Data storage flexibility is important to the Company's customers, and the Company's software uses an innovative object-oriented approach that dynamically maps data according to the type of workflow. Versions of the Company's systems can store customer service request data in the Microsoft SQL Server, Oracle, Informix, and Sybase relational databases.

Functionality

The Company's solutions employ a consistent architecture and support the following customer relationship management functions across call centers and other service delivery operations:

Receiving. An organization's customer contact center receives requests by telephone, mail, facsimile, or personal contact. Customer service representatives and agents may enter details of incoming requests into PegaREACH, the Company's easy-to-use, 32-bit graphical user interface. Alternatively, electronic service requests are received from various networks or messaging interfaces such as MQSeries, the SWIFT network, the Internet, or the VISA/MasterCard network. The Company's systems also support direct electronic access by customers through PCs, Internet

browsers, and voice response units. In all cases, the service request automatically initiates appropriate processing based on the rule base.

Routing. As processing steps are completed, the Company's systems categorize and queue the request for appropriate automatic or manual processing. Productivity-based load leveling and dynamic prioritization ensure high performance and responsiveness. As work is processed, each customer representative's "work list" is automatically updated in real time. The systems monitor each customer request for conformance to the organization's timeliness standards, automatically increasing priority and generating warnings based on the service standards of the organization.

Researching. The Company's systems determine when more information is needed and how to retrieve it from databases or other repositories. Pegasystems' rule-driven processing automatically extracts relevant data, directs it to the customer service representative or customer, links it to the work, and keeps it readily accessible. The Company's systems can access information from multiple data sources, whether maintained by the Company's systems or third-party systems.

Responding. The Company's systems facilitate communications by an organization with its customers by combining user-defined templates and specific customer information to create personalized correspondence. When appropriate, service representatives may further refine message content before forwarding by mail, facsimile, or electronic transmission, and may attach images of statements, checks, and other data. Follow-up communications are automatically composed, customized, and sent. Sensitive correspondence can be queued for online review before release, and the systems create a permanent audit trail of customer communications.

Resolving. Concluding a piece of work involves application of the organization's rules for resolving a request or stepping the customer service representative through the process when human judgment is required. Resolution also includes the creation of transactions, transmission to production systems, management of financial adjustments, posting of service charges, updating of general ledger accounts, and synchronization of multiple item requests. Pegasystems' solutions improve efficiency and reduce effort and errors.

Reporting. Data automatically collected by a Pegasystem enables an organization to analyze service representative efficiency and determine needs for service representative training or changes to work processes. The systems produce reports, graphical output, and feeds to spreadsheets illustrating the volume and status of customer requests, the productivity of customer service representatives, and service levels with specific customers.

The Company offers a number of different products with components and features designed to address particular business areas while sharing core technology and adaptable rule-driven processing. The Company intends to continue to develop and market standard packaged solutions targeted at traditional and new markets. The Company is moving toward product sets and brand identities associated with each market.

The Company offers industry specific solutions for:

Commercial Banking. The Company provides commercial banking solutions that automate payments research, money transfers, and other "cash management" service functions. These solutions improve the quality, accuracy, and efficiency of customer interactions, making it easy for commercial banking organizations to support their offerings a wide variety of services, including funds transfers, account reconciliation, lock-box services, controlled disbursement accounts, and account analysis.

Consumer Banking. The Company provides consumer banking solutions that automate customer sales and service initiatives across diverse delivery channels, such as Internet self-service, call centers, and branch networks. Targeted functions within consumer banking include customer-contact adjustments, sales-campaign management, and correspondence.

Securities and Mutual Funds. The Company services the mutual funds industry through an agreement with First Data Investor Services Group, Inc. (FDI), a subsidiary of First Data Corporation. The integrated product--marketed by FDI under the name IMPRESS Plus--offers mutual fund institutions a comprehensive service solution.

Card Processing. The Company's products are offered to the card processing market through a relicensing agreement with First Data Resources (FDR)--the largest card processor in the world. A jointly developed solution combines Pegasystems' workflow and service delivery technology with First Data's servicing functionality and on-line interfaces. It gives clients a flexible, user-friendly solution that can be quickly and easily adapted to meet evolving business needs without costly programming.

Insurance. The Company's insurance solutions integrate disparate back-end systems to ensure that when calls, letters, or faxes reach representatives, they have easy access to all the information they need to handle policyholder requests. The Company's solutions position insurance organizations to provide highly personalized customer service and increase profitability through cross-selling.

Healthcare. The Company's healthcare solutions enable healthcare organizations to more efficiently coordinate care. This allows health maintenance organizations, healthcare providers, pharmacists, laboratory clinicians, and health insurers to access integrated patient information over a network of previously disconnected systems. Personalized data presentation provides meaningful views of a patient's history, giving users easy access to just the information they need to quickly respond to requests including referrals, benefits verification, and claim status.

Telecommunications. The Company's flexible rule-base solutions can be configured to automate a telecommunications service provider's interactions with its customers and other providers. The Company provides workflow management solutions which integrate disparate information systems--a capability of importance to telecommunications providers facing competition due to deregulation.

Utilities. The Company offers solutions that unite departmental or organizational "islands of information" that may have evolved over years of internal systems development. They retrieve customer information from numerous legacy systems, identify cross-selling opportunities personalized to the individual needs of each customer, and provide convenient service alternatives. These solutions optimize customer service representative talk time and ensure consistently high-quality service. They can also be adapted for a wide variety of plant monitoring, management, and maintenance functions and can be configured to track and document authorizations, and to enforce adherence to regulated response times.

Product Pricing

The Company's systems are licensed to organizations under agreements requiring the payment of fees, typically in monthly installments, over the term of the agreement. The amount of the license fee is based on various factors, including the number of concurrent users, the functionality of the system, the number of servers on which the product is installed, and the scope of business usage. Typical recent individual system licenses have provided for the payment of monthly fees of between \$10,000 and \$100,000 for an initial implementation. Some organizations receive discounts for licensing multiple systems. The monthly license payments generally begin once a system is installed and its capabilities are accepted. The term of such licenses is typically five years, subject to automatic renewal at the organization's option.

Services

Consulting Services. The Company supports its customers' reengineering efforts during and after system installation with the PegaSTAR (the Pegasystems Structured Technique for Analysis and Reengineering) installation methodology. The Company encourages team building and transfer of knowledge from its consultants to an organization's staff through an interactive co-production methodology. Pegasystems and its customers work together to design, document and tailor the system's rule base to the customer's organization. Pegasystems' goal is to empower its customers' staffs with the knowledge and confidence to operate, refine, and evolve their systems. The Company's new PegaCSP program provides customers with the option of using third-party Systems Integrators' analytical, technical, and managerial expertise to assist in Pegasystems' implementation projects. Pegasystems Client Services Group, which as of December 31, 1997 was comprised of approximately 125 people located in the Company's twelve offices, provides consulting, training, and customer support.

Training. The Company offers training programs for its customers' operations staff and "Workflow Architects," who are responsible for evolving the rules that drive the various processes related to customer interactions. Pegasystems also organizes an annual PegaVISION Customer Conference and periodic Advisory Board meetings, which enable its clients to exchange ideas, learn about product directions, and influence Pegasystems' development process. Pegasystems has training centers in Cambridge, MA; San Francisco, CA; and Reading, U.K.

Maintenance and Support. Pegasystems provides comprehensive maintenance and support services, which may include 24 hours a day, 7 days a week customer service, periodic preventative maintenance, documentation updates, and new software releases.

Organizations that license the Company's systems may enter into a maintenance contract providing for the payment to the Company of a monthly maintenance fee over the term of the related license agreement generally equal to approximately 18% of the monthly license fee. Organizations seeking consulting and support services are generally charged an incremental fee ranging between \$70 and \$220 per hour.

Customers

Pegasystems provides robust and scalable customer service management solutions that can support thousands of concurrent users based in multiple countries, speaking different languages, and working with different currencies. A representative list of the Company's major customers and the uses to which they apply the Company's products is shown below:

Banco Popular de Puerto Rico -- Retail service center automation, check research, and consumer loan inquiry and service.

Bank of America -- Retail/check customer service and research, automation of branch support centers. Institutional funds transfer and foreign exchange customer service for U.S. and European operations. Credit and debit card correspondence, and dispute and chargeback service processing.

Bank of Ireland -- Retail/check clearings and research, automation of branch support centers, and exception/credit item review and verification.

Banque Nationale de Paris -- Institutional funds transfer service, research, and archive.

Barclays Bank PLC -- Institutional funds transfer and foreign exchange customer service for international operations. Merchant credit card service including telephony center, correspondence, and dispute and chargeback processing.

Cedel Bank -- Global custody and securities movement customer service.

Central Vermont Public Services Corp. -- Customer service management, providing call center representatives with access to consolidated customer information.

Citibank -- Global funds transfer and foreign exchange customer service. Check-related customer service and research. Domestic MasterCard and Visa service including image integration, correspondence, and dispute and chargeback processing.

Colonial Group -- Mutual fund customer service supporting telephony center and correspondence.

Federal Reserve Banks of Boston and San Francisco -- Check processing customer service, suspense ledger management, research, adjustment, and archive.

Fidelity Investments -- Mutual fund customer service supporting telephony center and correspondence.

First Chicago NBD -- Retail/check customer service and research. Wholesale banking, funds transfer, check, corporate lockbox, and interbank compensation service for global operations.

Franklin Templeton Group -- Mutual fund customer service supporting telephony center, correspondence, and research.

Homeside Lending -- Escrow analysis and payment processing.

Household Credit Services -- Credit card service including telephony center, correspondence, dispute, and chargeback processing. Private label customer service for major retailers.

Kaiser Permanente -- Automating healthcare member, patient, provider, and payer interactions.

Marine Midland Bank -- Institutional funds transfer customer service.

Mellon Bank Corporation -- Retail/check customer service, research, and archive. Wholesale, institutional, cash management, and corporate lockbox customer service.

Sears -- Customer service and authorizations at the Regional Credit Card Operations Centers of Sears Credit, the consumer credit division of Sears, Roebuck, and Co.

Trans Union Corporation -- Credit bureau data-management customer service for institutional customers and real estate property appraisal processing.

In 1995, Chemical Bank accounted for 12.6% of the Company's consolidated revenue and Citibank and Household Credit Services accounted for 16.2% and 14.9%, respectively, of the Company's consolidated revenue. In 1996, Bank of America, Chase Manhattan Bank, and Fleet Bank accounted for 14.5%, 11.4% and 10.5%, respectively, of the Company's consolidated revenue. In 1997, Kaiser Permanente and First Data Resources Corporation accounted for 13.7% and 10.0%, respectively, of the Company's consolidated revenue.

Sales and Marketing

The Company markets its software and services primarily through a direct sales force. As of December 31, 1997, the Company's sales force consisted of approximately 40 salespersons in the Company's domestic and foreign offices. The Company intends to continue to increase substantially the size of its sales force. In addition, the Company is seeking to enhance the productivity of its direct sales force by hiring additional support personnel to assist with the sales, marketing, and technical requirements of the Company's complex and lengthy sales cycle. To achieve significant revenue growth in the future, it will be necessary for the Company both to increase the size and to enhance the productivity of its direct sales force. Competition for qualified sales personnel is intense and there can be no assurance that the Company will be able to attract such personnel. If the Company is unable to hire additional qualified sales personnel on a timely basis, the Company's business, operating results, and financial condition could be materially and adversely affected.

Pegasystems entered into a strategic relationship with First Data Corporation which includes an agreement with First Data Resources (FDR) that gives FDR -- the largest card processor in the world -- world wide rights to use and re-license Pegasystems' solutions in the card issuing market. The Company has evolved its indirect distribution channel by entering into an agreement with First Data Investor Services Group, Inc., under which the Company's PegaSHARES product is distributed by First Data. In addition, the Company has established joint marketing relationships with Sun Microsystems, Hewlett-Packard Company, Oracle Corporation, Informix, and Sybase. Recently, the Company entered into a joint marketing agreement with Management Data, which develops solutions for reconciliation and exception management for financial transactions. In the future, the Company may also market and sell its products through value added resellers (VARs) and Systems Integrators. There can be no assurance, however, that the Company will be able to attract and retain VARs, Systems Integrators, and other third parties that will be able to market and sell the Company's products effectively.

To support its sales force, the Company conducts marketing programs which include trade shows, public relations, and seminars. Sales leads are also generated by the Company's consulting staff, partners, and other third parties.

In 1995, 1996, and 1997, international sales represented 10.5%, 17.7%, and 16.5%, respectively, of the Company's total revenue. See "Management's Discussion and Analysis of Financial Condition and Results of Operations--Results of Operations" incorporated herein by reference from the 1997 Annual Report. See Note 11 of Notes to Consolidated Financial Statements contained in the 1997 Annual Report.

Product Development

Since its inception, the Company has made substantial investments in product development. The Company believes that its future performance depends on its ability to maintain and enhance its current products and develop new products. The Company's product development priorities include (1) creating tools to enable organizations to configure more easily their customer service management systems; (2) integrating the Company's products with the Internet for customer self-service and with intranet systems for departmental service; and (3) developing standard Application Programming Interfaces that allow other client workstation and server applications to interoperate with the Company's systems.

In 1995, 1996, and 1997 the Company's research and development expenses were approximately \$7.1 million, \$8.2 million, and \$15.1 million, respectively.

Competition

The customer service management software market is intensely competitive and subject to rapid change. Competitors vary in size and in the scope and breadth of the products and services offered. The Company encounters competition primarily from internal information systems departments of potential or current customers that develop custom software. The Company also competes with: (1) software companies that target the customer interaction or workflow markets such

as Remedy Corporation, Scopus Technology, Inc., Siebel Systems, and The Vantive Corporation; (2) companies that target specific service areas such as DST Systems Inc.; and (3) professional services organizations such as Andersen Consulting that develop custom software in conjunction with rendering consulting services. In addition, the Company expects additional competition from other established and emerging companies, including Oracle Corporation and SAP AG, as the market continues to develop and expand. Increased competition may result in price reductions, less beneficial contract terms, reduced gross margins and loss of market share, any of which could materially and adversely affect the Company's business, operating results, and financial condition.

The Company believes that the principal competitive factors affecting its market include product features such as adaptability, scalability, ability to integrate with other products and technologies, functionality and ease-of-use, the timely development and introduction of new products and product enhancements, as well as product reputation, quality, performance, price, customer service and support, and the vendor's reputation. Although the Company believes that its products currently compete favorably with regard to such factors, there can be no assurance that the Company can maintain its competitive position against current and potential competitors.

Many of the Company's competitors have greater resources than the Company, and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards, or to changes in customer requirements or preferences. Many of the Company's competitors can devote greater managerial or financial resources than the Company can to develop, promote and distribute customer service management software products and provide related consulting, training, and support services. There can be no assurance that the Company's current or future competitors will not develop products or services which may be superior in one or more respects to the Company's or which may gain greater market acceptance. Some of the Company's competitors have established or may establish cooperative arrangements or strategic alliances among themselves or with third parties, thus enhancing their abilities to compete with the Company. It is likely that new competitors will emerge and rapidly acquire market share. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not materially and adversely affect its business, operating results, and financial condition.

Intellectual Property and Licenses

The Company relies primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect its proprietary rights. The Company also has one patent application pending in the United States relating to the architecture of the Company's systems. While the Company believes that its pending patent application relates to a patentable invention, there can be no assurance that such patent application or any future patent application will be granted or that any patent relied upon by the Company in the future will not be challenged, invalidated or circumvented or that rights granted thereunder will provide competitive advantages to the Company. Moreover, despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of the Company's products or to obtain the use of information that the Company regards as proprietary. In addition, the laws of some foreign countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States. There can be no assurance that the Company's means of protecting its proprietary rights will be adequate or that the Company's competitors will not independently develop similar technology.

The Company is not aware that any of its products infringes the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by the Company with respect to current or future products. The Company expects that software product developers will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays, or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results, and financial condition.

From time to time, the Company licenses software from third parties for use with its products. The Company believes that no such license agreement to which it is presently a party is material and that if any such license agreement were to terminate for any reason, the Company would be able to obtain a license or otherwise acquire other comparable technology or software on terms and on a timetable that would not be materially adverse to the Company.

Employees

As of December 31, 1997, the Company had approximately 400 employees, of whom approximately 325 were based in the United States, 65 were based in Europe, and 10 were based in Asia Pacific. Of the total, approximately 100 perform research and development, 160 perform consulting and customer support, 100 were in sales and marketing, and 40 were in administration and finance. The Company's future performance depends in significant part upon the continued service of its key technical, sales and marketing, and senior management personnel and its continuing ability to attract and retain highly qualified technical, sales and marketing and managerial personnel. Competition for such personnel is intense and there can be no assurance that the Company will be successful in attracting or retaining such personnel in the future. None of the Company's employees is represented by a labor union or is subject to a collective bargaining agreement. The Company has not experienced any work stoppages and considers its relations with its employees to be good.

Backlog of License and Maintenance

As of December 31, 1997, the Company had software license and maintenance agreements with customers expected to result in approximately \$26 million of revenue in 1998. As of December 31, 1996, the Company had software license and maintenance agreements with customers expected to result in approximately \$8.0 million of revenue in 1997.

Item 2 PROPERTIES

Pegasystems' principal administrative, sales, marketing, support, and research and development operations are located in a 50,000 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in March 1999, subject to the Company's option to extend the term for up to eight additional years. The Company also leases space for its other offices in the United States, Australia, France, and the United Kingdom. These leases expire at various dates through 2005. The Company believes that additional or alternative space will be available in the future on commercially reasonable terms as needed.

Item 3 LEGAL PROCEEDINGS

Actions Arising under Federal Securities Laws

In November 1997 and in early January 1998, two separate complaints purporting to be class actions were filed with the United States District Court for the District of Massachusetts alleging that the Company and several of its officers violated section 10(b) of the Securities Exchange Act of 1934, as amended, Rule 10b-5 promulgated by the Commission thereunder, and section 20(a) of the Securities Exchange Act of 1934, as amended. The two actions were consolidated by order of the Court and with the parties' consent, and a Consolidated Complaint in the case captioned Joseph Chalverus, et al. v. Pegasystems, Inc., et al. was filed in late-March, 1998. The complaint names the Company itself and Alan Trefler, Ira Vishner, and Kenneth W. Olson, three officers of the Company, as defendants.

The Consolidated Complaint alleges that certain of the defendants made materially false and misleading statements concerning the Pegasystems-First Data Resources transaction in the Company's filings with the Commission, analysts' reports, press releases, media reports, and in connection with the Company's financial results for the quarter ended June 30, 1997. The Consolidated Complaint also alleges that one of the defendants sold shares of the Company stock during the period between the date the transaction was first publicly announced and the date the Company announced that it and its former certifying auditor disagreed on the accounting treatment of the transaction. The Consolidated Complaint seeks certification of a class of persons who purchased Pegasystems' Common Stock between July 2, 1997 through October 29, 1997, and does not specify the amount of damages sought.

The defendants have not filed any answers, motions to dismiss or other responsive pleadings in this litigation, but anticipate filing a motion to dismiss in the near future. The Company intends to defend this matter vigorously.

Item 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of fiscal 1997 there were no matters submitted to a vote of security holders.

EXECUTIVE OFFICERS OF THE REGISTRANT

The names of the Company's executive officers and certain information about them are set forth below as of December 31, 1997:

Name ----	Age ---	Position(s) and Office(s) Held -----
Alan Trefler	41	President, Clerk and Director
Eugene A. Bonte	47	Vice President of Market Strategy and Delivery
Joseph J. Friscia	42	Vice President of Sales and Marketing
Kenneth W. Olson	47	Vice President of Technical Development
Michael R. Pyle	43	Vice President of Applications Development
Ira Vishner	44	Vice President, Corporate Services, Treasurer, Chief Financial Officer and Director

Executive officers of the Company are elected by the Board of Directors on an annual basis and serve until the next annual meeting of the Board of Directors and until their successors have been duly elected and qualified. There are no family relationships among any of the executive officers or directors of the Company.

Alan Trefler, a founder of the Company, has served as President and Clerk and has been a director since the Company's organization in 1983. Prior thereto, he managed an electronic funds transfer product for TMI Systems Corporation, a software and services company. Mr. Trefler holds a degree in economics and computer science from Dartmouth College.

Eugene A. Bonte joined the Company in April 1996 as Vice President of Market Strategy and Delivery. He was a founder of Object Design, Inc., a developer of object database management systems and tools, where he served as Vice President from August 1988 through September 1995 and was responsible, at different times, for marketing, corporate development and product management. Mr. Bonte holds a B.A. from The Johns Hopkins University and an M.B.A. from the Harvard Business School.

Joseph J. Friscia joined the Company in 1984 to establish its New York office. Mr. Friscia has served as Vice President of Sales and Marketing since 1987 and has recently undertaken responsibility for delivery of consulting and installation services. Prior to joining the Company, he worked as a money transfer operations manager with Bankers Trust Company and J. Henry Schroder Bank and Trust Company. Mr. Friscia holds a B.A. from Long Island University and an M.B.A. from Adelphi University.

Kenneth W. Olson, a founder of the Company, has served as Vice President of Technical Development since 1983. Prior thereto, he managed the development of specialized computer systems for large-volume transaction processing for TMI Systems Corporation. Mr. Olson holds an S.B. in Humanities and Sciences from the Massachusetts Institute of Technology.

Michael R. Pyle joined the Company in 1985 as an application development manager and has been Vice President of Applications Development since 1990. Mr. Pyle holds a B.C.S. from the CS College in London. Prior to joining the Company, Mr. Pyle worked in Europe and the United States

developing and deploying large-scale communications systems for the financial and commercial sectors.

Ira Vishner, a founder of the Company, has served as Vice President of Corporate Services, Treasurer, and Chief Financial Officer of the Company since 1983 and has been a director since 1994. Prior to 1983, he worked in the executive offices of TMI Systems Corporation where he was responsible for corporate planning, financial analysis, and product marketing. Mr. Vishner holds an S.B. in Mathematics from the Massachusetts Institute of Technology.

CERTAIN STATEMENTS FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The Company, desiring to avail itself of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, wishes to caution readers that the following important factors, among others, in some cases have caused and in the future could cause the Company's actual results to differ materially from those expressed in forward-looking statements made by or on behalf of the Company in filings with the Securities and Exchange Commission, press releases and oral statements.

Words such as "expects," "anticipates," "intends," "plans," "believes," "estimates," "should," and similar words and expressions are intended to identify the forward-looking statements contained in this Form 10-K Report. These statements are based on estimates, projections, beliefs, and assumptions of the Company and its management and are not guarantees of future performance.

Potential Fluctuations in Quarterly Results; Seasonality

The Company's revenue and operating results have varied considerably in the past, and are likely to vary considerably in the future. Such fluctuations may be particularly pronounced because a significant portion of the Company's revenue in any quarter is attributable to product acceptances or license renewals by a relatively small number of customers, and reflecting the Company's policy of recognizing license fee revenue upon product acceptance or license renewal in an amount equal to the present value of the total committed license payments due during the initial license term or renewal period, as the case may be. Product acceptance is generally preceded by an implementation period, typically ranging from one to six months but in some cases significantly longer, and by a lengthy sales cycle. The Company's sales cycle is subject to a number of significant risks over which the Company has little or no control, including customers' budgeting constraints and internal authorization reviews. Product implementation may be delayed for a variety of reasons including unforeseen technical problems and changes dictated by the customer in the scope or schedule of the implementation. Other factors contributing to fluctuations in the Company's revenue and operating results include changes in the level of operating expenses, demand for the Company's products and services, the introduction of new products and product enhancements by the Company and its competitors, competitive conditions in the industry, and general economic conditions. The Company budgets its product development and other expenses anticipating future revenue. If revenue falls below expectations, the Company's business, operating results, and financial condition are likely to be materially and adversely affected because only a small portion of the Company's expenses vary with its revenue. As a result, the Company believes that period-to-period comparisons of its operating results are not necessarily meaningful and should not be relied upon to predict future performance. There can be no assurance that the Company will be able to maintain profitability on an annual or quarterly basis.

