



## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box. [ ]

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box. [X]

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is declared effective. This prospectus is not an offer to sell these securities, and we are not soliciting offers to buy these securities, in any state where the offer or sale is not permitted.

PROSPECTUS  
PAYMENT DATA SYSTEMS, INC.  
OFFERING UP TO 40,000,000 COMMON SHARES

This prospectus relates to the sale of up to 40,000,000 shares of our common stock by a stockholder. We are not selling any securities in this offering and therefore will not receive any proceeds from this offering. We will, however, receive proceeds from the sale of securities under an Investment Agreement, also referred to as an Equity Line of Credit, that we have entered into with Dutchess Private Equities Fund, L.P., which permits us to "put" up to \$10 million in shares of common stock to Dutchess Private Equities Fund. Dutchess will pay us 95% of the lowest closing bid price of the common stock during the five consecutive trading day period immediately following the date of our notice to them of our election to put shares pursuant to the Equity Line of Credit. All costs associated with this registration will be borne by us.

The shares of common stock are being offered for sale by the selling stockholder at prices established on the Over-the-Counter Bulletin Board or in negotiated transactions during the term of this offering. Our common stock is quoted on the Over-the-Counter Bulletin Board under the symbol PYDS.OB. On July 21, 2004, the last reported sale price of our common stock was \$0.23 per share.

Dutchess Private Equities Fund, LP and Clayton Dunning and Co., Inc. are "underwriters" within the meaning of the Securities Act of 1933, as amended, in connection with the resale of common stock under the Investment Agreement.

This investment involves a high degree of risk. You should purchase securities only if you can afford a complete loss.

# Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

SEE "RISK FACTORS" BEGINNING ON PAGE 8.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Subject to Completion, the date of this Prospectus is August 3, 2004

## TABLE OF CONTENTS

PROSPECTUS SUMMARY	4
RISK FACTORS	8
USE OF PROCEEDS	13
DETERMINATION OF OFFERING PRICE	14
DILUTION	14
SELLING SECURITY HOLDERS	15
PLAN OF DISTRIBUTION	16
LEGAL PROCEEDINGS	18
DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS	19
SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT	20
DESCRIPTION OF SECURITIES	21
LEGAL MATTERS	22
INTEREST OF NAMED EXPERTS AND COUNSEL	22
DISCLOSURE OF COMMISSION POSITION OF INDEMNIFICATION FOR SECURITIES	22
ACT LIABILITIES	22
CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS	22
DESCRIPTION OF BUSINESS	22
MANAGEMENT'S DISCUSSION AND ANALYSIS OF PLAN OF OPERATION	30
DESCRIPTION OF PROPERTY	43
CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS	43
MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS	45
EXECUTIVE COMPENSATION	46
FINANCIAL STATEMENTS	F-1
CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE	F-31

## PROSPECTUS SUMMARY

The following information is a summary of the prospectus and it does not contain all of the information you should consider before making an investment decision. You should read the entire prospectus carefully, including the financial statements and the notes relating to the financial statements.

## OUR COMPANY

We provide integrated electronic payment processing services to merchants and businesses, including all types of Automated Clearinghouse, or ACH, Network processing and credit and debit card-based processing services. The ACH Network is a nationwide batch-oriented electronic funds transfer system that is regulated by the Federal Reserve and provides for the interbank clearing of electronic payments for participating financial institutions. Our ACH processing services enable merchants or businesses to both remit or collect funds electronically using e-checks to transfer funds instead of traditional paper checks. An e-check is an electronic debit to a bank checking account that is initiated at the point-of-sale, on the Internet, over the telephone or via a bill remittance sent through the mail and is processed using the ACH network. Our card-based processing services enable merchants to process both traditional card-present, or "swipe," transactions, as well as card-not-present transactions. A traditional card-present transaction occurs whenever a

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

cardholder physically presents a credit or debit card to a merchant at the point-of-sale. A card-not-present transaction occurs whenever the customer does not physically present a payment card at the point-of-sale and may occur over the Internet, mail, fax or telephone. Our electronic payment processing may take place in a variety of forms and channels. For example, our capabilities allow merchants to convert a paper check to an e-check or receive card authorization at the point-of-sale, have their customer service representatives take e-check or card payments from their consumers by telephone, and enable their consumers to make e-check or card payments directly through the use of a Web site or by calling an Interactive Voice Response, or IVR, telephone system. We also operate an online payment processing service for consumers under the domain name [www.bills.com](http://www.bills.com) through which consumers can pay anyone. We generate revenues by charging fees for the electronic processing of payment transactions and related services. We charge certain merchants for these processing services at a bundled rate based on a percentage of the dollar amount of each transaction and, in some instances, additional fees are charged for each transaction. We charge other merchant customers a flat fee per transaction, and may also charge miscellaneous fees to our customers, including fees for chargebacks or returns, monthly minimums, and other miscellaneous services. We operate solely in the United States as a single operating segment, and do not currently have any foreign operations.

