DST SYSTEMS INC
Form 10-K
February 29, 2012

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United States
Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-K

ý **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2011

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to
Commission file number 1-14036

(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**43-1581814** (I.R.S. Employer identification no.)
333 West 11th Street, Kansas City, Missouri (Address of principal executive offices)	**64105** (Zip code)

(816) 435-1000
Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each Exchange on which registered
Common Stock, $0.01 Per Share Par Value	New York Stock Exchange
Preferred Stock Purchase Rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ý NO o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES o NO ý

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 ý NO o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web-site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ý NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of 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. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO ý

Aggregate market value of the voting and non-voting stock held by non-affiliates of the Registrant as of June 30, 2011:
Common Stock, $0.01 par value $1,849,415,990

Number of shares outstanding of the Registrant's common stock as of January 31, 2012:
Common Stock, $0.01 par value 44,180,261

Documents incorporated by reference: Proxy Statement for the annual meeting of stockholders on May 8, 2012 (Part III)

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DST Systems, Inc.

2011 Form 10-K Annual Report

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The brand, service or product names or marks referred to in this Annual Report are trademarks or services marks, registered or otherwise, of DST Systems, Inc. or its subsidiaries or affiliates or of vendors to the Company.

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CAUTIONARY STATEMENT WITH RESPECT TO FORWARD-LOOKING COMMENTS

The discussions set forth in this annual report on Form 10-K contain statements concerning potential future events. Such forward-looking statements are based upon assumptions by the Company's management, as of the date of this Annual Report, including assumptions about risks and uncertainties faced by the Company. In addition, management may make forward-looking statements orally or in other writings, including, but not limited to, in press releases, in the annual report and in the Company's other filings with the Securities and Exchange Commission (the "SEC"). Readers can identify these forward-looking statements by the use of such verbs as expects, anticipates, believes or similar verbs or conjugations of such verbs. If any of management's assumptions prove incorrect or should unanticipated circumstances arise, the Company's actual results could materially differ from those anticipated by such forward-looking statements. The differences could be caused by a number of factors or combination of factors including, but not limited to, those factors identified in Item 1A, "Risk Factors" of this Form 10-K. Readers are strongly encouraged to consider those factors when evaluating any forward-looking statements concerning the Company. The Company undertakes no obligation to update any forward-looking statement in this annual report to reflect future events or developments.

PART I

Item 1. Business

This discussion of the business of DST Systems, Inc. ("DST" or the "Company") should be read in conjunction with, and is qualified by reference to, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") under Item 7 herein. In addition, pursuant to Rule 12b-23 under the Securities Exchange Act of 1934, as amended, the information set forth in the first paragraph and under the headings "Introduction" and "Seasonality" in the MD&A and the segment and geographic information included in Item 8, Note 16 are incorporated herein by reference in partial response to this Item 1.

The Company was originally established in 1969. Through a reorganization in August 1995, the Company is now a corporation organized in the State of Delaware.

The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports will be made available free of charge on or through the Company's Internet website (*www.dstsystems.com*) as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. In addition, the Company's corporate governance guidelines and the charters of the Audit Committee, the Corporate Governance/Nominating Committee and the Compensation Committee of the DST Board of Directors are available on the Company's Internet website. These guidelines and charters are available in print to any stockholder who requests them. Written requests may be made to the DST Corporate Secretary, 333 West 11th Street, Kansas City, Missouri 64105, and oral requests may be made by calling the DST Corporate Secretary's Office at (816) 435-8655. An individual may read and copy any materials the Company files with the SEC at the SEC's Public Reference Room at 100 F Street, N.E. Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site (*http://www.sec.gov*) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

NARRATIVE DESCRIPTION OF BUSINESS

The Company's business units offer sophisticated information processing and software services and products. These business units are reported as two operating segments, Financial Services and Output Solutions. In addition, investments in the Company's real estate subsidiaries and affiliates, equity

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securities, private equity investments and certain financial interests have been aggregated into the Investments and Other Segment.

A summary of each of the Company's segments follows:

Financial Services

The Company's Financial Services Segment provides technology based solutions principally to the mutual fund/investment management, brokerage, retirement, life and property/casualty insurance and healthcare payer industries. The Company has developed a number of proprietary systems that are integrated into its solutions. The Company's proprietary software systems include shareowner recordkeeping and distribution support systems for U.S. and international mutual fund companies, broker/dealers and financial advisors; a defined-contribution participant recordkeeping system for the U.S. retirement plan market; investment management systems offered to U.S. and international investment managers and fund accountants; a business process management and customer contact system offered to a broad variety of industries; medical and pharmacy claims administration processing systems and services offered to providers of healthcare plans, third party administrators, medical practice groups and pharmacy benefit managers; and an electronic file system offered to mutual fund companies, insurance companies and professional service (legal, accounting and others) firms. In certain cases, multiple products are integrated into a single solution.

During 2011, the Company determined that it would focus its Financial Services Segment activities around five key industry vertical markets: asset management, brokerage, retirement, insurance and healthcare and made a number of investments to better position the Company to pursue those vertical markets. These investments are summarized as follows:

Acquisition of ALPS Holdings ("ALPS"). On October 31, 2011, DST acquired ALPS Holdings ("ALPS") for $251.9 million. ALPS provides a comprehensive suite of asset servicing and asset gathering solutions. The acquisition of ALPS expands the Company's solutions to the U.S. mutual fund industry and also positions the Company to serve the hedge fund and the Exchange Traded Fund ("ETF") industry.

Acquisition of Finix Business Strategies and Finix Converge ("Finix"). On April 28, 2011, the Company acquired the assets of Finix, which offers consulting services and an enterprise social media platform to the broker-dealer industry. In connection with this acquisition, the Company formed DST Brokerage Solutions and offers its services to the broker-dealer industry, including broker-dealer mutual fund sub-accounting.

Acquisition of Subserveo, Inc. ("Subserveo"). On June 20, 2011, the Company acquired Subserveo, a provider of automated compliance and surveillance solutions to broker-dealers and investment advisors throughout the U.S. and Canada. Subserveo is part of DST Brokerage Solutions.

Acquisition of Intellisource Healthcare Solutions ("Intellisource"). On July 1, 2011, the Company acquired the assets of Intellisource, a provider of integrated care management, workflow and analytics solutions for the health care industry. Intellisource has been integrated into the Company's health care solutions offerings.

Formation of DST Insurance Solutions, LLC ("DSTIS"). In 2011, the Company formed DSTIS to offer policyholder solutions to the life insurance industry. In connection with the formation of DSTIS, the Company acquired from its joint venture, International Financial Services Ireland, the North American rights to Eclipse from Percana. Eclipse is a contemporary software solution providing policyholder recordkeeping to the life and annuity insurance markets. Leveraging the Percana software and integrating other technology including DST proprietary products, DSTIS will offer its processing solutions on a remote or "ASP" (Application Service Provider) basis or

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on a full service or "BPO" (Business Process Outsourcing) basis through Boston Financial Data Services, a joint venture between the Company and State Street Corporation ("State Street").

In addition to the above and as described in Part II, Item 7 "Significant Events" the following change occurred in the composition of the Financial Services Segment during the three years ended December 31, 2011:

On March 31, 2009, DST purchased the remaining 50% equity interest in Argus Health Systems, Inc. ("Argus") for $57.0 million in cash. As a result, Argus is no longer an unconsolidated affiliate of DST, but rather is a wholly-owned subsidiary resulting in DST consolidating the results of Argus after March 31, 2009.

The Financial Services Segment distributes its services and products on a direct basis and through subsidiaries and joint venture affiliates in the U.S., United Kingdom ("U.K."), Canada, Europe, Australia, South Africa, Asia-Pacific and the Middle East and, to a lesser degree, distributes such services and products through various strategic alliances.

Output Solutions

The Company's Output Solutions Segment provides single source, integrated print and electronic statement and billing output solutions, including customized statement and bill production, direct marketing and personalization services, fulfillment, postal optimization, and electronic presentment, payment and distribution solutions. These capabilities enable the Output Solutions Segment to provide services to industries that place a premium on customer communications that require high quality, accurate and timely statement and billing output processing.

The Company's Output Solutions Segments offers a full range of customer communications solutions serving a wide variety of industries. These solutions are offered in the U.S., Canadian and U.K. markets.

In 2011, the Company expanded its presence in the UK market and made acquisitions to extend its solutions to support its customers' marketing and sales efforts, which enables the Output Solutions Segment to more fully fulfill customer communication requirements along the full continuum of customer communications, both print and electronic. As described in Part II, Item 7 "Significant Events" the following changes have occurred in the composition of the Output Solutions Segment during the three years ended December 31, 2011:

Acquisitions

Acquisition of Newkirk Products, Inc. ("Newkirk") On May 2, 2011, the Company acquired Newkirk, an industry leader in the development and deployment of communications, education, and investment information for clients in the retirement planning, managed care, and wealth management industries. While reporting as part of the Output Solutions Segment, the acquisition of Newkirk expands the Company's offerings in both the Output Solutions and Financial Services Segments.

Acquisition of Lateral Group Ltd. ("Lateral") On August 5, 2011, the Company acquired Lateral, a UK based provider of print, data management and on line marketing services. The acquisition of Lateral complements the existing IOS business in terms of services offered and business outlook. In addition, this acquisition allows IOS to extend and develop its service/product offerings by further integrating communications through print, data and e-solutions and providing additional solutions such as data insight and online marketing to the IOS client base.

Canadian operating facility expansion To meet increased client commitments, the Company is increasing the size of its operating facility in Canada, which will enable the Company to process significant additional business through its facility. The expansion is expected to be completed in the first half of 2012.

Acquisition of dsicmm Group. On July 30, 2010, DST, through its wholly-owned U.K. subsidiary, Innovative Output Solutions Limited ("IOS"), acquired dsicmm Group Limited ("dsicmm"), a provider of print/mail services in the U.K., for cash and issuance of IOS stock. After completion of the transaction, DST owned 70.5% of IOS and the remaining 29.5% was owned by a group of the former stockholders of dsicmm. DST has consolidated the financial results of the combined IOS business from the closing date and has reflected the 29.5% owned by the former stockholders of dsicmm as a non-controlling interest. DST purchased the outstanding minority interest of IOS on January 6, 2012 for $17.7 million and now owns 100% of the Company.

Contract Termination

In the second quarter of 2010, and Output Solutions telecommunications client, representing approximately 6.6% of 2009 annual Output Solutions Segment operating revenues, terminated its contract and internalized its bill production. The termination occurred on April 30, 2010 and resulted in a contract termination of approximately $63.0 million.

The Output Solutions Segment North America business has four principal operating facilities located in the U.S. and Canada and is among the largest users of continuous, high-speed, full-color inkjet printing systems and among the largest First-class mailers in the U.S. The North America business provides print and electronic delivery services for client bills and statements related to transaction events. The acquisitions of Newkirk Products, Inc. in 2011 and Capital Fulfillment Group in 2010 expand the North America business to include participant enrollment and compliance communications related to retirement, insurance, mutual funds and healthcare plans. The business also provides significant cross sell opportunities and leverage in both DST's mutual fund, retirement and insurance solutions businesses.

Innovative Output Solutions Limited ("IOS") has three principal operating facilities in the United Kingdom and is among the largest direct communications manufacturers in that country. The United Kingdom business is oriented to data driven marketing communications and direct mail campaigns with transaction printing accounting for less than 20% of revenues.

The Output Solutions Segment's research and development efforts have resulted in two mail and postal processing initiatives, Smart Commingling and Intelligent Mail barcode, in compliance with United States Postal Services requirements. In addition, the Digital Press Technology ("DPT") high-speed color printing and inserting platform enables the Output Solutions Segment to produce high-speed transactional printing combined with dynamic color printing. The Company believes DPT is a technologically-differentiated service offering that enables it to provide better and more efficient products and services to clients.

The Output Solutions Segment in North America distributes its product directly to clients and through relationships in which its services are combined with or offered concurrently through providers of data processing services. The Output Solutions Segment's products in North America are also distributed or bundled with product offerings to clients of the Financial Services Segment.

Investments and Other

The Investments and Other Segment is comprised of the Company's real estate subsidiaries and joint ventures, investments in equity securities, private equity investments and other financial interests. The assets held by the Investments and Other Segment are primarily passive in nature. The Company owns and operates real estate mostly in the U.S. and U.K., primarily for lease to the Company's other business segments. The Company is a partner in certain real estate joint ventures that lease office space

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to the Company, certain of its unconsolidated affiliates and unrelated third parties. The Company is a 50% partner in a limited purpose real estate joint venture formed to develop and lease approximately 1.1 million square feet of office space to the U.S. government. The Investments and Other Segment holds investments in available-for-sale equity securities with a market value of approximately $730.3 million at December 31, 2011, including approximately 10.3 million shares of State Street Corporation ("State Street"), 15.0 million shares of Computershare Ltd. ("Computershare") and 1.9 million shares of Euronet Worldwide, Inc., with a market value of $416.4 million, $122.7 million and $34.8 million, respectively, based on closing exchange values at December 31, 2011.

Source of Revenue

The Company's sources of revenue, by industry served, are presented below. The sources listed may be served by more than one of the Company's business segments.

	Year Ended December 31,					
	2011		2010		2009	
	(dollars in millions)					
U.S. operating revenues						
Mutual fund / investment management	$ 768.9	44.1%	$ 774.9	45.2%	$ 766.8	48.1%
Healthcare related services	274.5	15.7%	283.7	16.6%	275.2	17.2%
Telecommunications, video and utilities	151.0	8.7%	231.8	13.5%	200.6	12.5%
Other financial services	135.5	7.8%	108.5	6.4%	98.4	6.2%
Other	58.6	3.3%	79.2	4.6%	82.2	5.2%
Total U.S. operating revenues	1,388.5	79.6%	1,478.1	86.3%	1,423.2	89.2%
International operating revenues						
Investment management and other financial services	208.9	12.0%	161.1	9.4%	133.3	8.4%
Telecommunications, video and utilities	46.2	2.6%	39.6	2.3%	34.0	2.1%
Other	100.4	5.8%	34.8	2.0%	4.9	0.3%
Total international operating revenues	355.5	20.4%	235.5	13.7%	172.2	10.8%
Total operating revenues	1,744.0	100.0%	1,713.6	100.0%	1,595.4	100.0%
Out-of-pocket reimbursements(1)	644.7		614.9		622.5	
Total revenues	$ 2,388.7		$ 2,328.5		$ 2,217.9	

(1) Principally postage and telecommunication expenditures, which are reimbursed by the customer.

FINANCIAL SERVICES SEGMENT

The Financial Services Segment is the largest operating segment of the Company, providing the following products and services: shareowner recordkeeping, broker subaccounting, retirement plan/participant recordkeeping, distribution support solutions, asset gathering and servicing by ALPS, business process management, investment management software and services, healthcare administration processing solutions and services, pharmacy claims processing and document management services.