The Company's business has experienced and may continue to experience significant seasonality. In recent years the Company has recognized a greater percentage of its revenue in its third and fourth quarters than in the first and second quarters due to the Company's sales commission structure and the impact of that structure on the timing of product acceptances and license renewals by customers. This pattern has been reinforced by the Company's maintenance contracts, some of which entitle customers to, among other things, a fixed number of hours of service per calendar year. Once the annual allotment of service hours is exhausted, customers pay for additional services on an hourly basis, typically resulting in higher services revenue in the Company's second, third, and fourth quarters.

Due to the foregoing factors, it is possible that in some future quarters the Company's operating results will fall below the expectations of the Company, market analysts, and investors. In such event, the price of the Company's Common Stock would likely be materially and adversely affected.

Dependence on New Products; Rapid Technological Change; Product Development and Implementation Risks

The market for customer relationship management software and related consulting and training services is subject to rapid technological change, changing customer needs and preferences, frequent new product introductions, and evolving programming languages and industry standards that may render existing products and services obsolete. The Company's position in its current market or other markets that it may enter could be eroded rapidly by product advances. The life cycles of the Company's products are difficult to estimate, and the Company's growth and future performance will depend in part upon its ability to enhance existing products, and to develop and introduce new products that keep pace with technological advancements, meet changing customer requirements, respond to competitive products, and achieve market acceptance. The Company's product development efforts require, and are expected to continue to require, substantial investments by the Company for research, refinement, and testing, and there can be no assurance that the Company will have the resources sufficient to make such investments. The Company has in the past experienced developmental delays, and there can be no assurance that the Company will not experience difficulties which would delay or prevent the successful development, introduction or implementation of new or enhanced products. In addition, there can be no assurance that such products will meet the requirements of the marketplace and achieve market acceptance, or that the Company's current or future products will conform to changing industry requirements. If the Company is unable for technological or other reasons to develop, introduce or implement new or enhanced products in a timely and effective manner, the Company's business, operating results, and financial condition could be materially and adversely affected.

Products as complex as the Company's may contain errors that may be detected at any point in the products' life cycles. In the past, the Company has discovered certain errors in its products and has experienced shipping delays while such errors were corrected. Such errors have also required the Company to ship corrected products to existing customers. There can be no assurance that errors will not be found in the future resulting in the loss of, or delay in, market acceptance and/or sales and revenue, diversion of development resources, injury to the Company's reputation, or increased service and warranty costs, any of which could have a material adverse effect on the Company's business, operating results, and financial condition.

Computing Platform Shift; Compatibility with Third-Party Relational Databases

The Company commenced efforts in 1992 to evolve versions of its products to use the C++ programming language and run on a variety of open platforms. In December 1995, for the first time one of the new C++ versions of the Company's products was used in production by a customer of the Company. The Company has since shipped new C++ versions of its products for use on RS 6000/AIX, Digital OpenVMS, Sun Solaris, Hewlett-Packard, and Windows/NT platforms. The Company is actively working with customers to bring additional installations of these products into production. There can be no assurance that the new versions of the Company's products will meet the requirements of the marketplace and achieve market acceptance, or that organizations will not migrate to other computing platforms not supported by the Company. Moreover, there can be no assurance that, notwithstanding the benefits of the new versions of the Company's products, some of the Company's existing customers may choose not to migrate to UNIX and Windows/NT systems. In such event, the Company may be required to support both the old and new versions of its products, which could have a material adverse effect on its business, operating results, and financial condition.

The Company believes that the compatibility of customer relationship management software systems with popular relational databases is an important factor in the purchase decision of many organizations. Consequently, the Company recently developed and shipped versions of its software capable of storing work items in Oracle, Informix, Sybase, and Microsoft SQL Server relational databases. However, the Company's existing and potential customers may demand that the Company's systems be compatible with other relational databases and there can be no assurance that the Company will not experience difficulties which would delay or prevent the successful development or introduction of these additional capabilities. Any such difficulty could have a material and adverse effect on the Company's business, operating results, and financial condition.

Dependence on the Financial Services Market; Industry Consolidation

The Company has derived a significant portion of its revenue to date from customers in the financial services market, and the Company's future growth depends, in part, upon increased sales to this market. The financial condition of the Company's customers and their willingness to pay for the Company's products and services are affected by competitive pressures, decreasing operating margins within the industry, currency fluctuations, active geographic expansion, and deregulation. The Company believes that its customers' purchasing patterns are somewhat discretionary. As a result, demand for the Company's products and services could be affected by the condition of the markets the Company serves or a deterioration in economic or market conditions generally.

The financial services market is undergoing intense domestic and international consolidation. In recent years, several customers of the Company have been merged or consolidated out of independent existence, and there is no assurance that the Company will not experience declines in revenue occasioned, in whole or in part, by future mergers or consolidations. Any decline in the demand for the Company's products would have a material, adverse effect on the Company's business, operating results, and financial condition.

Uncertainty of Growth into other Markets

As part of its growth strategy the Company believes that it is critical to continue selling its products to markets other than financial services, such as insurance, telecommunications, healthcare, public utilities, and retail. The Company believes that in connection with such efforts it will be necessary for the Company to continue to hire additional personnel with expertise in these other markets. There can be no assurance that the Company will continue to be successful in selling its products to these other markets or in continuing to attract and retain personnel with the necessary industry expertise. The inability of the Company to succeed in its penetration of these other markets could have a material adverse effect on its business, operating results, and financial condition.

Risks of Customer License Non-Renewal

Revenue attributable to license renewals has historically accounted for a significant portion of the Company's total revenue. While historically a substantial number have been renewed, there can be no assurance that a substantial majority of the Company's customers will continue to renew expiring licenses, and any such non-renewal would require the Company to obtain revenue from other sources in order to achieve its revenue targets. A decrease in the Company's license renewal rate without offsetting revenue from other sources would have a material adverse effect on the Company's business, results of operations, and financial condition.

Dependence on Key Personnel

The Company's future success depends to a significant extent on Mr. Trefler, its other executive officers, and certain technical, managerial, consulting, and sales and marketing personnel. The loss of the services of any of these individuals or group of individuals could have a material adverse effect on the Company's business, operating results, and financial condition. None of the Company's executive officers has entered into an employment contract with the Company, although each is subject to a non-disclosure and non-competition agreement with the Company. The Company does not have, and is not contemplating securing, any significant amount of key-man life insurance on any of its executive officers or other key employees. The Company believes that its future success also will depend significantly upon its ability to attract, motivate, and retain additional highly skilled technical, managerial, consulting, and sales and marketing personnel. In particular, delays in hiring and training qualified sales personnel would adversely affect the Company's operating results due to the substantial time period between the identification of new customers and the successful implementation and acceptance of the Company's products by those customers. Because developing, selling, and maintaining the Company's products requires extensive knowledge of computer hardware and operating systems, programming languages, and application software, the number of qualified potential employees is limited. Moreover, competition for such personnel is intense, and there can be no assurance that the Company will be successful in attracting and retaining the personnel it requires to continue to grow and operate profitably.

Intense Competition

The market for customer relationship management software and related consulting and training

services is relatively new, intensely competitive and highly fragmented. The Company encounters significant competition from internal information systems departments of potential or existing customers that develop custom software. The Company also competes with companies that target the customer interaction or workflow markets, and professional services organizations that develop custom software in conjunction with rendering consulting services. Such competitors vary in size and in the scope and breadth of products and services offered. The Company anticipates increased competition for market share and pressure to reduce prices and make sales concessions, which could materially and adversely affect the Company's business, operating results, and financial condition.

Many of the Company's competitors have greater resources than the Company, and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards, or to changes in customer requirements or preferences. Many of the Company's competitors can devote greater managerial or financial resources than the Company can to develop, promote, and distribute customer service management software products and provide related consulting and training services. There can be no assurance that the Company's current or future competitors will not develop products or services which may be superior in one or more respects to the Company's or which may gain greater market acceptance. Some of the Company's competitors have established or may establish cooperative arrangements or strategic alliances among themselves or with third parties, thus enhancing their abilities to compete with the Company. It is likely that new competitors will emerge and rapidly acquire market share. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not materially and adversely affect its business, operating results, and financial condition.

Management of Growth

The growth in the size, geographic scope and complexity of the Company's business and the expansion of its product offerings and customer base have placed, and are expected to continue to place, a significant strain on the Company's management, operations, and capital needs. The Company's continued growth, if any, will require it to hire, train, and retain many employees both in the United States and abroad, particularly additional sales and financial personnel, and will also require the Company to enhance its financial and managerial controls and reporting systems. There is no assurance that the Company can manage its growth effectively or that the Company will be able to attract and retain the necessary personnel to meet its business challenges. If the Company is unable to manage its growth effectively, the Company's business, operating results, and financial condition could be materially and adversely affected.

Risks Associated with International Operations; Currency and Other Risks

Sales to customers headquartered outside of the United States represented approximately 17.7% and 16.5% of the Company's total revenue in 1996 and 1997, respectively. The Company, in part through its wholly-owned subsidiary based in the United Kingdom, markets products and renders consulting and training services to customers based in Canada, the United Kingdom, France, Switzerland, Ireland, Luxembourg, Mexico, and Sweden and is in negotiations with potential customers based in other foreign countries. The Company established additional offices in continental Europe and the Pacific Rim. The Company believes that its continued growth will necessitate expanded international operations requiring a diversion of managerial attention and financial resources. The Company anticipates hiring additional personnel to accommodate international growth, and the

Company may also enter into agreements with local distributors, representatives, or resellers. If the Company is unable to do one or more of these things in a timely manner, the Company's growth, if any, in its foreign operations will be restricted, and the Company's business, operating results, and financial condition could be materially and adversely affected.

In addition, there can be no assurance that the Company will be able to maintain or increase international market demand for its products. Most of the Company's international sales are denominated in U.S. dollars. Accordingly, any appreciation of the value of the U.S. dollar relative to the currencies of those countries in which the Company distributes its products may place the Company at a competitive disadvantage by effectively making its products more expensive as compared to those of its competitors.

Additional risks inherent in the Company's international business activities generally include unexpected changes in regulatory requirements, increased tariffs and other trade barriers, the costs of localizing products for local markets and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights, heightened risks of political and economic instability, the possibility of nationalization or expropriation of industries or properties, difficulties in managing international operations, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of "double taxation"), enhanced accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws. There can be no assurance that one or more of these factors will not have a material adverse effect on the Company's foreign operations, and, consequentially, the Company's business, operating results, and financial condition.

Impact of Year 2000 Issue

The "Year 2000 Issue" refers to the problems associated with computer programs having been written using two digits rather than four to define the applicable year. The Company has performed an assessment of the software it uses internally and the software it licenses to customers and such assessment has not revealed any major outstanding problems in this regard. There can be no assurance that such problems will not develop or be revealed in the future which could materially and adversely affect the Company's business, operating results, and financial condition.

Reliance on Certain Relationships

The Company has a number of third party relationships that are significant to its sales, marketing and support activities and product development efforts. The Company relies upon relational database management systems applications and development tool vendors, software and hardware vendors, and consultants to provide marketing and sales opportunities for the Company's direct sales force, and strengthen its product offerings through the use of industry-standard tools and utilities. The Company has also recently begun establishing relationships with third parties that will distribute the Company's products. In particular, the Company's relationship with First Data Corporation is central to its distribution of products to several markets. The Company's strategy in entering into these relationships is to keep pace with the technological and marketing developments of major software vendors, to acquire technical assistance for the Company's product development efforts, and to leverage the Company's sales and marketing capabilities. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources than the

Company, will not develop or market software products which compete with the Company's products in the future or will not otherwise discontinue their relationships with or support of the Company. The failure of the Company to maintain its existing relationships, or to establish new relationships in the future, because of a divergence of interests, acquisition of one or more of these third parties, or for any other reason, could have a material adverse effect on the Company's business, results of operations, and financial condition.

PART II

Item 5 MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The information required by this item may be found in the section entitled "Stock Price History and Related Stockholder Matters," in the Company's 1997 Annual Report to Stockholders and is incorporated herein by reference.

Initial Public Offering Proceeds

The Company completed an initial public offering of 3.4 million shares of its common stock on July 24, 1996 at a price to the public of \$12.00 per share, pursuant to a registration statement on Form S-1 (SEC File No 3313-3807) declared effective by the Securities and Exchange Commission on July 18, 1996. The managing underwriters for the offering were Goldman Sachs & Co., Cowen and Company, and Montgomery Securities. Of the 3.4 million shares of common stock sold in the offering, 2.7 million were sold by the Company and 0.7 million were sold by stockholders of the Company, resulting in net proceeds to the Company and selling stockholders of \$29.4 million and \$7.8 million, respectively. None of the expenses incurred by the Company in connection with the offering (which expenses including the underwriting discount totaled approximately \$3.5 million) were paid, directly or indirectly, to directors or officers of the Company or their associates, to persons owning 10% or more of any class of equity securities of the Company or to affiliates of the Company. The proceeds have been used to fund the Company's working capital and asset purchase requirements as shown in the Company's Consolidated Statement of Cash Flows for 1996 and 1997 contained in the 1997 Annual Report to Stockholders.

Item 6 FIVE YEAR COMPARISON OF SELECTED CONSOLIDATED FINANCIAL DATA

The information required by this item may be found in the section entitled "Five Year Comparison of Selected Consolidated Financial Data," in the Company's 1997 Annual Report to Stockholders and is incorporated herein by reference.

Item 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Item 7A QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Not Applicable

The information required by this item may be found in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," in the Company's 1997 Annual Report to Stockholders and is incorporated herein by reference.

Item 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Company's consolidated financial statements and supplementary data appear in the Company's 1997 Annual Report to Stockholders and is incorporated herein by reference. Financial statement schedules are set forth in Item 14, "Exhibits, Financial Statement Schedules, and Reports on Form 8-K" of this Form 10-K and are filed herewith.

Item 9 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Reference is made to the Company's report on Form 8-K filed with the Securities and Exchange Commission (the "Commission") on November 6, 1997 (as amended by the Company's report on Form 8-K/A filed with the Commission on November 18, 1997) and to the Company's report on Form 8-K filed with the Commission on December 16, 1997.

PART III

Item 10 DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information relating to the Directors of the Company is set forth in the section entitled "Election of Directors" in the 1998 Proxy Statement, which section is incorporated herein by reference. Information relating to the executive officers of the Company is set forth in Part I, immediately following Item 4, of this Report under the caption "Executive Officers of the Registrant." Information relating to compliance with Section 16(a) of the Securities Exchange Act of 1934 is set forth in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the 1998 Proxy Statement, which section is incorporated herein by reference.

Item 11 EXECUTIVE COMPENSATION

Information relating to executive compensation is set forth in the sections entitled "Director Compensation," "Executive Compensation," "Option Grants," "Aggregated Option Exercises and Year-End Option Table," and "Compensation Committee Interlocks and Insider Participation" in the 1998 Proxy Statement, which sections are incorporated herein by reference.

Item 12 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information relating to ownership of equity securities of the Company by certain beneficial owners and management is set forth in the section entitled "Principal and Management Stockholders" in the 1998 Proxy Statement, which section is incorporated herein by reference.

Item 13 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information relating to certain relationships and related transactions is set forth in the section entitled "Certain Transactions" in the 1998 Proxy Statement, which section is incorporated herein by reference.

PART IV

Item 14 EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) (1) Financial Statements

The following consolidated financial statements required by Item 8 of this Form 10-K are incorporated by reference from the 1997 Annual Report.

Item -----	Location in 1997 Annual Report -----
Consolidated Balance Sheets at December 31, 1996 and 1997	Page 23
Consolidated Statements of Income for the years ended December 31, 1995, 1996, and 1997	Page 24
Consolidated Statements of Stockholders' Equity for the years ended December 31, 1995, 1996, and 1997	Page 25
Consolidated Statements of Cash Flows for the years ended December 31, 1995, 1996, and 1997	Page 26
Notes to Consolidated Financial Statements	Page 27 - 36
Reports of Independent Public Accountants	Page 37 - 38

(2) Financial Statement Schedules

The following financial statement schedule as of December 31, 1996 and 1997 and for the years ended December 31, 1995, 1996, and 1997 is required to be filed by Item 8 of this Form 10-K, and is filed herewith as noted below. The financial statement schedule should be read in conjunction with the consolidated financial statements of the Company.

Schedule II - Valuation and Qualifying Accounts Page 30

All other schedules are omitted because the required information is not present or not present in sufficient amounts to require submission of the schedule or because the information is reflected in the consolidated financial statements or notes thereto.

(3) Exhibits

The exhibits filed as part of this Report are listed in the Exhibit Index immediately following the financial statement schedule included in this Report.

(b) Reports on Form 8-K

On November 6, 1997, the Company filed a report on Form 8-K with the Commission (which was amended by a report on Form 8-K/A filed by the Company on November 18, 1997) in connection

with the termination of the relationship with the Company's independent public accountants. On December 16, 1997, the Company filed a report on Form 8-K with the Commission in connection with its appointment of the successor independent public accountants.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS ON SUPPLEMENTARY SCHEDULE

To Pegasystems Inc.:

We have audited, in accordance with generally accepted auditing standards, the consolidated statements of Pegasystems Inc. and have issued our report thereon dated April 2, 1998. Our audit was made for the purpose of forming an opinion on those consolidated financial statements taken as a whole. The schedule listed in the financial statement schedule index is the responsibility of the Company's management and is presented for the purposes of complying with the Securities and Exchange Commission's rules and is not a part of the basic consolidated financial statements. This schedule has been subjected to auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, fairly states, in all material respects, the financial data required to be set forth therein in relation to the basic consolidated financial statements taken as a whole.

Boston, Massachusetts
April 2, 1998

Arthur Andersen LLP

Page 29

SCHEDULE II

**PEGASYSTEMS INC. AND SUBSIDIARIES
VALUATION AND QUALIFYING ACCOUNTS
Three Years Ended December 31, 1997**

Description	Balance at beginning of period	Additions charged to costs and expenses	Charged to other account	Deductions (c)	Balance at end of period
Allowance for doubtful accounts:					
Year ended December 31, 1995	\$ --	\$ 793,310	\$ --	\$359,423	\$ 433,887
Year ended December 31, 1996	433,887	300,000	204,685 (a)	--	938,572
Year ended December 31, 1997	938,572	1,938,148	284,781 (b)	961,720	2,199,781

(a) Amount reclassified from liabilities during the year.

(b) Amount relates to service revenue reversed, which was previously charged against the allowance for doubtful accounts.

(c) Deductions are related to accounts receivable write-offs.

PEGASYSTEMS INC.

Exhibit Index

Exhibit No.	Description
3.3.*	Restated Articles of Organization of the Registrant.
3.4.*	Restated By-Laws of the Registrant.
4.1.*	Specimen certificate representing the Common Stock.
10.1.*	Amended and Restated 1994 Long-Term Incentive Plan.
10.2.*	1996 Non-Employee Director Stock Option Plan.
10.3.*	1996 Employee Stock Purchase Plan.
10.4.*	Loan Agreement dated as of December 16, 1993 between the Registrant and Fleet Bank of Massachusetts, N.A.
10.5.*	Loan Modification Agreement dated as of May 5, 1995 between the Registrant and Fleet Bank of Massachusetts, N.A.
10.6.*	Second Loan Modification Agreement dated May 15, 1996 between the Registrant and Fleet National Bank (successor by merger to Fleet Bank of Massachusetts, N.A.).
10.11.*	Promissory Note dated May 15, 1996 in the amount of \$5,000,000 made by the Registrant to the order of Fleet National Bank.
10.13.*	Lease Agreement dated February 26, 1993 between the Registrant and Riverside Office Park Joint Venture.
10.14.*	Amendment Number 1 to Lease Agreement dated August 7, 1994 between the Registrant and Riverside Office Park Joint Venture.
10.15.	Warrant agreement dated June 27, 1997 by and between the Registrant and First Data Resources Inc.
13.1.	Portions of the 1997 Annual Report to Stockholders incorporated by reference into this Report.
16.1.+	Letter of Ernst & Young LLP dated November 18, 1997 to the Securities and Exchange Commission.
21.1.*	Subsidiaries of the Registrant.
23.1.	Consent of Arthur Andersen LLP.
23.2.	Consent of Ernst & Young LLP.
27.1.	Financial Data Schedule-1997.
27.2.	Financial Data Schedule-1996.

* Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (Registration No. 333-03807) or an amendment thereto and incorporated herein by reference to the same exhibit number.

+ Filed as an exhibit to the Registrant's report on Form 8-K/A filed with the Securities and Exchange Commission on November 18, 1997 and incorporated herein by reference.

WARRANT AGREEMENT

dated June 27, 1997

by and between

PEGASYSTEMS INC.

and

FIRST DATA RESOURCES INC.

Confidential

WARRANT AGREEMENT

This Warrant Agreement (this "Warrant Agreement") is entered into as of June 27, 1997, by and between PEGASYSTEMS INC., a Massachusetts corporation with its principal place of business at 101 Main Street, Cambridge, Massachusetts 02142-1590 ("Pegasystems"), and FIRST DATA RESOURCES INC., a Delaware corporation with its principal place of business at 7302 Pacific Street, Omaha, Nebraska 68114 ("FDR").

WHEREAS, Pegasystems is in the business of inter alia developing, marketing, licensing, and installing customer service management software to automate customer interactions, including the Software (as hereafter defined); and

WHEREAS, FDR and its Affiliates are in the business of providing information processing products and services to a broad range of financial institutions and other commercial enterprises;

WHEREAS, contemporaneous with the signing of this Warrant Agreement, Pegasystems and FDR have entered into a Software License and Support Agreement (the "Agreement") pursuant to which Pegasystems has granted to FDR and its Affiliates certain rights in and to the Software; and

WHEREAS, as part of the consideration for and as a condition precedent to the Agreement, each party agrees to enter into this Warrant Agreement;

NOW THEREFORE, in consideration of the premises, covenants, representations, and warranties contained herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Pegasystems and FDR agree as follows:

DEFINITIONS

Unless the context shall otherwise require, the capitalized terms used herein shall have the respective meanings set forth in the Agreement. Each definition includes the singular and the plural, and reference to the neuter gender includes the masculine and feminine where appropriate. The headings to the Articles and Sections hereof are for convenience of reference and shall not affect the meaning or interpretation of this Warrant Agreement. Except as otherwise stated, reference to Articles, Sections, and Exhibits mean the Articles, Sections, and Exhibits of this Warrant Agreement. Any Exhibits are hereby incorporated by reference into and shall be deemed a part of this Warrant Agreement. Unless the context clearly indicates otherwise, the word "including" means "including but not limited to."

Confidential

**ARTICLE 1
WARRANT**

1.1. Warrant As soon as practicable after the execution of this Warrant Agreement, Pegasystems shall deliver to FDR a warrant in the form attached hereto as Exhibit A.

ARTICLE 2

INCORPORATION BY REFERENCE

2.1. Incorporation by Reference. Articles 8, 9, 10, 11, 12, and 15 of the Agreement are hereby incorporated by reference into and shall be deemed a part of this Warrant Agreement.

Confidential

IN WITNESS WHEREOF, the parties hereto have executed this Warrant Agreement as of the date first written above.

PEGASYSYSTEMS INC

FIRST DATA RESOURCES INC.

By: /s/ Alan Trefler

By: /s/ Donna M. Walsh

Alan Trefler
President

Donna M. Walsh
Vice President, Card Services Group

Dated June 27, 1997

Dated June 27, 1997

Confidential

**EXHIBIT A
FORM OF WARRANT**

See attached.

Confidential

WARRANT

Issued by

PEGASYSTEMS INC.