4

In July 2003, we sold substantially all of our assets to Harbor Payments Corp., formerly Saro, Inc. We had used the assets sold to provide Electronic Bill Presentment and Payment and related services to companies that generate recurring bills to their consumers. Electronic Bill Presentment and Payment is the process of sending bills in an electronic format to consumers securely through the Internet and processing Internet payment of bills utilizing an electronic transfer of funds. After we sold these assets, we no longer provided Electronic Bill Presentment and Payment and related services, which are presented in our financial statements as discontinued operations. We believe that the property and equipment we retained after this sale are sufficient to support our continuing operations. We also believe that our current available cash plus anticipated future revenues from continuing operations are likely to be insufficient for us to continue as a going concern.

Our auditors have issued a going concern opinion on our audited financial statements for the year ended December 31, 2003. As of March 31, 2004, our available cash balance was \$268,000 and we anticipate cash needs of approximately \$1.5 million for the next twelve months. Our ability to continue as a going concern is likely contingent on us receiving additional capital. If sufficient capital is not available to us, we would likely be required to reduce or discontinue our operations. We intend to use the proceeds from our equity line with Dutchess to pay current liabilities and fund our current level of operations in the future until we achieve positive cash flow from operations, if ever.

### HOW TO CONTACT US

Our executive offices are located at 12500 San Pedro, Suite 120, San Antonio, Texas 78216. Our phone number is (210) 249-4100. Our Internet address is [www.paymentdata.com](http://www.paymentdata.com).

### THE OFFERING

This prospectus relates to the resale of up to 40,000,000 shares of our common stock by Dutchess Private Equities Fund, LP, who will become a stockholder pursuant to our Investment Agreement.

Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

Common stock offered 40,000,000 shares

Use of proceeds We will not receive any proceeds from the sale by the selling stockholders of our common stock. We will receive proceeds from our Investment Agreement with Dutchess Private Equities Fund. See "Use of Proceeds."

Symbol for our common stock Our common stock trades on the OTCBB Market under the symbol "PYDS.OB"

OUR CAPITAL STRUCTURE AND SHARES ELIGIBLE FOR FUTURE SALE

Shares of common stock outstanding as of April 16, 2004	21,495,181	(1)
Shares of common stock potentially issuable upon exercise of the put right to Dutchess Private Equities Fund	40,000,000	(2)
	-----	
Total	61,495,181	
	=====	

(1) Assumes:

- No exercise of the following options to purchase common stock outstanding at March 31, 2004:

4,003,767 shares of common stock pursuant to Amended and Restated 1999 Employee Comprehensive Stock Plan

533,003 shares of common stock pursuant to 1999 Non-Employee Director Plan

- No exercise of the outstanding vested warrants to purchase common stock at March 31, 2004 as follows:

5

Holder	Shares of Common Stock	Exercise Price	Expiration Date
-----	-----	-----	-----
Private Placement	41,237	\$ 6.06	08/05/2004
Placement Agent	250	3.25	10/14/2004
Placement Agent	280	8.00	12/15/2004
Placement Agent	8,890	7.41	12/20/2004
Placement Agent	3,500	7.31	12/22/2004

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

Private Placement	2,000,000	1.80	11/27/2006
CheckFree	2,179,121	11.38	06/02/2010
	-----		

4,233,278  
=====

(2) For the purpose of determining the number of shares subject to registration with the Securities and Exchange Commission, we have assumed that we will issue no more than 40,000,000 shares pursuant to the exercise of our put right under the Investment Agreement. However, the number of shares that we will actually issue pursuant to that put right may be more than or less than 40,000,000, depending on the trading price of our common stock at the time of each put and how many times we issue a put. We currently have no intent to exercise the put right in a manner that would result in our issuance of more than 40,000,000 shares, but if we were to exercise the put right in that manner, we would be required to file a subsequent registration statement with the Securities and Exchange Commission and for that registration statement to be deemed effective prior to the issuance of any such additional shares.