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The information in Part II, Item 8 (Financial Statements and Supplementary Data), in Note 16 (Segment and Geographic Information) is incorporated by reference in partial response to this Item 1. The following table provides key operating data for the Financial Services Segment:

	Year Ended December 31,		
Financial Services Operating Data	**2011**	**2010**	**2009**
		(dollars in millions)	
Revenues			
U.S. operating revenues			
Mutual fund/investment management	$ 670.8	$ 670.8	$ 658.7
Healthcare related services	250.1	263.0	254.0
Telecommunications, video and utilities	4.1	6.0	7.1
Other financial services	50.8	46.6	49.1
Other	31.7	52.7	45.1
	1,007.5	1,039.1	1,014.0
International operating revenues			
Investment management and other financial services	123.6	110.1	96.5
Telecommunications, video and utilities	6.1	4.8	4.6
Other	1.2	2.7	0.1
	130.9	117.6	101.2
Total operating revenues	1,138.4	1,156.7	1,115.2
Out-of-pocket reimbursements(1)	42.1	44.6	54.3
Total revenues	$ 1,180.5	$ 1,201.3	$ 1,169.5
Mutual fund shareowner accounts processed (in millions)			
U.S.			
Registered accounts:			
Non tax-advantaged	42.4	55.1	63.6
Tax-advantaged:			
IRA mutual fund accounts	24.3	25.2	26.8
Other retirement accounts	8.9	9.7	10.0
Section 529 and Educational IRAs	9.5	9.4	9.5

Trupanion, Inc.
Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Three Months Ended March 31,	
	2017	2016
Operating activities		
Net loss	$(1,482)	$(2,572)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Depreciation and amortization	1,036	785
Stock-based compensation expense	781	696
Other, net	97	9
Changes in operating assets and liabilities:		
Accounts and other receivables	(3,372)	(234)
Prepaid expenses and other assets	(219)	153
Accounts payable	64	(200)
Accrued liabilities	(598)	(1,267)
Claims reserve	1,093	521
Deferred revenue	4,218	676
Other payables	239	135
Net cash provided by (used in) operating activities	1,857	(1,298)
Investing activities		
Purchases of investment securities	(5,172)	(3,959)
Maturities of investment securities	3,871	3,700
Purchases of property and equipment	(462)	(653)
Other investments	(2,710)	(34)
Net cash used in investing activities	(4,473)	(946)
Financing activities		
Proceeds from stock option exercises	1,037	486
(Repayment of) proceeds from debt financing and debt financing fees	(40)	987
Payments on capital lease obligations	(102)	—
Net cash provided by financing activities	895	1,473
Effect of foreign exchange rates on cash, net	21	341
Net change in cash, cash equivalents, and restricted cash	(1,700)	(430)
Cash, cash equivalents, and restricted cash at beginning of period	24,237	17,956
Cash, cash equivalents, and restricted cash at end of period	$22,537	$17,526
Supplemental disclosures		
Noncash investing and financing activities:		
Increase in payables for property and equipment	93	58
Property and equipment acquired under capital leases	45	—

Trupanion, Inc.
Notes to the Consolidated Financial Statements (unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies
Description of Business
Trupanion, Inc. (collectively with its wholly-owned subsidiaries, the Company) provides medical insurance plans for cats and dogs throughout the United States, Canada and Puerto Rico.
Basis of Presentation
The consolidated balance sheet data as of December 31, 2016 was derived from audited consolidated financial statements. The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for unaudited consolidated financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. These unaudited consolidated financial statements and notes should be read in conjunction with the Company’s audited consolidated financial statements and accompanying notes for the year ended December 31, 2016 included in the Company’s Annual Report on Form 10-K, filed with the U.S Securities and Exchange Commission on February 15, 2017. The accompanying unaudited consolidated financial statements reflect all adjustments consisting of normal recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the Company’s financial position and results of its operations, as of and for the periods presented. Operating results for the three months ended March 31, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017, or for any other period.
Reclassifications
Certain prior year amounts have been reclassified within the Company’s consolidated financial statements from their original presentation to conform to the current period presentation.
Use of Estimates
The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies and the reported amounts of revenue and expenses. Significant items subject to such estimates and assumptions include the valuation of deferred tax assets, stock-based compensation expense, claims reserve, useful lives of software developed for internal use, the valuation of assets evaluated for impairment and income tax uncertainties. Actual results could differ from the estimates used in preparing the consolidated financial statements.
Accumulated Other Comprehensive Loss
There were no reclassifications out of accumulated other comprehensive loss during the three months ended March 31, 2017 and 2016.
Accounting Pronouncements Adopted During Period
In November 2015, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) amending the accounting for income taxes and requiring all deferred tax assets and liabilities be classified as non-current in the consolidated balance sheets. The Company adopted this ASU as of January 1, 2017 and has retrospectively applied all provisions.
In March 2016, the FASB issued an ASU amending the accounting for employee share-based payments, including income tax recognition and classification. The Company adopted this ASU as of January 1, 2017. As a result, the Company has elected to use actual forfeitures in the estimate of stock-based compensation expense. Additionally, the guidance related to the accounting for excess tax benefits and deficiencies resulted in an initial adjustment as of January 1, 2017 to the Company's net operating loss deferred tax asset to eliminate the Company's existing windfall pool amounting to $4.3 million, which was offset by an adjustment to the Company's valuation allowance. Finally, tax withholding of shares will be allowed up to the employee's maximum individual tax rate in the relevant jurisdiction without resulting in liability classification of the award, subject to the Company's internal policies for making this election.

Recent Accounting Pronouncements

In February 2016, the FASB issued an ASU amending the lease presentation guidance. The ASU requires organizations that lease assets to recognize the rights and obligations created by those leases on the consolidated balance sheets. This ASU is effective for fiscal years beginning after December 15, 2018 including interim periods within that reporting period, with early adoption permitted. The Company plans to adopt this guidance as of January 1, 2019. The Company has determined this guidance will require recognition of a lease liability and corresponding asset on the consolidated balance sheets equal to the present value of minimum lease payments. The carrying amount of the asset is derived from the amount of the lease liability at the end of each reporting period.

In August 2016, the FASB issued an ASU which addresses eight specific cash flow issues intended to reduce diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This ASU is effective for fiscal periods beginning after December 15, 2017 including interim periods within that reporting period, with early adoption permitted. The Company plans to adopt this guidance as of January 1, 2018. The Company is in the process of assessing the impact of this guidance.

2. Net Loss per Share

Basic net loss per share is calculated by dividing the net loss by the weighted-average number of shares of common stock outstanding for the period. Excluded from the weighted-average number of shares outstanding are shares that have been issued and are subject to future vesting and unvested restricted stock. Diluted net loss per share is calculated by dividing the net loss by the weighted-average number of common stock equivalents outstanding for the period determined using the treasury-stock method. Potentially dilutive common stock equivalents are comprised of unvested restricted stock, stock options and warrants. For all periods presented, there is no difference in the number of shares used to calculate basic and diluted shares outstanding due to the Company’s net loss position.

The following potentially dilutive equity securities were not included in the diluted net loss per common share calculation because they would have had an antidilutive effect:

	As of March 31,	
	2017	2016
Stock options	3,983,098	4,760,535
Restricted stock awards and units	351,702	472,384
Warrants	810,000	869,999

3. Investment Securities

The amortized cost, gross unrealized holding losses, and fair value of available-for-sale and short-term investments by major security type and class of security were as follows as of March 31, 2017 and December 31, 2016 (in thousands):

	Amortized Cost	Gross Unrealized Holding Losses	Fair Value
As of March 31, 2017			
Available-for-sale:			
Foreign deposits	$ 1,671	$ —	$ 1,671
Municipal bond	1,000	(15)	985
	$ 2,671	$ (15)	$ 2,656
Short-term investments:			
U.S. treasury securities	$ 6,186	$ (1)	$ 6,185
Certificates of deposit	687	—	687
U.S. government funds	23,920	—	23,920
	$ 30,793	$ (1)	$ 30,792

	Amortized Cost	Gross Unrealized Holding Losses	Fair Value
As of December 31, 2016			
Available-for-sale:			
Foreign deposits	$ 1,587	$ —	$ 1,587
Municipal bond	1,000	(8)	992
	$ 2,587	$ (8)	$ 2,579
Short-term investments:			
U.S. treasury securities	$ 5,791	$ —	$ 5,791
Certificates of deposit	707	—	707
U.S. government funds	23,072	—	23,072
	$ 29,570	$ —	$ 29,570

Maturities of debt securities classified as available-for-sale were as follows (in thousands):

	March 31, 2017	
	Amortized Cost	Fair Value
Available-for-sale:		
Due under one year	$—	$—
Due after one year through five years	1,671	1,671
Due after five years through ten years	1,000	985
Due after ten years	—	—
	$2,671	$2,656

The Company had one investment with an unrealized loss of less than $0.1 million and a fair value of $1.0 million at March 31, 2017 and December 31, 2016. This investment has been in an unrealized loss position for more than 12 months. The Company assessed the bond for credit impairment and determined that there is no intent to sell this bond, and it is likely that it will hold the investment for a period of time sufficient to allow for recovery. Furthermore, future payments on this bond are insured by a financial guarantee insurer. Therefore, the Company believes that the unrealized loss on this bond constitutes a temporary impairment.

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4. Fair Value

The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible.

When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

- Level 1 inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.
- Level 2 inputs: Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.
- Level 3 inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

The following table presents the placement in the fair value hierarchy of assets and liabilities that are measured at fair value on a recurring basis (in thousands):

	As of March 31, 2017			
	Fair Value	Level 1	Level 2	Level 3
Assets				
Restricted cash	$600	$600	$—	$ —
Foreign deposits	1,671	1,671	—	—
Municipal bond	985	—	985	—
Money market funds	4,497	4,497	—	—
Total	$7,753	$6,768	$985	$ —

	As of December 31, 2016			
	Fair Value	Level 1	Level 2	Level 3
Assets				
Restricted cash	$600	$600	$—	$ —
Foreign deposits	1,587	1,587	—	—
Municipal bond	992	—	992	—
Money market funds	7,033	7,033	—	—
Total	$10,212	$9,220	$992	$ —

Long-term investments classified as available-for-sale are measured using quoted market prices when quoted market prices are available. If quoted market prices in active markets for identical assets are not available to determine fair value, then the Company uses quoted prices of similar instruments and other significant inputs derived from observable market data obtained from third-party data providers. Short-term investments are carried at amortized cost and the fair value is disclosed in Note 3. Fair value is determined in the same manner as available-for-sale securities and is considered a Level 1 measurement.

Notes receivable are comprised of secured funds loaned to third parties and are carried at their estimated collectible amounts, plus accrued interest and recorded in other long-term assets on the consolidated balance sheets until 12 months prior to the date they are due. The Company estimates fair value for its notes receivable using a variety of observable and unobservable inputs including, but not limited to, market interest rates and assessed creditworthiness of the third parties. This is a Level 3 measurement. Notes receivable, recorded in other long term assets on the consolidated balance sheets, totaled $2.7 million, for the three months ended March 31, 2017. Based upon this assessment, the carrying amount of notes receivable approximated fair value at March 31, 2017.

The Company estimates fair value for its long-term debt based upon rates currently available to the Company for debt with similar terms and remaining maturities. This is a Level 3 measurement. Based upon the terms of the debt, the carrying amount of long-term debt approximated fair value at March 31, 2017 and December 31, 2016.
The Company’s accounting policy is to recognize transfers between levels of the fair value hierarchy on the date of the event or change in circumstances that caused the transfer. There were no transfers between levels for the three months ended March 31, 2017 and 2016.

5. Debt
The Company has a revolving line of credit with a bank, which is secured by any and all interest the Company has in assets that are not otherwise restricted. This agreement was most recently amended in March 2017. The revolving line of credit bore a variable interest rate as of March 31, 2017 equal to the greater of 4.5%, or 1.25% plus the prime rate. Interest expense is due monthly on the outstanding principal amount with all amounts outstanding under the revolving line of credit due upon maturity in December 2019. The credit agreement requires the Company to comply with various financial and non-financial covenants. As of March 31, 2017 and December 31, 2016, the Company was in compliance with all covenants. This facility has a requirement that $0.6 million be held as restricted cash with the bank as of March 31, 2017. This facility also has a compensating balance requirement of $0.4 million and an irrevocable standby letter of credit totaling $1.1 million, which reduces the amount available on the line of credit.
As of March 31, 2017 and December 31, 2016, borrowings on the revolving line of credit are limited to the lesser of $30.0 million and the total amount of cash and securities held by the Company's insurance subsidiaries (American Pet Insurance Company and Wyndham Insurance Company (SAC) Limited), less up to $4.5 million and $3.0 million, respectively, for obligations the Company may have outstanding for other ancillary services in the future. As of March 31, 2017 and December 31, 2016, the Company's outstanding borrowings under this facility were $5.0 million. The Company had $20.5 million available under its revolving line of credit as of March 31, 2017.
6. Commitments and Contingencies
The outcomes of the Company’s legal proceedings are inherently unpredictable, subject to significant uncertainties, and could be material to the Company's operating results and cash flows for a particular period. The Company makes a provision for a liability relating to legal matters when it is both probable that a material liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, estimated settlements, legal rulings, advice of legal counsel and other information and events pertaining to a particular matter.
7. Stock-Based Compensation
The following table presents information regarding stock options granted, exercised and forfeited for the periods presented:

	Number Of Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)
December 31, 2016	4,123,023	$ 5.06	$ 43,185
Granted	152,199	15.82	
Exercised	(257,679)	4.02	3,068
Forfeited	(34,445)	8.85	
March 31, 2017	3,983,098	5.50	35,439
Vested and exercisable at March 31, 2017	2,986,493	$ 3.29	$ 32,695

As of March 31, 2017, the stock options outstanding had a weighted-average remaining contractual life of 5.6 years.
Stock-based compensation expense includes stock options and restricted stock awards and units granted to employees and non-employees and has been reported in the Company’s consolidated statements of operations in claims expenses, other cost of revenue, sales and marketing, technology and development, and general and administrative expenses depending on the function performed by the employee or non-employee. The Company measures stock-based compensation expense on a straight-line basis except for restricted stock with a performance condition which is measured on a graded vesting schedule. The remaining 350,631 shares of unvested restricted stock measured on a graded vesting schedule are expected to vest over the remaining service term of approximately 2.5 years.

As of March 31, 2017, the Company had unrecognized stock-based compensation expense of $5.1 million, which is expected to vest over a weighted-average period of approximately 2.4 years. As of March 31, 2017, the Company had 996,605 unvested stock options and 351,702 restricted stock awards and units that are expected to vest. No net tax benefits related to the stock-based compensation costs have been recognized since the Company's inception. The expense recognized in each category of the Company's consolidated statements of operations is provided in the table below:

	Three Months Ended March 31,	
	2017	2016
	(in thousands)	
Claims expenses	$70	$58
Other cost of revenue	43	8
Sales and marketing	187	82
Technology and development	50	55
General and administrative	431	493
Total stock-based compensation expense	$781	$696

8. Claims Reserve

The Company provides a reserve for unpaid claims and claims incurred but not reported (IBNR). This liability is primarily based on, but not limited to, patterns of claims being paid, patterns of claims received, seasonality patterns and historical experience. This, combined with the estimated cost of administering claims incurred but not reported makes up the Company's claims reserve. As the Company grows, the claims reserve is expected to increase. Additionally, if expected claims payout completion patterns extend, the claims reserve may further increase. The Company reviews estimates for the claims reserve quarterly. Any necessary adjustments are reflected in earnings.

The Company has two segments: subscription business and other business. The subscription business segment includes monthly subscriptions related to the Company's medical plan which are marketed directly to consumers, while the other business segment includes all other business that is not directly marketed to consumers.

Claims Reserve

Activity in the subscription business claims reserve is summarized as follows:

	Three Months Ended March 31,	
	2017	2016
	(in thousands)	
Claims reserve at beginning of year	$8,538	$5,384
Claims incurred during the period related to:		
Current year	36,518	28,123
Prior years	(195)	387
Total claims incurred	36,323	28,510
Claims paid during period related to:		
Current year	28,868	22,940
Prior years	6,400	4,913
Total claims paid	35,268	27,853
Non-cash claims expense	93	94
Claims reserve at end of period	$9,500	$5,947

The decrease in subscription business claims incurred for prior years for the three months ended March 31, 2017 is primarily due to less claims incurred than was expected relating to prior year claims. The increase in subscription business claims for prior years for the three months ended March 31, 2016 is primarily due to more claims incurred than was expected relating to prior year claims.

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Activity in the other business claims reserve is summarized as follows:

	Three Months Ended March 31,	
	2017	2016
	(in thousands)	
Claims reserve at beginning of year	$983	$890
Claims incurred during the period related to:		
Current year	3,048	2,104
Prior years	(184)	(10)
Total claims incurred	2,864	2,094
Claims paid during period related to:		
Current year	2,092	1,357
Prior years	634	720
Total claims paid	2,726	2,077
Non-cash claims expense	—	—
Claims reserve at end of period	$1,121	$907

Incurred but not reported claims

The following table summarizes the activity for incurred but not reported claims plus expected development for the Company's subscription business segment (in thousands):

Year Incurred	As of March 31, 2017 Total of IBNR plus expected development on reported claims
2015	$ 174
2016	1,725
2017	7,557

The following table summarizes the activity for incurred but not reported claims plus expected development for the Company's other business segment (in thousands):

Year Incurred	As of March 31, 2017 Total of IBNR plus expected development on reported claims
2015	$ 2
2016	162
2017	957

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9. Segments

The Company has two segments: subscription business and other business. The subscription business segment includes monthly subscriptions related to the Company's medical plan which are marketed directly to consumers, while the other business segment includes all other business that is not directly marketed to consumers.

The chief operating decision maker uses two measures to evaluate segment performance: revenue and gross profit. Additionally, other operating expenses, such as sales and marketing expenses, are allocated to each segment and evaluated when material. Interest and other expenses and income taxes are not allocated to the segments, nor included in the measure of segment profit or loss. The Company does not analyze discrete segment balance sheet information related to long-term assets.

Revenue and gross profit of the Company's segments were as follows (in thousands):

	Three Months Ended March 31,	
	2017	2016
Revenue:		
Subscription business	$50,229	$39,143
Other business	4,500	3,556
	54,729	42,699
Claims expenses:		
Subscription business	36,323	28,510
Other business	2,864	2,094
	39,187	30,604
Other cost of revenue:		
Subscription business	4,923	3,693
Other business	1,464	1,098
	6,387	4,791
Gross profit:		
Subscription business	8,983	6,940
Other business	172	364
	9,155	7,304
Sales and marketing:		
Subscription business	4,041	3,802
Other business	48	38
	4,089	3,840
Technology and development	2,403	2,287
General and administrative	4,012	3,722
Operating loss	$(1,349)	$(2,545)

The following table presents the Company's revenue by geographic region of the member (in thousands):

	Three Months Ended March 31,	
	2017	2016
United States	$44,134	$34,477
Canada	10,595	8,222
Total revenue	$54,729	$42,699

Substantially all of the Company's long-lived assets were located in the United States as of March 31, 2017 and December 31, 2016.

Item 2. - Management’s Discussion and Analysis of Financial Condition and Results of Operations

Overview

We provide a medical insurance plan for cats and dogs throughout the United States, Canada and Puerto Rico. Our data-driven, vertically-integrated approach enables us to provide pet owners with what we believe is the highest value medical plan for their pets, priced specifically for each pet’s unique characteristics. Our growing and loyal member base provides us with highly predictable and recurring revenue. We operate our business similar to other subscription-based businesses, with a focus on maximizing the lifetime value of each pet while sustaining a favorable ratio of lifetime value relative to pet acquisition cost.