Warrant No. A-1

Original Issue

Date: _____, 1997

NEITHER THIS WARRANT NOR ANY OF THE SECURITIES PURCHASABLE UPON EXERCISE HEREOF HAVE BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT"), OR ANY STATE SECURITIES LAW. NO TRANSFER OF THIS WARRANT OR OF THE SECURITIES PURCHASABLE UPON EXERCISE HEREOF SHALL BE VALID OR EFFECTIVE UNLESS SUCH TRANSFER IS MADE PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE ACT OR AN EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE ACT AND IN ACCORDANCE WITH THE APPLICABLE PROVISIONS OF THIS WARRANT.

Warrant No. A-1

**WARRANT
Issued by
PEGASYSTEMS INC.**

THIS IS TO CERTIFY THAT FIRST DATA RESOURCES INC. ("FDR"), or registered assigns, is entitled, at any time during the Exercise Period, defined below, to purchase from PEGASYSTEMS INC., a Massachusetts corporation ("Pegasystems"), Two hundred eighty-four thousand, eight hundred seventy-six (284,876) shares (subject to adjustment as provided herein) of the Common Stock defined below, of Pegasystems, at a purchase price of Twenty-eight and twenty five cents (\$28.25) per share (the initial "Exercise Price", subject to adjustment as provided herein), all on the terms and conditions and pursuant to the provisions hereinafter set forth.

1. DEFINITIONS

As used in this Warrant, the following terms have the respective meanings set forth below:

"Affiliate" shall mean, with respect to any Period any other Person that directly or indirectly controls, or is under common control with, or is controlled by, such Person. As used in this definition, "control" (including, with its correlative meanings, "controlled by" and "under common control with") shall mean possession directly or indirectly, of the power to direct or cause the direction of management or policies (whether through ownership of securities or partnership or other ownership interests, by contract or otherwise). Notwithstanding the foregoing, (i) no individual shall be deemed to be an Affiliate of a corporation solely by reason of being an officer or director of such corporation and (ii) neither Pegasystems nor any Affiliate of Pegasystems shall be deemed to be an Affiliate of FDR or of any Affiliate of FDR.

"Business Day" shall mean any day that is not a Saturday or Sunday or a day on which banks are required or permitted to be closed in New York City.

"Call Notice" shall have the meaning set forth in Section 8.

"Call Price" shall have the meaning set forth in Section 8.

"Call Right" shall have the meaning set forth in Section 8.

"Cashless Exercise Option" shall have the meaning set forth in Section 2.1(c).

"Cash Out Merger Event" shall mean any transfer of more than fifty percent (50%) of the voting stock or assets of Pegasystems to one or a related group of Persons pursuant to a merger, consolidation exchange offer, tender offer or other form of business combination other than a business combination in which the shareholders of Pegasystems prior to the consummation of such transaction end up owning a majority of the voting stock of the surviving entity in such transaction.

"Commission" shall mean the Securities and Exchange Commission or any other federal agency then administering the Securities Act and other federal securities laws.

"Common Stock" shall mean (except where the context otherwise indicates) the Common Stock of Pegasystems, par value \$0.01 per share, as constituted on the Original Issue Date, and any capital stock into which such Common Stock may thereafter be changed or that may be issued in respect of, in exchange for or in substitution for such Common Stock by reason of any stock splits, reclassifications, stock dividends or distributions, and shall also include shares of common stock of any successor or acquiring corporation received by or distributed to the holders of Common Stock of Pegasystems in the circumstances contemplated by Section 3.4.

"Continuously Effective", with respect to a specified registration statement, shall mean that it shall not cease to be effective and available for Transfers of Registrable Securities thereunder for longer than either (i) any three (3) consecutive business days, or (ii) an aggregate of six (6) business days during the period specified in the relevant provision of this Agreement.

"Convertible Securities" shall mean evidences of indebtedness, shares of stock or other securities that are convertible into or exchangeable for, with or without payment of additional consideration in cash or property, shares of Non-Preferred Stock either immediately or upon the occurrence of a specified date or a specified event.

"Current Market Price" shall mean as of any specified date with respect to a specified class of Non-Preferred Stock the average of the daily market prices of such class of Non-Preferred Stock of Pegasystems for the twenty (20) consecutive trading days immediately preceding such date; provided that for the purpose of determining the Call Price under Article 8 below, "Current Market Price" shall mean the greater of (A) the average of the daily market prices of the Common Stock of Pegasystems during the twenty (20) consecutive trading days commencing on the date of the related Demand Request (or if such date is not a trading day, commencing on the next trading day) and (B) the average of the daily market prices of the Common Stock of Pegasystems during the twenty (20)

consecutive trading days commencing on the date of the related Call Notice (or if such date is not a trading day, commencing on the next trading day). The "daily market price" of a specified class of Non-Preferred Stock for each such trading day shall be: (i) if such Non-Preferred Stock is then listed on a national securities exchange or is listed on NASDAQ and is designated as a National Market System security, the last sale price, regular way, on such day on the principal stock exchange or market system on which such class of Non-Preferred Stock is then listed or admitted to trading, or, if no such sale takes place on such day, the average of the closing bid and asked prices for such class of Non-Preferred Stock on such day as reported on such stock exchange or market system or (ii) if such class of Non-Preferred Stock is not then listed or admitted to trading on any national securities exchange or designated as a National Market System security on NASDAQ but is traded over-the-counter, the average of the closing bid and asked prices for such class of Non-Preferred Stock as reported on NASDAQ or the Electronic Bulletin Board or in the National Daily Quotation Sheets, as applicable.

"Demanding Holders" shall have the meaning set forth in Section 7.1(a).

"Demand Registration" shall have the meaning set forth in Section 7.1(a).

"Demand Request" shall have the meaning set forth in Section 7.1(a).

"Designated Office" shall have the meaning set forth in Section 10.

"Effective Date" shall mean, with respect to a Cash Out Merger Event, the date and time of consummation of the transaction constituting such Cash Out Merger Event.

"Exercise Date" shall have the meaning set forth in Section 2.1(a).

"Exercise Notice" shall have the meaning set forth in Section 2.1(a).

"Exercise Period" shall mean the period commencing at 9:00 A.M. Eastern Time on the first annual anniversary of the Original Issue Date and ending at 5:00 P.M. Eastern Time on the fifth annual anniversary of the Original Issue Date; provided: (i) that if the scheduled expiration date of the Exercise Period is not a Business Day, the Exercise Period shall be automatically extended until the next succeeding Business Day; (ii) that upon the occurrence of a Cash Out Merger Event, the Exercise Period shall commence on the Effective Date of such Cash Out Merger Event and (iii) that the Exercise Period shall terminate if the License Agreement is terminated pursuant to Section 11.3 thereof. Notwithstanding the foregoing, the Exercise Period shall be subject to automatic extension to the extent provided in Section 7.1(c).

"Exercise Price" shall mean, in respect of a share of Common Stock at any date herein specified, the initial Exercise Price set forth in the preamble of this Warrant as adjusted from time to time pursuant to Section 3.

"Expert's Determination" shall have the meaning set forth in Section 13.8.

"Fair Distribution Value" of any evidences of indebtedness or other assets distributed to holders of Common Stock in a distribution subject to Section 3.2(a), shall mean the aggregate fair market value of such evidences of indebtedness or other assets as determined in good faith by the Board of Directors, if the Board of Directors has made such a determination, and otherwise as determined by the Chief Financial Officer of Pegasystems, subject to the right of the Majority Holders to challenge such valuation pursuant to Section 13.8.

"Fair Value" per share of Common Stock or other class of Non-Preferred Stock as of any specified date shall mean (i) if the Common Stock or such class of Non-Preferred Stock is publicly traded on such date, the Current Market Price per share or (ii) if the Common Stock or such Non-Preferred Stock is not publicly traded on such date, the fair market value per share as determined in good faith by the Board of Directors, if the Board of Directors has made such a determination, and otherwise as determined by the Chief Financial Officer of Pegasystems and set forth in a written notice to each Holder, subject to the right of the Majority Holders to challenge such valuation pursuant to Section 13.8. The "fair market value" per share of Common Stock or Non-Preferred Stock for such purposes shall be based on the fair market value of 100% of Pegasystems and its Subsidiaries as if sold as a going concern and assuming full conversion, exercise and exchange of all Warrants, Convertible Securities and Stock Purchase Rights, as well as any transfer restrictions, forfeiture conditions or other relevant factors relevant to the determination of the fair market value of the Common Stock or Non-Preferred Stock in question.

"FDR" shall mean First Data Resources Inc., a Delaware corporation, and any successor corporation.

"Fully Diluted Outstanding" shall mean, when used with reference to Common Stock or Non-Preferred Stock, at any date as of which the number of shares thereof is to be determined: (i) all issued and outstanding shares of Common Stock or Non-Preferred Stock (as the case may be), (ii) all shares of Common Stock or Non-Preferred Stock (as the case may be) issuable upon the exercise of any issued and outstanding Convertible Securities and (iii) all shares of Common Stock or Non-Preferred Stock (as the case may be) directly or indirectly issuable upon the exercise of any issued and outstanding Stock Purchase Rights, except in each such case any such shares of Common Stock or Non-Preferred Stock Convertible Securities or Stock Purchase Rights then owned or held by or for the account of any subsidiary of Pegasystems, and shall include all shares of Common Stock or Non-Preferred Stock (as the case may be) issuable in respect of outstanding scrip or any certificates representing fractional interests in shares of Common Stock or Non-Preferred Stock, as the case may be.

"Holder" or "Holders" shall mean any Person who is the registered holder of a Warrant or of any Common Stock issued upon exercise of a Warrant.

"Holders' Determination" shall have the meaning set forth in Section 13.8.

"Independent Financial Expert" shall mean an investment banking firm or other Person jointly selected by Pegasystems and the relevant Majority Holders; provided that, if Pegasystems and such Majority Holders are unable to so agree, they shall each select a nationally recognized investment banking firm and the two firms so selected shall jointly select a third investment banking firm or appraiser to act as an Independent Financial Expert. Unless otherwise agreed by Pegasystems and the Majority Holders, no Person shall be selected as an Independent Financial Expert: (i) if such Person (or any of its Affiliates) has a direct or indirect financial interest in Pegasystems or any of the Holders (other than in its trading accounts), (ii) if any of the senior officers, directors, principals or partners of such Person (or any of its Affiliates) has acted as a promoter, director or senior officer of Pegasystems or any Holder (or any of their respective Affiliates) during the twenty-four month period immediately preceding the date such Person is called upon to serve as an Independent Financial Expert hereunder, (iii) if such Person (or any of its Affiliates) has acted as an underwriter with respect to any of the securities of Pegasystems or any Holder (or any of their respective Affiliates) during the twenty-four month period immediately preceding the date such Person is called upon to serve as an Independent Financial Expert hereunder or (iv) if such Person (or any of its Affiliates) has provided any advice or opinions to Pegasystems or any Holder during the twenty-four month period immediately preceding the date such Person is called upon to serve as an Independent Financial Expert hereunder. In the event that the parties are unable to agree on an Independent Financial Expert, Pegasystems and the relevant Majority Holders shall each be responsible for the fees and expenses of the investment banking firm respectively appointed by them for the purpose of selecting an Independent Financial Expert. The fees and expenses of the Independent Financial Expert shall be borne in accordance with Section 13.8.

"License Agreement" shall mean the Software License and Support Agreement, dated as of June 27, 1997, between Pegasystems and FDR, as the same may be amended from time to time.

"Lock-Up Period" with respect to an underwritten registered offering shall mean the period, if any, following the effective date of the registration statement filed with the Commission in connection with such offering during which the underwriters require (i) that the Holders of Registrable Securities refrain from selling shares of Common Stock in the market or (ii) that Pegasystems refrain from selling shares of Common Stock or filing a registration statement with the Commission with respect to sales of Common Stock.

"Majority Holders", with respect to a given determination, shall mean the Holders of Warrants and/or Common Stock issued upon the exercise of Warrants representing more than fifty percent (50%) of the Common Stock issued or issuable upon exercise of the Warrants (with any such Warrants being deemed to represent, for the purposes of such calculation, the shares of Common Stock then issuable upon exercise thereof) directly affected by such determination.

"Majority Selling Holders" shall mean, with respect to a Demand Registration, Selling Holders representing a majority of the Registrable Securities to be included in such Demand Registration.

"NASDAQ" shall mean the NASDAQ quotation system, or any successor reporting system.

"Non-Preferred Stock" shall mean the Common Stock and any other class of capital stock of Pegasystems (regardless of how denominated) unless such class is limited in respect of the right to participate in dividends or distributions to an amount that is (i) fixed or (ii) set by formula, auction or similar mechanism without reference to the amount of Pegasystems earnings or surplus (e.g., by reference to a floating interest rate).

"Non-Registered Distribution" shall have the meaning set forth in Section 7.1(a).

"Original Issue Date" shall mean the date on which the Original Warrant was issued, as set forth on the cover page of this Warrant.

"Original Warrant" shall mean the Warrant originally issued by Pegasystems on the Original Issue Date to FDR.

"Pegasystems" shall mean Pegasystems Inc., a Massachusetts corporation, and any successor corporation

"Pegasystems Determination" shall have the meaning set forth in Section 13.8.

"Person" shall mean any individual, sole proprietorship, partnership, limited liability company, joint venture, trust, incorporated organization, association, corporation, institution, public benefit corporation, entity or government (whether federal, state, county, city, municipal or otherwise, including, without limitation, any instrumentality, division, agency, body or department thereof).

"Piggyback Registration" shall have the meaning set forth in Section 7.2.

"Register", "registered" and "registration" shall refer to a registration effected by preparing and filing a registration statement or similar document in compliance with the Securities Act, and the declaration or ordering by the Commission of effectiveness of such registration statement or document.

"Registrable Securities" shall mean (i) any shares of Restricted Stock issued or issuable to the Holders upon the exercise of the Warrants and (ii) any securities issued to the Holders in substitution or exchange for, or upon the transfer of, Restricted Stock which immediately prior to such substitution, exchange or transfer constituted Registrable Securities. As to any particular Registrable Securities, once issued, such Registrable Securities shall cease to be Registrable Securities when (A) a registration statement with respect to the sale of such Registrable Securities shall have become effective under the Securities Act and such Registrable Securities shall have been disposed of in accordance with such registration statement, (B) they shall have been distributed to the public pursuant to Rule 144, (C) Pegasystems shall have delivered to the Holders new certificates or other evidences of ownership for such securities not bearing any legend relating to restrictions on transfer

and such shares may be resold without subsequent registration under the Securities Act and any applicable state securities laws then in effect or (D) such securities are no longer outstanding or are held by Pegasystems or any Affiliate of Pegasystems. In addition, for the purposes of determining whether the Holders of any requisite portion of Registrable Securities have taken any action contemplated by this Agreement, (x) a Person shall be deemed to hold Registrable Securities issuable upon conversion of any Warrants or Convertible Securities owned by it or which it has the right to acquire, and (y) any Registrable Securities owned by Pegasystems or any Affiliate of Pegasystems shall not be deemed outstanding.

"Registration Expenses" shall have the meaning specified in Section 7.4.

"Restricted Stock" shall mean shares of Common Stock issued upon exercise of any Warrant that have not been registered under the Securities Act.

"Rule 144" shall mean Rule 144 under the Securities Act or any successor provision.

"Securities Act" shall mean the Securities Act of 1933, as amended, or any similar federal statute, and the rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

"Selling Holders" shall mean, collectively, any holders of Registrable Securities whose Registrable Securities are included in any Demand Registration or Piggyback Registration.

"Selling Holders' Counsel Fees" shall mean the reasonable fees and expenses of (i) one primary counsel representing all Selling Holders in a Demand Registration (as selected by the Majority Selling Holders) and (ii) any additional local counsel reasonably required to assist such primary counsel, but excluding any such fees (but not expenses) that exceed \$25,000. To the extent that any such excess fees are attributable to the exercise by Pegasystems of its registration postponement rights under Section 7.1(c) or the occurrence of a stop order, non-routine post-effective amendment or other deviation from the normal course of a registered offering of securities such excess fees shall be additional to such aforementioned \$25,000 and shall be borne by Pegasystems.

"Stock Purchase Rights" shall mean any options, warrants or other securities or rights to subscribe to or exercisable for the purchase of shares of Non-Preferred Stock or Convertible Securities, whether or not immediately exercisable.

"Subsidiary" shall mean, with respect to any Person, any corporation or other entity of which at least 30% of the outstanding securities or other ownership interests having by the terms thereof ordinary voting power to elect a majority of the board of directors or other Persons performing similar functions (regardless of whether at the time stock of any other class or classes of such corporation or entity shall have or might have voting power by reason of the happening of any contingency) is at the time directly or indirectly owned or controlled by such Person or one or more of its Subsidiaries unless another Person then owns or controls an equal or greater percentage of such

outstanding securities or other ownership interests. "Wholly Owned Subsidiary" means any such corporation or other entity of which all of such securities or other ownership interests, other than director's qualifying shares, are so owned or controlled.

"Substitute Property" shall have the meaning set forth in Section 3.4.

"Transfer" shall mean any disposition of any Warrant or Restricted Stock or of any interest in either thereof, which would constitute a "sale" thereof within the meaning of the Securities Act.

"Warrant Price" shall mean an amount equal to (i) the number of shares of Common Stock being purchased upon exercise of this Warrant pursuant to Section 2.1, multiplied by (ii) the Exercise Price as of the date of such exercise.

"Warrants" shall mean the Original Warrant and any warrant issued upon permitted transfer, division or combination of, or in substitution for, such Original Warrant or any other such Warrant. All Warrants shall at all times be identical as to terms and conditions and date except for the number of shares of Common Stock for which they may be exercised.

2. EXERCISE OF WARRANT

2.1. Manner of Exercise. (a) From time to time during the Exercise Period, a Holder may exercise this Warrant, on any Business Day, for all or any part of the number of shares of Common Stock purchasable hereunder (subject to Section 2.2 below and provided that no exercise shall be for fewer than 10,000 shares of Common Stock). In order to exercise this Warrant, in whole or in part, a Holder shall (i) deliver to Pegasystems (at the notice address provided for in Section 13.2) a written notice of the Holder's election to exercise this Warrant (an "Exercise Notice"), which Exercise Notice shall be irrevocable and specify the number of shares of Common Stock to be purchased, together with this Warrant and

(ii) pay to Pegasystems the Warrant Price as provided in Section 2.1(c) below (the date on which both such delivery and payment shall have first taken place being hereinafter sometimes referred to as the "Exercise Date"). Such Exercise Notice shall be in the form of the subscription form appearing at the end of this Warrant as Annex A, duly executed by the Holder or its duly authorized agent or attorney.

(b) Upon receipt of such Exercise Notice, Warrant and payment, Pegasystems shall, as promptly as practicable, and in any event within five (5) Business Days thereafter, cause to be executed and delivered to the Holder a certificate or certificates representing the aggregate number of full shares of Common Stock purchasable upon such exercise, together with cash in lieu of any fraction of a share (as provided in Section 2.2). The stock certificate or certificates so delivered shall be, to the extent possible, in such denomination or denominations as the exercising Holder shall reasonably request in the Exercise Notice and shall be registered in the name of the Holder or such other name as shall be designated in the Exercise Notice. This Warrant shall be deemed to have been exercised and such certificate or certificates shall be deemed to have been issued, and the Holder or any other Person so designated to be named therein shall be deemed to have become a holder of

record of such shares for all purposes, as of the Exercise Date. If this Warrant shall have been exercised in part, Pegasystems shall, at the time of delivery of the certificate or certificates representing the shares of Common Stock being issued, deliver to the Holder a new Warrant evidencing the rights of the Holder to purchase the unpurchased shares of Common Stock called for by this Warrant. Such new Warrant shall in all other respects be identical with this Warrant.

(c) Payment of the Warrant Price shall be made at the option of the Holder either (i) by delivery of a certified or official bank check or by wire transfer to an account designated by Pegasystems, in either case in immediately available funds in the amount of such Warrant Price, or (ii) by instructing Pegasystems to withhold a number of shares of Common Stock then purchasable upon exercise of this Warrant with an aggregate Fair Value equal to such Warrant Price (the "Cashless Exercise Option"). In the event of any such withholding of Common Stock purchasable upon exercise of this Warrant where the number of shares whose Fair Value is equal to the Warrant Price is not a whole number, the number of shares withheld by Pegasystems shall be rounded up to the nearest whole share and Pegasystems shall make a cash payment to the Holder based on the incremental fraction of a share being so withheld by Pegasystems in an amount determined in accordance with Section 2.2.

2.2. Fractional Shares. Pegasystems shall not be required to deliver any fractional shares of Common Stock upon exercise of this Warrant. As to any fraction of a share that the Holder of this Warrant would otherwise be entitled to purchase upon any such exercise, Pegasystems shall pay a cash adjustment in respect of such fraction in an amount equal to the same fraction of the Fair Value of one share of Common Stock as of the Exercise Date.

2.3. Continued Validity and Application. A Holder of shares of Common Stock (or any Substitute Property) issued upon the exercise of this Warrant, in whole or in part, including any transferee of such shares (or such Substitute Property), shall continue, with respect to such shares (or such Substitute Property), to be entitled to all rights and to be subject to all obligations that are applicable to such Holder by the terms of this Warrant (all of which rights and obligations shall survive the exercise of this Warrant), including without limitation the provisions of Section 7. Pegasystems shall, at the time of any exercise of this Warrant or any transfer of such Common Stock (or Substitute Property), upon the request of such Holder, acknowledge in writing, in form and substance reasonably satisfactory to such Holder, their continuing obligations to afford to such Holder such rights referred to in this Section 2.3; provided, however, that if such Holder shall fail to make any such request, such failure shall not affect the continuing obligation of Pegasystems to afford to such Holder all such rights.

3. ANTIDILUTION PROVISIONS

The number of shares of Common Stock for which this Warrant is exercisable, and the price at which such shares may be purchased upon exercise of this Warrant, shall be adjusted from time to

time as set forth in this Section 3.

3.1. Stock Dividends, Subdivisions and Combinations. If at any time after the Original Issue Date Pegasystems shall:

(i) take a record of the holders of its Common Stock for the purpose of entitling them to receive a dividend payable in, or other distribution of, additional shares of Common Stock

(ii) subdivide its outstanding shares of Common Stock into a larger number of shares of such Common Stock, or

(iii) combine its outstanding shares of Common Stock into a smaller number of shares of such Common Stock

then the Exercise Price shall be adjusted to equal the product of the Exercise Price in effect immediately prior to such event multiplied by a fraction, the numerator of which is equal to the number of shares of Fully Diluted Outstanding Common Stock immediately prior to the adjustment and the denominator of which is equal to the number of shares of Fully Diluted Outstanding Common Stock immediately after such adjustment. The adjustments described in this Section 3.1 shall be made whenever any of the events set forth herein occurs and shall become effective immediately after the effective date of any such event, retroactive to the record date therefor with respect to any exercise of this Warrant after such record date.

3.2. Distributions of Evidences of Indebtedness or Other Assets. (a) If at any time after the Original Issue Date Pegasystems shall issue or transfer as a dividend or distribution to the holders of the Common Stock evidences of its indebtedness or other assets (including securities of Pegasystems or any other issuer but excluding (i) any dividend paid in cash out of earnings or out of any surplus legally available for dividends under the laws of the jurisdiction in which Pegasystems is incorporated at the time of such dividend (other than an extraordinary or special dividend) and (ii) any dividend or distribution subject to Section 3.1), then the Exercise Price shall be adjusted to equal the product of the Exercise Price in effect immediately prior to such distribution multiplied by a fraction, the numerator of which is equal to the Fair Value per share of the Common Stock as of the record date for such distribution less the Fair Distribution Value per share of Common Stock of the evidences of indebtedness or other assets distributed and the denominator of which is equal to the Fair Value per share of the Common Stock as of such record date.