### THE INVESTMENT AGREEMENT

The Investment Agreement we have with Dutchess Private Equities Fund, L.P. allows us to "put" to Dutchess Private Equities Fund either (A) four hundred percent of the average daily volume of our common stock for the ten trading days prior to the applicable put notice date, multiplied by the average of the three daily closing best bid prices immediately preceding the put date, or (B) \$25,000; provided that in no event will the put amount be more than \$1,000,000 with respect to any single put. We shall not be entitled to submit a put notice until after the previous put has been completed. The purchase price for the common stock identified in the put notice shall be equal to 95% of the lowest closing bid price of the common stock during the five consecutive trading day period immediately following the date of our notice to them of our election to put shares. The discount at which we will issue our common stock to Dutchess will be accounted for as a direct cost of equity financing and recorded as interest expense on the day the common stock is issued. Assuming we draw down the full amount of the equity line of \$10 million, we would incur approximately \$500,000 of such interest expense. Existing stockholders may experience significant dilution from the sale of securities pursuant to our Investment Agreement. The lower our stock price is at the time we exercise our put option, the more shares we will have to issue to Dutchess Private Equities Fund to draw down the full amount under the equity line with Dutchess Private Equities Fund. At a stock price of \$0.26 or less, we would have to issue all 40,000,000 shares registered under this offering in order to draw down on the full equity line.

6

Dutchess Private Equities Fund, L.P. will only purchase shares when we meet the following conditions:

- a registration statement has been declared effective and remains effective for the resale of the common stock subject to the Equity Line of Credit;
- our common stock has not been suspended from trading for a period of five consecutive trading days and we have not have been notified of any pending or threatened proceeding or other action to delist or suspend our common stock;
- we have complied with our obligations under the Investment Agreement and the Registration Rights Agreement;

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

- no injunction has been issued and remain in force, or action commenced by a governmental authority which has not been stayed or abandoned, prohibiting the purchase or the issuance of our common stock;
- the issuance of the common stock will not violate any shareholder approval requirements of any exchange or market where our securities are traded;
- the registration statement does not contain any untrue statement of a material fact or omit to state any material fact required to be stated or necessary to make the statements not misleading or which would require public disclosure or an update supplement to the prospectus; and
- We have not filed a petition in bankruptcy, either voluntarily or involuntarily, and there shall not have commenced any proceedings under any bankruptcy or insolvency laws.

The Investment Agreement will terminate when any of the following events occur:

- Dutchess Private Equities Fund, L.P. has purchased an aggregate of \$10,000,000 of our common stock;
- 36 months after the SEC declares this registration statement effective;
- we file or otherwise enter an order for relief in bankruptcy;
- trading of our common stock is suspended for a period of 5 consecutive trading days; or
- we issue or sell any equity securities or securities convertible into, or exchangeable for, equity securities or enter into any other equity financing facility during the term of the Investment Agreement in certain circumstances, without the prior written approval of Dutchess.

7

### RISK FACTORS

An investment in our common stock involves a high degree of risk. You should carefully consider the following factors that management considers to be the material risks facing the company as of the date of this prospectus, other information included in this prospectus and information in our periodic reports filed with the SEC. If any of the following risks actually occur, our business, financial condition or results of operations could be materially and adversely affected, and you may lose some or all of your investment.

#### RISKS RELATED TO OUR BUSINESS

OUR INDEPENDENT ACCOUNTANTS HAVE ISSUED A GOING CONCERN OPINION AND IF WE CANNOT OBTAIN ADDITIONAL FINANCING BY JULY 31, 2004, WE MAY HAVE TO CURTAIL OPERATIONS AND MAY ULTIMATELY CEASE TO EXIST.

Our independent accountants have issued a going concern opinion. Due to continuing operating losses, our current available cash and cash equivalents along with anticipated revenues are likely to be insufficient to meet our anticipated cash needs for the near future. Consequently, our ability to continue as a going concern is likely contingent on us receiving additional funds in the form of equity or debt financing. We currently plan to meet our capital requirements primarily through the issuance of equity securities or new borrowing arrangements. Accordingly, we are aggressively pursuing strategic alternatives, including the Equity Line of Credit for which we are registering shares in this registration statement. However, financing may not be available

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

in amounts or on terms acceptable to us, if at all. If we cannot raise funds on acceptable terms, or achieve positive cash flow, by July 31, 2004, we may be forced to curtail operations or may ultimately cease to exist.