We operate in two business segments: subscription business and other business. We generate revenue in our subscription business segment primarily from subscription fees for our medical plan, which we market to consumers. Our medical plan automatically renews on a monthly basis and members pay the subscription fee at the beginning of each subscription period, in most cases by authorizing us to directly charge their credit card, debit card or bank account through automatic funds transfer. Subscription revenue is recognized on a pro rata basis over the monthly enrollment term. We generate revenue in our other business segment primarily from writing policies on behalf of third parties where we do not undertake the direct consumer marketing. This segment includes the writing of policies that provide different coverage and may have materially different terms and conditions than our subscription medical plan.

We generate leads for our subscription business through both third-party referrals and direct-to-consumer acquisition channels, which we then convert into members through our website and contact center. Veterinary practices represent our largest referral source. We engage a national referral network of partners, which we refer to as our Territory Partners, who are paid fees based on activity in their regions. Our Territory Partners are dedicated to cultivating direct veterinary relationships and building awareness of the benefits that our medical plan offers veterinarians and their clients. Veterinarians then educate pet owners, who visit our website or call our contact center to learn more about, and potentially enroll in, our medical plan. We also receive a significant number of new leads from existing members adding pets and referring their friends and family members. Our direct-to-consumer acquisition channels serve as important resources for pet owner education and drive new member leads and conversion. We continuously evaluate the effectiveness of our member acquisition channels and marketing initiatives based upon their return on investment, which we measure by comparing the ratio of the lifetime value of a pet generated through each specific channel or initiative to the related acquisition cost.

Our revenue increased from $42.7 million for the three months ended March 31, 2016 to $54.7 million for the three months ended March 31, 2017, representing 28% year-over-year growth. We have made and expect to continue to make substantial investments in member acquisition and in expanding our operations. For the three months ended March 31, 2017 and 2016, we had a net loss of $1.5 million and $2.6 million, respectively. As of March 31, 2017, our accumulated deficit was $82.8 million.

Key Financial and Operating Metrics

The following table sets forth our key financial and operating metrics for each of the last eight fiscal quarters.

	Three Months Ended							
	Mar. 31, 2017	Dec. 31, 2016	Sept. 30, 2016	Jun. 30, 2016	Mar. 31, 2016	Dec. 31, 2015	Sept. 30, 2015	Jun. 30, 2015
Total pets enrolled (at period end)	364,259	343,649	334,070	320,896	307,298	291,818	276,988	259,948
Total subscription pets enrolled (at period end)	334,909	323,233	312,282	299,856	287,123	272,636	258,546	241,808
Monthly average revenue per pet	$50.50	$49.17	$48.37	$47.39	$46.12	$45.48	$45.15	$45.10
Lifetime value of a pet (LVP)	$637	$631	$624	$622	$603	$591	$591	$570
Average pet acquisition cost (PAC)	$128	$133	$120	$118	$123	$132	$129	$133
Average monthly retention	98.58 %	98.60 %	98.61 %	98.64 %	98.65 %	98.64 %	98.66 %	98.67 %
Adjusted EBITDA (in thousands)	$452	$302	$304	$522	$(1,066)	$(1,588)	$(3,211)	$(3,165)

Total pets enrolled. Total pets enrolled reflects the number of pets subscribed to either our plan or one of the insurance products offered in our other business segment at the end of each period presented. We monitor total pets enrolled because it provides an indication of the growth of our consolidated business.

Total subscription pets enrolled. Total subscription pets enrolled reflects the number of pets subscribed to the plan marketed by us to consumers at the end of each period presented. We monitor total subscription pets enrolled because it provides an indication of the growth of our subscription business.

Monthly average revenue per pet. Monthly average revenue per pet is calculated as amounts billed in a given month for subscriptions divided by the total number of subscription pet months in the period. Total subscription pet months in a period represents the sum of all pets enrolled for each month during the period. We monitor monthly average revenue per pet because it is an indicator of the per pet unit economics of our business.

Lifetime value of a pet. Lifetime value of a pet (LVP) is calculated in part based on gross profit from our subscription business segment for the 12 months prior to the period end date excluding stock-based compensation expense related to cost of revenue from our subscription business segment, sign-up fee revenue and the change in deferred revenue between periods, multiplied by the implied average subscriber life in months. Implied average subscriber life in months is calculated as the quotient obtained by dividing one by one minus the average monthly retention rate. We monitor LVP to assess how much lifetime value we might expect from new pets over their implied average subscriber life in months and to evaluate the amount of sales and marketing expenses we may want to incur to attract new pet enrollments.

Average pet acquisition cost. Average pet acquisition cost (PAC) is calculated as net acquisition cost divided by the total number of new subscription pets enrolled in that period. Net acquisition cost, a non-GAAP financial measure, is calculated in a reporting period as sales and marketing expenses, excluding stock-based compensation expense, offset by sign-up fee revenue and other business segment sales and marketing expenses. We offset sales and marketing expenses with sign-up fee revenue since it is a one-time charge to new members used to partially offset initial setup costs, which are included in sales and marketing expenses. We monitor average pet acquisition cost to evaluate the efficiency of our sales and marketing programs in acquiring new members and measure effectiveness using the ratio of our lifetime value of a pet to average pet acquisition cost.

Average monthly retention. Average monthly retention is measured as the monthly retention rate of enrolled subscription pets for each applicable period averaged over the 12 months prior to the period end date. As such, our average monthly retention rate as of March 31, 2017 is an average of each month’s retention from April 1, 2016 through March 31, 2017. We calculate monthly retention as the number of pets that remain after subtracting all pets that cancel during a month, including pets that enroll and cancel within that month, divided by the total pets enrolled at the beginning of that month. We monitor average monthly retention because it provides a measure of member satisfaction and allows us to calculate the implied average subscriber life in months.

Adjusted EBITDA. Adjusted EBITDA is a non-GAAP financial measure that we define as net loss excluding stock-based compensation expense, depreciation and amortization expense, interest income, interest expense, income tax expense (benefit) and loss (income) from equity method investment. For more information about adjusted EBITDA and a reconciliation of net loss to adjusted EBITDA, see "Non-GAAP Financial Measures" below.

Non-GAAP Financial Measures

We believe that using acquisition cost, net acquisition cost and adjusted EBITDA to calculate and present certain of our other key metrics is helpful to our investors. These measures, which are non-GAAP financial measures, are not prepared in accordance with U.S. GAAP. We define acquisition cost as sales and marketing expenses, excluding stock-based compensation expense. We define net acquisition cost as acquisition cost net of sign-up fee revenue and other business segment sales and marketing expenses. We define adjusted EBITDA as net loss excluding stock-based compensation expense, depreciation and amortization expense, interest income, interest expense, income tax expense (benefit) and loss (income) from equity method investment.

Our non-GAAP financial measures may not provide information that is directly comparable to that provided by other companies in our industry as other companies in our industry may calculate or use non-GAAP financial measures differently. In addition, there are limitations in using non-GAAP financial measures because the non-GAAP financial measures are not prepared in accordance with GAAP, may be different from non-GAAP financial measures used by other companies and exclude expenses that may have a material impact on our reported financial results. Further, stock-based compensation expense and other items used in the calculation of adjusted EBITDA have been and will continue to be for the foreseeable future significant recurring expenses in our business. The presentation and utilization of non-GAAP financial measures is not meant to be considered in isolation or as a substitute for the directly comparable financial measures prepared in accordance with GAAP. We urge our investors to review the reconciliation of our non-GAAP financial measures to the most directly comparable GAAP financial measures in our consolidated financial statements that is included below, and not to rely on any single financial or operating measure to evaluate our business.

Because of varying available valuation methodologies, subjective assumptions and the variety of equity instruments that can impact a company’s non-cash expenses, we believe that providing non-GAAP financial measures such as acquisition cost, net acquisition cost and adjusted EBITDA that exclude stock-based compensation expense and loss (income) from equity method investments, allows for more meaningful comparisons between our operating results from period to period. We net sign-up fees with sales and marketing expenses in our calculation of net acquisition cost because we collect it from new members at the time of enrollment and consider it to be an offset to a portion of our sales and marketing expenses. We believe this allows us to calculate and present acquisition cost, net acquisition cost and the related financial measures we derive from them, as well as adjusted EBITDA, in a consistent manner across periods. Our non-GAAP financial measures and the related financial measures we derive from them are important tools for financial and operational decision-making and for evaluating our own operating results over different periods of time.

The following table reflects the reconciliation of acquisition cost and net acquisition cost to sales and marketing expense:

	Three Months Ended							
	Mar. 31, 2017	Dec. 31, 2016	Sept. 30, 2016	Jun. 30, 2016	Mar. 31, 2016	Dec. 31, 2015	Sept. 30, 2015	Jun. 30, 2015
	(in thousands)							
Sales and marketing expense	$4,089	$3,951	$3,892	$3,564	$3,840	$3,919	$4,128	$3,533
Excluding:								
Stock-based compensation expense	(187)	(113)	(172)	(165)	(82)	(104)	(102)	(110)
Acquisition cost	3,902	3,838	3,720	3,399	3,758	3,815	4,026	3,423
Net of:								
Sign-up fee revenue	(544)	(526)	(525)	(495)	(527)	(506)	(542)	(451)
Other business segment sales and marketing expense	(48)	(62)	(63)	(55)	(38)	(8)	(16)	(30)
Net acquisition cost	$3,310	$3,250	$3,132	$2,849	$3,193	$3,301	$3,468	$2,942

The following table reflects the reconciliation of adjusted EBITDA to net loss:

	Three Months Ended							
	Mar. 31, 2017	Dec. 31, 2016	Sept. 30, 2016	Jun. 30, 2016	Mar. 31, 2016	Dec. 31, 2015	Sept. 30, 2015	Jun. 30, 2015
	(in thousands)							
Net loss	$(1,482)	$(1,723)	$(1,637)	$(964)	$(2,572)	$(3,001)	$(4,643)	$(4,625)
Excluding:								
Stock-based compensation expense	781	731	776	743	696	653	749	897
Depreciation and amortization expense	1,036	1,229	1,093	739	785	741	672	563
Interest income	(51)	(41)	(29)	(26)	(23)	(19)	(19)	(18)
Interest expense	137	81	66	41	30	26	14	40
Income tax expense (benefit)	24	7	13	4	14	12	16	(22)
Loss (income) from equity method investment	7	18	22	(15)	4	—	—	—
Adjusted EBITDA	$452	$302	$304	$522	$(1,066)	$(1,588)	$(3,211)	$(3,165)

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Factors Affecting Our Performance

Average monthly retention. Our performance depends on our ability to continue to retain our existing and newly enrolled pets and is impacted by our ability to provide a best-in-class value and member experience. Our ability to maintain the retention rate of enrolled pets may be affected by a number of factors, including the actual and perceived value of our services and the quality of our member experience, our claims payment process and the competitive environment. In addition, if the number of new pets enrolled increases at a faster rate than our historical experience, our average monthly retention rate could be adversely impacted, as our retention rate is generally lower during the first year of member enrollment.

Investment in pet acquisition. We have made and plan to continue to make significant investments to grow our member base. Our net acquisition cost and the number of new members we enroll depends on a number of factors, including the amount we elect to invest in sales and marketing activities in any particular period in the aggregate and by channel, effectiveness of our sales execution and marketing initiatives, changes in costs of media, the mix of our sales and marketing expenditures and the competitive environment. Our average pet acquisition cost has in the past significantly varied and in the future may significantly vary from period to period based upon specific marketing initiatives and the actual or expected relationship to LVP. For example, the timing of our Territory Partner conference may increase our average pet acquisition cost in a given period (historically, during the fourth quarter of each year). We also regularly test new member acquisition channels and marketing initiatives, which may be more expensive than our traditional marketing channels and may increase our average acquisition costs. We plan to expand the number of Territory Partners and continue testing new member acquisition channels and marketing initiatives, which is likely to increase our average pet acquisition cost. We continually assess our sales and marketing activities by monitoring the ratio of LVP to PAC.

Timing of initiatives. Over time we plan to implement new initiatives to improve our member experience, make modifications to our medical plan and find other ways to maintain a strong value proposition for our members. These initiatives will sometimes be accompanied by price adjustments, in order to compensate for an increase in benefits received by our members. The implementation of such initiatives may not always coincide with the timing of price adjustments, resulting in fluctuations in revenue and gross profit in our subscription business segment.

Geographic mix of sales. The relative mix of our business between the United States and Canada impacts the monthly average revenue per pet we receive. Prices for our plan in Canada are generally higher than in the United States (in local currencies), which is consistent with the relative cost of veterinary care in each country. As our revenue has grown faster in the United States compared to Canada, this geographic shift in the mix of business has reduced the growth in our monthly average revenue per pet. In addition, as our mix of revenue changes between the United States and Canada, our exposure to foreign exchange fluctuations will be impacted.

Other business segment. Our other business segment primarily includes revenue and expenses related to policies written on behalf of third parties where we do not undertake the direct consumer marketing. This segment includes the writing of policies that provide different coverage and may have materially different terms and conditions than our subscription medical plan. Our relationships in our other business segment are generally subject to termination provisions and are non-exclusive. Accordingly, we cannot control how much business is written with us, even if a contract is not terminated. Loss of an entire program via contract termination could result in the associated policies and revenues being lost over a period of 12 to 18 months, which could have a material impact on our results of operations. We may enter into additional relationships in the future to the extent we believe they will be profitable to us, which could also impact our operating results.

Basis of Presentation

General

We operate in two business segments: subscription business and other business. Our subscription business segment includes revenue and expenses related to monthly subscriptions for our medical plan, which we market to consumers. Our other business segment includes revenue and expenses related to our other operations that are not directly marketed to consumers. We report our financial information in accordance with U.S. GAAP.

Revenue

We generate revenue in our subscription business segment primarily from subscription fees for our medical plan. Our medical plan automatically renews on a monthly basis, and members pay the subscription fee at the beginning of each subscription period, in most cases by authorizing us to directly charge their credit card, debit card or bank account through automatic funds transfer. Subscription revenue is recognized on a pro rata basis over the monthly enrollment term. Membership may be canceled at any time without penalty, and we issue a refund for the unused portion of the canceled membership.

We generate revenue in our other business segment primarily from writing policies on behalf of third parties where we do not undertake the direct consumer marketing. This segment includes the writing of policies that provide different coverage and may have materially different terms and conditions than our subscription medical plan.

Cost of Revenue

Cost of revenue in each of our segments is comprised of claims expenses and other cost of revenue.

Claims expenses

Claims expenses include claims incurred, the cost of personnel administering the claims and providing member service relating to claims, and other operating expenses directly or indirectly related to claims administration. Claims incurred are the claims approved for payment plus an accrual for claims incurred that have not yet been submitted or approved for payment. This accrual is based on our historical experience and developments in claims frequency and severity and the cost of veterinary care, and also includes the cost of administering such claims.

Other cost of revenue

Other cost of revenue for the subscription business segment includes direct and indirect member service expenses, renewal fees, credit card transaction fees and premium tax expenses. Other cost of revenue for the other business segment includes the commissions the Company pays to unaffiliated general agents, costs to administer the programs in the other business segment and premium taxes on the policies in this segment.

For both our subscription business and our other business segments, we generally expect our cost of revenue to remain relatively constant as a percentage of revenue, although there may be some periodic variability due to a number of factors including the rate of claims occurrences during such periods. Claims expenses as a percentage of our subscription business revenue may increase over the long-term as part of our strategy to return more value to our members to further enhance our member experience, retention rates and lifetime value of a pet. We currently expect that, in the long-term, such increases generally would be offset by economies of scale in our other cost of revenue.

Gross Profit

Gross profit is total revenue less cost of revenue. We expect gross profit as a percentage of revenue in our subscription segment to remain relatively consistent in the long-term, although there has been and may be in the future some periodic variability due to a number of factors, including the rate of claims occurrences during such periods and in the timing and significance of our pricing adjustments. The timing of our implementation of various initiatives to improve the experience of our members also may affect gross profit in the short-term. Further, as the mix of subscription business and other business changes and as we add or modify relationships in our other business segment, this may impact our total gross profit as a percentage of revenue.

Operating Expenses

Our operating expenses are classified into three categories: sales and marketing, technology and development, and general and administrative. For each category, the largest component is personnel costs, which include salaries, employee benefit costs, bonuses and stock-based compensation expense.

Sales and Marketing

Sales and marketing expenses primarily consist of lead generation costs; converting leads to enrolled pets; print, online and promotional advertising costs; strategic partnership fees and personnel costs and related expenses. Sales and marketing expenses are driven primarily by investments to acquire new members. We plan to continue to invest in existing and new member acquisition channels and marketing initiatives to grow our business. Investments in new member acquisition channels and marketing initiatives are generally more expensive than our traditional marketing channels and increase our average pet acquisition cost. We manage our sales and marketing expense on a per pet basis. As such, we expect sales and marketing expenses to fluctuate in absolute values and as a percentage of revenue based on how many new pets are enrolled in a period as well as the average pet acquisition cost. We base our sales and marketing spend on what we determine to be the appropriate ratio of lifetime value of a pet to average pet acquisition cost which is based on our desired return on our investments to grow our business.