(b) If at any time after the Original Issue Date Pegasystems shall issue or transfer as a dividend or distribution to the holders of any class of Non-Preferred Stock other than Common Stock evidences of its indebtedness or other assets (including securities of Pegasystems or any other issuer but excluding (i) any dividend paid in cash out of earnings or out of any surplus legally available for dividends under the laws of the jurisdiction in which Pegasystems is incorporated at the time of such dividend (other than an extraordinary or special dividend) and (ii) any dividend or distribution subject

to Section 3.1), then the Exercise Price shall be adjusted to equal the product of the Exercise Price in effect immediately prior to such distribution multiplied by a fraction, the numerator of which is equal to the Fair Value per share of the Common Stock as of the "ex-dividend" date for such dividend or distribution and the denominator of which is equal to the Fair Value per share of the Common Stock immediately prior to such "ex-dividend" date.

(c) The adjustments described in this Section shall be made whenever any of the events set forth herein occurs and shall become effective immediately after the effective date of any such event, retroactive to the record date therefor with respect to any exercise of this Warrant after such record date.

3.3. Adjustment of Number of Shares Purchasable. Upon any adjustment of the Exercise Price as provided in Section 3.1 or 3.2, the Holder shall thereafter be entitled to purchase upon the exercise of this Warrant, at the Exercise Price resulting from such adjustment, the number of shares of Common Stock (calculated to the nearest 1/100th of a share) obtained by multiplying the Exercise Price in effect immediately prior to such adjustment by the number of shares of Common Stock purchasable on the exercise hereof immediately prior to such adjustment and dividing the product thereof by the Exercise Price resulting from such adjustment.

3.4. Reorganization, Reclassification, Merger, Consolidation or Disposition of Assets. If at any time after the Original Issue Date Pegasystems shall reorganize its capital, reclassify its capital stock consolidate or merge with or into another corporation (where Pegasystems is not the surviving entity or where there is any change whatsoever in, or distribution with respect to, the outstanding Common Stock of Pegasystems), or sell, transfer or otherwise dispose of all or substantially all of its property, assets or business to another Person and, pursuant to the terms of such reorganization, reclassification, merger, consolidation or disposition of assets, shares of capital stock of the successor or acquiring entity or of Pegasystems (if it is the surviving entity) or any cash or other securities or property of any nature whatsoever (including warrants or other subscription or purchase rights) ("Substitute Property") are to be received by or distributed to the holders of Common Stock of Pegasystems who are holders immediately prior to such transaction then the Holder of this Warrant shall have the right thereafter to receive, upon exercise of this Warrant in accordance with Section 2, the amount of Substitute Property receivable as a result of such reorganization, reclassification, merger, consolidation or disposition of assets by a holder of the number of shares of Common Stock for which this Warrant is exercisable immediately prior to such event. In such event, the aggregate Exercise Price payable for the shares of Common Stock purchasable upon exercise of this Warrant immediately prior to such event (as it may be adjusted) shall be allocated among the items of Substitute Property receivable as a result of such reorganization, reclassification, merger, consolidation or disposition of assets (and, to the extent still applicable, the shares of Common Stock for which this Warrant was exercisable immediately prior to such transaction) in proportion to the respective fair market values of such items of Substitute Property (and such shares of Common Stock) as determined in good faith by the Board of Directors or Chief Financial Officer of Pegasystems, subject to the right of the Majority Holders to challenge such allocation under Section 13.8. In case of any such reorganization, reclassification, merger, consolidation or disposition of

assets, the successor or acquiring entity (if other than Pegasystems) shall expressly assume the due and punctual observance and performance of each and every covenant and condition of this Warrant to be performed and observed by Pegasystems and all the obligations and liabilities hereunder (including, without limitation, its obligations under Section 7), subject to such modifications as may be reasonably agreed upon by Pegasystems (or the successor or acquiring entity) and the Majority Holders in order to provide for appropriate antidilution adjustments with respect to any equity securities included in such Substitute Property, which modifications shall be as equivalent as practicable to the adjustments provided for in this Section 3. Alternatively, upon the request of the Holder of this Warrant accompanied by the surrender of this Warrant, such successor or acquiring entity shall issue in its own name a new Warrant reflecting such modifications. The foregoing provisions of this

Section shall similarly apply to successive reorganizations, reclassification, mergers, consolidations or disposition of assets.

3.5. Other Dilutive Events. In case any event shall occur as to which the other provisions of this Section 3 are not strictly applicable but as to which the failure to make any adjustment would not fairly protect the purchase rights represented by this Warrant in accordance with the essential intent and principles hereof, then, upon the written request of the Majority Holders, Pegasystems shall determine what adjustments, if any, are required to be made to the Exercise Price and/or the number of shares of Common Stock issuable upon exercise of this Warrant on a basis consistent with the essential intent and principles established herein as a result of such event in order to preserve the purchase rights represented by this Warrant, which determination shall be made by the Board of Directors or Chief Financial Officer of Pegasystems. Pegasystems shall give the Holders written notice of such determination within thirty (30) days after receipt of the request of the Majority Holders, which Majority Holders shall have the right to challenge such determination pursuant to Section 13.8. Pegasystems shall promptly take any actions necessary to implement the adjustments provided for in its determination or, in the event of a challenge to such determination by the Majority Holders, the determination agreed to by Pegasystems and such Majority Holders or the determination of the Independent Financial Expert that results from the procedures contemplated in Section 13.8.

3.6. Other Provisions Applicable to Adjustments under this Section. The following provisions shall be applicable to the adjustments provided for pursuant to this Section 3:

- (a) When Adjustment to Be Made. The adjustments required by this Section 3 shall be made whenever and as often as any specified event requiring an adjustment shall occur. For the purpose of any adjustment, any specified event shall be deemed to have occurred at the close of business on the date of its occurrence.
- (b) Fractional Interests. In computing adjustments under this Section 3, fractional interests in Common Stock shall be taken into account to the nearest 1/100th of a share.
- (c) When Adjustment Not Required. If Pegasystems shall take a record of the holders of its Common Stock for the purpose of entitling them to receive a dividend or distribution and shall, thereafter and before the distribution to stock-holders thereof, legally

abandon its plan to pay or deliver such dividend or distribution, then thereafter no adjustment shall be required by reason of the taking of such record and any such adjustment previously made in respect thereof shall be rescinded and annulled.

(d) **Certain Limitations.** Notwithstanding anything herein to the contrary, Pegasystems agrees not to enter into any transaction that, by reason of any adjustment under this Section 3, would cause the Exercise Price to be less than the par value of the Common Stock if any, unless Pegasystems first reduces the par value of the Common Stock to be less than the Exercise Price that would result from such transaction.

(e) **Notice of Adjustments.** Whenever the number of shares of Common Stock for which this Warrant is exercisable or the Exercise Price shall be adjusted pursuant to this Section 3, Pegasystems shall forthwith prepare a certificate to be executed by the Chief Financial Officer or General Counsel of Pegasystems setting forth, in reasonable detail, the event requiring the adjustment and the method by which such adjustment was calculated, specifying the number of shares of Common Stock for which this Warrant is exercisable and (if such adjustment was made pursuant to Section 3.6) describing the number and kind of any other shares of stock or Substitute Property for which this Warrant is exercisable, and any related change in the Exercise Price, after giving effect to such adjustment or change. Pegasystems shall promptly cause a signed copy of such certificate to be delivered to each Holder in accordance with Section 13.2.

(f) **Record Date.** In case Pegasystems shall take a record of the holders of its Common Stock for the purpose of entitling them (i) to receive a dividend or other distribution payable in Non-Preferred Stock Convertible Securities or Stock Purchase Rights or (ii) to subscribe for or purchase Non-Preferred Stock Convertible Securities or Stock Purchase Rights, then all references in this Section 3 to the date of the issuance or sale of such shares of Non-Preferred Stock Convertible Securities or Stock Purchase Rights shall be deemed to be references to such record date.

(g) **Maximum Exercise Price.** Except as provided in Section 3.1 above, at no time shall the Exercise Price per share of Common Stock exceed the amount set forth in the first paragraph of the preamble of this Warrant.

4. NO IMPAIRMENT

Pegasystems shall not, by any action, including, without limitation, amending its charter documents or through any reorganization, reclassification, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other similar voluntary action, avoid or seek to avoid the observance or performance of any of the terms of this Warrant, but shall at all times in good faith assist in the carrying out of all such terms and in the taking of all such actions as may be necessary or appropriate to protect the rights of the Holder hereunder against impairment. Without limiting the

generality of the foregoing, Pegasystems shall take all such action as may be necessary or appropriate in order that it may validly and legally deliver fully paid and nonassessable shares of Common Stock to the Holder upon the exercise of this Warrant, free and clear of all liens and encumbrances.

5. RESERVATION AND AUTHORIZATION OF COMMON STOCK

From and after the Original Issue Date, Pegasystems shall at all times reserve and keep available for issuance to the Holder pursuant to such exercise such number of its authorized but unissued shares of Common Stock as will be sufficient to permit the exercise in full of this Warrant. All shares of Common Stock purchasable pursuant to the terms hereof, when delivered to the Holder upon exercise of this Warrant with payment therefor in accordance with the terms hereof, shall be duly and validly issued and fully paid and nonassessable, not subject to preemptive rights and shall be free and clear of all liens and encumbrances.

6. TRANSFERS OF WARRANT AND RESTRICTED STOCK; DIVISION OR COMBINATION OF WARRANTS

6.1. Warrant Transfer Procedures. Subject to compliance with this Section 6, the Holder of this Warrant shall be entitled to transfer or assign its interest in this Warrant in whole or in part to any of its Affiliates. Each transfer of this Warrant and all rights hereunder shall be registered on the books to be maintained by or on behalf of Pegasystems for such purpose, upon surrender of this Warrant at the Designated Office, together with a written assignment of this Warrant in the form of Annex B hereto duly executed by the Holder or its agent or attorney. Upon such surrender and delivery, Pegasystems shall, subject to Section 6.3, execute and deliver a new Warrant or Warrants in the name of the assignee or assignees and in the denominations specified in such instrument of assignment, and shall issue to the assignor a new Warrant evidencing the portion of this Warrant not so assigned and this Warrant shall promptly be canceled. A Warrant, if properly assigned in compliance with Section 6.3, may be exercised by the new Holder for the purchase of shares of Common Stock without having a new Warrant issued in its name.

6.2. Division and Combination. Subject to compliance with the applicable provisions of this Warrant, this Warrant may be divided or combined with other Warrants without cost to the Holder thereof upon presentation of this Warrant at the Designated Office, together with a written notice specifying the names and denominations in which new Warrants are to be issued, signed by the Holder or its agent or attorney. Subject to compliance with the applicable provisions of this Warrant as to any transfer which may be involved in such division or combination, Pegasystems shall execute and deliver a new Warrant or Warrants in exchange for the Warrant or Warrants to be divided or combined in accordance with such notice.

6.3. Restrictions on Transfer. (a) Prior to the commencement of the Exercise Period, this Warrant may not be assigned, pledged or Transferred by any Holder to any Person other than an Affiliate of FDR (or its or their successors).

(b) Whether prior to the commencement of or during the Exercise Period, neither this Warrant nor any shares of Restricted Stock issued upon the exercise hereof shall be Transferred other than pursuant to an effective registration statement under the Securities Act or an exemption from the registration provisions thereof and in compliance with any applicable state securities laws. No Transfer of this Warrant or any such shares of Restricted Stock to any Person (other than (i) a Transfer pursuant to such an effective registration statement under the Securities Act or (ii) a Transfer to an Affiliate of the transferring Holder of such securities in compliance with the requirements set forth below) shall be valid or effective unless such Holder shall have first delivered to Pegasystems a legal opinion reasonably satisfactory to Pegasystems (which opinion may be given by either in-house or outside counsel with expertise in such securities laws) to the effect that the proposed Transfer is exempt from the registration requirements of the Securities Act and that any state securities laws requirements applicable to such Transfer are being complied with. A Transfer of this Warrant or such shares of Restricted Stock may be made by any Holder thereof to an Affiliate of such Holder without delivery of such a legal opinion if such Affiliate shall first have delivered to Pegasystems an officer's certificate signed by a senior officer of such Affiliate to the effect that such Affiliate is acquiring such securities for investment only and not with a view to distribution thereof (excluding a possible Transfer pursuant to available exemptions under applicable federal and state securities laws); provided that if within five (5) Business Days after the receipt of such certificate Pegasystems notifies the transferring Holder that Pegasystems has reasonably determined in good faith, after consultation with counsel with expertise in the applicable securities laws, that a substantial uncertainty exists as to whether the proposed Transfer of such securities to such Affiliate is exempt from the registration requirements of the Securities Act or complies with any applicable state securities laws, the transferring Holder may not complete the proposed Transfer to such Affiliate unless such Holder first delivers to Pegasystems a legal opinion reasonably satisfactory to Pegasystems (which opinion may be given by either in-house or outside counsel expert in such securities laws) to the effect that the proposed Transfer is exempt from the registration requirements of the Securities Act and that any applicable state securities laws requirements are being complied with. Each certificate, if any, evidencing such shares of Restricted Stock issued upon any such Transfer, other than in a public offering pursuant to an effective registration statement, shall bear the restrictive legend set forth in Section 6.4(a) below, and each Warrant issued upon such Transfer shall bear the restrictive legend set forth in Section 6.4(b), unless the Holder delivers to Pegasystems a legal opinion (which opinion may be given by either in-house or outside counsel with expertise in such securities laws) reasonably satisfactory to Pegasystems to the effect that such legend is not required for the purposes of compliance with the Securities Act and any applicable state securities laws. Holders of a Warrant or the Restricted Stock, as the case may be, shall not be entitled to Transfer such Warrant or such Restricted Stock except in accordance with this Section 6.3(b).

6.4. Restrictive Legends. (a) Except as otherwise provided in this Section 6, each certificate for Restricted Stock initially issued upon the exercise of this Warrant, and each certificate for Restricted Stock issued to any subsequent transferee of any such certificate, shall be stamped or otherwise imprinted with a legend in substantially the following form:

"THE SHARES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT"), OR ANY STATE SECURITIES LAW. NO TRANSFER OF THE SHARES REPRESENTED BY THIS CERTIFICATE SHALL BE VALID OR EFFECTIVE UNLESS SUCH TRANSFER IS MADE PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE ACT OR AN EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE ACT AND IN ACCORDANCE WITH THE APPLICABLE PROVISIONS OF THE WANT UNDER WHICH SUCH SHARES WERE ISSUED."

(b) Except as otherwise provided in this Section 6, each Warrant shall be stamped or otherwise imprinted with a legend in substantially the following form:

"NEITHER THIS WARRANT NOR ANY OF THE SECURITIES PURCHASABLE UPON EXERCISE HEREOF HAVE BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT"), OR ANY STATE SECURITIES LAW. NO TRANSFER OF THIS WARRANT SHALL BE VALID OR EFFECTIVE UNLESS SUCH TRANSFER IS MADE PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE ACT OR AN EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE ACT AND IN ACCORDANCE WITH THE APPLICABLE PROVISIONS OF THIS WARRANT."

6.5. Termination of Securities Law Restrictions. Notwithstanding the foregoing provisions of this Section 6, the restrictions imposed by Section 6.3(b) on the transferability of this Warrant and Restricted Stock and the legend requirements of Section 6.4 shall terminate as to any particular Warrant or shares of Restricted Stock when Pegasystems shall have received from the Holder thereof a legal opinion reasonably satisfactory to the Pegasystems to the effect that such legend is not required in order to ensure compliance with the Securities Act or any applicable state securities laws. Whenever the restrictions imposed by Sections 6.3(b) shall terminate as to this Warrant, as hereinabove provided, the Holder hereof shall be entitled to receive a new Warrant bearing the following legend in place of the restrictive legend set forth hereon:

"THE RESTRICTIONS ON TRANSFERABILITY OF THE WITHIN WARRANT CONTAINED IN SECTIONS 6.3(b) AND 6.4 TERMINATED ON _____, _____, AND ARE OF NO FURTHER FORCE AND EFFECT."

Each Warrant issued upon registration of transfer of any Warrant entitled to bear such legend shall have a similar legend endorsed thereon. Wherever the restrictions imposed by this Section shall terminate as to any share of Restricted Stock as hereinabove provided, the Holder thereof shall be entitled to receive a new certificate representing such Common Stock not bearing the restrictive legend set forth in Section 6.4 (a).

6.6. Maintenance of Books. Pegasystems agrees to maintain, at the Designated Office, books for the registration and transfer of this Warrant.

6.7. Rule 144 Current Information. Pegasystems shall use its best efforts to at all times make public information available and to take such other actions as the Holders of this Warrant or shares of Restricted Stock may reasonably request so as to afford such Holders the benefits of Rule 144 in connection with resales.

7. REGISTRATION RIGHTS

7.1. Demand Registration Rights.

(a) Demand Registration. At any time during the Exercise Period, the Holders of all of the outstanding Registrable Securities ("Demanding Holders") may give Pegasystems written notice that such Demanding Holders desire to sell Registrable Securities in a transaction involving a public distribution. Promptly after receipt of such notice, Pegasystems and the Demanding Holders shall discuss the feasibility of arranging for a sale of such Registrable Securities pursuant to Rule 144 that would enable such Demanding Holders to dispose of such Registrable Securities within a single thirty-day distribution period commencing not later than thirty (30) days after the date of such written notice and with respect to which the Demanding Holders would not be required to register and would be permitted to freely sell such Registrable Securities under any applicable state securities laws (a "Non-Registered Distribution"). If required as a condition to the availability of Rule 144 for such a Non-Registered Distribution, the Holders shall utilize the Cashless Exercise Option in acquiring the Registrable Securities to be sold in such Non-Registered Distribution. However, the Demanding Holders may at any time following the initiation of such discussions request in writing (a "Demand Request") that Pegasystems file with the Commission a registration statement under the Securities Act for a public offering of such Registrable Securities (a "Demand Registration") and Pegasystems shall be obligated to prepare and file such registration statement on the terms and conditions set forth below unless, within ten (10) days after the receipt of such Demand Request, Pegasystems either (i) (A) delivers to the Demanding Holders an unqualified opinion in form and substance reasonably satisfactory to the Demanding Holders of nationally recognized counsel reasonably satisfactory to the Demanding Holders and with expertise in securities laws concluding that the Demanding Holders may sell the Registrable Securities subject to the Demand Request in a Non-Registered Distribution without violating and in accordance with applicable securities laws and (B) agrees to indemnify such Demanding Holders against any Damages suffered or incurred by such Demanding Holders directly or indirectly resulting from such opinion proving to be incorrect in whole or in part or (ii) elects to exercise its Call Right with respect to such Registrable Securities. If the conditions described in either clause (i) or (ii) of the preceding sentence are met, Pegasystems shall have no obligation to take any further action under this Section 7 with respect to such Demand Request. Notwithstanding any provision to the contrary contained herein, Pegasystems shall have no obligation to effect a Demand Registration unless all Registrable Securities are included therein.

(b) Notice of Request for Registration. Within ten (10) days after delivery of a Demand Request, Pegasystems shall give notice of such Demand Request to all Holders of Registrable Securities and shall include in such Demand Registration all Registrable Securities with respect to which Pegasystems has received written requests from such Holders for inclusion within fifteen (15) Business Days after such notice is given. All requests for inclusion of Registrable Securities pursuant to this Section 7.1 (b), as well as the initial Demand Request, shall specify the aggregate number of the Registrable Securities of each Holder to be registered and also shall specify the intended methods of disposition thereof (including without limitation whether such offering is to be an underwritten offering).

(c) Pegasystem's Right to Postpone Registration. In the event that Pegasystems receives a Demand Request during the Lock-Up Period applicable to any underwritten registered offering of Common Stock Convertible Securities or Stock Purchase Rights (so long as Pegasystems has complied with its obligations under Section 7.2 in respect of such offering), Pegasystems shall have the right to postpone the Demand Registration until the expiration of such Lock-Up Period. In addition Pegasystems shall have the right to postpone the filing of any Demand Registration for a reasonable period not to exceed 120 days if at any time prior to such filing (A) Pegasystems has decided to effect a public offering of Non-Preferred Stock Convertible Securities or Stock Purchase Rights or (B) if Pegasystems's Board of Directors or Chief Financial Officer has reasonably determined in good faith that the disclosures required to be made in such Demand Registration or the sale of the Registrable Securities pursuant thereto would prejudice in any significant respect any significant financing, acquisition or other transaction then pending or planned by Pegasystems or any of its Subsidiaries. Pegasystems shall give the Demanding Holders written notice of any such postponement, which notice shall be accompanied by a certificate signed by the Chief Financial Officer or General Counsel of Pegasystems certifying as to the existence of the prerequisites for such postponement. The Demanding Holders may withdraw their Demand Request at any time between the date of such notice and the end of the applicable postponement period, in which case no Demand Registration shall be deemed to have occurred pursuant to such Demand Request for the purposes of paragraph (d) below. If the Demand Request is not so withdrawn upon expiration of the applicable postponement period, Pegasystems shall proceed with the requested Demand Registration on the terms and conditions set forth below. Pegasystems may exercise its postponement right under this paragraph (c) only once with respect to any Demand Request. If Pegasystems postpones a Demand Registration with respect to which a Demand Request was given prior to the expiration of the Exercise Period and such Demand Request is not withdrawn by the Demanding Holders, the Exercise Period shall be extended automatically until the expiration of the registration period provided for below or, if greater, by a number of days equal to the number of days in the postponement period.

(d) Holders Limited to One Demand Registration. Pegasystems shall be obligated to effect no more than one Demand Registration in total. For purposes of the preceding sentence, registration shall not be deemed to have been effected (i) unless a registration statement with respect thereto has become effective, (ii) if after such registration statement has become effective, such registration or the related offer, sale or distribution of Registrable Securities thereunder is interfered with by any stop order, injunction or other order or requirement of the Commission or other governmental agency or

court for any reason not attributable to the Selling Holders and such interference is not thereafter eliminated or (iii) if the conditions to closing specified in the underwriting agreement, if any, entered into in connection with such registration are not satisfied or waived, other than by reason of a failure on the part of the Selling Holders. Subject to the foregoing, if Pegasystems shall have complied with its obligations under this Section 7, a right to demand a registration pursuant to this Section 7.1 shall be deemed to have been satisfied upon the earlier of (x) the date as of which all of the Registrable Securities included therein shall have been disposed of pursuant to the registration statement and (y) the date as of which such Demand Registration shall have been Continuously Effective for a period of 60 days, provided that if any Registrable Securities remain unsold as of the end of such 60-day period for reasons beyond the reasonable control of the Selling Holders, such Selling Holders may by written notice to Pegasystems abandon such Demand Registration, in which case the Holders of Registrable Securities shall be entitled to one additional Demand Registration under this Section 7.1 (but in no event shall Pegasystems be required to effect more than one such additional Demand Registration) but only if such Selling Holders first agree in writing to promptly reimburse Pegasystems for all Registration Expenses incurred by Pegasystems in connection with such additional Demand Registration.

(e) Effective Registration Expenses. Subject to the proviso in the last sentence of paragraph (d) above, in any registration initiated as a Demand Registration, Pegasystems will pay all Registration Expenses whether or not the registration has become effective.

(f) Priority on Demand Registrations. If the managing underwriters of a Demand Registration, in good faith, advise Pegasystems in writing that in their opinion the number of securities proposed to be sold in such Demand Registration exceeds the number that can be sold in such offering or that such number of securities could only be sold if the selling price anticipated to be received by the Selling Holders would have to be reduced, Pegasystems will include in such Demand Registration (i) first, the Registrable Securities of the Holders, pro rata among the Holders on the basis of the number of shares of Registrable Securities then owned by them, after assuming the exercise of the outstanding Warrants; (ii) second, any securities to be issued and sold by Pegasystems and (iii) last, any securities held by all other Persons, pro rata among such Persons on the basis of the number of shares proposed to be so registered by them.