WE HAVE GENERATED SIGNIFICANT LOSSES AND EXPECT TO GENERATE OPERATING LOSSES FOR THE FORESEEABLE FUTURE, THEREFORE WE MAY NOT BECOME PROFITABLE.

We organized in 1998 and began operations as a public company in 1999 by offering electronic billing services to other companies. After the sale of our primary business in July 2003, we have concentrated on building our electronic payments services operations. We have not been profitable since inception and we may never become profitable. As of December 31, 2003, our accumulated deficit was \$46.7 million.

IF OUR SECURITY APPLICATIONS ARE NOT SUFFICIENT TO ADDRESS CHANGING MARKET CONDITIONS AND CUSTOMER CONCERNS, WE MAY NOT BE ABLE TO SELL OUR SERVICES.

Our use of applications designed for premium data security and integrity to process electronic transactions may not be sufficient to address changing market conditions or the security and privacy concerns of existing and potential customers. Adverse publicity raising concerns about the safety or privacy of electronic transactions, or widely reported breaches of our or another provider's security, have the potential to undermine consumer confidence in the technology and could have a materially adverse effect on our business.

IF THE TREND OF AN INCREASING PERCENTAGE OF PAYMENTS CLEARED ELECTRONICALLY DOES NOT CONTINUE, WE MAY NOT BE ABLE TO GROW OUR BUSINESS.

Our future financial performance will be materially affected by the percentage of payments that can be cleared electronically. Based on reports by the Federal Reserve, paper check use as a percentage of retail non-cash payments declined from 77.1% in 1995 to 59.5% in 2000. Accordingly, a reversal of the current trend toward a smaller proportion of paper-based payments would limit the potential growth of our business.

8

IF WE DO NOT ADAPT TO RAPID TECHNOLOGICAL CHANGE, OUR BUSINESS MAY FAIL.

Our success depends on our ability to develop new and enhanced services, and related products that meet changing customer needs. The market for our services, however, is characterized by rapidly changing technology, evolving industry standards, emerging competition and frequent new and enhanced software, service and related product introductions. In addition, the software market is subject to rapid and substantial technological change. To remain successful, we must respond to new developments in hardware and semiconductor technology, operating systems, programming technology and computer capabilities. In many instances, new and enhanced services, products and technologies are in the emerging stages of development and marketing, and are subject to the risks inherent in the development and marketing of new software, services and products. We may not successfully identify new service opportunities, and develop and bring new and enhanced services and related products to market in a timely manner. Even if we do bring such services, products or technologies to market, they may not become commercially successful. Additionally, services, products or technologies developed by others may render our services and related products noncompetitive or obsolete. If we are unable, for technological or other reasons, to develop and introduce new services and products in a timely manner in response to changing market conditions or customer requirements, our business may fail.

WE RELY ON OUR RELATIONSHIP WITH THE AUTOMATED CLEARINGHOUSE NETWORK AND IF THE FEDERAL RESERVE RULES WERE TO CHANGE, OUR BUSINESS COULD BE ADVERSELY AFFECTED.



## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

We have a contractual relationship with a third party provider, which maintains a relationship with multiple Originating Depository Financial Institutions, or ODFI, in the Automated Clearinghouse, or ACH, Network. The ACH Network is a nationwide batch-oriented electronic funds transfer system that provides for the interbank clearing of electronic payments for participating financial institutions. An ODFI is a participating financial institution that must abide by the provisions of the ACH Operating Rules and Guidelines. Through our relationship with this third party provider, we are able to process payment transactions on behalf of our customers and their consumers by submitting payment instructions in a prescribed ACH format. We pay volume-based fees to the third party provider for debit and credit transactions processed each month, and pay fees for other transactions such as returns and notices of change to bank accounts. These fees are part of our cost structure. If the Federal Reserve rules were to change to introduce restrictions or modify access to the ACH, our business could be materially adversely affected.

IF OUR THIRD PARTY CARD PROCESSING PROVIDER OR OUR BANK SPONSOR FAIL TO COMPLY WITH THE APPLICABLE REQUIREMENTS OF VISA AND MASTERCARD CREDIT CARD ASSOCIATIONS, WE MAY HAVE TO FIND A NEW THIRD PARTY PROCESSING PROVIDER WHICH COULD INCREASE OUR COSTS.