Technology and Development

Technology and development expenses primarily consist of personnel costs and related expenses for our operations staff, which includes information technology development and infrastructure support, third-party services and depreciation of hardware and capitalized software and amortization of intangible assets. We expect technology and development expenses to decrease as a percentage of revenue in the near term as we continue to experience scale in our technology expenses.

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General and Administrative

General and administrative expenses consist primarily of personnel costs and related expenses for our finance, actuarial, human resources, regulatory, legal, general management functions, as well as facilities and professional services. We expect general and administrative expenses to decrease as a percentage of revenue as we continue to experience scale in our general and administrative expenses.

Results of Operations

The following tables set forth our results of operations for the periods presented both in absolute dollars and as a percentage of our revenue for those periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
	(in thousands)	
Consolidated Statement of Operations Data:		
Revenue:		
Subscription business	$50,229	$39,143
Other business	4,500	3,556
Total revenue	54,729	42,699
Cost of revenue:		
Subscription business[1]	41,246	32,203
Other business	4,328	3,192
Total cost of revenue	45,574	35,395
Gross profit:		
Subscription business	8,983	6,940
Other business	172	364
Total gross profit	9,155	7,304
Operating expenses:		
Sales and marketing[1]	4,089	3,840
Technology and development[1]	2,403	2,287
General and administrative[1]	4,012	3,722
Total operating expenses	10,504	9,849
Operating loss	(1,349)	(2,545)
Interest expense	137	30
Other income, net	(28)	(17)
Loss before income taxes	(1,458)	(2,558)
Income tax expense	24	14
Net loss	$(1,482)	$(2,572)

(1) Includes stock-based compensation expense as follows:

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
	(in thousands)	
Cost of revenue	$113	$66
Sales and marketing	187	82
Technology and development	50	55
General and administrative	431	493
Total stock-based compensation expense	$781	$696

	Three Months Ended March 31,	
	2017	2016
	(as a % of revenue)	
Revenue	100 %	100 %
Cost of revenue	83	83
Gross profit	17	17
Operating expenses:		
Sales and marketing	8	9
Technology and development	4	5
General and administrative	7	9
Total operating expenses	19	23
Operating loss	(3)	(6)
Interest expense	—	—
Other income, net	—	—
Loss before income taxes	(3)	(6)
Income tax expense	—	—
Net loss	(3)%	(6)%

	Three Months Ended March 31,			
	2017		2016	
	(as a % of subscription revenue)			
Subscription business revenue	100	%	100	%
Subscription business cost of revenue	82		82	
Subscription business gross profit	18	%	18	%

Comparison of Three Months Ended March 31, 2017 and 2016

Revenue

	Three Months Ended March 31,				%	
	2017		2016		Change	
	(in thousands, except percentages, pet and per pet data)					
Revenue:						
Subscription business	$ 50,229		$ 39,143		28	%
Other business	4,500		3,556		27	
Total revenue	$ 54,729		$ 42,699		28	
Percentage of Revenue by Segment:						
Subscription business	92	%	92	%		
Other business	8		8			
Total revenue	100	%	100	%		
Total pets enrolled (at period end)	364,259		307,298		19	
Total subscription pets enrolled (at period end)	334,909		287,123		17	
Monthly average revenue per pet	$ 50.50		$ 46.12		9	
Average monthly retention	98.58	%	98.65	%		

Three months ended March 31, 2017 compared to three months ended March 31, 2016. Total revenue increased by $12.0 million to $54.7 million for the three months ended March 31, 2017, or 28%. Revenue from our subscription business segment increased by $11.1 million to $50.2 million for the three months ended March 31, 2017, or 28%. This increase in subscription business revenue was primarily due to a 17% increase in total subscription pets enrolled as of March 31, 2017 compared to March 31, 2016, and increased average revenue per pet of 9% for the same period due to increases in pricing to cover the increased cost of veterinary care. Additionally, there was approximately $0.4 million positive impact on our Canadian revenue due to changes in foreign exchange rates when compared to the three months ended March 31, 2016. Revenue from our other business segment increased $0.9 million to $4.5 million for the three months ended March 31, 2017, or 27%, due to an increase in enrolled pets in this segment.

Cost of Revenue

	Three Months Ended March 31, 2017	2016	% Change
	(in thousands, except percentages and pet data)		
Cost of Revenue:			
Subscription business:			
Claims expenses	$36,323	$28,510	27 %
Other cost of revenue	4,923	3,693	33
Total cost of revenue	41,246	32,203	28
Gross profit	8,983	6,940	29
Other business:			
Claims expenses	2,864	2,094	37
Other cost of revenue	1,464	1,098	33
Total cost of revenue	4,328	3,192	36
Gross profit	172	364	(53)
Total pets enrolled (at period end)	364,259	307,298	19
Total subscription pets enrolled (at period end)	334,909	287,123	17
Percentage of Revenue by Segment:			
Subscription business:			
Claims expenses	72 %	73 %	
Other cost of revenue	10	9	
Total cost of revenue	82	82	
Gross profit	18	18	
Other business:			
Claims expenses	64	59	
Other cost of revenue	33	31	
Total cost of revenue	96	90	
Gross profit	4	10	

Three months ended March 31, 2017 compared to three months ended March 31, 2016. Cost of revenue for our subscription business segment was $41.2 million, or 82% of revenue, for the three months ended March 31, 2017, compared to $32.2 million, or 82% of revenue, for the three months ended March 31, 2016. This $9.0 million increase in subscription cost of revenue was primarily the result of a 17% increase in total subscription pets enrolled and an increase in the cost of veterinary care. Claims expenses were 72% of revenue for the three months ended March 31, 2017 and 73% of revenue for the three months end March 31, 2016 due to normal variation in claims expenses. Additionally, compensation expense and related costs increased by $0.9 million due to an increase in employee resources to service our growth. Cost of revenue for our other business segment increased $1.1 million to $4.3 million for the three months ended March 31, 2017, due to an increase in enrolled pets in this segment.

Sales and Marketing Expenses

	Three Months Ended March 31,		% Change
	2017	2016	
	(in thousands, except percentages, pet and per pet data)		
Sales and marketing	$4,089	$3,840	6 %
Percentage of total revenue	8 %	9 %	
Total subscription pets enrolled (at period end)	334,909	287,123	17
Average pet acquisition cost (PAC)	$128	$123	4
Lifetime value of a pet (LVP)	$637	$603	6

Three months ended March 31, 2017 compared to three months ended March 31, 2016. Sales and marketing expenses increased $0.2 million to $4.1 million for the three months ended March 31, 2017, or 6%. Expenses increased primarily due to a $0.2 million increase in compensation expense and related costs. Our LVP to PAC ratio increased from 4.9:1 to 5.0:1 for the three months ended March 31, 2017.

Technology and Development Expenses

	Three Months Ended March 31,		% Change
	2017	2016	
	(in thousands, except percentages)		
Technology and development	$2,403	$2,287	5 %
Percentage of total revenue	4 %	5 %	

Three months ended March 31, 2017 compared to three months ended March 31, 2016. Technology and development expenses increased $0.1 million to $2.4 million for the three months ended March 31, 2017, or 5%. The increase was primarily due to a $0.3 million increase in depreciation expense, driven by several projects being placed into service between the first quarter of 2016 and the first quarter of 2017. This increase was partially offset by a $0.2 million decrease in compensation expense and related costs and professional services resulting from completion of our direct pay and other initiatives.

General and Administrative Expenses

	Three Months Ended March 31,		% Change
	2017	2016	
	(in thousands, except percentages)		
General and administrative	$4,012	$3,722	8 %
Percentage of total revenue	7 %	9 %	

Three months ended March 31, 2017 compared to three months ended March 31, 2016. General and administrative expenses increased $0.3 million to $4.0 million for the three months ended March 31, 2017, or 8%. This was primarily due to an increase of $0.3 million to rent expense related to our office move during the third quarter of 2016. General and administrative expenses decreased from 9% to 7% as a percentage of revenue for the three months ended March 31, 2017, as we experienced scale in our support functions.

Other Expense, Net

	Three Months Ended March 31,	
	2017	2016
	(in thousands)	
Interest expense	$137	$30
Other income, net	(28)	(17)
Total other expense, net	$109	$13

Three months ended March 31, 2017 compared to three months ended March 31, 2016. Other expense, net increased to $0.1 million for the three months ended March 31, 2017 due to a $0.1 million increase in interest expense resulting from a higher outstanding debt balance compared to the three months ended March 31, 2016.

Liquidity and Capital Resources

Since inception, we have financed our operations and met capital requirements primarily through the sale of equity securities, from borrowings and from cash flows provided by operating activities. Our principal uses of cash are paying claims, funding operations and capital requirements, investing in new member acquisition, enhancements to our member experience and servicing debt.

Sources of Funds

As of March 31, 2017, we had $52.7 million in cash, cash equivalents and short-term investments and $20.5 million available under our line of credit which excludes $1.5 million reserved under the credit agreement for an outstanding letter of credit and other ancillary services. We believe that our existing cash, cash equivalents, short-term investments and line of credit will be sufficient to fund our operations and statutory capital requirements for at least the next 12 months. From time to time, we may explore additional financing, which could include equity, equity-linked and debt financing. However, there can be no assurance that any additional financing will be available to us on acceptable terms, or at all.

Cash and investments held by our insurance subsidiaries, American Pet Insurance Company (APIC) and Wyndham Insurance Company (SAC) Limited (WICL) Segregated Account AX, are subject to certain capital and dividend rules and regulations as applicable within the jurisdictions in which they are authorized to operate. For more information on this change, see "Liquidity and Capital Resources—Regulation."

Long-Term Debt

Pacific Western Bank Loan and Security Agreement

In December 2016, we entered into a syndicated loan agreement with Pacific Western Bank (PWB) and Western Alliance Bank (WAB), that increased our previous facility from $20.0 million to $30.0 million. This agreement was most recently amended in March 2017. We refer to the restated and amended loan and security agreement as our PWB credit facility. The PWB credit facility provides for a revolving line of credit, under which we may take advances up to $30.0 million. The maximum amount available to us under the PWB credit facility, inclusive of any amounts outstanding under the revolving line of credit, is the lesser of $30.0 million or the total amount of cash and securities held by our insurance subsidiaries (APIC and WICL), less up to $0.4 million for obligations we may have outstanding from PWB and/or WAB for other ancillary services and our $1.1 million letter of credit.

Interest on the PWB credit facility accrues at a variable annual rate equal to the greater of 4.5% or 1.25% plus the prime rate. The PWB credit facility matures in December 2019.

The PWB credit facility requires us to maintain certain financial covenants, including having APIC maintain statutory capital and surplus at all times of not less than the greater of $0.5 million or 110% of the highest amount of statutory capital and surplus required in any state in which APIC is licensed, maintaining a minimum cash balance of $0.6 million in our accounts at WAB and/or one or more WAB affiliates, maintaining all of our depository and operating accounts at PWB and/or WAB, achieving certain quarterly revenue levels and remaining within certain monthly maximum EBITDA loss levels. EBITDA is defined for such purposes as earnings, plus an amount equal to the sum of (i) tax, plus (ii) depreciation and amortization, plus (iii) interest and non-cash expenses, plus (iv) any non-cash stock-based compensation expense, plus (v) loss from equity method investments, and minus gain from equity method investments.

The PWB credit facility also requires us to maintain certain non-financial covenants, including those that restrict our ability to dispose of our assets, change the name, location, office or executive management of our business, merge with or acquire other entities, incur other indebtedness, incur encumbrances, pay dividends or make distributions to holders of our capital stock, make investments, engage in transactions with our affiliates, permit withdrawals from APIC (with certain exceptions) and conduct operations in certain of our Canadian subsidiaries.

As of March 31, 2017, we were in compliance with each of the financial and non-financial covenants.

Our obligations under the PWB credit facility are secured by substantially all of our assets and a pledge of certain of our subsidiaries' stock. As of March 31, 2017, we had $5.0 million aggregate borrowings outstanding under the PWB credit facility.

Regulation

As of March 31, 2017, our insurance entities, APIC and WICL Segregated Account AX, held $30.8 million in short-term investments and $15.1 million in other current assets, including $2.5 million held in cash and cash equivalents to be used for operating expenses of our insurance subsidiaries. Most of the assets in APIC and WICL Segregated Account AX are subject to certain capital and dividend rules and regulations prescribed by jurisdictions in which they are authorized to operate. As of March 31, 2017, total assets and liabilities held outside of our insurance entities totaled $39.2 million and $14.0 million, respectively, including $16.4 million of cash and cash equivalents that are segregated from other operating funds and held in trust for the payment of claims on behalf of our insurance subsidiaries.

To comply with the regulations and contractual obligations of APIC and WICL Segregated Account AX, we may be required to maintain capital that we would otherwise invest in our growth and operations, which may require us to modify our operating plan or marketing initiatives, delay the implementation of new solutions or development of new technologies, decrease the rate at which we hire additional personnel and enter into relationships with Territory Partners, incur indebtedness or pursue equity or debt financings or otherwise modify our business operations.

APIC

The majority of our investments are held by our insurance entities to satisfy risk-based capital requirements of the National Association of Insurance Commissioners (NAIC). The NAIC requirements provide a method for analyzing the minimum amount of risk-based capital (statutory capital and surplus plus other adjustments) appropriate for an insurance company to support its overall business operations, taking into account the risk characteristics of the company's assets, liabilities and certain other items. An insurance company found to have insufficient statutory capital based on its risk-based capital ratio may be subject to varying levels of additional regulatory oversight depending on the level of capital inadequacy. APIC must hold certain capital amounts in order to comply with the statutory regulations and, therefore, we cannot use these amounts for general operating purposes without regulatory approval. As our business grows, the amount of capital we are required to maintain to satisfy our risk-based capital requirements may increase significantly. As of December 31, 2016, APIC was required to maintain at least $25.8 million of risk-based capital to avoid this additional regulatory oversight. As of that date, APIC maintained $30.5 million of risk-based capital. The New York Department of Financial Services may increase the required levels of risk-based capital in the future, and we anticipate that we will need to maintain greater amounts of risk-based capital if our pet enrollment continues to grow.

New York laws also restrict the ability of APIC to pay dividends to our parent holding company. The dividend restrictions are based in part on the prior year's statutory income and surplus. In general, dividends up to specified levels are considered ordinary and may be paid without prior approval. In general, dividends or distributions that, in the aggregate in any 12-month period exceed the lesser of (i) 10% of surplus as of the preceding December 31 or (ii) the insurer's adjusted net investment income for such 12-month period ended the preceding December 31, not including realized capital gains, are subject to approval by regulatory authorities. As of December 31, 2016, less than $0.1 million was able to be paid in the form of a dividend from APIC to our parent holding company without prior approval from regulatory authorities.

WICL Segregated Account AX

WICL Segregated Account AX was established by WICL, with Trupanion, Inc. as the shareholder, to enter into a reinsurance agreement with Omega General Insurance Company. All of the assets and liabilities of WICL Segregated

Account AX are legally segregated from other assets and liabilities within WICL, and all shares of the segregated account are owned by Trupanion, Inc. During January 2017, our parent entity received a dividend of $2.7 million from WICL Segregated Account AX as allowed under our agreements with WICL. As required by the Office of the Superintendent of Financial Institutions regulations related to our reinsurance agreement with Omega General Insurance Company, we are required to maintain a Canadian Trust account with the greater of CAD $2.0 million or 115% of unearned Canadian premium plus 15% of outstanding Canadian claims, including all incurred but not reported claims.

Though we are not directly regulated by the Bermuda Monetary Authority (BMA), WICL's regulation and compliance impacts us as it could have an adverse impact on the ability of WICL Segregated Account AX to pay dividends. WICL is regulated by the BMA under the Insurance Act of 1978 (Insurance Act) and the Segregated Accounts Company Act of 2000. The Insurance Act imposes on Bermuda insurance companies, solvency and liquidity standards, certain restrictions on the declaration and payment of dividends and distributions, certain restrictions on the reduction of statutory capital, and auditing and reporting requirements, and grants the BMA powers to supervise and, in certain circumstances, to investigate and intervene in the affairs of insurance companies. Under the Insurance Act, WICL, as a class 3 insurer, is required to maintain available statutory capital and surplus at a level equal to or in excess of a prescribed minimum established by reference to net written premiums and loss reserves.

Under the Bermuda Companies Act 1981, as amended, a Bermuda company may not declare or pay a dividend or make a distribution out of contributed surplus if there are reasonable grounds for believing that: (a) the company is, or would after the payment be, unable to pay its liabilities as they become due; or (b) the realizable value of the company's assets would thereby be less than its liabilities. The Segregated Accounts Company Act of 2000 further requires that dividends out of a segregated account can only be paid to the extent that the cell remains solvent and the value of its assets remain greater than the aggregate of its liabilities and its issued share capital and share premium accounts.

Investments

As of March 31, 2017, we had $33.4 million of short-term and long-term investments in our insurance entities. These investments are held to satisfy statutory requirements and support operating needs. The majority of our investments are highly rated U.S. treasury securities, certificates of deposit, and U.S. government funds. In addition, we have one investment in a municipal bond that is insured by a third-party insurance company with a rating of "A2" with Moody's.