(g) Limitations on Right of Pegasystems or Other Persons to Piggyback on Demand Registrations. Neither Pegasystems nor any Person owning any of its securities (other than the Holders of Warrants and Common Stock purchasable upon exercise of the Warrants) shall have the right to include any of Pegasystems's securities in a registration statement initiated as a Demand Registration under this Section 7.1, unless (i) such securities are of the same class as the Registrable Securities being registered and (ii) if such Demand Registration is an underwritten offering, Pegasystems or such Persons, as applicable, agree in writing to sell their securities on the same terms and conditions as apply to the Registrable Securities being sold. If any Persons owning securities of Pegasystems (other than the Holders of Registrable Securities in such capacity) register securities of Pegasystems in a Demand Registration, such Persons shall pay the fees and expenses of counsel to such Persons and their pro rata share of the Registration Expenses if the Registration Expenses are

not paid by Pegasystems for any reason. Pegasystems covenants that it shall not grant any registration rights to any Person which rights would conflict or be inconsistent with the provisions of this Section 7.1(g).

(h) Selection of Underwriters and Counsel, Etc. If a Demand Registration involves an underwritten offering: (i) the Majority Selling Holders shall be entitled to select the managing underwriter to administer the offering, subject to the approval of Pegasystems (which approval shall not be unreasonably withheld) and (ii) the Majority Selling Holders shall have the right to select the counsel to represent the Selling Holders. The underwriting agreements for any Registration involving an underwritten offering shall require that the underwriters purchase all Warrants properly included by the Selling Holders in a Demand Registration at the closing of the public offering, at a purchase price equal to the aggregate public offering price for the Registrable Securities covered by such Warrants less the aggregate Exercise Price therefor and less applicable underwriters' discounts and commissions.

7.2. Piggyback Registration. If Pegasystems proposes or is required to file a registration statement under the Securities Act with respect to an offering by Pegasystems for its own account and/or for the account of others of any class of equity security (including any Convertible Securities or Stock Purchase Rights), other than a registration statement on Form S4 or Form S-8 (or any successor form) or filed in connection with any exchange offer or an offering of securities solely to Pegasystems existing stockholders or a registration statement filed pursuant to Section 7.1, then Pegasystems shall in each case promptly give notice of such proposed filing to all Holders at least 10 Business Days before the anticipated filing date, and such notice shall offer such Holders the opportunity to register such number of shares of Registrable Securities held by such Holders as such Holders may request by written notice given to Pegasystems within 10 days after receipt of such notice (a "Piggyback Registration"); provided that Pegasystems may at any time withdraw or cease proceeding with any Piggyback Registration described in this Section 7.2 if it shall at the same time withdraw or cease proceeding with the registration of such other securities originally proposed to be registered. Pegasystems shall use its reasonable best efforts to cause the underwriter of a proposed underwritten offering to permit such Holders to include the specified Registrable Securities of such Holders in such offering on the same terms and conditions as any similar securities of Pegasystems included therein. Notwithstanding the foregoing, if the underwriter of such offering delivers a written opinion to the Holders that the number of securities which such Holders, Pegasystems and any other Persons intend to include in such offering exceeds the number that can be sold in such offering or that such number of securities could only be sold if the selling price anticipated to be received would have to be reduced then the amount to be offered shall be reduced, first, pro rata among the Holders and any other Persons proposing to register securities (other than a Person for whom Pegasystems is making a required registration) on the basis of the number of shares proposed to be registered by them and, second, out of the securities proposed to be registered by Pegasystems or any Persons for whom Pegasystems is making a required registration, to the extent necessary to reduce the total amount of securities to be included in such offering to the amount recommended by such managing underwriter.

7.3. Registration Procedures. If and whenever Pegasystems is required by the provisions of this Section 7 to effect or cause the registration of any Registrable Securities under the Securities Act, Pegasystems will use its best efforts to effect the registration and the sale of such Registrable Securities in accordance with the intended method of disposition thereof as quickly as practicable; provided, that Pegasystems shall not be required to honor any request for registration under Section 7.2 if such request is received by Pegasystems later than 30 Business Days after the date Pegasystems first notifies the Holders of such registration. In connection with any such registration Pegasystems will:

(a) within a reasonable time, prepare and file with the Commission a registration statement with respect to such Registrable Securities and use its best efforts to cause such registration statement to become effective; and prepare and file with the Commission such amendments and supplements to such registration statement and prospectus used in connection therewith as may be necessary to keep such registration statement effective for a period of not less than 60 days, or such shorter period as may be required if all Registrable Securities covered by such registration statement are sold prior to the expiration of said 60-day period; and comply with the provisions of the Securities Act with respect to the disposition of all securities covered by such registration statement during such period in accordance with the intended methods of disposition by the sellers thereof set forth in such registration statement;

(b) prior to filing a registration statement, furnish to each Selling Holder, managing underwriter or agent, copies of such registration statement as proposed to be filed, and thereafter such number of copies of such registration statement, each amendment and supplement thereto (in each case including all exhibits thereto), the prospectus included in the registration statement (including each preliminary prospectus) and such other documents as such Selling Holder, managing underwriter or agent may reasonably request, and will furnish to the managing underwriter, for each underwriter participating in an underwritten offering, one conformed copy of such registration statement as originally filed and each amendment thereto (including documents incorporated by reference into the related prospectus);

(c) deliver to each Selling Holder and each underwriter or agent participating in such offering, without charge, as many copies of each preliminary prospectus as such Selling Holder or underwriter or agent may reasonably request, and consent to the use of such copies for purposes permitted by the Securities Act; deliver to each such Selling Holder and underwriter and agent participating in such offering, without charge, from time to time during the period when a prospectus is required to be delivered under the Securities Act, such number of copies of the prospectus (as supplemented or amended) as such Selling Holder or such underwriter or agent may reasonably request;

(d) use its best efforts promptly to register or qualify such Registrable Securities under such other securities or blue sky laws of such jurisdictions as any Selling Holder reasonably requests and do any and all other acts and things which may be reasonably necessary or advisable to enable such Selling Holder to consummate the disposition in such jurisdictions of the Registrable Securities

- owned by such Selling Holder; provided, that for any such purpose Pegasystems will not be required to (i) qualify generally to do business in any jurisdiction where it would not otherwise be required to qualify but for this Section 7.3(d),
- (ii) subject itself to taxation in any such jurisdiction or (iii) consent to general service of process in any such jurisdiction;
- (e) use its best efforts promptly to cause the Registrable Securities covered by such registration statement to be registered with or approved by such other governmental agencies or authorities as may be necessary by virtue of the business and operations of Pegasystems to enable the Selling Holders thereof to consummate the disposition of such Registrable Securities;
- (f) immediately notify the Selling Holders and the managing underwriter or agent, and confirm the notice in writing, (i) when a registration statement, or any post-effective amendment to such registration statement shall have become effective, or any supplement to the related prospectus or any amended prospectus shall have been filed, (ii) of the receipt of any comments from the Commission, (iii) of any request by the Commission to amend the registration statement or amend or supplement the prospectus or for additional information, (iv) of the issuance by the Commission of any stop order suspending the effectiveness of the registration statement or of any order preventing or suspending the use of any preliminary prospectus, or of the suspension of the qualification of the registered securities for offering or sale in any jurisdiction, or of the institution or threatening of any proceedings for any of such purposes and (v) if at any time when a prospectus is required by the Securities Act to be delivered in connection with sales of the registered securities any representation and warranty of Pegasystems contemplated by Section 7.3(g) ceases to be true and correct;
- (g) if at any time when a prospectus is required by the Securities Act to be delivered in connection with sales of the Warrants and Registrable Securities any event shall occur or condition exist as a result of which it is necessary, in the opinion of counsel for the Selling Holders, counsel for the underwriters or agents or counsel for Pegasystems, to amend the registration statement covering such Registrable Securities or amend or supplement the related prospectus in order that such prospectus will not include an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein not misleading in the light of the circumstances existing at the time it is delivered to a purchaser, or if it shall be necessary, in the opinion of any of such counsel, at any such time to amend such registration statement or amend or supplement the related prospectus in order to comply with the requirements of the Securities Act, promptly prepare and file such amendment or supplement as may be necessary to correct such untrue statement or omission or to make such registration statement or the related prospectus comply with such requirements;
- (h) use every reasonable effort to prevent the issuance of any stop order suspending the effectiveness of a registration statement or of any order preventing or suspending the use of any preliminary prospectus and, if any such order is issued, to obtain the lifting thereof at the earliest possible time;

(i) not at any time file or make any amendment to a registration statement, or any amendment of or supplement to a related prospectus (including amendments of the documents incorporated by reference into such prospectus), of which the Selling Holders or the managing underwriter or agent shall not have been previously advised and furnished a copy, or to which such Selling Holders, the managing underwriter or agent or counsel for any of the foregoing shall reasonably object;

(j) enter into customary agreements (including an underwriting agreement in customary form) and take such other actions (including without limitation making such representations and warranties to the Selling Holders, the underwriters and agents, if any, in form, substance and scope as are customarily made by issuers to underwriters and agents in primary underwritten public offerings) as are reasonably required in order to expedite or facilitate the disposition of such Registrable Securities, and shall use its best efforts to cause such underwriters to agree in such customary agreements to purchase from any Holder who so requests its Warrants in connection with such underwritten public offering (without requiring any such Holder to exercise its Warrant for Common Stock purchasable upon exercise of the Warrants);

(k) make available for inspection by any Selling Holder, any managing underwriter or agent participating in any disposition pursuant to such registration statement, and any attorney, accountant or other agent retained by any such Selling Holder, underwriter or agent (collectively, the "Inspectors"), all financial and other records, pertinent corporate documents and properties of Pegasystems (collectively, the "Records") as shall be reasonably necessary to enable them to exercise their due diligence responsibility, and cause Pegasystems's officers, directors and employees to supply all information reasonably requested by any such Inspectors in connection with such registration statement, provided that Pegasystems shall not be required to disclose any such Records to any Inspector that has not executed a confidentiality agreement in substantially the form attached as Annex C;

(l) on the effective day of a registration statement or, in the case of an underwritten offering, on the date of delivery of the Registrable Securities sold pursuant thereto, cause to be delivered to the Selling Holders and the underwriters or agents, if any, opinions of counsel for Pegasystems, which counsel, and opinions (in form, scope and substance) shall be reasonably satisfactory to counsel for the Selling Holders, covering the matters customarily covered in opinions given to underwriters in primary underwritten public offerings; immediately prior to the effectiveness of a registration statement or, in the case of an underwritten offering, at the time of delivery of any Registrable Securities sold pursuant thereto, cause to be delivered to the Selling Holders and the underwriters or agents, if any, letters from Pegasystems's independent public accountants stating that such accountants are independent public accountants with respect to Pegasystems within the meaning of the Securities Act, and otherwise in customary form and covering such financial and accounting matters as are customarily covered by letters of the independent public accountants delivered in connection with primary underwritten public offerings;

(m) Each Selling Holder agrees that, upon receipt of any notice from Pegasystems of the

happening of any event of the kind described in Section 7.3(g), such Selling Holder will forthwith discontinue disposition of Registrable Securities pursuant to the registration statement covering such Registrable Securities until such Holder's receipt of the copies of the supplemented or amended prospectus contemplated by Section 7.3(g), and, if so directed by Pegasystems, such Selling Holder will deliver to Pegasystems all copies, other than permanent file copies then in such Selling Holder's possession, of the prospectus covering such Registrable Securities current at the time of receipt of such notice. In the event Pegasystems shall give any such notice, Pegasystems shall extend the period during which such registration statement shall be maintained effective pursuant to this Agreement by the number of days during the period from and including the date of the giving of such notice pursuant to Section 7.3(g) to and including the date when each Selling Holder shall have received the copies of the supplemented or amended prospectus contemplated by Section 7.3(g).

7.4. Registration Expenses. All reasonable expenses incident to Pegasystems's performance of compliance with Sections 7.1 through 7.4, including without limitation, all registration and filing fees, fees and expenses of compliance with securities or blue sky laws (including reasonable fees and disbursements of counsel in connection with blue sky qualifications of the Registrable Securities), rating agency fees, printing expenses (including without limitation, expenses of printing prospectuses), messenger and delivery expenses, internal expenses (including, without limitation, all salaries and expenses of its officers and employees performing legal or accounting duties), the fees and expenses incurred in connection with the listing of the securities to be registered on each securities exchange on which this Agreement requires such securities to be listed, and fees and disbursements of counsel for Pegasystems and its independent certified public accountants (including without limitation the expenses of any special audit or "cold comfort" letters required by or incident to such performance), securities acts liability insurance (in the event Pegasystems elects to obtain such insurance), the reasonable fees and expenses of any special experts retained by Pegasystems in connection with such registration, reasonable fees and expenses of other Persons retained by Pegasystems and any Selling Holders' Counsel Fees incurred in connection with each registration hereunder (but not including any underwriting discounts or commissions attributable to the sale of Registrable Securities) (all such expenses collectively the "Registration Expenses") will be borne by Pegasystems; provided that in the event that (i) Pegasystems presents the Selling Holders in any Demand Registration with a list of at least three nationally recognized underwriters that have participated in securities offerings by Pegasystems within two years prior to the date of the related Demand Request or who have undertaken due diligence with respect to Pegasystems during such period in connection with a merger, acquisition or other type of transaction, together with an estimate of the due diligence expenses of each underwriter (and its counsel) for the contemplated underwriting, (ii) such underwriters are ready, willing and able to effect the underwriting of the Registrable Securities at the time contemplated by the Selling Holders and (iii) the Majority Selling Holders select a managing underwriter pursuant to Section 7.1(h) that is not on such list, then the Selling Holders shall be required to pay the incremental due diligence expenses of the underwriters and their counsel resulting from such selection.

7.5. Indemnification: Contribution.

(a) Indemnification by Pegasystems. Pegasystems agrees to indemnify, to the full extent permitted by law, each Selling Holder, its officers, directors and agents and each Person who controls such Holder (within the meaning of the Securities Act), and any investment advisor thereof or agent therefor, against all losses, claims, penalties, damages, liabilities and expenses (collectively, "Damages") caused by any untrue or alleged untrue statement of a material fact contained in any registration statement, prospectus or preliminary prospectus or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements made therein (in the case of a prospectus, in the light of the circumstances under which they were made) not misleading, except insofar as the same are caused by or contained in any information with respect to such Selling Holder furnished in writing to Pegasystems by such Selling Holder expressly for use therein or by such Selling Holder's failure to deliver a copy of the registration statement or prospectus or any amendments or supplements thereto after Pegasystems has furnished or made available to such Selling Holder a sufficient number of copies of the same. Pegasystems will also indemnify the underwriters of the Registrable Securities, their officers and directors and each Person who controls such underwriters (within the meaning of the Securities Act) to the same extent as provided above with respect to the indemnification of the Selling Holders. Pegasystems's indemnity set forth in the preceding sentences of this Section 7.5(a) is subject to the condition that, insofar as such indemnity relates to any untrue statement or omission or any alleged untrue statement or omission made in a preliminary prospectus but eliminated or remedied in a final prospectus, it shall not inure to the benefit of any Selling Holder, its officers, directors and agents or any Person who controls such Selling Holder, if a copy of the final prospectus was not delivered by the Selling Holder to a Person purchasing from such Selling Holder and asserting the claim at or prior to the time required by the Securities Act, sufficient copies of such final prospectus were furnished or made available to such Selling Holder and the delivery thereof to such Person would have constituted a defense to the claim asserted by such Person.

(b) Indemnification by Selling Holders. In connection with any registration statement in which a Selling Holder is participating, each such Person hereby indemnifies, to the full extent permitted by law, Pegasystems, its directors, officers and agents and each Person who controls Pegasystems (within the meaning of the Securities Act) against any Damages resulting from any untrue or alleged untrue statement of a material fact or any omission or alleged omission of a material fact required to be stated in the registration statement or prospectus or any amendment thereof or supplement thereto or necessary to make the statements therein (in the case of a prospectus, in the light of the circumstances under which they were made) not misleading, to the extent, but only to the extent, that such untrue statement or omission is contained in any information or affidavit with respect to such Selling Holder furnished in writing by such Selling Holder expressly for inclusion in such registration statement or prospectus.

(c) Conduct of Indemnification Proceedings. Any Person entitled to indemnification under this Section 7.5 agrees to give prompt written notice to the indemnifying party after the receipt by such Person of any notice of the commencement of any action, suit, proceeding or investigation or threat thereof made in writing for which such Person will claim indemnification or contribution pursuant to this Section 7.5 and, unless in the reasonable judgment of the indemnified party a conflict

of interest may exist between such indemnified party and the indemnifying party with respect to such claim, permit the indemnifying party to assume defense of such claim with counsel reasonably satisfactory to the indemnified party; provided, that the failure to so notify such indemnifying party shall not relieve such party from any liability which it may have to such indemnified party except to the extent that the failure to give notice is prejudicial to such indemnifying party. If the indemnifying party is not entitled to, or elects not to, assume the defense of a claim, it will not be obligated to pay the fees and expenses of more than one counsel (plus any required local counsel) with respect to such claim, unless in the reasonable judgment of such indemnified party a conflict of interest may exist between such indemnified party and any other indemnified parties represented by such counsel with respect to such claim, in which event the indemnifying party shall be obligated to pay the fees and disbursements of one additional counsel (and any required local counsel) for the indemnified party subject to such conflict of interest. The indemnifying party will not be subject to any liability for any settlement made without its consent, which consent shall not be unreasonably withheld.

(d) Contribution. If the indemnification provided for in this Section 7.5 from the indemnifying party is unavailable to an indemnified party hereunder (other than by reason of exception provided in Section 7.5(a) or (b)) in respect of any Damages referred to therein, then the indemnifying party, in lieu of indemnifying such indemnified party, shall contribute to the amount paid or payable by such indemnified party as a result of such Damages in such proportion as is appropriate to reflect the relative fault of the indemnifying party and the indemnified party in connection with the actions which resulted in such Damages, as well as any other relevant equitable considerations. The relative fault of such indemnifying party and indemnified party shall be determined by reference to, among other things, whether any action in question, including any untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact, has been made by, or related to information supplied by, such indemnifying party or indemnified parties, and the parties' relative intent, knowledge, access to information and opportunity to correct or prevent such statement or omission. The amount paid or payable by a party as a result of the Damages referred to above shall be deemed to include, subject to the limitations set forth in Section 7.5(c), any legal or other fees and expenses reasonably incurred by such party in connection with any investigation or proceeding. The parties hereto agree that it would not be just and equitable if contribution pursuant to this Section 7.5(d) were determined by pro rata allocation or by any other method of allocation which does not take account of the equitable considerations referred to in the immediately preceding paragraph. No Person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the Securities Act) shall be entitled to contribution from any Person who was not guilty of such fraudulent misrepresentation. If indemnification is available under this Section 7.5, the indemnifying parties shall indemnify each indemnified party to the full extent provided in Section 7.5(a) and (b) without regard to the relative fault of said indemnifying party or indemnified party or any other equitable consideration provided for in this Section 7.5(d).

7.6. Participation in Underwritten Registrations. No Person may participate in any underwritten registration hereunder unless such Person (a) agrees to sell such Person's securities on the basis provided in any underwriting arrangements approved by the Persons entitled hereunder to

approve such arrangements and (b) completes and executes all powers of attorney, underwriting agreements and other documents reasonably required under the terms of such underwriting arrangements. Each Selling Holder participating in any registration under this Section 7 agrees not to use any materials in connection with the sale of Registrable Securities pursuant to such registration other than materials filed by Pegasystems with the Commission or, after such registration becomes effective, otherwise publicly available.

8. CALL RIGHT

At any time between the receipt by Pegasystems of a Demand Request and the effective date of the related registration statement, Pegasystems shall have the right (the "Call Right") to purchase the Registrable Securities sought to be included by the Selling Holders (or, if the Call Right is exercised within 10 days of such Demand Request, the Demanding Holders) in a Demand Registration, or the Warrants under which such Registrable Securities are issuable (as applicable) for a purchase price (the "Call Price") equal to the Fair Value of such Registrable Securities, in each such case determined (i) if the Common Stock is publicly traded at the time, in accordance with the definition of "Current Market Price" and (ii) otherwise as of the date of the applicable Call Notice; provided that to the extent that any such Warrants are to be repurchased, the applicable Call Price shall be reduced by the amount of the Exercise Price then in effect. Pegasystems may exercise such Call Right by giving written notice of such exercise (a "Call Notice") to the applicable Holders at any time within the time period specified above. The Call Price shall be paid by Pegasystems to the applicable Holders within five (5) Business Days after the applicable Call Price is determined by wire transfer to such accounts as shall be designated by such Holders, and shall be accompanied by a certificate setting forth Pegasystems's calculation of the Call Price.

9. LOSS OR MUTILATION

Upon receipt by Pegasystems from any Holder of evidence reasonably satisfactory to it of the ownership of and the loss, theft, destruction or mutilation of this Warrant and an indemnity reasonably satisfactory to Pegasystems and, in case of mutilation upon surrender and cancellation of this Warrant, Pegasystems will execute and deliver in lieu hereof a new Warrant of like tenor to such Holder; provided, however, in the case of mutilation no indemnity shall be required if this Warrant in identifiable form is surrendered to Pegasystems for cancellation.

10. DESIGNATED OFFICE

As long as this Warrant remains outstanding, Pegasystems shall maintain an office or agency (the "Designated Office"), where this Warrant may be presented for exercise or registration of transfer as provided in this Warrant. Such Designated Office shall initially be the office of Pegasystems at ADDRESS, Attention: TITLE. Pegasystems may from time to time change the Designated Office

to another office within the United States by notice given to the registered holder of this Warrant at least ten (10) Business Days prior to the effective date of such change.

11. SHAREHOLDER INFORMATION

Until the earlier of the expiration of the Exercise Period or the Exercise Date, Pegasystems shall deliver to the Holder of this Warrant one copy of each annual report, proxy statement and each other document distributed by Pegasystems generally to the holders of its Common Stock concurrently with the delivery thereof to such shareholders. In addition, Pegasystems shall deliver to such Holder copies of any report on Form 10-K, Form 10-Q or Form 8-K filed by Pegasystems with the Commission promptly after such filing.

12. REPRESENTATIONS AND WARRANTIES

Pegasystems represents and warrants to each of the Holders that, as of the Original Issue Date:

12.1. Subscriptions, Options, Etc. As of the Original Issue Date, no subscription, warrant, option or other right to purchase or acquire any shares of any class of capital stock of Pegasystems or any security convertible into or exchangeable for any such shares, in each case issued by or binding upon Pegasystems, is outstanding except: (i) the Original Warrant, and (ii) options and other awards outstanding under Pegasystems' employee benefit plans.

12.2. Authority to Execute and Perform Agreement. It has all necessary corporate power and authority to execute, deliver and perform its obligations under this Warrant and to issue or transfer the Common Stock purchasable upon exercise of this Warrant; the execution, delivery and performance by it of this Warrant have been duly authorized by all necessary corporate action on its part; and this Warrant has been duly executed and delivered by and constitutes the legal, valid and binding obligation of it, enforceable against it in accordance with its terms, except as such enforceability may be limited by (a) bankruptcy, reorganization, insolvency and similar laws of general application relating to or affecting the enforcement of creditors' rights generally or (b) the principles governing the availability of equitable remedies.

12.3. Authorized Capital Stock. The authorized capital stock of Pegasystems as of the Original Issue Date consists of 45,000,000 shares of Common Stock of which 28,487,600 shares are issued and outstanding and none are reserved for issuance upon the exercise of outstanding Stock Purchase Rights and Convertible Securities (excluding the shares reserved for issuance upon exercise of the Original Warrant and shares issuable under Pegasystems stock plans). The Common Stock has the rights and preferences set forth in the Certificate of Incorporation of Pegasystems, a true, correct and complete copy of which, together with the Bylaws of Pegasystems, in each case with all amendments through the Original Issue Date, have been delivered to Pegasystems.