Substantially all of the card-based transactions we process involve Visa or MasterCard. If our third party processing provider, Network 1 Financial, Inc., or our bank sponsor, Harris Bank, fail to comply with the applicable requirements of the Visa and MasterCard credit card associations, Visa or MasterCard could suspend or terminate their registration. Also, our contract with these third parties is subject to cancellation upon limited notice by either party. The cancellation of our contract, termination of their registration or any changes in the Visa or MasterCard rules that would impair their registration could require us to stop providing such payment processing services if we are unable to obtain another provider or sponsor at similar costs. Additionally, changing our bank sponsor could adversely affect our relationship with our merchants if the new sponsor provides inferior service or charges higher costs.

WE DEPEND ON MICHAEL R. LONG AND LOUIS A. HOCH AND IF THESE OFFICERS CEASED TO BE ACTIVE IN OUR MANAGEMENT, OUR BUSINESS MAY NOT BE SUCCESSFUL.

Our success depends to a significant degree upon the continued contributions of our key management, marketing, service and related product development and operational personnel, including our Chairman, Chief Executive Officer and Chief Financial Officer, Michael R. Long and our President and Chief Operating Officer, Louis A. Hoch. We have employment agreements with Mr. Long and Mr. Hoch that expire in July 2004 and prohibit them from competing with us for a period of two years upon termination of their employment. Our business may not be successful if, for any reason, either of these officers ceased to be active in our management.

9

IF OUR SOFTWARE FAILS, AND WE NEED TO REPAIR OR REPLACE IT, OR WE BECOME SUBJECT TO WARRANTY CLAIMS, OUR COSTS COULD INCREASE.

Our software products could contain errors or "bugs" that could adversely affect the performance of services or damage a user's data. We attempt to limit our potential liability for warranty claims through technical audits and limitation-of-liability provisions in our customer agreements. However, these measures may not be effective in limiting our exposure to warranty claims. We have not experienced a significant increase in software errors or warranty claims. Despite the existence of various security precautions, our computer infrastructure may also be vulnerable to viruses or similar disruptive problems caused by our customers or third parties gaining access to our processing

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

system. If our software fails, and we need to replace or repair it, or we become subject to warranty claims, our costs could increase.

OUR BUSINESS STRATEGY INCLUDES IDENTIFYING NEW BUSINESSES TO ACQUIRE, AND IF WE CANNOT INTEGRATE ACQUISITIONS INTO OUR COMPANY SUCCESSFULLY, WE MAY NOT BECOME PROFITABLE.

Our success partially depends upon our ability to identify and acquire undervalued businesses within our industry. Although we believe that there are companies available for potential acquisition that are undervalued and might offer attractive business opportunities, we may not be able to make any acquisitions, and if we do make acquisitions, they may not be profitable. As a result, our business may not grow and we may not achieve or sustain profitability.

IF WE DO NOT MANAGE OUR GROWTH, WE MAY NOT ACHIEVE OR SUSTAIN PROFITABILITY.

We may experience a period of rapid growth that could place a significant strain on our resources. In order to manage our growth successfully, we will have to continue to improve our operational, management and financial systems and expand our work force. A significant increase in our customer base may necessitate the hiring of a significant number of additional personnel, qualified candidates for which, at the time needed, may be in short supply. In addition, the expansion and adaptation of our computer and administrative infrastructure will require substantial operational, management and financial resources. Although we believe that our current infrastructure is adequate to meet the needs of our customers in the foreseeable future, we may not be able to expand and adapt our infrastructure to meet additional demand on a timely basis, at a commercially reasonable cost, or at all. If our management is unable to manage growth effectively, hire needed personnel, expand and adapt our computer infrastructure and improve our operational, management, and financial systems and controls, we may not attain or sustain profitability.

IF WE DO NOT MANAGE OUR CREDIT RISKS RELATED TO OUR MERCHANT ACCOUNTS, WE MAY INCUR SIGNIFICANT LOSSES.