Historical Cash Flow Trends

The following table shows a summary of our cash flows for the periods indicated (in thousands):

	Three Months Ended March 31,	
	2017	2016
Net cash provided by (used in) operating activities	$1,857	$(1,298)
Net cash used in investing activities	(4,473)	(946)
Net cash provided by financing activities	895	1,473
Effect of foreign exchange rates on cash	21	341
Net change in cash, cash equivalents and restricted cash	$(1,700)	$(430)

Operating Cash Flows

We derive operating cash flows from cash collected from the sale of subscriptions to our medical plan, which is used to pay claims and other cost of revenue. Additionally, cash is used to support the growth of our business by reinvesting to acquire new pets and projects to improve member experience.

Net cash provided by operating activities for the three months ended March 31, 2017 consisted of our net loss of $1.5 million reduced by non-cash expenses, including stock-based compensation expense of $0.8 million and depreciation and amortization of $1.0 million and a $1.4 million change in operating assets and liabilities. The change in cash provided by (used in) operating activities compared to the three months ended March 31, 2016 was primarily related to higher revenue and decreased operating expenses as a percentage of revenue as we experienced efficiencies in our Claims and Customer Service departments and scale in our Technology and Development and General and Administrative departments.

Investing Cash Flows

Net cash used in investing activities for the three months ended March 31, 2017 was primarily related to $2.7 million in funding of notes receivable and $1.3 million of net purchases of investments to increase our statutory capital as we increase enrollments. In addition, purchases of property and equipment totaled $0.5 million, primarily related to internally developed software projects.

Financing Cash Flows

For the three months ended March 31, 2017, net cash provided by financing activities primarily consisted of proceeds from the exercise of stock options of $1.0 million, partially offset by $0.1 million of payments on capital lease obligations.

Contractual Obligations

We enter into long-term contractual obligations and commitments in the normal course of business, primarily debt obligations and non-cancellable operating leases. Management believes there have been no material changes to our contractual obligation disclosure during the three months ended March 31, 2017, compared to those discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

Critical Accounting Policies and Significant Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosure of contingent assets and liabilities, revenue and expenses at the date of the financial statements. Generally, we base our estimates on historical experience and on various other assumptions in accordance with GAAP that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

There have been no material changes to our critical accounting policies and estimates as compared to the critical accounting policies and estimates described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

Item 3. Quantitative and Qualitative Disclosures About Market Risks

Management believes there have been no material changes to our quantitative and qualitative disclosures about market risks during the three months ended March 31, 2017, compared to those discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a- 15(e) and 15d- 15(e) under the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of such date, our disclosure controls and procedures were effective.

Changes in Internal Control

There were no changes in our internal control over financial reporting identified in management's evaluation pursuant to Rules 13a-15(d) or 15d-15(d) of the Exchange Act during the period covered by this Quarterly Report on Form 10-Q that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply judgment in evaluating the benefits of possible controls and procedures relative to their costs.

PART II - OTHER INFORMATION
Item 1. Legal Proceedings
The outcome of our legal proceedings are inherently unpredictable, subject to significant uncertainties, and could be material to our operating results for a particular period. We make a provision for a liability relating to legal matters when it is both probable that a material liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, estimated settlements, legal rulings, advice of legal counsel and other information and events pertaining to a particular matter.
From time to time we may be subject to various legal proceedings and claims in the ordinary course of business activities, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights; employment claims; and general contract or other claims. We may, from time to time, also be subject to various other legal or government claims, disputes or investigations.
Item 1A. Risk Factors
Investing in our common stock involves a high degree of risk. You should carefully consider the risks and uncertainties described below, together with all of the other information in this report, including our consolidated financial statements and related notes, as well as in our other filings with the SEC, in evaluating our business and before investing in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that are not expressly stated, that we are unaware of, or that we currently believe are not material, may also become important factors that affect us. If any of the following risks occur, our business, operating results, financial condition and prospects could be materially harmed. In that event, the price of our common stock could decline, and you could lose part or all of your investment.
Risks Related to Our Business and Industry
We have incurred significant net losses since our inception and may not be able to achieve or maintain profitability in the future.
We have incurred significant net losses since our inception. We had a net loss of $1.5 million for the three months ended March 31, 2017. Additionally, as of March 31, 2017, our accumulated deficit was $82.8 million. We have funded our operations through equity financings, borrowings under a revolving line of credit and term loans and, more recently, positive cash flows from operations. We may not be able to achieve or maintain profitability in the near future or at all. Our recent growth, including our growth in revenue and membership, may not be sustainable or may decrease, and we may not generate sufficient revenue to achieve or maintain profitability. Additionally, our expense levels are based, in significant part, on our estimates of future revenue and many of these expenses are fixed in the short term. As a result, we may be unable to adjust our spending in a timely manner if our revenue falls short of our expectations. Accordingly, any significant shortfall of revenue in relation to our estimates could have an immediate negative effect on our financial results.
We have made and plan to continue to make significant investments to grow our member base. Our average pet acquisition cost and the number of new pets we enroll depends on a number of factors, including the effectiveness of our sales execution and marketing initiatives, changes in costs of media, the mix of our sales and marketing expenditures and the competitive environment. Our average pet acquisition cost has in the past significantly varied and in the future may significantly vary period to period based upon specific marketing initiatives. We also regularly test new member acquisition channels and marketing initiatives, which often are more expensive than our traditional marketing channels and generally increase our average acquisition costs. We plan to expand the number of Territory Partners we use to reach veterinarians and other referral sources and to engage in other marketing activities, including direct to consumer advertising, which are likely to increase our acquisition costs.
We expect to continue to make significant expenditures to maintain and expand our business including expenditures relating to the acquisition of new members, retention of our existing members and development and implementation of our technology platforms. These increased expenditures will make it more difficult for us to achieve and maintain future profitability. Our ability to achieve and maintain profitability depends on a number of factors, including our ability to attract and service members on a profitable basis. If we are unable to achieve or maintain profitability, we may not be able to execute our business plan, our prospects may be harmed and our stock price could be materially

and adversely affected.

We base our decisions regarding our member acquisition expenditures primarily on the projected lifetime value of the pets that we expect to acquire. Our estimates and assumptions may not accurately reflect our future results, we may overspend on member acquisition, and we may not be able to recover our member acquisition costs or generate profits from these investments.

We invest significantly in member acquisition. We spent $4.1 million on sales and marketing to acquire new members for the three months ended March 31, 2017. We expect to continue to spend significant amounts to acquire additional members. We utilize Territory Partners, who are paid fees based on activity in their regions, to communicate the benefits of our medical plan to veterinarians through in-person visits. Veterinarians then educate pet owners, who visit our website or call our contact center to learn more about, and potentially enroll in, our medical plan. We also invest in other third-party referrals and direct to consumer member acquisition channels, though we have limited experience with some of them.

We base our decisions regarding our member acquisition expenditures primarily on the lifetime value of the pets that we project to acquire. This analysis depends substantially on estimates and assumptions based on our historical experience with pets enrolled in earlier periods, including our key financial and operating metrics described in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Key Financial and Operating Metrics."

If our estimates and assumptions regarding the lifetime value of the pets that we project to acquire and our related decisions regarding investments in member acquisition prove incorrect, or if the expected lifetime value of the pets that we project to acquire differs significantly from that of pets acquired in prior periods, we may be unable to recover our member acquisition costs or generate profits from our investment in acquiring new members. Moreover, if our member acquisition costs increase or we invest in member acquisition channels that do not ultimately result in any or an adequate number of new member enrollments, the return on our investment may be lower than we anticipate irrespective of the lifetime value of the pets that we project to acquire as a result of the new members. If we cannot generate profits from this investment, we may need to alter our growth strategy, and our growth rate and operating results may be adversely affected.

If we are unable to maintain high member retention rates, our growth prospects and revenue will be adversely affected.

We have historically experienced high average monthly retention rates. For example, our average monthly retention rate from 2010 through 2016 was 98.5%. If our efforts to satisfy our existing members are not successful or if new marketing initiatives result in enrolling more pets that inherently have a lower retention rate, we may not be able to maintain our retention rates. Members we obtain through aggressive promotions or other channels that involve relatively less meaningful contact between us and the member may be more likely to terminate their medical plan subscription. In the past, we have experienced reduced retention rates during periods of rapid member growth, as our retention rate generally has been lower during the first year of member enrollment. Members may choose to terminate their medical plan subscription for a variety of reasons, including increased subscription fees, perceived or actual lack of value, delays or other unsatisfactory experiences in claims administration, unsatisfactory member service, an economic downturn, loss of a pet, a more attractive offer from a competitor, changes in our medical plan or other reasons, including reasons that are outside of our control. When a member terminates his or her medical plan subscription, we no longer receive the related revenue and may not be able to recover the member acquisition cost or other expenses, including claims expenses, related to that member. Our cost of acquiring a new member is substantially greater than the cost involved in maintaining our relationship with an existing member. If we are not able to successfully retain existing members and limit medical plan subscription terminations, our revenue and operating margins will be adversely impacted and our business, operating results and financial condition would be harmed.

The prices of our medical plan subscriptions are based on assumptions and estimates and may be subject to regulatory approvals. If our actual experience differs from the assumptions and estimates used in pricing our medical plan subscriptions or if we are unable to obtain any necessary regulatory pricing approvals we need, at all or in a timely manner, our revenue and financial condition could be adversely affected.

The pricing of our medical plan subscriptions reflect expected claim payment patterns derived from assumptions that we make regarding a number of factors, including a pet's species, breed, age, gender and location. Factors related to pet location include the current and assumed changes in the cost and availability of veterinary technology and treatments and local veterinary practice preferences. The prices of our medical plan subscriptions also include assumptions and estimates regarding our own operating costs and expenses. We monitor and manage our pricing and overall sales mix to achieve target returns. Profitability from new members emerges over a period of years depending on the nature and length of time a pet is enrolled in our medical plan, and is subject to variability as actual results may differ from pricing assumptions. If the subscription fees we collect are insufficient to cover actual claim costs, operating costs and expenses within anticipated pricing allowances, or if our member retention rates are not high enough to ensure recovery of member acquisition costs, then our gross profit could be adversely affected, and our revenue may be insufficient to achieve profitability. Conversely, if our pricing assumptions differed from actual results such that we overpriced risks, our competitiveness and growth prospects could be adversely affected. Further, even if our pricing assumptions are accurate, we may not be able to obtain the necessary regulatory approvals for any pricing changes that we may determine are appropriate based on our pricing assumptions, which could prevent us from obtaining sufficient revenue from medical plan subscriptions to cover claims expenses, pet acquisition costs and other expenses in any such jurisdiction unless and until such regulatory approvals are obtained in appropriate amounts.

The anticipated benefits of our analytics platform may not be fully realized.

Our analytics platform draws upon our proprietary pet data to price our medical plan subscriptions. The assumptions we make about breeds and other factors in pricing medical plan subscriptions may prove to be inaccurate and, accordingly, these pricing analytics may not accurately reflect the claims expense that we will ultimately incur. Furthermore, if any of our competitors developed similar or better data systems, adopted similar or better underwriting criteria and pricing models or received our data, our competitive advantage could decline or be lost.

Our actual claims expenses may exceed our current reserve established for claims and may adversely affect our operating results and financial condition.

As of March 31, 2017, our claims reserve was $10.6 million. As of December 31, 2016, claims exceeded our claims reserve for prior years and this may happen again in the future. Our recorded claims reserve is based on our best estimates of claims, both reported and incurred but not reported, after considering known facts and interpretations of circumstances and the estimated cost to adjudicate those claims. We consider internal factors, including data from our proprietary data analytics platform, experience with similar cases, actual claims paid, historical trends involving claim payment patterns, patterns of claims being received, seasonality patterns, pending levels of unpaid claims, claims management programs and contractual terms. We may also consider external factors, including changes in the law, court decisions, changes to regulatory requirements and economic conditions. Because reserves are estimates of the unpaid portion of claims that have occurred, including claims incurred but not reported, the establishment of appropriate reserves is an inherently uncertain and complex process that involves significant subjective judgment. Further, we do not transfer or cede our risk as an insurer and, therefore, we maintain more risk than we would if we purchased reinsurance. The ultimate cost of claims and claims administration may vary materially from recorded reserves, and such variance may result in adjustments to the claims reserve, which could have a material effect on our operating results.

We rely significantly on Territory Partners, veterinarians and other third parties to recommend our medical plan.

We rely significantly on Territory Partners and other third parties to cultivate direct veterinary relationships and build awareness of the benefits that our medical plan offers veterinarians and their clients. In turn, we rely on veterinarians to introduce and refer our medical plan to their clients. We also rely significantly on other third parties, such as existing members, online and offline businesses, animal shelters, breeders and veterinary affiliates, including veterinarian purchasing groups and associations, to help generate leads for our medical plan subscriptions. Veterinary practices represent our largest member acquisition channel, accounting for over 50% of our enrollments and approximately 70% of our enrollments excluding existing members adding pets and referring their friends and family in the three months ended March 31, 2017.

Many factors influence the success of our relationships with these referral sources, including:

- the continued positive market presence, reputation and growth of our company and of the referral sources;
- the effectiveness of referral sources;
- the decision of any such referral source to support one or more of our competitors;
- the interest of the referral sources' customers or clients in the medical plan we offer;

- the relationship and level of trust between Territory Partners and veterinarians, and between us and the referral source;
- the percentage of the referral sources' customers or clients that submit applications or use trial certificates to enroll in a medical plan through our website or contact center;
- our ability to implement or maintain any marketing programs, including trial certificates, in any jurisdiction; and
- our ability to work with the referral source to implement any changes in our marketing initiatives, including website changes, infrastructure and technology and other programs and initiatives necessary to generate positive consumer experiences.

In order for us to implement our business strategy and grow our revenue, we must effectively maintain and increase the number and quality of our relationships with Territory Partners, veterinarians and other referral sources, and continue to scale and improve our processes, programs and procedures that support them. Those processes, programs and procedures could become increasingly complex and difficult to manage. We expend significant time and resources attracting qualified Territory Partners and providing them with complete and current information about our business. Their relationship with us may be terminated at any time, and, if terminated, we may not recoup the costs associated with educating them about our medical plan or be able to maintain any relationships they may have developed with veterinarians within their territories. Further, if we experience an increase in the rate at which Territory Partner relationships are terminated, we may not develop or maintain relationships with veterinarians as quickly as we have in the past. If the financial cost to maintain our relationships with Territory Partners outweighs the benefits provided by Territory Partners, or if they feel unsupported or undervalued by us and terminate their relationship with us, our growth and financial performance could be adversely affected.

The success of our relationships with veterinary practices depends on the overall value our medical plan can provide to veterinarians. If the scope of our medical plan coverage is perceived to be inadequate or our claims settlement process is unsatisfactory to the veterinarians' clients because, for example, our coverage is insufficient, member requests for reimbursement are denied or we fail to timely settle and pay veterinary invoices, veterinarians may be unwilling to recommend our medical plan to their clients and they may encourage their existing clients who have subscribed to our medical plan to stop subscribing to our medical plan or to purchase a competing product. If veterinarians determine our medical plan is unreliable, cumbersome or otherwise does not provide sufficient value, they may terminate their relationship with us or begin recommending a competing product, which could negatively impact our ability to increase our member base and grow our business.

If we fail to establish or are unable to maintain successful relationships with Territory Partners, veterinarians and other referral sources, or experience an increase in the rate at which any of these relationships are terminated, it could negatively impact our ability to increase and retain our member base and our financial results. If we are unable to maintain our existing member acquisition channels and/or continue to add new member acquisition channels, if the cost of our existing sources increases or does not scale as we anticipate, or if we are unable to continue to use any existing channels or programs in any jurisdiction, including our trial certificate program, our member levels and sales and marketing expenses may be adversely affected.

Territory Partners are independent contractors and, as such, may pose additional risks to our business.

Territory Partners are independent contractors and, accordingly, we do not directly provide the same direction, motivation and oversight over Territory Partners as we otherwise could if Territory Partners were our own employees. Territory Partners may decide not to participate in our marketing initiatives or training opportunities, accept our introduction of new solutions or comply with our policies and procedures applicable to the Territory Partners, any of which may adversely affect our ability to develop relationships with veterinarians and grow our membership. Our sole recourse against Territory Partners who fail to perform is to terminate their contract, which could also trigger contractually obligated termination payments or result in disputes, including threatened or actual legal or regulatory proceedings. In addition, termination of these contracts may trigger termination penalties that obligate us to pay significantly more than the amounts that otherwise would have been paid to the terminated Territory Partner.

We believe that Territory Partners are not and should not be classified as employees under existing interpretations of the applicable laws of the jurisdictions in which we operate. We do not pay or withhold any employment tax with respect to or on behalf of Territory Partners or extend any benefits to them that we generally extend to our employees, and we otherwise treat Territory Partners as independent contractors. Applicable authorities or the Territory Partners have in the past questioned and may in the future challenge this classification. Further, the applicable laws or regulations, including tax laws or interpretations, may change. If it were determined that we had misclassified any of our Territory Partners, we may be subjected to penalties and/or be required to pay withholding taxes, extend employee benefits, provide compensation for unpaid overtime, or otherwise incur substantially greater expenses with respect to Territory Partners.

Any of the foregoing circumstances could have a material adverse impact on our operating results and financial condition.