12.4. No Breach; No Contractual Restriction on Repurchase. Neither the execution and delivery of this Warrant, the consummation of the transactions contemplated hereby (including without limitation the issuance of Common Stock upon the exercise hereof), nor compliance with the terms and provisions hereof will: (a) conflict with or result in a breach of, or require any consent under, (i) the Certificate of Incorporation or bylaws of Pegasystems, (ii) any applicable law or regulation or (iii) any order, writ, injunction or decree of any court or governmental authority or agency applicable to Pegasystems, or any agreement or instrument to which Pegasystems is a party or by which Pegasystems is bound or to which Pegasystems is subject or (b) constitute a default under any such agreement or instrument, or result in the creation or imposition of any lien upon any of the revenues or assets of Pegasystems pursuant to the terms of any such agreement or instrument.

12.5. Approvals. No authorizations, approvals or consents of, and no filings or registrations with, any governmental or regulatory authority or agency on or prior to the Original Issue Date, which have not already been made or obtained, are necessary for the execution, delivery or performance by Pegasystems of this Warrant, the consummation of the transactions herein contemplated or for the validity or enforceability thereof.

13. MISCELLANEOUS

13.1. Nonwaiver. No course of dealing or any delay or failure to exercise any right hereunder on the part of Pegasystems or any Holder shall operate as a waiver of such right or otherwise prejudice the rights, powers or remedies of such Person.

13.2. Notices. Any notice, demand, request, consent, approval, declaration, delivery or communication hereunder to be made pursuant to the provisions of this Warrant shall be sufficiently given or made if in writing and either delivered in person with receipt acknowledged or sent by registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

(i) if to any Holder of this Warrant or holder of Restricted Stock issued upon the exercise hereof, at its last known address appearing on the books of Pegasystems maintained for such purpose;

(ii) if to Pegasystems, at ADDRESS, Attention: TITLE;

or at such other address as may be substituted by notice given as herein provided. The giving of any notice required hereunder may be waived in writing by the party entitled to receive such notice. Every notice, demand, request, consent, approval, declaration, delivery or other communication hereunder shall be deemed to have been duly given or served on the date on which personally delivered, with receipt acknowledged, or three (3) Business Days after the same shall have been deposited in the United States mail, or one (1) Business Day after the same shall have been delivered to Federal Express or another overnight courier service.

13.3. Limitation of Liability. No provision hereof, in the absence of affirmative action by the Holder of this Warrant to purchase shares of Common Stock, and no enumeration herein of the rights or privileges of the Holder hereof, shall give rise to any liability of such Holder to pay the Exercise Price for any Common Stock other than pursuant to an exercise of this Warrant or any liability as a stockholder of Pegasystems, whether such liability is asserted by Pegasystems or by creditors of Pegasystems.

13.4. Remedies. Each Holder of this Warrant, in addition to being entitled to exercise its rights granted by law, including recovery of damages, shall be entitled to specific performance of its rights provided under this Warrant. Pegasystems agrees that monetary damages would not be adequate compensation for any loss incurred by reason of a breach by it of the provisions of this Warrant and hereby agree, in an action for specific performance, to waive the defense that a remedy at law would be adequate.

13.5. Successors and Assigns. Subject to the provisions of Section 6, this Warrant and the rights evidenced hereby shall inure to the benefit of and be binding upon the successors of Pegasystems and the successors and permitted assigns of the Holder hereof. The provisions of this Warrant are intended to be for the benefit of all Holders from time to time of this Warrant, and shall be enforceable by any current Holder. In addition, the provisions of Section 7 and any other provisions hereof that by their terms apply to Holders of Common Stock issued upon exercise hereof shall survive any exercise of this Warrant and inure to the benefit of and be binding upon such Holders and any transferees of such Common Stock. Notwithstanding the foregoing, with respect to the transfer of this Warrant or shares of Common Stock received upon exercise of this Warrant other than to an Affiliate of FDR, the registration rights granted under this Warrant shall be transferable only to Persons receiving under such transfer at least 100,000 shares of Common Stock or the right to receive 100,000 shares of Common Stock upon exercise of this Warrant.

13.6. Severability. Wherever possible, each provision of this Warrant shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Warrant shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Warrant.

13.7. Headings. The headings used in this Warrant are for the convenience of reference only and shall not, for any purpose, be deemed a part of this Warrant.

13.8. Right of Holders to Challenge Certain Determinations of Pegasystems. The following provisions shall apply to any determination by the Board of Directors or Chief Financial Officer of Pegasystems (the "Pegasystems Determination") of (i) the Fair Value of any Non-Preferred Stock (ii) the Fair Distribution Value of any dividend or distribution to the holders of any class of NonPreferred Stock radii) the fair market value or allocation of any consideration for the issuance of Non-Preferred Stock and (iv) any other valuation, allocation or adjustment hereunder that is stated to be subject to the right of the Majority Holders to challenge such determination pursuant to this Section

13.8. Upon the request of the Majority Holders, Pegasystems shall make available to the Majority Holders such material information as the Majority Holders may reasonably request relevant to the issue addressed by such Pegasystems Determination; provided that Pegasystems shall not be required to disclose any confidential information to any Holder that has not executed and delivered a confidentiality agreement substantially in the form of Annex C hereto or the disclosure of which would violate any contractual or other legally binding confidentiality restriction applicable to Pegasystems. If the Majority Holders at any time believe that the Pegasystems Determination is inaccurate in a way that disadvantages the Holders, they may propose an alternative valuation or allocation (the "Holders' Determination") by written notice to Pegasystems setting forth the basis for such Holders' Determination. Upon delivery of such notice, Pegasystems and the Majority Holders shall negotiate in good faith for a period of thirty (30) days in an effort to resolve the differences in valuation or allocation represented by the Pegasystems Determination and the Holders' Determination. If such differences are not resolved by agreement of Pegasystems and the Majority Holders by the end of such thirty-day period, the Majority Holders will have the right, exercisable by written notice to Pegasystems, to require that such dispute be resolved by an Independent Financial Expert, who shall be instructed to make its own independent determination of the valuation or allocation in question (the "Expert's Determination"), which Expert's Determination shall not be less favorable to the Holders than Pegasystems's Determination nor more favorable to the Holders than the Holders' Determination. The Expert shall be instructed to make its determination within sixty (60) days, and its determination shall be final and binding on Pegasystems and all Holders or Warrants and Common Stock. The reasonable fees and expenses of the Independent Financial Expert shall be paid by Pegasystems if the Expert's Determination is more than five percent (5%) closer to the Holders' Determination than to Pegasystems's Determination than to the Holders' Determination, but shall be shared equally by Pegasystems and the Majority Holders if the Expert's Determination does not vary from the mean between Pegasystems's Determination and the Holders' Determination by more than five percent (5%) of such mean. Pending final resolution of the dispute by negotiation or by submission of the dispute to an Independent Financial Expert, Pegasystems's Determination shall be used for the purpose of making any payment hereunder to the Holders, for making any adjustment to the Exercise Price hereunder or for any other purpose hereunder. If the resolution of such dispute is more favorable to the Holders than Pegasystems's Determination, Pegasystems shall make such additional payments and shall take such other additional actions as are necessary to place the Holders in the same position as they would have been in if the Expert's Determination had been used for the purpose of making such payment or adjustment to the Exercise Price or for such other purpose at the time of taking such original action.

13.9. Waiver or Amendment. This Warrant and all other Warrants may be modified or amended or the provisions hereof waived only with the written consent of Pegasystems and the Majority Warrant Holders, provided that no such Warrant may be modified or amended to reduce the number of shares of Common Stock for which such Warrant is exercisable or to increase the price at which such shares may be purchased upon exercise of such Warrant (before giving effect to any adjustment as provided therein) without the written consent of the Holder thereof.

13.10. GOVERNING LAW. THE PARTIES HEREBY ACKNOWLEDGE AND AGREE THAT, IN ALL RESPECTS, INCLUDING ALL MATTERS OF CONSTRUCTION, VALIDITY AND PERFORMANCE, THIS WARRANT AND THE OBLIGATIONS ARISING HEREUNDER SHALL BE GOVERNED BY, AND CONSTRUED AND ENFORCED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF DELAWARE APPLICABLE TO CONTRACTS MADE AND PERFORMED IN SUCH STATE WITHOUT REFERENCE TO ANY CONFLICTS OF LAWS PRINCIPLES.

IN WITNESS WHEREOF, Pegasystems has caused this Warrant to be duly executed by their duly authorized officers.

PEGASYSTEMS INC.

By:

Name:

Title:

**ACKNOWLEDGED AND AGREED TO
BY FIRST DATA RESOURCES INC.**

By:

Name:

Title:

ANNEX A

SUBSCRIPTION FORM

[To be executed only upon exercise of Warrant]

The undersigned registered owner of this Warrant irrevocably exercises this Warrant for the purchase of an aggregate of _____ shares Common Stock of PEGASYSTEMS INC. and herewith makes payment therefor, all at the price and on the terms and conditions specified in this Warrant and requests that certificates for the indicated number of shares of Common Stock hereby purchased (and any securities or other property purchasable upon such exercise) be issued in the name of and delivered to:

Name	Address	Number of Shares
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[Replicate additional delivery instruction blocks as necessary]

Dated: _____

(Name of Registered Owner)

(Signature of Registered Owner)

(Street Address)

(City) (State) (Zip Code)

ANNEX B

ASSIGNMENT FORM

FOR VALUE RECEIVED the undersigned registered owner of this Warrant hereby sells, assigns and transfers unto the Assignee(s) named below all of the rights of the undersigned under this Warrant, with respect to the number of shares of Common Stock set forth below:

Name	Address	Number of Shares
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[Replicate additional assignment blocks as necessary]

and does hereby irrevocably constitute and appoint _____ attorney-in-fact to register such transfer onto the books of Pegasystems Inc. maintained for the purpose, with full power of substitution in the premises.

Dated: _____

(Name of Registered Owner)

(Signature of Registered Owner)

(Street Address)

(City) (State) (Zip Code)

ANNEX C

FORM OF CONFIDENTIALITY AGREEMENT

CONFIDENTIALITY AGREEMENT

THIS CONFIDENTIALITY AGREEMENT (this "Agreement") is entered into as of the ___ day of _____, _____ by and between PEGASYSTEMS INC., a Massachusetts corporation ("Pegasystems"), and _____, a STATE corporation ("Recipient").

WHEREAS, Recipient is the holder of a Warrant (the "Warrant") issued by Pegasystems or of shares of Pegasystems Common Stock issued upon exercise of such a Warrant and, pursuant to Section 13.8 of such applicable Warrant, has requested that Pegasystems disclose to the Recipient certain Confidential Information (as defined below);

WHEREAS, it is a condition to Pegasystems's obligation under Section 7.3(k) or Section 13.8 of the Warrant to disclose such Confidential Information that Recipient agree to abide by certain confidentiality restrictions with respect to such Information, as more fully set forth below:

NOW, THEREFORE, in consideration of these premises and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Pegasystems and Recipient agree as follows:

1. Confidential Information Defined. For the purposes of this Agreement, "Confidential Information" of Pegasystems or any Affiliate (collectively, the "Disclosing Party") will include all oral and written information and material, in tangible or intangible form (including, without limitation, technical, operating, business, marketing and financial information), which such Disclosing Party furnishes, directly or indirectly, to the Recipient or any of its Affiliates (collectively, the "Receiving Party") pursuant to Section 7.3(k) or Section 13.8 of the Warrant and which is specifically identified in writing as being confidential. Such identification of Confidential Information may be made by the Disclosing Party before or during the disclosure of such information or by written notice delivered following such disclosure confirming that such disclosure constituted Confidential Information; provided that in the event that any such Confidential Information is identified by a written notice delivered to the Recipient following such disclosure the provisions of this Agreement shall not be deemed to apply to such Confidential Information (or to any disclosure thereof by the Recipient) prior to the giving of such notice. However, none of the following will be considered Confidential Information:

- (i) information that was already known to the Receiving Party (and not otherwise subject to an obligation of confidentiality to the Disclosing Party) prior to disclosure of such information to the Receiving Party by the Disclosing Party;
- (ii) information that is disclosed to the Receiving Party by a third party which, to the knowledge of the Receiving Party, is not under any obligation of confidentiality to the

Disclosing Party with respect to such information;

(iii) information that is in the public domain or hereafter enters the public domain through no fault of the Receiving Party;

(iv) information that is independently developed by employees, consultants or agents of the Receiving Party without reference to Confidential Information of the Disclosing Party.

2. **Obligation to Maintain Confidentiality.** Each Receiving Party shall: (1) keep all Confidential Information disclosed to it by the Disclosing Party in strict confidence; (2) protect such Confidential Information with the same degree of care as the Receiving Party treats its own confidential information;

(3) not, without the prior written consent of the Disclosing Party, disclose or permit any such Confidential Information to be disclosed to anyone other than the Receiving Party's directors, officers, employees, agents or consultants who have a legitimate need to know the Confidential Information in connection with matters contemplated in Section 7.3(k) or Section 13.8 of the Warrant or, if the Recipient is a "Holder" within the meaning of the Warrant, in connection with such Holder's exercise of any of its rights under the Warrant or other pending business matters between such Holder and Pegasystems; and (4) not use, and not permit its directors, officers, employees, agents or consultants to use, any such Confidential Information for any reason other than as contemplated in Section 7.3(k) or Section 13.8 of the Warrant or, if the Recipient is a "Holder" within the meaning of the Warrant, in connection with such Holder's exercise of any of its rights under the Warrant or other pending business matters between such Holder and Pegasystems].

3. **Obligations of Permitted Disclosees.** Each Receiving Party shall advise all directors, officers and employees to whom any Confidential Information is disclosed of the confidentiality obligations of such directors, officers and officers under this Agreement with respect to such information, and such Receiving Party shall require all agents, consultants and other third parties to whom Confidential Information is disclosed pursuant to paragraph 2 above to agree in writing to be bound by the confidentiality obligations set forth in this Agreement.

4. **Required Disclosures.** In the event any Receiving Party is required by any court or legislative or administrative body (by oral questions, interrogatories, requests for information or documents, subpoena, civil investigation, demand or similar process) to disclose any Confidential Information, the Receiving Party shall provide the Disclosing Party with prompt notice of such requirement in order to afford the Disclosing Party an opportunity to seek an appropriate protective order. However, if the Disclosing Party is unable to obtain or does not seek such protective order and the Receiving Party is compelled to disclose such Confidential Information under pain of liability for contempt or other censure or penalty, disclosure of such information may be made without liability.

5. **Equitable Relief.** Each Receiving Party agrees that the Disclosing Party would suffer irreparable harm and that damages caused by a breach of this Agreement may be impossible to calculate and may, therefore, be an inadequate remedy. Accordingly, each Receiving Party agrees that the Disclosing Party shall be entitled to temporary and permanent injunctive relief against the

Receiving Party and/or its agents for any threatened or actual breach hereof.

6. Notices. Any notice, demand, request, consent, approval, declaration, delivery or communication hereunder to be made pursuant to this Agreement shall be sufficiently given or made if in writing and either delivered in person with receipt acknowledged or sent by registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

(a) if to the Recipient, at its last known address appearing on the stock or Warrant transfer records of Pegasystems;

(b) if to Pegasystems, at ADDRESS, Attention: TITLE;

or at such other address as may be substituted by notice given as herein provided. The giving of any notice required hereunder may be waived in writing by the party entitled to receive such notice. Every notice, demand, request, consent, approval, declaration, delivery or other communication hereunder shall be deemed to have been duly given or served on the date on which personally delivered, with receipt acknowledged, or three (3) business days after the same shall have been deposited in the United States mail, or one (1) business day after the same shall have been delivered to Federal Express or another overnight courier service.

7. Successors and Assigns. This Agreement shall inure to the benefit of and be binding upon the successors and assigns of Pegasystems and Recipient.

8. Severability. Wherever possible, each provision of this Agreement shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Agreement.

9. Headings. The headings used in this Agreement are for the convenience of reference only and shall not, for any purpose, be deemed a part of this Agreement.

10. GOVERNING LAW. THE PARTIES HEREBY ACKNOWLEDGE AND AGREE THAT, IN ALL RESPECTS, INCLUDING ALL MATTERS OF CONSTRUCTION, VALIDITY AND PERFORMANCE, THIS WARRANT AND THE OBLIGATIONS ARISING HEREUNDER SHALL BE GOVERNED BY, AND CONSTRUED AND ENFORCED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF DELAWARE APPLICABLE TO CONTRACTS MADE AND PERFORMED IN SUCH STATE WITHOUT REFERENCE TO ANY CONFLICTS OF LAWS PRINCIPLES.

IN WITNESS WHEREOF, the parties have caused this Agreement to be executed and

delivered by their duly authorized officers as of the day and year first above written.

PEGASYSTEMS INC.

By:

Name:

Title:

[Recipient]

By:

Name:

Title:

TABLE OF CONTENTS

	Page
1.	DEFINITIONS1
2.	EXERCISE OF WARRANT8
2.1.	Manner of Exercise8
2.2.	Fractional Shares9
2.3.	Continued Validity and Application9
3.	ANTIDILUTION PROVISIONS9
3.1.	Stock Dividends, Subdivisions and Combinations10
3.2.	Distributions of Evidences of Indebtedness or Other Assets10
3.3.	Adjustment of Number of Shares Purchasable11
3.4.	Reorganization, Reclassification, Merger, Consolidation or Disposition of Assets11
3.5.	Other Dilutive Events12
3.6.	Other Provisions Applicable to Adjustments under this Section12
4.	NO IMPAIRMENT13
5.	RESERVATION AND AUTHORIZATION OF COMMON STOCK; REGULATORY PROBLEMS.....14
6.	TRANSFERS OF WARRANT AND RESTRICTED STOCK; DIVISION OR COMBINATION OF WARRANTS14
6.1.	Warrant Transfer Procedures14
6.2.	Division and Combination14
6.3.	Restrictions on Transfer14
6.4.	Restrictive Legends15
6.5.	Termination of Securities Law Restrictions16
6.6.	Maintenance of Books17
9.	LOSS OR MUTILATION27
10.	DESIGNATED OFFICE27
11.	SHAREHOLDER INFORMATION28
12.	REPRESENTATIONS AND WARRANTIES28
13.1.	Nonwaiver29
13.2.	Notices29
13.3.	Limitation of Liability30
13.4.	Remedies30
13.5.	Successors and Assigns30
13.6.	Severability30
13.7.	Headings30
13.8.	Right of Holders to Challenge Certain Determinations of Pegasystems30
13.9.	Waiver or Amendment31
13.10.	GOVERNING LAW32

Exhibit 13.1

STOCK PRICE HISTORY AND RELATED STOCKHOLDER MATTERS (unaudited)

The following table sets forth the range of high and low sales prices on the National Association of Security Dealers Automatic Quotation ("Nasdaq") National Market System under the Nasdaq symbol PEGA, for 1996 and 1997. The Company's common stock has been traded on the Nasdaq National Market System since its initial public offering in July 1996. Prior to that date, there was no public market for the Company's common stock. As of February 6, 1998, the Company had approximately 39 stockholders of record and approximately 2,600 beneficial owners of the Company's common stock. On February 25, 1998, the closing sale price of the common stock was \$22.00. The Company has never declared or paid any dividends on its common stock. The Company intends to retain its earnings to finance future growth, and therefore does not anticipate paying any dividends in the foreseeable future.

1997	High	Low
-----	-----	-----
First Quarter	\$ 39.13	\$ 19.38
Second Quarter	\$ 32.06	\$ 16.75
Third Quarter	\$ 38.50	\$ 26.81
Fourth Quarter	\$ 33.88	\$ 15.13
1996	High	Low
-----	-----	-----
Third Quarter (beginning July 19, 1996)	\$27.00	\$10.00
Fourth Quarter	\$37.00	\$26.13

PEGASYSTEMS INC.
FIVE YEAR COMPARISON OF SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data presented below at December 31, 1993, 1994, 1995, 1996 and 1997 have been derived from the consolidated financial statements of Pegasystems Inc. ("Pegasystems" or the "Company"). This data may not be indicative of the Company's future condition or results of operations and should be read in conjunction with the consolidated financial statements and related notes included herein.

(in thousands, except per share data)	Years Ended December 31,				
	1993	1994	1995	1996	1997
Consolidated Statement of Income Data:					
Total revenue	\$10,212	\$16,263	\$22,247	\$33,545	\$44,361
Income (loss) from operations	793	2,236	3,257	10,019	(3,388)
License interest income	1,305	1,457	1,486	1,565	1,789
Net income	1,233	2,193	2,878	7,500	1,085
*Earnings per share:					
Basic	\$ 0.05	\$ 0.09	\$ 0.12	\$ 0.30	\$ 0.04
Diluted	\$ 0.05	\$ 0.09	\$ 0.12	\$ 0.28	\$ 0.04
Weighted average number of common shares outstanding:					
Basic	22,501	23,407	23,490	24,802	28,284
Diluted	23,437	23,472	23,743	26,397	30,268

(in thousands)	December 31,				
	1993	1994	1995	1996	1997
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 435	\$ 456	\$ 511	\$24,201	\$ 52,005
Working capital	4,231	4,441	4,393	34,364	62,708
Long-term license installments, net	6,782	9,135	13,399	23,802	36,403
Total assets	17,057	20,787	25,876	66,855	127,520
Long-term debt	458	450	816	--	--
Stockholders' equity	9,676	11,872	14,674	52,385	108,649

Certain of these amounts have been restated in accordance with the adoption of SFAS No. 128, "Earnings Per Share."

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The Company was founded in April 1983 to develop, market and support customer management software solutions for financial services organizations. Product development began immediately and by the end of the year the Company had secured its first customer.

The Company's revenue is derived from two sources: software license fees and services revenue. License fees, which have historically represented the majority of the Company's total revenue, are generally payable on a monthly basis under license agreements which typically have a five-year term and may be extended at the customer's option for an additional fixed period. Such license agreements are generally non-cancellable, although some may be terminated by the licensee for a fee prior to the expiration of the initial term but after a minimum specified period. The Company's licenses generally provide for annual license fee increases (the "inflation adjustments") based on recognized inflation indexes (sometimes subject to maximums). The Company believes that both it and its customers derive substantial benefits from the recurring fee model because it encourages the Company to be responsive to customer needs and provides the Company with additional revenue opportunities through license renewals.

License revenue is generally recognized upon product acceptance. In the case of license agreement renewals or extensions, revenue is recognized upon execution of the renewal or the extension. The inflation adjustments are recognized ratably over the periods to which they apply. The amount of software license revenue recognized upon product acceptance or license renewal is equal to the present value of the payments due during the minimum initial or renewal term, as the case may be, plus the present value of any early termination fee. In 1995, and the three months ended March 31, 1996, the discount rate for purposes of the present value calculation was 7%; for the nine months ended December 31, 1996, such discount rate was 6.75%. Commencing with the three months ended March 31, 1996, the Company established and intends to continue to establish the discount rate quarterly as a function of the Company's current marginal borrowing rate. In 1997, the discount rate for purposes of the present value calculation was 7%. The imputed interest portion of the license fees, which is reported as license interest income in the Company's consolidated statements of income, is recognized over the minimum initial or the renewal term, as the case may be. To date, a substantial majority of the Company's software licenses have been renewed upon expiration. The fact that a portion of the Company's revenue is derived from the renewal of license agreements with fixed expiration dates assists the Company in anticipating future revenue.

The Company's services revenue is comprised of fees for implementation, consulting, maintenance and training services. Software license customers are offered the ability to enter into a maintenance contract requiring the customer to pay a monthly maintenance fee over the term of the related license agreement typically equal to approximately 18% of the license fee. Maintenance fees are recognized ratably over the term of the maintenance agreement. The Company's software implementation agreements typically require the Company to provide a specified level of implementation services for a fixed fee, typically with additional implementation services available at an hourly rate. Implementation fees are payable upon the achievement of specified milestones. The Company generally recognizes implementation as well as consulting and training fees as the services are provided.

The Company's export revenue has fluctuated considerably in the past due to the fact that such revenue has been largely attributable to a small number of product acceptances during a given period. Export revenue declined from \$3.9 million to \$2.3 million in 1995 due to the lack of large product acceptances during the year. In 1996, export revenue increased to \$5.9 million, as a result of new customers in the European marketplace. In 1997, export revenue increased to \$7.3 million as a result of new product acceptances and license renewals in Europe, Canada and Mexico.