We rely on the Federal Reserve's ACH system for electronic fund transfers and the Visa and MasterCard associations for settlement of payments by credit or debit card on behalf of our merchant customers. In our use of these established payment clearance systems, we generally bear the credit risks arising from returned transactions caused by insufficient funds, stop payment orders, closed accounts, frozen accounts, unauthorized use, disputes, customer charge backs theft or fraud. Consequently, we assume the credit risk of merchant disputes, fraud, insolvency or bankruptcy in the event we attempt to recover funds related to such transactions from our customers. We have not experienced a significant increase in the rate of returned transactions or incurred any losses with respect to such transactions. We utilize a number of systems and procedures to manage and limit credit risks, but if these actions are not successful in managing such risks, we may incur significant losses.

10

### RISKS RELATED TO OUR INDUSTRY

THE ELECTRONIC COMMERCE MARKET IS RELATIVELY NEW AND IF IT DOES NOT GROW, WE MAY NOT BE ABLE TO SELL SUFFICIENT SERVICES TO MAKE OUR BUSINESS VIABLE.

The electronic commerce market is a relatively new and growing service industry. If the electronic commerce market fails to grow or grows slower than anticipated, or if we, despite an investment of significant resources, are unable to adapt to meet changing customer requirements or technological changes in this emerging market, or if our services and related products do not maintain

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

a proportionate degree of acceptance in this growing market, our business may not grow and could even fail. Additionally, the security and privacy concerns of existing and potential customers may inhibit the growth of the electronic commerce market in general, and our customer base and revenues, in particular. Similar to the emergence of the credit card and automatic teller machine, or ATM, industries, we and other organizations serving the electronic commerce market must educate users that electronic transactions use encryption technology and other electronic security measures that make electronic transactions more secure than paper-based transactions.

CHANGES IN REGULATION OF ELECTRONIC COMMERCE AND RELATED FINANCIAL SERVICES INDUSTRIES COULD INCREASE OUR COSTS AND LIMIT OUR BUSINESS OPPORTUNITIES.

We believe that we are not required to be licensed by the Office of the Comptroller of the Currency, the Federal Reserve Board, or other federal or state agencies that regulate or monitor banks or other types of providers of electronic commerce services. It is possible that a federal or state agency will attempt to regulate providers of electronic commerce services, which could impede our ability to do business in the regulator's jurisdiction. We are subject to various laws and regulations relating to commercial transactions, such as the Uniform Commercial Code, and may be subject to the electronic funds transfer rules embodied in Regulation E, promulgated by the Federal Reserve Board. Given the expansion of the electronic commerce market, the Federal Reserve Board might revise Regulation E or adopt new rules for electronic funds transfer affecting users other than consumers. Because of growth in the electronic commerce market, Congress has held hearings on whether to regulate providers of services and transactions in the electronic commerce market. It is possible that Congress or individual states could enact laws regulating the electronic commerce market. If enacted, such laws, rules and regulations could be imposed on our business and industry and could increase our costs or limit our business opportunities.

IF WE CANNOT COMPETE SUCCESSFULLY IN OUR INDUSTRY, WE COULD LOSE MARKET SHARE AND OUR COSTS COULD INCREASE.

Portions of the electronic commerce market are becoming increasingly competitive. We expect to face growing competition in all areas of the electronic payment processing market. New companies could emerge and compete for merchants of all sizes. We expect competition to increase from both established and emerging companies and that such increased competition could lower our market share and increase our costs. Moreover, our current and potential competitors, many of whom have greater financial, technical, marketing and other resources than us, may respond more quickly than us to new or emerging technologies or could expand to compete directly against us in any or all of our target markets. Accordingly, it is possible that current or potential competitors could rapidly acquire market share. We may not be able to compete against current or future competitors successfully. Additionally, competitive pressures may increase our costs, which could lower our earnings, if any.

11

### RISKS RELATED TO OUR COMMON STOCK AND THIS OFFERING

OUR STOCK PRICE IS VOLATILE AND YOU MAY NOT BE ABLE TO SELL YOUR SHARES AT A PRICE HIGHER THAN WHAT YOU PAID.

The market for our common stock is highly volatile. In 2002, our stock price fluctuated between \$0.17 and \$1.70. The trading price of our common stock could be subject to wide fluctuations in response to, among other things, quarterly variations in operating and financial results, announcements of technological innovations or new products by our competitors or us, changes in prices of our products and services or our competitors' products and services, changes in

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

product mix, or changes in our revenue and revenue growth rates.

EXISTING STOCKHOLDERS MAY EXPERIENCE SIGNIFICANT DILUTION FROM THE SALE OF SECURITIES PURSUANT TO OUR INVESTMENT AGREEMENT WITH DUTCHESS PRIVATE EQUITIES FUND.