Our member base has grown rapidly in recent periods, and we may not be able to maintain the same rate of membership growth.

Our ability to grow our business and to generate revenue depends significantly on attracting new members. For the three months ended March 31, 2017, we generated 92% of our revenue from medical plan subscriptions. In order to continue to increase our membership, we must continue to offer a medical plan that provides superior value to our members. Our ability to continue to grow our membership will also depend in part on the effectiveness of our sales and marketing programs. Our member base may not continue to grow or may decline as a result of increased competition or the maturation of our business.

We may not maintain our current rate of revenue growth.

Our revenue has increased quickly and substantially in recent periods. We believe that our continued revenue growth will depend on, among other factors, our ability to:

- improve our market penetration through efficient and effective sales and marketing programs to attract new members;
- maintain high retention rates;
- increase the lifetime value per pet to, in turn, enable us to spend more on sales and marketing programs;
- maintain positive relationships with veterinarians and other referral sources, and convince them to recommend our medical plan;
- maintain positive relationships with and increase the number and efficiency of Territory Partners;
- continue to offer a superior value medical plan with competitive features and rates;
- accurately price our medical plan subscriptions in relation to actual membership claims costs and operating expenses and achieve required regulatory approval for pricing changes;
- provide our members with superior member service, including a timely and efficient claims experience and by recruiting, integrating and retaining skilled and experienced claims personnel who can appropriately and efficiently adjudicate member claims;
- generate new and maintain existing relationships and programs in our other business segment;
- recruit, integrate and retain skilled, qualified and experienced sales department professionals who can demonstrate our value proposition to new and existing members;
- react to changes in technology and challenges in the industry, including from existing and new competitors;
- increase awareness of and positive associations with our brand; and
- successfully respond to any regulatory matters and defend any litigation.

You should not rely on our historical rate of revenue growth as an indication of our future performance.

Our use of capital may be constrained by risk-based capital regulations or contractual obligations.

Our subsidiary, American Pet Insurance Company, is subject to risk-based capital regulations that require us to maintain certain levels of surplus to support our overall business operations in consideration of our size and risk profile. We have in the past and may in the future fail to maintain the amount of risk-based capital required to avoid additional regulatory oversight, which was $25.8 million as of December 31, 2016. To comply with these regulations and our related contractual obligations, we may be required to maintain capital that we would otherwise invest in our growth and operations, which may require us to modify our operating plan or marketing initiatives, delay the implementation of new solutions or development of new technologies, decrease the rate at which we hire additional personnel and enter into relationships with Territory Partners, incur indebtedness or pursue equity or debt financings or otherwise modify our business operations, any of which could have a material adverse effect on our operating results and financial condition.

We are also subject to a contractual obligation related to the Company’s reinsurance agreement with Omega General Insurance Company (Omega). Under this agreement, the Company is required to fund a Canadian Trust account in accordance with Canadian regulations. As of December 31, 2016, the account held CAD $2.1 million.

Unexpected increases in the severity or frequency of claims may negatively impact our operating results.
Unexpected changes in the severity or frequency of claims may negatively impact our operating results. Changes in claims severity are driven primarily by inflation in the cost of veterinary care and the increasing availability and usage of expensive, technologically advanced medical treatments. Increases in claims severity also could arise from unexpected events that are inherently difficult to predict, such as a pandemic that spreads through the pet population, tainted pet food or supplies or an unusually high number of serious injuries or illnesses. We may experience volatility in claim frequency from time to time, and short-term trends may not continue over the longer term. The frequency of claims may be affected by the level of care and attentiveness an owner provides to the pet, the pet's breed and age and other factors outside of our control, as well as fluctuations in member retention rates and by new member initiatives that encourage more frequent claims and other new member acquisition activities. A significant increase in claim severity or frequency could increase our cost of revenue and have a material adverse effect on our financial condition.
Changes in the Canadian currency exchange rate may adversely affect our revenue and operating results.
We offer our medical plan in Canada, which exposes us to the risk of changes in the Canadian currency exchange rates. For the three months ended March 31, 2017, approximately 19.4% of our total revenue was generated in Canada. Fluctuations in the relative strength of the Canadian economy and the Canadian dollar has in the past and could in the future adversely affect our revenue and operating results.
Our success depends on our ability to adjust member claims timely and accurately.
We must accurately evaluate and timely pay member claims in a manner that gives our members high satisfaction. Many factors can affect our ability to pay member claims accurately, and in a timely manner that gives our members high satisfaction, including the training, experience and skill of our personnel, our ability to reduce the number of claims requests made for non-covered conditions and ineligible invoice items, the department's culture and the effectiveness of its management, our ability to develop or select and implement appropriate procedures, technologies and systems to support our member claims functions and changes in our policy coverage. Our failure to pay claim requests fairly, accurately and in a timely manner, or to deploy resources appropriately, could result in unanticipated costs to us, lead to material litigation, undermine member goodwill and our reputation, and impair our brand image and, as a result, materially and adversely affect our competitiveness, financial results, prospects and liquidity.
We may not identify fraudulent or improperly inflated claim submissions.
It is possible that a member, or a third-party actually or purportedly on behalf of the member, could submit an invoice which we would then pay that appears authentic but in fact does not reflect services provided or products purchased for which the member paid. It is also possible that veterinarians will charge insured customers higher amounts than they would charge their non-insured clients for the same service or product. Such activity could lead to unanticipated claims costs to us and/or to time and expense to recover such costs. They could also lead to strained relationships with veterinarians and/or members, and could adversely affect our competitiveness, financial results and liquidity.
We are and will continue to be faced with many competitive challenges, any of which could adversely affect our prospects, operating results and financial condition.
We compete with pet owners that self-finance unexpected veterinary invoices with savings or credit, as well as traditional "pet insurance" providers and relatively new entrants into our market. The vast majority of pet owners in the United States and Canada do not currently have medical coverage for their pets. We are focused primarily on expanding the overall size of the market, and we view our primary competitive challenge as educating pet owners on why our medical plan is a better alternative to self-financing.
Additionally, there are traditional insurance companies that provide pet insurance products, either as a stand-alone product or along with a broad range of other insurance products. The largest of these traditional "pet insurance" providers is Nationwide Pet (formerly Veterinary Pet Insurance Company), a division of Nationwide Insurance. They have historically offered a number of traditional policy options and are now offering an additional product that may appear similar to ours. In addition, new entrants backed by large insurance companies have attempted to enter the pet insurance market in the past and may do so again in the future. Further, traditional "pet insurance" providers may consolidate or take other actions to mimic the efficiencies from our vertically-integrated structure or create other operational efficiencies, which could lead to increased competition.

Some of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, technical, marketing and other resources than we do. Some of our competitors may be able to undertake more extensive marketing initiatives for their brands and services, devote more resources to website and systems development and make more attractive offers to potential employees, referral sources and third-party service providers.

To compete effectively, we will need to continue to invest significant resources in sales and marketing, in improving the service at our contact center and claims department, in the online experience and functionalities of our website and in other technologies and infrastructure. Failure to compete effectively against our current or future competitors could result in loss of current or potential members, medical plan subscription terminations or a reduction in member retention rates, which could adversely affect our pricing, lower our revenue and prevent us from achieving or maintaining profitability. We may not be able to compete effectively for members in the future against existing or new competitors, and the failure to do so could result in loss of existing or potential members, increased sales and marketing expenses or diminished brand strength, any of which could harm our business.

If we are not successful in cost-effectively converting visitors to our website and contact center into members, our business and operating results would be harmed.

Our growth depends in large part upon growth in our member base. We seek to convert consumers who visit our website and call our contact center into members. The rate at which consumers visiting our website and contact center seeking to enroll in our medical plan are converted into members is a significant factor in the growth of our member base. A number of factors have influenced, and could in the future influence, the conversion rates for any given period, some of which are outside of our control. These factors include:

- the competitiveness of the medical plan we offer, including its perceived value, coverage, simplicity and fairness;
- changes in consumer shopping behaviors due to circumstances outside of our control, such as economic conditions and consumers' ability or willingness to pay for a pet medical plan;
- the quality of and changes to the consumer experience, including on our website or with our contact center or claims department;
- regulatory requirements, including those that make the experience on our website cumbersome or difficult to navigate or that hinder our call center or claims department's ability to speak with potential members quickly and in a way that is conducive to converting leads, enrolling new pets, and/or resolving member concerns;
- system failures or interruptions in the operation of our abilities to write policies or operate our website or contact center; and
- changes in the mix of consumers who are referred to us through various member acquisition channels, such as veterinary referrals, existing members adding a pet and referring their friends and family members and other third-party referrals and direct-to-consumer acquisition channels.

Our ability to convert consumers into members can be impacted by a change in the mix of referrals received through our member acquisition channels. In addition, changes to our website or contact center, or other programs or initiatives we undertake, may adversely impact our ability to convert consumers into members at our current rate, or at all. These changes may have the unintended consequence of adversely impacting our conversion rates. A decline in the percentage of members who enroll in our medical plan on our website or telephonically through our contact center also could result in increased member acquisition costs. To the extent the rate at which we convert consumers into members suffers, the growth rate of our member base may decline, which would harm our business, operating results and financial condition.

We have made and plan to continue to make substantial investments in features and functionality for our website and training and staffing for our contact center that are designed to generate traffic, increase member engagement and improve new and existing member service. These activities do not directly generate revenue, however, and we may never realize any benefit from these investments. If the expenses that we incur in connection with these activities do not result in sufficient growth in members to offset the cost, our business, operating results and financial condition will be adversely affected.

If we are unable to maintain and enhance our brand recognition and reputation, our business and operating results will be harmed.

We believe that maintaining and enhancing our brand recognition and reputation is critical to our relationships with existing members, Territory Partners, veterinarians and other referral sources, and to our ability to attract new members, new Territory Partners, additional supportive veterinarians and other referral sources. We also believe that the importance of our brand recognition and reputation will continue to increase as competition in our market continues to develop and mature. Our success in this area will depend on a wide range of factors, some of which are out of our control, including the following:

- the efficacy and viability of our sales and marketing programs;
- the perceived value of our medical plan;
- quality of service provided by our contact center and claims professionals, including the fairness, ease and timeliness of our claims administration process;
- actions of our competitors, Territory Partners, veterinarians and other referral sources;

- positive or negative publicity, including regulatory pronouncements and material on the Internet or social media;
- regulatory and other government-related developments; and
- litigation-related developments.

The promotion of our brand may require us to make substantial investments, and we anticipate that, as our market becomes increasingly competitive, these branding initiatives may become increasingly difficult and expensive. Our brand promotion activities may not be successful or yield increased revenue, and to the extent that these activities result in increased revenue, the increased revenue may not offset the expenses we incur and our operating results could be harmed. If we do not successfully maintain and enhance our brand, our business may not grow and our relationships with veterinarians and other referral sources could be terminated, which would harm our business, operating results and financial condition.

Furthermore, negative publicity, whether or not justified, relating to events or activities attributed to us, our employees, our strategic partners, our affiliates, or others associated with any of these parties, may tarnish our reputation and reduce the value of our brands. Damage to our reputation and loss of brand equity may reduce demand for our services and have an adverse effect on our business, operating results, and financial condition. Moreover, any attempts to rebuild our reputation and restore the value of our brands may be costly and time consuming, and such efforts may not ultimately be successful.

Our business depends on our ability to maintain and scale the infrastructure necessary to operate our technology platform and could be adversely affected by a system failure.

Our business depends on our ability to maintain and scale the infrastructure necessary to operate our technology platform, which includes our analytics and pricing engine, claims management systems, customer relationship management system, contact center phone system and website. We use these technology frameworks to price our medical plan subscriptions, enroll members, engage with current members and administer member claims under our medical plan. Additionally, our members review and purchase subscriptions to our medical plan and submit reimbursement requests through our website and contact center. Our reputation and ability to acquire, retain and serve our members depends on the reliable performance of our technology platform and the underlying network systems and infrastructure, and on providing best-in-class member service, including through our contact center and website. As our member base continues to grow, the amount of information collected and stored on the systems and infrastructure supporting our technology platform will continue to grow, and we expect to require an increasing amount of network capacity, computing power and information technology personnel to develop and maintain our technology platform and service our departments involved in member interaction.

We have made, and expect to continue to make, substantial investments in equipment and related network infrastructure to handle the operational demands on our technology platform, including increasing data collection, software development, traffic on our website and the volume of calls at our contact center. The operation of the systems and infrastructure supporting our technology platform is expensive and complex and could experience operational failures. In the event that our data collection, member base or amount of traffic on these systems grows more quickly than anticipated, we may be required to incur significant additional costs to increase the capacity in our systems. Any system failure that causes an interruption in or decreases the responsiveness of our services could impair our revenue-generating capabilities, harm our business and operating results and damage our reputation. In addition, any loss or mishandling of data could result in breach of confidence, competitive disadvantage or loss of members, and subject us to potential liability. Any failure of the systems and infrastructure that we rely on could negatively impact our enrollments as well as our relationship with members. If we do not maintain or expand the systems and infrastructure underlying our technology platform successfully, or if we experience operational failures, our reputation could be harmed and we could lose current and potential members, which could harm our operating results and financial condition.

We have made, and expect to continue to make, significant investments in new solutions and enhancements to our technology platform. These new solutions and enhancements may not be successful, and we may not recognize the expected benefits.

We have a team of product and engineering professionals dedicated in part to enhancing our technology platform and developing new solutions. We have made, and expect to continue to make, significant investments in these new solutions and enhancements. For example, we have made significant investments in Trupanion Express™, which is designed to facilitate the direct payment of invoices to veterinary practices. These development and implementation activities may not be successful, and we may incur delays or cost overruns or elect to curtail our currently planned expenditures related to them. Further, if or when these new solutions or enhancements are introduced, they may not be well received by veterinarians or by new or existing members, particularly if they are costly, cumbersome or unreliable. Even if they are well-received, they may be or become obsolete due to technological reasons or to the availability of alternative solutions in the marketplace. If new solutions and enhancements are not successful on a long-term basis, we may not recognize benefits from these investments, and our business and financial condition could be adversely affected.

If we fail to effectively manage our growth, our business, operating results and financial condition may suffer.
We have recently experienced, and expect to continue to experience, significant growth, which has placed, and may continue to place, significant demands on our management and our operational and financial systems and infrastructure. We expect that our growth strategy will require us to commit substantial financial, operational and technical resources. It may also result in increased costs, including unexpected increases in our underlying costs (such as member acquisition costs or the frequency or severity of claims costs) generated by our new business, which could prevent us from becoming profitable and could impair our ability to compete effectively for pet medical plan business. Additionally, we have in the past, and may in the future, experience increases in medical plan subscription terminations as our membership grows, which negatively affects our retention rate. If we do not effectively manage growth at any time, our financial condition could be harmed and the quality of our services could suffer.
In order to successfully expand our business, we need to hire, integrate and retain highly skilled and motivated employees. We also need to continue to improve our existing systems for operational and financial management. These improvements could require significant capital expenditures and place increasing demands on our management. We may not be successful in managing or expanding our operations or in maintaining adequate financial and operating systems and controls. If we do not successfully implement improvements in these areas, our business, operating results and financial condition will be harmed.
Our operating results may vary, which could cause the trading price of our stock to fluctuate or decline, make period-to-period comparisons less meaningful, and make our future results difficult to predict.
We may experience fluctuations in our revenue, expenses and operating results in future periods. Our operating results may fluctuate in the future as a result of a number of factors, many of which are beyond our control. These fluctuations may lead analysts to change their long-term models for valuing our common stock, cause us to face short-term liquidity issues, impact our ability to retain or attract key personnel or cause other unanticipated issues, all of which could result in declines in our stock price. Moreover, these fluctuations may make comparing our operating results on a period-to-period basis less meaningful and make our future results difficult to predict. You should not rely on our past results as an indication of our future performance. In addition, if revenue levels do not meet our expectations, our operating results and ability to execute on our business plan are likely to be harmed. In addition to the other factors listed in this "Risk Factors" section, factors that could affect our operating results include the following:

- our ability to retain our current members and grow our member base;
- the level of operating expense we elect to incur related to sales and marketing and technology and development initiatives that are discretionary in nature;
- the effectiveness of our sales and marketing programs;
- our ability to improve veterinarians' and other third-parties' willingness to recommend our medical plan;
- the timing, volume and severity of our claims and the adequacy of our claims reserve;
- our ability to accurately price our medical plans and achieve required regulatory pricing approvals;
- regulatory limitations or other constraints on our ability or our willingness to implement pricing changes;
- the level of demand for and the cost of our medical plan subscriptions or those of our competitors;
- fluctuations in applicable foreign currency exchange rates;
- the perceived value of our medical plan to veterinarians and pet owners;
- spending decisions by our members and prospective members;
- our costs and expenses, including pet acquisition costs and claims expenses;
- our ability to expand the scope and efficiency of our Territory Partner network;
- our ability to effectively manage our growth;
- the effects of increased competition in our business;
- our ability to keep pace with changes in technology and our competitors;
- the impact of any security incidents or service interruptions;
- costs associated with defending any regulatory action or litigation or with enforcing our intellectual property, contractual or other rights;
- the impact of economic conditions on our revenue and expenses; and
- changes in government regulation affecting our business.