Most of the Company's contracts are denominated in U.S. dollars, although several are denominated in other currencies, primarily British pounds sterling. The Company expects that in the future more of its contracts will be denominated in foreign currencies. The Company has not experienced any significant foreign exchange gains or losses, and the Company does not expect that foreign currency fluctuations will significantly affect either its revenue or costs in the near term.

The Company's business has experienced and is expected to continue to experience significant seasonality. Historically, the Company has recognized a greater percentage of its revenue in its third and fourth quarters than in its first and second quarters due to the Company's sales commission structure and the impact of that structure on the timing of product acceptances and license renewals by customers. This pattern is reinforced by the Company's maintenance contracts, which generally entitle customers to, among other things, a fixed number of hours of service per calendar year. Once the annual allotment of service hours is exhausted, customers pay for additional services on an hourly basis, typically resulting in higher services revenue in the Company's second, third, and fourth quarters.

RESULTS OF OPERATIONS

The following table sets forth for the years indicated the percentage of total revenue represented by certain items reflected in the Statements of Income of the Company:

	Years Ended December 31,		
	1995	1996	1997
	(as a percentage of total revenue)		
Revenue:			
Software license	60.8%	66.4%	64.6%
Services	39.2	33.6	35.4
Total revenue	100.0	100.0	100.0
Cost of revenue:			
Cost of software license	2.9	1.4	0.6
Cost of services	27.7	20.8	26.5
Total cost of revenue	30.6	22.2	27.1
Gross profit	69.4	77.8	72.9
Operating expenses:			
Research and development	31.7	24.5	34.1
Selling and marketing	16.1	17.9	39.4
General and administrative	6.9	5.5	7.0
Total operating expenses	54.7	47.9	80.5
Income (loss) from operations	14.7	29.9	(7.6)
License interest income	6.7	4.7	4.0
Other interest income	0.1	1.8	7.5
Interest expense	(0.5)	(0.3)	--
Income before provision for income taxes	21.0	36.1	3.9
Provision for income taxes	7.9	13.7	1.5
Net income	13.1%	22.4%	2.4%

YEAR ENDED DECEMBER 31, 1997 COMPARED TO YEAR ENDED DECEMBER 31, 1996

The Company restated its consolidated financial statements for the unaudited quarters ended March 31, 1997, June 30, 1997, and September 30, 1997. The restatements reflect changes in the timing of revenue recognition and expense on certain contracts and increased reserves for revenue and doubtful accounts. In the opinion of management, all material adjustments necessary to correct the financial statements have been made.

Revenue

Total revenue for 1997 increased 32.2% to \$44.4 million from \$33.5 million for 1996. The increase was primarily due to an increase in software license revenue.

Software license revenue for 1997 increased 28.7% to \$28.7 million from \$22.3 million for 1996. The increase in software license revenue was primarily attributable to software license acceptances by new customers, software license agreement renewals, expanded software usage by existing customers, the licensing of standard product templates, and inflation-based increases in monthly license fees.

Services revenue for 1997 increased 39.1% to \$15.7 million from \$11.3 million for 1996. The increase in services revenue was primarily attributable to increased demand for implementation and consulting services.

Cost of Revenue

Cost of software license consists of amortization expense related to stock warrant and capitalized software costs, royalty payments to third party software vendors, and costs of product media, duplication and packaging. Cost of software license for 1997 decreased 46.4% to \$0.3 million from \$0.5 million for 1996, and decreased as a percentage of total revenue from 1.4% for 1996 to 0.6% for 1997. As a percentage of software license revenue, cost of software license decreased from 2.1% for 1996 to 0.9% for 1997. Such decreases were due to decreased amortization of purchased software costs partially offset by the costs associated with a stock purchase warrant issued by the Company in June 1997, which cost is being amortized through December 31, 2002.

Cost of services consists primarily of the costs of providing implementation, consulting, maintenance, and training services. Cost of services for 1997 increased 68.9% to \$11.8 million from \$7.0 million for 1996. Cost of services as a percentage of total revenue increased from 20.8% for 1996 to 26.6% for 1997, and increased as a percentage of services revenue from 61.8% for 1996 to 75.0% for 1997. These increases in cost of services were mainly due to increased staffing in the Company's Client Services group worldwide.

Operating Expenses

Research and development expenses consist primarily of the cost of personnel and equipment needed to conduct the Company's research and development efforts. Research and development expenses for 1997 increased 83.8% to \$15.1 million from \$8.2 million for 1996. The increase in research and development expenses was due to the hiring of additional development personnel as well as the depreciation of purchased capitalized software. As a percentage of total revenue, research and development expenses increased from 24.5% for 1996 to 34.0% for 1997. The Company has been increasing spending on sales and marketing more rapidly than increases in development and intends to continue a strategy of leveraging existing product functionality by balancing its historical focus on research and development with an increased emphasis on sales and marketing.

Selling and marketing expenses for 1997 increased 191.4% to \$17.5 million from \$6.0 million for 1996. As a percentage of total revenue, selling and marketing expenses increased from 17.9% for 1996 to 39.4% for 1997 as the Company invested in building its sales force. Such increases were attributable to the hiring of additional direct sales and marketing personnel, increased sales commission payments attributable to higher sales, and increased investment

in marketing support activities and materials. During 1997, the Company continued to build its sales and marketing infrastructure in its domestic and international offices.

General and administrative expenses consist primarily of the salaries of the Company's executive, administrative and financial personnel, and associated expenses. General and administrative expenses for 1997 increased 68.2% to \$3.1 million from \$1.9 million for 1996 due to increased investment in the infrastructure needed to support the Company's growth. Such expenses increased as a percentage of total revenue from 5.5% for 1996 to 7.0% for 1997 due to the Company's investment in infrastructure.

License Interest Income

License interest income represents the portion of all license fees due under software license agreements which was not recognized upon product acceptance or license renewal. License interest income for 1997 increased 14.3% to \$1.8 million from \$1.6 million for 1996 reflecting a larger installed product base.

Provision for Income Taxes

The provisions for federal, state and foreign taxes were \$4.6 million and \$0.7 million for 1996 and 1997, respectively. The effective tax rates were 38.1% for 1996 and 38.0% for 1997. At December 31, 1997, the Company had \$9.1 million in net operating loss and research and development tax credit carryforwards available to offset future federal taxable income. See Note 8 of Notes to Consolidated Financial Statements.

YEAR ENDED DECEMBER 31, 1996 COMPARED TO YEAR ENDED DECEMBER 31, 1995

Revenue

Total revenue for 1996 increased 50.8% to \$33.5 million from \$22.2 million for 1995. The increase was primarily due to an increase in software license revenue.

Software license revenue for 1996 increased 64.5% to \$22.3 million from \$13.5 million in 1995. The increase in software license revenue was primarily attributable to software license acceptances by new customers, software license agreement renewals, expanded software usage by existing customers, the licensing of standard product templates, and inflation-based increases in monthly license fees.

Services revenue for 1996 increased 29.5% to \$11.3 million from \$8.7 million for 1995. The increase in services revenue was primarily attributable to increased demand for consulting and implementation services, and to a lesser extent, increased maintenance revenue from a larger installed product base.

Cost of Revenue

Cost of software license for 1996 decreased 24.9% to \$0.5 million from \$0.6 million for 1995, and decreased as a percentage of total revenue from 2.9% for 1995 to 1.4% for 1996. As a percentage of software license revenue, cost of software license decreased from 4.7% for 1995 to 2.1% for 1996. Such decreases were due to decreased amortization expense related to capitalized software development costs. No software development costs were capitalized in 1995 or 1996.

Cost of services for 1996 increased 13.2% to \$7.0 million from \$6.2 million for 1995, mainly due to increased staffing in the Company's Reengineering and Client Services group in the United Kingdom and in the Company's domestic regional offices to meet growing client commitments. Cost of services as a percentage of total revenue declined from 27.7% for 1995 to 20.8% for 1996, and declined as a percentage of services revenue from 70.7% for 1995 to 61.8% for 1996, in both cases due to the growth in the Company's total revenue and increased utilization of service personnel.

Operating Expenses

Research and development expenses for 1996 increased 16.4% to \$8.2 million from \$7.1 million for 1995. The increase in research and development expenses was due to the hiring of additional development personnel. As a percentage of total revenue, research and development expenses declined from 31.7% for 1995 to 24.5% for 1996, reflecting the Company's strategy of leveraging existing product functionality by balancing its historical focus on research and development with an increased emphasis on sales and marketing. In addition, research and development expenses declined as a percentage of total revenue due to the growth in the Company's total revenue.

Selling and marketing expenses for 1996 increased 67.0% to \$6.0 million from \$3.6 million for 1995. As a percentage of total revenue, selling and marketing expenses increased from 16.1% for 1995 to 17.9% for 1996. Such increases were attributable to the hiring of additional direct sales and marketing personnel, increased sales commission payments attributable to higher sales, and increased investment in marketing support activities and materials.

General and administrative expenses for 1996 increased 20.5% to \$1.9 million from \$1.5 million for 1995 due to increased investment in the infrastructure needed to support the Company's growth. Such expenses declined as a percentage of total revenue from 6.9% for 1995 to 5.5% for 1996 due to the growth in the Company's total revenue.

License Interest Income

License interest income for 1996 increased 5.3% to \$1.6 million from \$1.5 million for 1995, reflecting a larger installed product base.

Provision for Income Taxes

The provisions for federal, state and foreign taxes were \$1.8 million and \$4.6 million for 1995 and 1996, respectively. The effective tax rates were 38.0% for 1995 and 38.1% for 1996. At December 31, 1996, the Company had \$0.8 million in research and development tax credit carryforwards available to offset future federal taxable income. See Note 8 of Notes to Consolidated Financial Statements.

LIQUIDITY AND CAPITAL RESOURCES

Since its inception, the Company had funded its operations primarily through cash flow from operations and bank borrowings. In July 1996, the Company issued and sold 2.7 million shares of Common Stock in connection with its initial public offering. Net proceeds to the Company from such offering were approximately \$29.4 million. In January 1997, the Company issued and sold 1.8 million shares of Common Stock in connection with a second public offering. Net proceeds to the Company from such second public offering were approximately \$51.9 million. At December 31, 1997, the Company had cash and cash equivalents of approximately \$52.0 million and working capital of approximately \$62.7 million. The Company's approach of charging license fees payable in installments over the term of its licenses has historically deferred the receipt of cash and, prior to its initial public offering, had limited the availability of working capital.

Net cash provided by operating activities for the year ended December 31, 1995 was \$0.8 million. Net cash used in operating activities for the years ended December 31, 1996 and 1997 was \$2.9 million and \$10.0 million, respectively. The increase in cash used in operating activities was primarily due to a reduction in net income, and an increase in accounts receivable, prepaid expenses and other assets.

Net cash used by investing activities for the years ended December 31, 1995, 1996 and 1997 was \$1.4 million, \$2.0 million and \$14.5 million, respectively. This cash was used mainly to support the purchase of development software, in addition to the purchase of property and equipment consisting mainly of computer hardware and software and furniture and fixtures to support the Company's growing employee base.

Net cash provided by financing activities for the years ended December 31, 1995, 1996 and 1997 was \$0.7 million, \$28.5 million and \$52.6 million, respectively. This cash was provided mainly as a result of the Company completing an initial public stock offering in 1996 and a second public stock offering in 1997.

The Company's capital commitments consist primarily of operating leases for office space and equipment. At December 31, 1997, the Company's commitments under non-cancellable operating leases for office space with terms in excess of one year totaled \$1.6 million, \$0.8 million and \$0.3 million for 1998, 1999 and 2000, respectively. The Company's total payments under such leases was \$1.1 million, \$1.4 million and \$3.0 million for 1995, 1996 and 1997, respectively. See Note 7 of Notes to Consolidated Financial Statements.

The Company's \$5.0 million revolving credit line, which expired on June 30, 1997, was renewed with the same bank and has a maturity date of June 30, 1999. At December 31, 1997, the Company had no borrowings under such facility. The Company's credit agreement prohibits the payment of dividends, has profitability requirements and requires maintenance of specified levels of tangible net worth and certain financial ratios. The Company intends to renegotiate the term and the covenant requirements under the existing line of credit with the same bank. See Note 4 of Notes to Consolidated Financial Statements.

The Company recorded bad debt expense in the amounts of \$0.8 million, \$0.3 million and \$1.9 million in 1995, 1996, and 1997, respectively, as a result of indications that certain receivables relating primarily to consulting and installation services rendered by the Company would not be collected in full.

The Company believes that the net proceeds from its initial public offering in July of 1996, and its second public offering which was completed in January of 1997, together with cash generated by operations and availability under its bank credit facility will be sufficient to fund the Company's operations for at least the next year. However, there can be no assurance that additional capital beyond the amounts currently forecasted by the Company will not be required or that any such required additional capital will be available on reasonable terms, if at all, at such time as required by the Company.

INFLATION

Inflation has not had a significant impact on the Company's operating results to date, nor does the Company expect it to have a significant impact in the future due to the fact that the Company's license and maintenance fees are typically subject to annual increases based on recognized inflation indexes.

SIGNIFICANT CUSTOMERS

In 1995, the Company had three customers that accounted for 16.2%, 14.9% and 12.6%, respectively, of the Company's consolidated revenue. In 1996, the Company had three customers that accounted for 14.5%, 11.4% and 10.5%, respectively, of the Company's consolidated revenue. In 1997, the Company had two customers that accounted for 13.7% and 10.0%, respectively, of the Company's consolidated revenue.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Annual Report are "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. These statements involve various risks and uncertainties which could cause the Company's actual results to differ from those expressed in such forward-looking statements. These risks and uncertainties include the seasonal variation of the Company's operations and fluctuations in the Company's quarterly results, rapid technological change involving the Company's products, delays in product development and implementation, the technological compatibility of the Company's products with its customers' systems, the Company's dependence on customers in the financial services market, intense competition in the markets for the Company's products, risk of non-renewal by current customers, management of the Company's growth, and other risks and uncertainties. Words such as "expects," "anticipates," "intends," "plans," "believes," "estimates," and "should" and similar words and expressions are intended to identify the forward-looking statements contained in this Annual Report. These statements are based on estimates, projections, beliefs, and assumptions of the Company and its management and are not guarantees of future performance. Further information regarding those factors which could cause the Company's actual results to differ materially from any forward-looking statements contained herein is included in the Company's report on Form 10-K for the year ended December 31, 1997, which has been filed with the Securities and Exchange Commission.

PEGASYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share-related data)

	December 31,	
Assets	1996	1997
Current assets:		
Cash and cash equivalents	\$24,201	\$ 52,005
Trade and installment accounts receivable, net of allowance for doubtful accounts of \$939 in 1996 and \$2,200 in 1997	14,582	20,319
Prepaid expenses and other current assets	1,235	1,514
Total current assets	40,018	73,838
Long-term license installments, net	23,802	36,403
Equipment and improvements, net	3,035	5,578
Purchased software and other, net	--	11,701
Total assets	\$66,855	\$127,520
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 2,697	\$ 5,398
Deferred revenue	53	1,754
Deferred income taxes	2,904	3,978
Total current liabilities	5,654	11,130
Deferred income taxes	8,816	3,669
Commitments (Note 7)		
Stockholders' equity:		
Preferred stock, \$.01 par value, 1,000,000 shares authorized; no shares issued and outstanding	--	--
Common stock, \$.01 par value, 45,000,000 shares authorized; 26,392,200 shares and 28,545,100 shares issued and outstanding in 1996 and 1997, respectively	264	285
Additional paid-in capital	30,206	86,841
Deferred compensation	(73)	(55)
Stock warrant	--	2,897
Retained earnings	22,022	23,107
Cumulative foreign currency translation adjustment	(34)	(354)
Total stockholders' equity	52,385	112,721
Total liabilities and stockholders' equity	\$66,855	\$127,520

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

PEGASYSTEMS INC.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)

Years Ended December 31,	1995	1996	1997
Revenue:			
Software license	\$13,528	\$22,258	\$28,657
Services	8,719	11,287	15,704
Total revenue	22,247	33,545	44,361
Cost of revenue:			
Cost of software license	635	477	256
Cost of services	6,161	6,975	11,782
Total cost of revenue	6,796	7,452	12,038
Gross profit	15,451	26,093	32,323
Operating expenses:			
Research and development	7,061	8,218	15,104
Selling and marketing	3,592	5,999	17,483
General and administrative	1,541	1,857	3,124
Total operating expenses	12,194	16,074	35,711
Income (loss) from operations	3,257	10,019	(3,388)
License interest income	1,486	1,565	1,789
Other interest income	16	619	3,348
Interest expense	(118)	(85)	--
Income before provision for income taxes	4,641	12,118	1,749
Provision for income taxes	1,763	4,618	664
Net income	\$ 2,878	\$ 7,500	\$ 1,085
Earnings per share:			
Basic	\$ 0.12	\$ 0.30	\$ 0.04
Diluted	\$ 0.12	\$ 0.28	\$ 0.04
Weighted average number of common shares outstanding:			
Basic	23,490	24,802	28,284
Diluted	23,743	26,397	30,268

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

PEGASYS SYSTEMS INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Additional Paid-in Capital	Deferred Compensation	Stock Warrant
	Number of Shares	Amount			
Balance at December 31, 1994	23,490	\$235	\$15	\$--	\$--
Foreign currency translation adjustment	--	--	--	--	--
Issuance of stock options	--	--	91	(91)	--
Net income	--	--	--	--	--
Balance at December 31, 1995	23,490	235	106	(91)	--
Issuance of common stock, net of issuance costs	2,700	27	29,339	--	--
Exercise of stock options	202	2	64	--	--
Tax benefit from exercise of stock options	--	--	697	--	--
Foreign currency translation adjustment	--	--	--	--	--
Amortization of deferred compensation	--	--	--	18	--
Net income	--	--	--	--	--
Balance at December 31, 1996	26,392	264	30,206	(73)	--
Issuance of common stock, net of issuance costs	1,837	18	51,925	--	--
Exercise of stock options	316	3	638	--	--
Tax benefit from exercise of stock options	--	--	4,072	--	--
Foreign currency translation adjustment	--	--	--	--	--
Amortization of deferred compensation	--	--	--	18	--
Issuance of stock warrant	--	--	--	--	2,897
Net income	--	--	--	--	--
Balance at December 31, 1997	28,545	\$285	\$86,841	(\$55)	\$2,897

	Retained Earnings	Cumulative Foreign Currency Translation Adjustment	Total Stockholders' Equity
Balance at December 31, 1994	\$11,644	(\$22)	\$11,872
Foreign currency translation adjustment	--	(76)	(76)
Issuance of stock options	--	--	0
Net income	2,878	--	2,878
Balance at December 31, 1995	14,522	(98)	14,674
Issuance of common stock, net of issuance costs	--	--	29,366
Exercise of stock options	--	--	66
Tax benefit from exercise of stock options	--	--	697
Foreign currency translation adjustment	--	64	64
Amortization of deferred compensation	--	--	18
Net income	7,500	--	7,500
Balance at December 31, 1996	22,022	(34)	52,385
Issuance of common stock, net of issuance costs	--	--	51,943
Exercise of stock options	--	--	641
Tax benefit from exercise of stock options	--	--	4,072
Foreign currency translation adjustment	--	(320)	(320)
Amortization of deferred compensation	--	--	18
Issuance of stock warrant	--	--	2,897

Net income	1,085	--	1,085
	-----	-----	-----
Balance at December 31, 1997	\$23,107	(\$354)	\$112,721
	=====	=====	=====

PEGASYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

Years Ended December 31,	1995	1996	1997
	-----	-----	-----
Cash flows from operating activities:			
Net income	\$ 2,878	\$ 7,500	\$ 1,085
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Provision for deferred income taxes	1,836	3,977	722
Depreciation and amortization	1,455	1,633	3,159
Provision for doubtful accounts	793	300	1,938
Change in operating assets and liabilities:			
Trade and installment accounts receivable	(5,638)	(16,389)	(20,276)
Prepaid expenses and other current assets	(221)	(810)	(279)
Accounts payable and accrued expenses	(244)	950	1,978
Deferred revenue	(25)	(61)	1,701
	-----	-----	-----
Net cash provided by (used in) operating activities	834	(2,900)	(9,972)
 Cash flows from investing activities:			
Purchase of equipment and improvements	(1,423)	(2,005)	(4,488)
Purchased software	--	--	(10,000)
	-----	-----	-----
Net cash used in investing activities	(1,423)	(2,005)	(14,488)
 Cash flows from financing activities:			
Repayment of note payable to stockholder	(50)	--	--
Proceeds from issuance of long-term debt	1,345	--	--
Repayments of long-term debt	(575)	(1,598)	--
Issuance of common stock, net	--	29,366	51,943
Exercise of stock options	--	66	641
Tax benefit from exercise of stock options	--	697	--
	-----	-----	-----
Net cash provided by financing activities	720	28,531	52,584
 Effect of exchange rate on cash and cash equivalents	(76)	64	(320)
	-----	-----	-----
Net increase in cash and cash equivalents	55	23,690	27,804
	-----	-----	-----
Cash and cash equivalents, at beginning of year	456	511	24,201
	-----	-----	-----
Cash and cash equivalents, at end of year	\$ 511	\$ 24,201	\$ 52,005
	=====	=====	=====
Supplemental disclosures of cash flow information:			
Cash paid during period:			
Interest	\$ 119	\$ 86	\$ 7
	=====	=====	=====
Income Taxes	\$ 315	\$ 90	\$ 13
	=====	=====	=====
Non-cash financing activity:			
Issuance of stock warrant	--	--	\$2,897
	=====	=====	=====

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

1. SIGNIFICANT ACCOUNTING POLICIES

(a.) Business

Pegasystems Inc. (the "Company") was incorporated on April 21, 1983 and develops customer service management software used by large, transaction-intensive organizations to automate and manage their customer interactions. Customers of the Company include large banks and credit card processors and mutual fund companies and more recently major companies in non-financial service industries. The Company also offers consulting, training, and maintenance and support services to facilitate the installation and use of its solutions.

The environment of rapid technological change and intense competition which is characteristic of the software development industry results in frequent new products and evolving industry standards. The Company's continued success depends upon its ability to penetrate vertical markets, enhance current products and develop new products on a timely basis that keep pace with the changes in technology and competitors' innovations.

International revenue is subject to various risks, including imposition of government controls, export license requirements, political and economic conditions and instability, trade restrictions, currency fluctuations, changes in taxes, difficulties in staffing and managing international operations, and high local wage scales and other operating costs and expenses.

(b.) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Pegasystems Limited, Pegasystems Investment Inc., Pegasystems Worldwide Inc., and Pegasystems Pty Ltd. All intercompany accounts and transactions have been eliminated in consolidation.

(c.) Foreign Currency Translation

The translation of assets and liabilities of the Company's foreign subsidiaries is made at year-end rates of exchange, while revenue and expense accounts are recorded at the average rates of exchange. The resulting translation adjustments are excluded from net income and are charged or credited to "Cumulative foreign currency translation adjustment" included as part of stockholders' equity. Realized and unrealized exchange gains or losses from transaction adjustments are reflected in operations and are not material.

(d.) Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position (SOP) 91-1, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants. Specifically, revenue from software licenses is generally recognized upon product acceptance pursuant to non-cancellable license agreements and is based on management's assessment that the collectibility on the long-term license installments is probable. Upon acceptance, the Company has no significant vendor obligations. The Company accrues the estimated cost of warranty and product returns in the period in which product revenue is recognized; historically these amounts have not been material. In the case of license agreement renewals or extensions, revenue is recognized upon execution of the renewal or the extension. Maintenance fees are recognized ratably over the term of the maintenance agreement. The Company recognizes implementation as well as consulting and training fees as the services are provided.

Beginning in 1998, the Company will be required to adopt the provisions of SOP 97-2, "Software Revenue Recognition." The adoption of the statement is not estimated to have a significant impact on the Company. Software license revenue represents the present value of future payments under non-cancellable license agreements which provide for payment in installments, typically over a five-year period. A portion of the revenue from each agreement is recognized as interest income over the term of the agreement.