The sale of shares pursuant to our Investment Agreement with Dutchess Private Equities Fund may have a dilutive impact on our stockholders. As a result, our net income per share could decrease in future periods and the market price of our common stock could decline. In addition, the lower our stock price is at the time we exercise our put option, the more shares we will have to issue to Dutchess Private Equities Fund to draw down on the full equity line with Dutchess Private Equities Fund. If our stock price decreases, then our existing stockholders would experience greater dilution. At a stock price of \$0.26 or less, we would have to issue all 40,000,000 shares registered under this offering in order to draw down on the full equity line.

DUTCHESS PRIVATE EQUITIES FUND WILL PAY LESS THAN THE THEN-PREVAILING MARKET PRICE OF OUR COMMON STOCK WHICH COULD CAUSE THE PRICE OF OUR COMMON STOCK TO DECLINE.

Our common stock to be issued under our agreement with Dutchess Private Equities Fund will be purchased at a 5% discount to the lowest closing best bid price during the five days immediately following our notice to Dutchess Private Equities Fund of our election to exercise our put right. Dutchess Private Equities Fund has a financial incentive to sell our common stock immediately upon receiving the shares to realize the profit between the discounted price and the market price. If Dutchess Private Equities Fund sells our shares, the price of our stock could decrease. If our stock price decreases, Dutchess Private Equities Fund may have a further incentive to sell the shares of our common stock that it holds. The discounted sales under our agreement with Dutchess Private Equities Fund could cause the price of our common stock to decline.

WE MUST COMPLY WITH PENNY STOCK REGULATIONS THAT COULD EFFECT THE LIQUIDITY AND PRICE OF OUR STOCK.

The SEC has adopted rules that regulate broker-dealer practices in connection with transactions in "penny stocks." Penny stocks generally are equity securities with a price of less than \$5.00, other than securities registered on certain national securities exchanges or quoted on NASDAQ, provided that current price and volume information with respect to transactions in such securities is provided by the exchange or system. Prior to a transaction in a penny stock, a broker-dealer is required to:

- deliver a standardized risk disclosure document prepared by the SEC;
- provide the customer with current bid and offer quotations for the penny stock;
- explain the compensation of the broker-dealer and its salesperson in the transaction;

12

- provide monthly account statements showing the market value of each penny stock held in the customer's account;
- make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's executed acknowledgement of the same; and
- provide a written agreement to the transaction.

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

These requirements may have the effect of reducing the level of trading activity in the secondary market for our stock. Because our shares are subject to the penny stock rules, you may find it more difficult to sell your shares.

WE HAVE ADOPTED CERTAIN MEASURES THAT MAY MAKE IT MORE DIFFICULT FOR A THIRD PARTY TO ACQUIRE CONTROL OF OUR COMPANY AND COULD LOWER THE PRICE OF OUR STOCK.

On October 4, 2000, we approved a stockholder rights plan to protect stockholders in the event of an unsolicited attempt to acquire our company in a manner that would not be in the best interests of our stockholders. This stockholder rights plan could have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from attempting to acquire, control of our company. Our Board of Directors is also classified into three classes of directors serving staggered three-year terms. Such classification of the Board of Directors expands the time required to change the composition of a majority of directors and may tend to discourage a proxy contest or other takeover bid for our company. The issuance of common stock under a stockholder rights plan could decrease the amount of earnings and assets available for distribution to the holders of our common stock or could adversely affect the rights and powers, including voting rights, of the holders of our common stock. In certain circumstances, such issuance could have the effect of decreasing the market price of our common stock.

### USE OF PROCEEDS

The 40,000,000 shares of common stock covered by this prospectus will be sold by Dutchess Private Equities Fund, LP who will receive all of the proceeds from such sales. We will not receive any proceeds from the sale of the 40,000,000 shares. However, we will receive proceeds from the sale of our common shares pursuant to our Investment Agreement with Dutchess Private Equities Fund.

For illustrative purposes, we have set forth below our intended use of proceeds for the range of net proceeds indicated below to be received under the Investment Agreement. The Gross Proceeds represent the total dollar amount that Dutchess Private Equities Fund, L.P. is obligated to purchase. The table assumes estimated offering expenses of \$25,000.