Seasonal or periodic variations in the behavior of our members also may cause fluctuations in our financial results. Enrollment in our medical plan tends to be discretionary in nature and may be sporadic, reflecting overall economic conditions, budgeting constraints, pet-buying patterns and a variety of other factors, many of which are outside our control. For example, we expect to experience some effects of seasonal trends in visits to veterinarians in the fourth quarter and in the beginning of the first quarter of each year in connection with the traditional holiday season. While we believe seasonal trends have affected and will continue to affect our quarterly results, our growth may have overshadowed these effects to date. We believe that our business will continue to be subject to seasonality in the future, which may result in fluctuations in our financial results.

Due to these and other factors, our financial results for any quarterly or annual period may not meet our expectations or the expectations of investors or analysts that follow our stock and may not be meaningful indications of our future performance.

Our vertical integration may result in higher costs.

We manage all aspects of our business, including writing our medical plan, implementing our own national independent referral network of Territory Partners, pricing our medical plan subscriptions with our in-house actuarial team, administering claims made with respect to our medical plan, operating our own contact center and owning our own brand. While we believe this vertically integrated approach reduces frictional costs and enhances members' experiences, third-party providers may, now or in the future, be able to replicate this model, partially or entirely, on a more efficient and effective basis. If our in-house services are or become less efficient or less effective than the same services provided by a third party, we may not realize the related cost savings and may be unable to provide a superior membership experience, which may have an adverse effect on our operating results.

Our forecasts of market growth may prove to be inaccurate, and even if the market for medical coverage for cats and dogs in North America achieves the forecasted growth, our business may not grow at similar rates, if at all.

Growth forecasts are subject to significant uncertainty and are based on assumptions and estimates, which may not prove to be accurate. Although we believe that the North American market for pet medical coverage will grow over time if consumers are offered a high-value product, the market for medical coverage for cats and dogs in North America has been historically growing slowly or stagnant and may not be capable of growing further. Even if this market experiences significant growth, we may not grow our business at similar rates, or at all. For example, the market for medical coverage for cats and dogs in North America has been highly competitive and may become even more competitive in the future. Our growth is subject to many factors, including our success in implementing our business strategy and maintaining our position in a highly competitive market, which are subject to many risks and uncertainties.

We depend on key personnel to operate our business and, if we are unable to retain, attract and integrate qualified personnel, our ability to develop and successfully grow our business could be harmed.

Our success depends to a significant extent on the continued services of our current management team, including Darryl Rawlings, our founder and Chief Executive Officer. The loss of Mr. Rawlings or several other key executives or employees within a short time frame could have a material adverse effect on our business. We employ all of our executive officers and key employees on an at-will basis, and their employment can be terminated by us or them at any time, for any reason and without notice, subject, in certain cases, to severance payment rights. In order to retain valuable employees, in addition to salary and cash incentives, we have provided stock options and restricted stock that vest over time and may in the future grant equity awards tied to company performance. The value to employees of stock options and restricted stock that vest over time will be significantly affected by movements in our stock price that are beyond our control and may at any time be insufficient to maintain their retention benefit or counteract offers from other companies. Additionally, if we were to lose a large percentage of our current employees in a relatively short time period, or our employees were to engage in a work stoppage or unionize, we may be unable to hire and train new employees quickly enough to prevent disruptions in our operations, which may result in the loss of members, Territory Partners or referral sources.

Our success also depends on our ability to attract, retain and motivate additional skilled management personnel. We plan to continue to expand our work force, which we believe will enhance our business and operating results. We believe that there is significant competition for qualified personnel with the skills and knowledge that we require.

Many of the other companies with which we compete for qualified personnel have greater financial and other resources than we do. They also may provide more diverse opportunities and better chances for career advancement. Some of these characteristics may be more appealing to high-quality candidates than those we have to offer. If we are unable to attract and retain the necessary qualified personnel to accomplish our business objectives, we may experience constraints that will significantly impede the achievement of our business objectives and our ability to pursue our business strategy. New hires require significant training and, in most cases, take significant time before they achieve full productivity. New employees may not become as productive as we expect, and we may be unable to hire or retain sufficient numbers of qualified individuals. If our recruiting, training and retention efforts are not successful or do not generate a corresponding increase in revenue, our business will be harmed.

If we cannot maintain our corporate culture as we grow, we could lose the innovation, teamwork and focus that contribute crucially to our business.

Our culture is fundamental to our success and defines who we are and how we operate our business. We were founded on a deep appreciation of the special relationship between pet owners, their beloved pets and their trusted veterinarians. We have invested substantial time, energy and resources in developing a culture that fosters teamwork, innovation, creativity and a focus on providing value for our members as well as for Territory Partners and veterinarians. As we develop our infrastructure while we grow, we may find it difficult to maintain these valuable aspects of our corporate culture. Any failure to preserve our culture could negatively impact our future success, including our ability to attract and retain personnel, encourage innovation and teamwork and effectively focus on and pursue our corporate objectives.

We depend on relationships with strategic partners, and our inability to maintain our existing and secure new relationships with strategic partners could harm our revenue and operating results.

A portion of our enrollment leads are attributable to a variety of different types of strategic partnership arrangements. These partnerships involve various risks, depending on their structure, including the following:

- we may be unable to maintain or secure favorable relationships with strategic partners;
- our strategic partners may not be successful in creating leads;
- we may be unable to convert leads from our strategic partners into enrolled pets;
- our strategic partners could terminate their relationships with us;
- we may not experience a consistent correlation between revenues and expenditures related to the partnership, and
- bad publicity and other issues faced by our strategic partners could negatively impact us.

Our business and financial condition is subject to risks related to our writing of policies pursuant to contractual relationships with unaffiliated third parties.

Our other business segment generally includes revenues and expenses involving contractual relationships with unaffiliated third parties and marketing to enterprises. We have relatively limited experience in writing policies for unaffiliated third parties. This business is not expected to grow at the same rate as our core business and may decline. Changes to this business may be volatile due to the nature of the relationships. Further, this business historically has had, and we expect it to continue to have, lower margins than our core business. As a result of this line of business, we are subject to additional regulatory requirements and scrutiny, which increase our costs, risks and may have an adverse effect on our operations. Further, administration of this business and any similar business in the future may divert our time and attention away from our core business, which could adversely affect our operating results in the aggregate.

For example, we have written pet insurance policies for general agents since 2012. These policies provide different coverage and are subject to materially different terms and conditions than the Trupanion medical plan. Further, the unaffiliated general agents administer these policies and market them to consumers. For the three months ended March 31, 2017, premiums from these policies accounted for 6.2% of our total revenue. These relationships can be terminated by either party and, if terminated, would result in a reduction in our revenue to the extent we cannot enter other relationships and generate equivalent revenues with different general agents. In addition, the general agents control trust accounts they maintain on our behalf. If the general agents make operating decisions that adversely affect its business or brand, our business or brand could also be adversely affected.

In Canada, our medical plan is written by Omega General Insurance Company. If Omega were to terminate its underwriting arrangement with us, our business could be adversely affected.

In Canada, our medical plan is written by Omega, and we assume all premiums written by Omega and the related claims through an agency agreement and a fronting and administration agreement. These agreements will remain in effect until December 31, 2017 but may be terminated by either party with one year's prior written notice. If Omega were to terminate our agreement or be unable to write insurance for regulatory or other reasons, we may have to terminate subscriptions with our existing members, or suspend member enrollment and renewals, in Canada until we entered into a relationship with another third party to write our medical plan, which may take a significant amount of time and require significant expense. We may not be able to enter into a new relationship, and any new relationship would likely be on less favorable terms. Any delay in entry into a new relationship or suspension of member enrollment and renewals could have a material adverse effect on our operating results and financial condition.

If we are unable to implement and maintain effective internal control over financial reporting in the future, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock may be negatively affected.

We are required to maintain internal control over financial reporting and to report any material weaknesses in such internal control. Section 404 of the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) requires that we evaluate and determine the effectiveness of our internal control over financial reporting and provide a management report on the internal control over financial reporting, which must be attested to by our independent registered public accounting firm to the extent we no longer qualify for the exemption provided to an emerging growth company, as defined by The Jumpstart Our Business Startups Act of 2012 (JOBS Act).

We may not detect errors on a timely basis and our financial statements may be materially misstated. We have had in the past, and may have in the future, material weaknesses and significant deficiencies in our internal control over financial reporting. If we or our independent registered public accounting firm identify future material weaknesses in our internal control over financial reporting, are unable to comply with the requirements of Section 404 in a timely manner, are unable to assert that our internal control over financial reporting is effective or our independent registered public accounting firm is unable to express an opinion as to the effectiveness of our internal control over financial reporting, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock could be negatively affected. We could also become subject to investigations by the stock exchange on which our securities are listed, the SEC or other regulatory authorities, which could require additional financial and management resources.

If our security measures are breached and unauthorized access is obtained to our data, including our members’ data, we may lose our competitive advantage, our systems may be perceived as not being secure and we may incur third-party liability.

Our data repository contains proprietary information that we believe gives us a competitive advantage, including claims data and other data with respect to members, Territory Partners, veterinarians and other third parties. Security breaches could expose us to a risk of loss of our data and/or disclosure of this data, either publicly or to a third party who could use the information to gain a competitive advantage. In the event of a loss of our systems or data, we could experience increased costs or delays, which in turn may harm our financial condition, damage our brand and result in the loss of members. Such a disclosure also could lead to litigation and possible liability.

In the course of operating our business, we may store and/or transmit our members’ confidential information, including credit card and bank account numbers and other private information. Security breaches could expose us to a risk of loss of this information, litigation and possible liability. Our payment services may be susceptible to credit card and other payment fraud schemes, including unauthorized use of credit cards, debit cards or bank account information, identity theft or merchant fraud.

If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to our data, including data of our members, our reputation may be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or implement adequate preventative measures. If an actual or perceived breach of our security occurs, the public perception of the effectiveness of our security measures could be harmed and we could lose members, which would adversely affect our business.

Any legal liability, regulatory penalties or negative publicity we encounter, including based on the information on our website or that we otherwise distribute or provide, directly or through Territory Partners or other referral sources, could harm our business, operating results and financial condition.

Any legal disputes or regulatory penalties involving us may be publicly announced, which could materially harm our reputation and adversely affect our business. We also provide information on our website, through our contact center and in other ways regarding pet health, the pet insurance industry in general and our medical plan, including information relating to subscription fees, coverage, benefits, exclusions, limitations, availability and medical plan comparisons. A significant amount of both automated and manual effort is required to maintain the medical plan information on our website. Separately, from time to time, we use the information provided on our website and otherwise collected by us to publish reports designed to educate consumers. For example, we produce a significant amount of marketing materials regarding our medical plan. If the information we provide on our website, through our contact centers or otherwise is not accurate or is construed as misleading, or if we improperly assist individuals in purchasing subscriptions to our medical plan, our members, competitors or others could attempt to hold us liable for damages, our relationships with veterinarians and other referral sources could be terminated and regulators could attempt to subject us to penalties, revoke our licenses to transact business in one or more jurisdictions or compromise the status of our licenses to transact our business in other jurisdictions, which could result in our loss of revenue. In the ordinary course of operating our business, we may receive complaints that the information we provided was not accurate or was misleading. These types of claims could be time-consuming and expensive to defend, could divert our management's attention and other resources and could cause a loss of confidence in our business. As a result, whether or not we are able to successfully resolve these claims, they could harm our business, operating results and financial condition.

We are subject to a number of risks related to accepting automatic fund transfers and credit card and debit card payments.

We accept payments of subscription fees from our members through automatic fund transfers and credit and debit card transactions. For credit and debit card payments, we pay interchange and other fees, which may increase over time. An increase in the number of members who utilize credit and debit cards to pay their subscription fees or related credit and debit card fees would reduce our margins and could require us to increase the subscription fees for our medical plan, which could cause us to lose members and revenue, or suffer an increase in our operating expenses, either of which could adversely affect our operating results.

If we, or any of our processing vendors or banks have problems with our billing software, or if the billing software malfunctions, it could have an adverse effect on our member satisfaction and could cause one or more of the major credit card companies or banks to disallow our continued use of their payment products. In addition, if our billing software fails to work properly and, as a result, we do not automatically charge our members' credit cards on a timely basis or at all, or a bank withdraws the incorrect amount or fails to timely transfer the correct amount to us, we could lose revenue and harm our member experience, which could adversely affect our business and operating results. Moreover, a vendor could fail to process payments, or could process payments in the wrong amounts, which could result in us failing to collect premiums, could result in increased cancellations and could adversely affect our reputation.

We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, including the Payment Card Industry Data Security Standard (PCI DSS), a security standard applicable to companies that collect, store or transmit certain data regarding credit and debit cards, holders and transactions. In the past we may not have been, we currently are not and in the future we may not be, fully or materially compliant with PCI DSS. Any failure to comply fully or materially with the PCI DSS now or at any point in the future may violate payment card association operating rules, federal and state laws and regulations, and the terms of our contracts with payment processors and merchant banks. Such failure to comply fully or materially also may subject us to fines, penalties, damages and civil liability, and may result in the loss of our ability to accept credit and debit card payments. In addition, there is no guarantee that PCI DSS compliance, if we are able to become compliant, will prevent illegal or improper use of our payment systems or the theft, loss or misuse of data pertaining to credit and debit cards, credit and debit card holders and credit and debit card transactions.

If we fail to adequately control fraudulent credit card transactions, we may face civil liability, diminished public perception of our security measures and significantly higher credit card-related costs, each of which could adversely affect our business, operating results and financial condition.
If we are unable to maintain our chargeback rate at acceptable levels, our credit card fees for chargeback transactions, or our fees for many or all categories of credit and debit card transactions, credit card companies and debit card issuers may increase our fees or terminate their relationship with us. Any increases in our credit card and debit card fees could adversely affect our operating results, particularly if we elect not to raise our subscription fees. The termination of our ability to process payments on any major credit or debit card would significantly impair our ability to operate our business.

Failure to adequately protect our intellectual property could substantially harm our business and operating results.
We rely on a combination of intellectual property rights, including trade secrets, copyrights, trademarks and domain names, as well as contractual restrictions, to establish and protect our intellectual property. As of March 31, 2017, we had two pending patent applications and one issued patent in the United States, two pending patent applications in Canada, one pending patent application in Brazil, one pending patent application in Japan, one pending patent application in China, one pending patent application in Hong Kong, two pending patents filed under the Patent Cooperation Treaty, and one pending patent application and one issued patent in Europe. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy our digital content, pricing analytics, technology, software, branding and functionality, or obtain and use information that we consider proprietary. Moreover, policing our proprietary rights is difficult and may not always be effective. If we continue to expand internationally, we may need to enforce our rights under the laws of countries that do not protect proprietary rights to as great an extent as do the laws of the United States, which may be expensive and divert management's attention away from other operations.
Our digital content is not protected by any registered copyrights or other registered intellectual property. Rather, our digital content is protected by statutory and common law rights, user agreements that limit access to and use of our data and by technological measures. Compliance with use restrictions is difficult to monitor, and our proprietary rights in our digital content databases may be more difficult to enforce than other forms of intellectual property rights.
As of March 31, 2017, we had ten registered trademarks in the United States, including "Trupanion". We had one registered trademark in Canada, and four pending trademarks. Many of our unregistered trademarks, however, contain words or terms having a common usage and, as a result, may not be protectable under applicable law. Trademark protection may also not be available, or sought by us, in every country in which our medical plan may become available. Competitors may adopt names similar to ours, or purchase our trademarks and confusingly similar terms as keywords in Internet search engine advertising programs, thereby impeding our ability to build brand identity and possibly confusing members. Moreover, there could be potential trade name or trademark infringement claims brought by owners of other registered trademarks or trademarks that incorporate marks similar to our trademarks.
We may take action, including initiating litigation, to protect our intellectual property rights and the integrity of our brand, and these efforts may prove costly, ineffective and increase the likelihood of counterclaims against us.
We currently hold the "Trupanion.com" Internet domain name and numerous other related domain names. Domain names generally are regulated by Internet regulatory bodies. If we lose the ability to use a domain name in the United States, Canada or any other country, we may be forced to acquire domain names at significant cost or, in the alternative, be forced to incur significant additional expenses to market our medical plan, including the development of a new brand and the creation of new promotional materials, which could substantially harm our business and operating results. The regulation of domain names in the United States, Canada and in other foreign countries is subject to change. Regulatory bodies could establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may not be able to acquire or maintain the domain names that utilize the "Trupanion" name in all of the countries in which we currently intend to conduct business.
We seek to control access to our proprietary technology, software and documentation by entering into confidentiality and invention assignment agreements with our employees and partners, confidentiality agreements with third parties, such as service providers, vendors, individuals and entities that may be exploring a business relationship with us, and terms of use with third parties, such as veterinary hospitals desiring to use our technology, software and documentation. These agreements may not prevent disclosure of intellectual property, trade secrets and/or other confidential information, and may not provide an adequate remedy in the event of misappropriation of trade secrets or any unauthorized disclosure of trade secrets and other confidential information. In addition, others may independently discover trade secrets and confidential information and, in such cases, we may not be able to assert any trade secret rights against such parties. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our intellectual property rights and related confidentiality and nondisclosure provisions, and failure to obtain or maintain trade secret protection, or our competitors being able to obtain our trade secrets or to independently develop technology similar to ours or competing technologies, could adversely affect our competitive business position.