The discount rate in effect for 1995 and the three months ended March 31, 1996 was 7%. The discount rate for the nine-month period ended December 31, 1996 was 6.75%. In 1997, the discount rate for purposes of the present value calculation was 7%. The trade and installment accounts receivable recorded on the balance sheet are net of \$5.1 million and \$6.8 million as of December 31, 1996 and 1997, respectively, which represents the imputed interest portion of future payments due under the Company's license agreements. Deferred revenue represents payments from customers, primarily for maintenance services, which are recognized as revenue as the related services are performed.

(e.) Cash and Cash Equivalents

Cash and cash equivalents are stated at cost, which approximates market, and consist of short-term, highly liquid investments with original maturities of three months or less.

(f.) Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of substantially all of the trade accounts receivable and long-term license installments receivable. The Company records long-term license installments in accordance with its revenue recognition policy, which results in receivables from customers (primarily large financial service organizations with strong credit ratings).

(g.) Equipment and Improvements

Equipment and improvements are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which are three years for equipment and five years for furniture and fixtures. Leasehold improvements are amortized over the life of the lease.

(h.) Software Costs

In compliance with Statement of Financial Accounting Standards (SFAS) No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed," certain software costs are capitalized in the accompanying consolidated balance sheets. Capitalization of software costs begins upon the establishment of technological feasibility, defined by the Company as a working model or an operative version of the computer software product that is completed in the same language and is capable of running on all of the platforms as the product to be ultimately marketed. No costs were capitalized during 1995, 1996, or 1997.

Amortization of capitalized software costs are included in cost of software license revenue. Total amortization expense charged to cost of software was \$0.6 million and \$0.5 million during 1995 and 1996, respectively. No amortization expense for capitalized software costs was charged to software license revenue in 1997.

(i.) Net Income Per Share

The Company adopted SFAS No. 128, "Earnings Per Share," effective December 15, 1997. SFAS No. 128 establishes standards for computing and presenting earnings per share and applies to entities with publicly held common stock or potential common stock. In accordance with the Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 98, the Company has determined that there were no nominal issuances of common stock or potential common stock in the period prior to the Company's initial public offering (IPO). The Company has applied the provisions of SFAS No. 128 and SAB No. 98 retroactively to all periods presented. Calculations of basic and diluted net income per share and potential common share are as follows:

Years Ended December 31,	1995	1996	1997
(in thousands, except per share data)			
Basic			
Net income	\$ 2,878	\$7,500	\$ 1,085
Weighted average common shares outstanding	23,490	24,802	28,284
Basic earnings per share	\$ 0.12	\$ 0.30	\$0.04
Diluted			
Net income	\$ 2,878	\$7,500	\$ 1,085
Weighted average common shares outstanding	23,490	24,802	28,284
Effect of:			
Assumed exercise of stock options	253	1,595	1,984
Weighted average common shares outstanding, assuming dilution	23,743	26,397	30,268
Diluted earnings per share	\$ 0.12	\$ 0.28	\$ 0.04

As of December 31, 1995, no outstanding options were excluded from the weighted average common shares outstanding, assuming dilution. As of December 31, 1996 and 1997, 7,201 options and 185,481 options, respectively, were excluded from the weighted average common shares outstanding, assuming dilution, as their effect would be anti-dilutive.

(j.) New Accounting Standards

In June 1997, the Financial Accounting Standards Board (FASB) issued SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 requires disclosure of all components of comprehensive income on an annual and interim basis. Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. SFAS No. 130 is effective for fiscal years beginning after December 15, 1997.

In June 1997, the FASB issued SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS No. 131 requires certain financial and supplemental information to be disclosed on an annual and interim basis for each reportable segment of an enterprise. SFAS No. 131 is effective for fiscal years beginning after December 15, 1997.

(k.) Stock Options

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair market value of the shares at the date of the grant. The Company accounts for stock option grants in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and intends to continue to do so. During 1995, the Company granted stock options for a fixed number of shares to employees with an exercise price less than the then fair market value of the shares at the date of the grant. For the difference between the fair market value and the exercise price, the Company recorded deferred compensation in the consolidated statements of stockholders' equity, which is being expensed over the vesting period.

The Company has adopted the disclosure provisions only of SFAS No. 123, "Accounting for Stock-Based Compensation," and will continue to account for its stock option plans in accordance with the provisions of Accounting Principles Board (APB) Statement No. 25, "Accounting for Stock Issued to Employees."

(l.) Use of Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

2. EQUIPMENT AND IMPROVEMENTS

The cost and accumulated depreciation of equipment and improvements consist of the following:

(in thousands)	December 31,	
	1996	1997
Equipment	\$3,956	\$7,243
Furniture and fixtures	1,005	1,895
Leasehold improvements	527	838
	5,488	9,976
Less: accumulated depreciation	(2,453)	(4,398)
Equipment and improvements, net	\$3,035	\$5,578

Depreciation expense was approximately \$0.8 million, \$1.2 million and \$2.0 million for the years ended December 31, 1995, 1996 and 1997, respectively.

3. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consist of the following:

(in thousands)	December 31,	
	1996	1997
Trade accounts payable	\$ 692	\$ 863
Employee compensation and benefits	1,257	1,332
Accrued income taxes	160	754
Other accrued expenses	588	1,114
Sales return reserve	--	961
Accrued consulting costs	--	374
	=====	=====
	\$ 2,697	\$ 5,398
	=====	=====

4. DEBT

The Company had no outstanding long-term debt at December 31, 1996 and December 31, 1997.

As of December 31, 1997, the Company had a line of credit with a bank allowing for borrowings up to \$5.0 million at the prime rate which will expire on June 30, 1999. The Company had no borrowings outstanding under the line of credit at December 31, 1997. Borrowings are subject to various covenants which call for a specified level of working capital and net worth, maintenance of certain financial ratios and restrictions on the payments of dividends. As of December 31, 1997, the Company was in compliance with all covenants, except for the profitability financial covenant, for which the Company received a non-compliance waiver.

5. STOCKHOLDERS' EQUITY

(a.) Secondary Public Offering

On January 28, 1997, the Company issued and sold 1.8 million shares of common stock in connection with its second public offering. Net proceeds to the Company from this offering were approximately \$51.9 million.

(b.) Recapitalization and Stock Split

On July 10, 1996, the Company increased the number of shares of common stock authorized from 9.0 million to 45.0 million shares. The Company's Board of Directors approved a three-for-one stock split in the form of a stock dividend effective on July 10, 1996. The financial statements give effect to the stock split for all periods presented.

The Board of Directors is authorized, subject to certain limitations prescribed by law, without further stockholder approval, to issue from time to time up to an aggregate 1.0 million shares of preferred stock in one or more series and to fix or alter the designations, preferences, rights and any qualifying limitations or restrictions of the shares of each such series thereof, including the dividend rights, dividend rates, conversion rights, voting rights, terms of redemptions (including sinking fund provisions), redemption price or prices, liquidation preferences and the number of shares constituting any shares or designations of such series.

(c.) Long-Term Incentive Plan

In 1994, the Company adopted a Long-Term Incentive Plan (the "1994 Plan") to provide employees, directors and consultants with opportunities to purchase stock through incentive stock options and through options that do not qualify as incentive stock options.

In addition to options, eligible participants under the 1994 Plan may be granted stock appreciation rights, restricted stock and long-term performance awards. As of December 31, 1997, a total of 5.0 million shares of common stock were reserved for issuance under the 1994 Plan.

The option price per share is determined at the date of grant. For incentive stock options, the option price may not be less than 100% of the fair market value of the Company's common stock at the grant date. Incentive stock options granted to a person having greater than 10% of the voting power of all classes of stock must have an exercise price of at least 110% of fair market value of the Company's common stock. Options granted under the 1994 Plan generally vest over five years and expire no later than ten years from the date of grant.

(d.) 1996 Non-Employee Director Stock Option Plan

The 1996 Non-Employee Director Stock Option Plan (the "Director Plan") was adopted by the Board of Directors on May 13, 1996 and approved by the stockholders on June 26, 1996. The Director Plan provides for the grant of options for the purchase of up to 250,000 shares of common stock of the Company. As of December 31, 1997, options to purchase 90,000 shares were outstanding under the Director Plan but no shares had been issued under the plan.

The Director Plan is administered by the Compensation Committee and provides that each person who becomes a director of the Company after May 13, 1996, and who is not also an employee of the Company, will receive upon initial election to the Board of Directors an option to purchase 30,000 shares of common stock vesting in equal annual installments over five years. The exercise price for all options granted under the Director Plan is equal to the market price of the common stock as of the date of grant.

(e.) 1996 Employee Stock Purchase Plan

The 1996 Employee Stock Purchase Plan (the "Stock Purchase Plan") was adopted by the Board of Directors on May 13, 1996 and approved by the stockholders on June 26, 1996. An aggregate of 500,000 shares of common stock are reserved for issuance pursuant to this plan. To date, there have been no offerings under the Stock Purchase Plan and no shares of common stock have been issued thereunder.

The following table presents the combined activity of the two option plans from which options have been granted during the years ended December 31, 1995, 1996 and 1997:

	1995		1996		1997	
	Number of Options (in thousands)	Weighted Average Exercise Price	Number of Options (in thousands)	Weighted Average Exercise Price	Number of Options (in thousands)	Weighted Average Exercise Price
Outstanding options at beginning of year	1,672	\$ 0.33	1,924	\$ 0.34	2,582	\$ 5.04
Granted	335	\$ 0.39	993	\$13.19	1,214	\$22.79
Exercised	--	\$ --	(202)	\$ 0.33	(316)	\$ 2.03
Cancelled	(83)	\$ 0.48	(133)	\$ 4.94	(381)	\$20.52
Outstanding options at end of year	1,924	\$ 0.34	2,582	\$ 5.04	3,099	\$10.40
Exercisable options at end of year	606	\$ 0.33	679	\$ 0.33	822	\$ 2.13
Weighted average fair value of options granted during the year		\$ 0.09		\$ 8.84		\$11.38

In December 1995, the Company granted options to purchase 335,250 shares of common stock at an exercise price of \$.39 per share. The Company recorded an increase to additional paid-in capital and a corresponding charge to deferred compensation in the amount of \$91,000 to recognize the aggregate difference between the deemed fair value for accounting purposes of the stock options at the date of grant and the exercise price. The deferred compensation will be amortized over the option vesting period of five years.

The following table presents weighted average price and life information about significant option groups outstanding at December 31, 1997:

Range of exercise prices	Options Outstanding			Options Exercisable	
	Number Outstanding (in thousands)	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number Exercisable (in thousands)	Weighted Average Exercise Price
\$0.33 - \$ 0.39	1,303	7.18	\$ 0.34	698	\$ 0.33
\$6.00 - \$10.00	615	8.37	\$ 9.64	78	\$10.00
\$12.50 - \$18.25	549	9.06	\$17.37	46	\$16.17
\$20.56 - \$31.88	632	9.51	\$25.83	--	--
	3,099			822	

Pursuant to the requirements of SFAS 123, the following are the pro forma net income and net income per share for 1995, 1996 and 1997, as if the compensation expense for the option plans had been determined based on the fair value at the grant date for grants in 1995, 1996 and 1997, consistent with the provisions of SFAS 123:

	1995		1996		1997	
	As Reported	Pro Forma	As Reported	Pro Forma	As Reported	Pro Forma
Net income (loss) (in thousands)	\$2,878	\$2,878	\$7,500	\$7,122	\$1,085	\$ (774)
Basic net income (loss) per share	\$ 0.12	\$ 0.12	\$ 0.30	\$ 0.29	\$.04	\$ (0.03)
Diluted net income (loss) per share	\$ 0.12	\$ 0.12	\$ 0.28	\$ 0.26	\$.04	\$ (0.03)

A range of expected vesting percentages were given to each range of exercise prices. In 1997, the range of exercise prices from \$0.33 to \$0.39, \$6.00 to \$10.00, \$12.50 to \$18.25 and \$20.56 to \$31.88, it is expected that 95 percent, 90 percent, 75 percent and 50 percent of those options will vest, respectively. These ranges were based upon the Company's estimates that a more significant number of lower priced options as compared to higher priced options will vest.

The fair value of options at the date of grant were estimated using the Black-Scholes model with the following weighted-average assumptions:

	Option		
	1995	1996	1997
Volatility	0.0	0.0 - 9.9	0.5
Expected option life (years)	5.0	5.0	5.0
Interest rate (risk free)	5.51%	5.38 - 6.69%	6.13 - 6.57%
Dividend yield	0.0%	0.0%	0.0%

Volatility for 1997 was calculated on a quarterly basis and was determined to be 0.5. Volatility for 1996 was calculated on a monthly basis. For 1996, exclusive of one month's data where volatility was 9.9, volatility ranged from 0.0 to 1.4. The Company has never declared nor paid dividends on any of its capital stock and does not expect to in the foreseeable future.

The effects on 1995, 1996, and 1997 pro forma net income (loss) and net income (loss) per share of expensing the estimated fair value of stock options and shares are not necessarily representative of the effects on reporting the results of operations for future years as the periods presented include only one, two and three years of option grants under the Company's plan.

(6) Software License and Support and Warrant Agreements

On June 27, 1997, the Company entered into Software License and Support and Warrant Agreements with First Data Resources, Inc. (FDR).

The provisions of the Software License and Support Agreement give FDR the right to use the Company's software in connection with new products and also the exclusive right to market, distribute and sublicense the Company's software and new products to FDR customers and prospects. In addition to the granting of a license to use its software, the Company will also provide services to FDR in connection with the new products. For the right to the license and the services, FDR is expected to pay the Company a base fee of \$49.25 million. FDR paid \$5.0 million in 1997 and remaining fees are expected to be paid on a monthly basis over the term of the agreement. The initial term of this agreement commences on June 27, 1997 and runs through December 31, 2002.

In accordance with the Software License and Support Agreement, the Company was granted a license for access to and use of the designs, specifications and code of FDR's ESP Product. As consideration for this right, the Company paid FDR \$10.0 million. This amount was recorded as purchased software on the accompanying consolidated balance sheet.

In connection with the Software License and Support Agreement on June 27, 1997, the Company committed to provide a Warrant to FDR. Pursuant to the Warrant Agreement, the Company gave FDR the right to purchase 284,876 shares of the Company's Common Stock at a purchase price of \$28.25 per share which represented the fair market value of the common stock on the date of the agreement. The warrant will become exercisable on June 27, 1998 and will expire on June 27, 2002. The warrant was valued at \$2.9 million and the corresponding deferred asset was capitalized and included in "purchased software and other" on the accompanying consolidated balance sheet.

The Company will recognize the base fee revenue and also amortize the value of the purchased software and the warrant on a pro rata basis over the initial 5-1/2 year term of the agreement. During the period from June 27, 1997 through December 31, 1997, the Company recognized revenue of approximately \$4.6 million related to the Software License and Support Agreement and recorded amortization expense of approximately \$1.2 million related to the ESP software and warrant.

7. LEASES

The Company leases certain equipment and office space under non-cancellable operating leases. Future minimum rental payments required under the operating leases with non-cancellable terms in excess of one year at December 31, 1997 are as follows:

Year ended December 31,	(in thousands)
1998	\$1,594
1999	797
2000	329
2001	329
2002	329
Thereafter	987
	=====
Total	\$4,365
	=====

Total rent expense under operating leases was approximately \$1.1 million, \$1.4 million and \$3.0 million for the years ended December 31, 1995, 1996 and 1997, respectively.

8. INCOME TAXES

Income before income taxes consists of the following:

(in thousands)	1995	1996	1997
Domestic	\$4,318	\$11,546	\$1,392
Foreign	323	572	357
	-----	-----	-----
Total	\$4,641	\$12,118	\$1,749
	=====	=====	=====

The provision (benefit) for income taxes for the years ended December 31, 1995, 1996 and 1997 consisted of the following:

(in thousands)	1995	1996	1997
	-----	-----	-----
Current:			
Federal	\$(107)	\$6	\$(149)
State	(39)	212	(30)
Foreign	73	160	121
	-----	-----	-----
Total current	(73)	378	(58)
	-----	-----	-----
Deferred:			
Federal	1,563	3,662	688
State	273	578	34
	-----	-----	-----
Total deferred	1,836	4,240	722
	-----	-----	-----
	\$1,763	\$4,618	\$664
	=====	=====	=====

The effective income tax rate differed from the statutory federal income tax rate due to the following:

	1995	1996	1997
	-----	-----	-----
Statutory federal income tax rate	34.0%	35.0%	34.0%
State income taxes, net of federal benefit and tax credits	5.8%	4.2%	3.9%
Permanent differences	0.7%	0.3%	6.4%
Tax credits	(2.5)%	(0.6)%	(8.6)%
Other	--	(0.8)%	2.3%
	-----	-----	-----
Effective income tax rate	38.0%	38.1%	38.0%
	=====	=====	=====

Deferred income taxes at December 31, 1996 and 1997 reflect the net tax effects of net operating loss and tax credit carryforwards and temporary differences between the carrying amounts of assets and liabilities for financial statement purposes and the amounts used for tax purposes. The approximate income tax effect of the Company's net deferred tax liability as of December 31, 1996 and 1997 are as follows:

(in thousands)	December 31,	
	1996	1997
	-----	-----
Software revenue	\$(14,103)	\$(18,195)
Depreciation	(215)	(76)
Deferred state taxes	836	--
Vacation accrual	380	184
Receivable and other reserves	367	1,198
Net operating loss carryforwards	--	8,195
Tax credits	798	864
Other	217	183
	-----	-----
Net deferred tax liabilities	(11,720)	(7,647)
Less current portion	(2,904)	(3,978)
	-----	-----
	\$(8,816)	\$(3,669)
	=====	=====

At December 31, 1997, the Company had alternative minimum tax (AMT) and research and development (R&D) credit carryforwards of approximately \$864,000, available to offset future federal taxable income. The carryforward period for the AMT credit is unlimited. The R&D credit carryforwards generally expire from 2004 to 2008.

As of December 31, 1997 the Company also has available net operating loss carryforwards of approximately \$20,932,000 expiring through 2012. These carryforwards may be used to offset future income taxes payable, if any, and are subject to review by the Internal Revenue Service.

The Company has recorded a deferred tax asset for the effect of its net operating loss carryforward as management has concluded that it is more likely than not that the tax benefit will be realized. However, approximately \$12,251,000 of the net operating loss carryforward relates to the excess tax benefit of disqualifying dispositions and the exercise of non-qualified stock options. Accordingly, approximately \$4,769,000 of the deferred tax asset was recorded in additional paid in capital.

9. LITIGATION

The Company is a defendant in two purported class action suits which have been consolidated and in which the Company and several of its officers are alleged to have violated Section 10(b) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), Rule 10(b) (5) promulgated thereunder and Section 20(a) of the 1934 Act. The consolidated complaint does not specify the amount of the damages sought. Accordingly, the Company is unable to determine or estimate the outcome at this time. The Company has not yet filed any responsive pleadings in this litigation, but intends to defend the matter vigorously.

10. SIGNIFICANT CUSTOMERS

In 1995, the Company had three customers that accounted for 16.2%, 14.9% and 12.6%, respectively, of the Company's consolidated revenue. In 1996, the Company had three customers that accounted for 14.5%, 11.4% and 10.5%, respectively, of the Company's consolidated revenue. In 1997, the Company had two customers that accounted for 13.7% and 10.0%, respectively, of the Company's consolidated revenue.

11. INTERNATIONAL OPERATIONS

The Company's export sales from the United States for 1995, 1996 and 1997 are as follows:

(in thousands)	1995	1996	1997
United Kingdom	\$1,343	\$3,698	\$3,642
Europe	877	2,017	1,715
Other	114	232	1,973
	=====	=====	=====
Total	\$2,334	\$5,947	\$7,330
	=====	=====	=====

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors of
Pegasystems Inc.:

We have audited the accompanying consolidated balance sheet of Pegasystems Inc. as of December 31, 1997 and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pegasystems Inc. at December 31, 1997, and the consolidated results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Boston, Massachusetts
April 2, 1998

The Board of Directors
Pegasystems Inc.

We have audited the accompanying consolidated balance sheet of Pegasystems Inc. as of December 31, 1996 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pegasystems Inc. at December 31, 1996, and the consolidated results of its operations and its cash flows for each of the two years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.

Ernst & Young LLP

Boston, Massachusetts
February 24, 1997

Exhibit 23.1

CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

As independent public accountants, we hereby consent to the incorporation by reference of our report dated April 2, 1998 included in this annual report on Form 10-K, into the Company's previously filed Registration Statement No. 333-09305.

Arthur Andersen LLP

Boston, Massachusetts
April 14, 1998

Exhibit 23.2

CONSENT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

We consent to the incorporation by reference in this Annual Report (Form 10-K) of Pegasystems Inc. of our report dated February 24, 1997, included in the 1997 Annual Report to Stockholders of Pegasystems Inc.

Our audits also included the financial statement schedule of Pegasystems Inc. for the years ended December 31, 1996 and 1995, listed in Item 14(a). This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion based on our audits. In our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the 1996 and 1995 information set forth therein.

We also consent to the incorporation by reference in the Registration Statement (Form S-8 No. 333-09305) pertaining to the Amended and Restated 1994 Long-Term Incentive Plan, the 1996 Employee Stock Purchase Plan, and the 1996 Non-Employee Director Stock Option Plan of Pegasystems Inc. of our report dated February 24, 1997, with respect to the consolidated financial statements and schedule of Pegasystems Inc. as of December 31, 1996 and for each of the two years in the period ended December 31, 1996, included or incorporated by reference in the Annual Report (Form 10-K) for the year ended December 31, 1997.

ERNST & YOUNG LLP

Boston, Massachusetts
April 14, 1998

ARTICLE 5

MULTIPLIER: 1,000

CURRENCY: U.S. DOLLARS

PERIOD TYPE	12 MOS
FISCAL YEAR END	DEC 31 1997
PERIOD START	JAN 01 1997
PERIOD END	DEC 31 1997
EXCHANGE RATE	1
CASH	52,005
SECURITIES	0
RECEIVABLES	20,319
ALLOWANCES	0
INVENTORY	0
CURRENT ASSETS	73,838
PP&E	9,976
DEPRECIATION	4,398
TOTAL ASSETS	127,520
CURRENT LIABILITIES	11,130
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	285
OTHER SE	86,841
TOTAL LIABILITY AND EQUITY	127,520
SALES	44,361
TOTAL REVENUES	44,361
CGS	12,038
TOTAL COSTS	12,038
OTHER EXPENSES	35,711
LOSS PROVISION	0
INTEREST EXPENSE	0
INCOME PRETAX	1,749
INCOME TAX	664
INCOME CONTINUING	0
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	\$1,085
EPS PRIMARY	0.04
EPS DILUTED	0.04

ARTICLE 5

MULTIPLIER: 1,000

CURRENCY: U.S. DOLLARS

PERIOD TYPE	12 MOS
FISCAL YEAR END	DEC 31 1996
PERIOD START	JAN 01 1996
PERIOD END	DEC 31 1996
EXCHANGE RATE	1
CASH	\$24,201
SECURITIES	0
RECEIVABLES	14,582
ALLOWANCES	0
INVENTORY	0
CURRENT ASSETS	40,018
PP&E	5,488
DEPRECIATION	2,453
TOTAL ASSETS	66,855
CURRENT LIABILITIES	5,654
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	264
OTHER SE	30,206
TOTAL LIABILITY AND EQUITY	66,855
SALES	33,545
TOTAL REVENUES	33,545
CGS	7,452
TOTAL COSTS	7,452
OTHER EXPENSES	16,074
LOSS PROVISION	0
INTEREST EXPENSE	0
INCOME PRETAX	12,118
INCOME TAX	4,618
INCOME CONTINUING	0
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	\$7,500
EPS PRIMARY	0.30
EPS DILUTED	0.28

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