	Proceeds If 100% Sold	Proceeds If 50% Sold	Proce If 25%
	-----	-----	-----
Gross Proceeds	\$10,000,000	\$5,000,000	\$2,500
Estimated Expenses of the Offering	\$ 25,000	\$ 25,000	\$ 25
	-----	-----	-----
Net Proceeds	\$ 9,975,000	\$4,975,000	\$2,475
	=====	=====	=====
	Priority	Priority	Priori
	-----	-----	-----
Working capital and general corporate expenses	1st \$2,000,000	\$2,000,000	\$2,000
Expansion of internal operations	2nd \$1,500,000	\$1,500,000	\$ 475
Potential acquisition costs (1)	3rd \$6,475,000	\$1,475,000	\$
	-----	-----	-----
	\$9,975,000	\$4,975,000	\$2,475
	=====	=====	=====

Proceeds of the offering which are not immediately required for the purposes described above will be invested in United States government securities, short-term certificates of deposit, money market funds and other high-grade, short-term interest-bearing investments.

(1) From time to time we evaluate opportunities to make acquisitions of assets or businesses that we believe would help us achieve our goal of profitability, but we are not currently planning any material acquisitions.

#### DETERMINATION OF OFFERING PRICE

The selling stockholders may sell shares in any manner at the current market price or through negotiated transactions with any person at any price.

#### DILUTION

Our net tangible book value as of December 31, 2003 was \$205,232, or \$0.01 per share of common stock. Net tangible book value per share is determined by dividing our tangible book value (total tangible assets less total liabilities) by the number of outstanding shares of our common stock. Net tangible book value as of December 31, 2003 is calculated by subtracting our net intangible asset of \$7,500 that is included in other assets from net total book value (total assets less total liabilities) of \$212,732. Since this offering is being made solely by the selling stockholders and none of the proceeds will be paid to us, our net tangible book value will be unaffected by this offering. Our net tangible book value, however, will be impacted by the common stock to be issued to Dutchess Private Equities Fund, L.P. The amount of dilution will depend on the offering price and number of shares to be issued. The following example shows the dilution to new investors at an assumed offering price of \$0.24 per share which is based on the closing price of our common stock on June 10, 2004 of \$0.25 adjusted for the 5% discount at which we will issue shares under our agreement with Dutchess Private Equities Fund. The discount is defined as 95% of the lowest closing bid price of our common stock during the five consecutive trading day period immediately following our notice to Dutchess Private Equities Fund of our election to exercise our put rights.

If we assume that we were to issue 100%, 50%, 25% and 10% of the 40,000,000 shares of common stock to Dutchess Private Equities Fund, L.P. at an assumed offering price of \$0.24 per share, less \$25,000 of offering expenses, our pro forma net tangible book value as of December 31, 2003 would have been as follows:

#### Pro Forma Effects of Dilution from Offering:

Assumed percentage of shares issued	100%	50%	25%
Number of shares issued (in millions)	40	20	10
Assumed public offering price per share	\$0.24	\$0.24	\$0.24
Stock discount recognized as interest expense	\$505,263	\$252,632	\$126,316
Net tangible book value per share before this offering	\$0.01	\$0.01	\$0.01
Net tangible book value after this offering	\$9,274,969	\$4,727,600	\$2,453,900
Net tangible book value per share after this offering	\$0.15	\$0.12	\$0.08
Dilution of net tangible book value per share to new investors	\$0.09	\$0.12	\$0.16
Increase in net tangible book value per share to existing shareholders	\$0.14	\$0.11	\$0.07

## Edgar Filing: PAYMENT DATA SYSTEMS INC - Form SB-2/A

You should be aware that there is an inverse relationship between our stock price and the number of shares to be issued under the Investment Agreement to Dutchess Private Equities Fund, L.P. That is, as our stock price declines, we would be required to issue a greater number of shares under the Investment Agreement for a given advance. This inverse relationship is demonstrated by the table below, which shows the number of shares to be issued under the Investment Agreement at a price of \$0.24 per share and 75%, 50% and 25% discounts to that price.

Offering price: \$0.24	75%	50%	25%	-
PURCHASE PRICE: (1)	\$0.06	\$0.12	\$0.18	\$0.24
NO. OF SHARES: (2)	40,000,000	20,000,000	13,333,334	10,000,000
TOTAL OUTSTANDING: (3) .	60,987,956	40,987,956	34,321,289	30,987,956
PERCENT OUTSTANDING: (4)	65.6%	48.8%	38.8%	32.3%