Litigation or proceedings before the U.S. Patent and Trademark Office or other governmental authorities and administrative bodies in the United States and abroad may be necessary in the future to enforce our intellectual property rights, to protect our domain names and to determine the validity and scope of the proprietary rights of others. Our efforts to enforce or protect our proprietary rights may be ineffective, could result in substantial costs and diversion of resources and could substantially harm our operating results.

Assertions by third parties of infringement or other violation by us of their intellectual property rights could result in significant costs and substantially harm our business and operating results.
Third parties have in the past and may in the future claim that our services infringe or otherwise violate their intellectual property rights. We may be subject to legal proceedings and claims, including claims of alleged infringement by us of the intellectual property rights of third parties. Any dispute or litigation regarding intellectual property could be expensive and time consuming, regardless of the merits of any claim, and could divert our management and key personnel from our operations.
If we were to discover or be notified that our services potentially infringe or otherwise violate the intellectual property rights of others, we may need to obtain licenses from these parties in order to avoid infringement. We may not be able to obtain the necessary licenses on acceptable terms, or at all, and any such license may substantially restrict our use of the intellectual property. Moreover, if we are sued for infringement and lose the lawsuit, we could be required to pay substantial damages or be enjoined from offering the infringing services. Any of the foregoing could cause us to incur significant costs and prevent us from selling or properly administering subscriptions to our medical plan or performing under our other contractual relationships.
We rely on third parties to provide intellectual property and technology necessary for the operation of our business.
We utilize intellectual property and technology owned by third parties in developing and operating our technology platform and operating our business. From time to time, we may be required to renegotiate with these third parties or negotiate with other third parties to include or continue using their intellectual property or technology in our existing technology platform or business operations or in modifications or enhancements to our technology platform or business operations. We may not be able to obtain the necessary rights from these third parties on commercially reasonable terms, or at all, and the third-party intellectual property and technology we use or desire to use may not be appropriately supported, maintained or enhanced by the third parties. If we are unable to obtain the rights necessary to use or continue to use third-party intellectual property and technology in our operations, or if those third parties are unable to support, maintain and enhance their intellectual property and technology, we could experience increased costs or delays, which in turn may harm our financial condition, damage our brand and result in the loss of members.
Our technology platform and our data are also hosted by a third-party service provider. The terms under which such third-party service provider provides us services may change and we may be required to renegotiate with that third party. If we are unable to renegotiate satisfactory terms, we may not be able to transition to an alternative service provider without interrupting the availability of our technology platform and any interruption could materially and adversely affect our business. Additionally, if our third-party service provider experiences any disruptions, outages or catastrophes, or if it ceases to conduct business for any reason, we could experience an interruption in our business, which in turn may damage our brand, result in a loss of members and harm our financial condition.
The outcome of litigation or regulatory proceedings could subject us to significant monetary damages, restrict our ability to conduct our business, harm our reputation and otherwise negatively impact our business.
From time to time, we have been, and in the future may become, subject to litigation, claims and regulatory proceedings and inquiries, including market conduct examinations and investigations by state insurance regulatory agencies and threatened or filed lawsuits by employees, customers or business partners.
We cannot predict the outcome of these actions or proceedings, and the cost of defending such actions or proceedings could be material. Further, defending such actions or proceedings could divert our management and key personnel from our business operations. If we are found liable in any action or proceeding, we may have to pay substantial damages or fines, or change the way we conduct our business, either of which may have a material adverse effect on our business, operating results, financial condition and prospects. There may also be negative publicity associated with litigation or regulatory proceedings that could harm our reputation or decrease acceptance of our services. These claims may be costly to defend and may result in assessment of damages, adverse tax consequences and harm to our reputation.

Covenants in the credit agreement governing our revolving line of credit may restrict our operations, and if we do not effectively manage our business to comply with these covenants, our financial condition could be adversely affected.
The credit agreement governing our revolving line of credit contains various restrictive covenants, including restrictions on our ability to dispose of our assets, change the name, location, office or executive management of our business, merge with or acquire other entities, incur other indebtedness, incur encumbrances, pay dividends or make distributions to holders of our capital stock, make investments, engage in transactions with our affiliates, permit withdrawals from APIC (with certain exceptions) and conduct operations in certain of our Canadian subsidiaries. Our credit agreement also contains financial covenants, including having APIC maintain statutory capital and surplus at all times of not less than the greater of $0.5 million or 110% of the highest amount of statutory capital and surplus required in any state in which APIC is licensed, maintaining a minimum unrestricted cash balance of $0.6 million in our accounts at Western Alliance Bank (WAB) and/or one or more WAB affiliates, maintaining all of our depository and operating accounts at WAB and/or one or more WAB affiliates, maintaining all of our depository and operating accounts at WAB, achieving certain monthly revenue and remaining within certain maximum EBITDA loss levels. Our ability to meet these restrictive covenants can be affected by events beyond our control, and we have been in the past, and may be in the future, unable to do so. In addition, our failure to maintain effective internal controls to measure compliance with our financial covenants could affect our ability to take corrective actions on a timely basis and could result in our being in breach of these covenants. Our credit agreement provides that our breach or failure to satisfy certain covenants constitutes an event of default. Upon the occurrence of an event of default, our lenders could elect to declare any future amounts outstanding under our credit agreement to be immediately due and payable. If we are unable to repay those amounts, our financial condition could be adversely affected.
Any indebtedness we incur could adversely affect our business and limit our ability to expand our business or respond to changes, and we may be unable to generate sufficient cash flow to satisfy any of our debt service obligations.
As of March 31, 2017, we had $5.0 million outstanding indebtedness. We may incur indebtedness in the future, including any additional borrowings available under our revolving line of credit. Any substantial indebtedness and the fact that a substantial portion of our cash flow from operating activities could be needed to make payments on this indebtedness could have adverse consequences, including the following:

- reducing the availability of our cash flow for our operations, capital expenditures, future business opportunities and other purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industries in which we operate, which could place us at a competitive disadvantage compared to our competitors that may have less debt;
- limiting our ability to borrow additional funds; and
- increasing our vulnerability to general adverse economic and industry conditions.

Our ability to borrow any funds needed to operate and expand our business will depend in part on our ability to generate cash. Our ability to generate cash is subject to the performance of our business, as well as general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. We may also need to use operating funds to support risk-based capital requirements and borrow additional funds to support our growth. If our business does not generate sufficient cash flow from operating activities or if future borrowings are not available to us, under our revolving credit facility or otherwise, in amounts sufficient to enable us to fund our liquidity needs, our operating results, financial condition and ability to expand our business and meet our risk-based capital requirements may be adversely affected.
Our financial results may be negatively affected if we are required to pay income tax, premium tax, transaction tax or other taxes in jurisdictions where we are currently not collecting and reporting tax.
We currently pay income tax, premium tax, transaction tax and other taxes in certain jurisdictions in which we do business. A successful assertion by one or more jurisdictions that we should be paying income, premium, transaction or other taxes on our income or in connection with enrollment in our medical plan or intercompany services, or the enactment of new laws requiring the payment of income, premium, transfer or other taxes in connection with our business operations, including enrollment in our medical plan or intercompany services, could result in substantial tax liabilities. Our voluntary disclosure of tax obligations and any future assertions by any jurisdiction that we should be paying taxes may create increased administrative burdens or costs, require payment of substantial fines and penalties,

discourage consumers from enrolling in our medical plan, reduce our operational efficiencies, decrease our ability to compete or otherwise substantially harm our business and operating results.

If consumer acceptance of the Internet as an acceptable marketplace for a pet medical plan does not continue to increase, our growth prospects will be harmed.

Our success depends in part on widespread consumer acceptance of the Internet as a marketplace for the purchase of a pet medical plan. Internet use may not continue to develop at historical rates, and consumers may not continue to use the Internet to research, select and purchase a pet medical plan. In addition, the Internet may not be accepted as a viable resource for a number of reasons, including lack of security of information or privacy protection, possible disruptions, computer viruses or other damage to Internet servers or to users' computers, and excessive governmental regulation.

Our success will depend, in large part, on third parties maintaining the Internet infrastructure to provide a reliable network backbone with the speed, data capacity, security and hardware necessary for reliable Internet access and services.

We depend in part on Internet search engines to attract potential new members to visit our website. If Internet search engines' methodologies are modified or our search result page rankings decline for other reasons, our new member growth could decline, and our business and operating results could be harmed.

We derive a significant amount of traffic to our website from consumers who search for pet medical insurance through Internet search engines, such as Google, Bing and Yahoo!. A critical factor in attracting consumers searching for pet medical insurance on the Internet to our website is whether we are prominently displayed in response to an Internet search relating to pet insurance. Algorithmic search result listings are determined and displayed in accordance with a set of formulas or algorithms developed by the particular Internet search engine, which may change from time to time. If we are listed less prominently in, or removed altogether from, search result listings for any reason, the traffic to our websites would decline and we may not be able to replace this traffic, which in turn would harm our business, operating results and financial condition. If we decide to attempt to replace this traffic, we may be required to increase our sales and marketing expenditures, including by utilizing paid search advertising, which would also increase our pet acquisition costs and harm our business, operating results and financial condition.

Changes in the economy may negatively impact our business, operating results and financial condition.

Our business may be affected by changes in the economic environment. Pet medical plans are a discretionary purchase, and members may reduce or eliminate their discretionary spending during an economic downturn, resulting in an increase in medical plan subscription terminations and a reduction in the number of new member enrollments. We may experience a material increase in medical plan subscription terminations or a material reduction in our member retention rate in the future, especially in the event of a prolonged recessionary period or a downturn in economic conditions. Conversely, consumers may have more income to pay veterinary costs out-of-pocket and less desire to purchase a pet medical plan during a period of economic growth. In addition, media prices may increase during a period of economic growth, which could increase our sales and marketing expenses. As a result, our business, operating results and financial condition may be significantly affected by changes in the economic environment.

We may acquire other companies or technologies, which could divert our management's attention, result in additional dilution to our stockholders and otherwise disrupt our operations and harm our operating results.

We may decide to acquire businesses, products and technologies. Our ability to successfully make and integrate acquisitions is unproven. The pursuit of potential acquisitions may divert the attention of management and cause us to incur various expenses in identifying, investigating and pursuing suitable acquisitions, whether or not they are consummated. Further, even if we successfully acquire additional businesses or technologies, we may not be able to migrate the policyholders to our medical plan, integrate the acquired personnel, operations and technologies successfully, or effectively manage the combined business following the acquisition. We also may not achieve the anticipated benefits from the acquired business or technology. In addition, we may unknowingly inherit liabilities from future acquisitions that arise after the acquisition and are not adequately covered by indemnities. Acquisitions could also result in dilutive issuances of equity securities or the incurrence of debt, which could adversely affect our operating results. If an acquired business or technology fails to meet our expectations, our business, operating results and financial condition may suffer.

Our ability to use our net operating loss carryforwards and certain other tax attributes may be limited.

As of December 31, 2016, we had U.S. federal net operating loss carryforwards of approximately $79.0 million that will begin to expire in 2027. Under Sections 382 and 383 of the Internal Revenue Code of 1986, as amended, if a corporation undergoes an “ownership change,” the corporation’s ability to use its pre-change net operating loss carryforwards and other pre-change tax attributes, such as research tax credits, to offset its post-change income and taxes may be limited. In general, an “ownership change” generally occurs if there is a cumulative change in our ownership by “5-percent stockholders” that exceeds 50 percentage points over a rolling three-year period. Similar rules may apply under state tax laws. Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of the Company’s net operating loss carryforwards and credit carryforwards may be limited if the Company experiences an ownership change. As of December 31, 2016, we believe the utilization of approximately $0.5 million of net operating losses are subject to limitation as a result of prior ownership changes however subsequent ownership changes may further affect the limitation in future years.

We may explore opportunities to expand our operations globally, and we may therefore become subject to a number of risks associated with international expansion and operations.

As part of our growth plan, we expect to explore opportunities to expand our operations globally. We have no history of marketing, selling, administrating and supporting our medical plan to consumers outside of the United States, Canada and Puerto Rico. International sales and operations are subject to a number of risks, including the following:

- regulatory rules and practices, foreign exchange controls, tariffs, tax laws and treaties that are different than those we operate under in the United States, Canada and Puerto Rico and that carry a greater risk of unexpected changes;
- the costs and resources required to modify our technology and sell our medical plan in non-English speaking countries;
- the costs and resources required to modify our medical plan appropriately to suit the needs and expectations of residents and veterinarians in such foreign countries;
- our data analytics platform may have limited applicability in foreign countries, which may impact our ability to develop adequate underwriting criteria and accurately price subscriptions to our medical plan in such countries;
- increased expenses incurred in establishing and maintaining office space and equipment for our international operations;
- technological incompatibility;
- fluctuations in exchange rates between the U.S. dollar and foreign currencies in markets where we do business;
- difficulties in attracting and retaining personnel with experience in international operations;
- difficulties in modifying our business model in a manner suitable for any particular foreign country, including any modifications to our Territory Partner model to the extent we determine that our existing model is not suitable for use in foreign countries;
- our lack of experience in marketing to consumers and veterinarians, and encouraging online marketing, in foreign countries;
- our relative lack of industry connections in many foreign countries;
- difficulties in managing operations due to language barriers, distance and time zone differences, staffing, cultural differences and business infrastructure constraints, including difficulty in obtaining foreign and domestic visas;
- application of foreign laws and regulations to us, including more stringent or materially different insurance, employment, consumer and data protection laws;
- the uncertainty of protection for intellectual property rights in some countries;
- greater risk of a failure of foreign employees to comply with applicable U.S. and foreign laws, including antitrust regulations, the U.S. Foreign Corrupt Practices Act and any trade regulations ensuring fair trade practices; and
- general economic and political conditions in these foreign markets.

These factors and other factors could harm our ability to gain future international revenue and, consequently, materially impact our business and operating results. The expansion of our existing international operations and entry into additional international markets will require significant management attention and financial resources, detracting from management attention and financial resources otherwise available to our existing business. Our failure to successfully manage our international operations and the associated risks effectively could limit the future growth of our business and could have an adverse effect on our operating results and financial condition.

A downgrade in the financial strength rating of our insurance company may have an adverse effect on our competitive position, the marketability of our medical plan, and/or on our liquidity, access to and cost of borrowing, operating results and financial condition.

Although we do not believe that the financial strength rating of APIC is material for customers or to understand our business beyond what is already publicly available, financial strength ratings can be important factors in establishing the competitive position of insurance companies and generally have an effect on an insurance company's business. On an ongoing basis, rating agencies review the financial performance and condition of APIC and could downgrade or change the outlook on its ratings due to, for example, a change in its statutory capital, a change in the rating agency's determination of the amount of risk-based capital required to maintain a particular rating or a reduced confidence in management or its business strategy, as well as a number of other considerations that may or may not be under our control. The insurance financial strength rating of APIC is subject to quarterly review, and APIC may not retain the current rating. A downgrade in this or any future ratings could have a material effect on our sales, our competitiveness, the marketability of our medical plan, our liquidity, access to and cost of borrowing, operating results and financial condition.

Our business is subject to the risks of earthquakes, floods, fires and other natural catastrophic events and to interruption by man-made problems such as computer viruses or terrorism.

Our systems and operations are vulnerable to damage or interruption from earthquakes, human error, intentional bad acts, hurricanes, floods, fires, power losses, telecommunications failures, hardware and system failures, terrorist attacks, acts of war, break-ins or similar events. For example, our corporate headquarters and facilities are located in Seattle, Washington near known earthquake fault zones and are vulnerable to significant damage from earthquakes. In addition, acts of terrorism could cause disruptions in our business or the economy as a whole. Our servers and systems may also be vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems, which could lead to interruptions, delays, loss of critical data or the unauthorized disclosure of confidential member data. We currently have limited disaster recovery capability, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Such disruptions could negatively impact our ability to run our business, which could have an adverse effect on our operating results and financial condition.

Risks Related to Compliance with Laws and Regulations

We may not maintain the amount of risk-based capital required to avoid additional regulatory oversight, which may adversely affect our ability to operate our business.

Memberships in our U.S. medical plan are written by APIC. APIC is an insurance company domiciled in the state of New York and licensed by the New York Department of Financial Services. Regulators in the states in which we do business impose risk-based capital requirements on APIC that generally are approved by the National Association of Insurance Commissioners to ensure APIC maintains reasonably appropriate levels of surplus to protect our members against adverse developments in APIC's financial circumstances, taking into account the risk characteristics of our assets, liabilities and certain other items. Generally, the NY DFS will compare, on an annual basis as of December 31 or more often as deemed necessary, an insurer's total adjusted capital and surplus against what is referred to as an "Authorized Control Level" of risk-based capital that is calculated based on a formula designed to estimate an insurer's capital adequacy. There generally are five outcomes possible from this comparison, depending on the insurer's level of risk-based capital as compared to the applicable Authorized Control Level.

- No Action Level: Insurer's total adjusted capital is equal to or greater than 200% of the Authorized Control Level.
- Company Action Level: Insurer's total adjusted capital is less than 200% but greater than 150% of the Authorized Control Level. When at this level, an insurer must prepare and submit a financial plan to the NY DFS for review and approval. Generally, a risk-based capital plan would identify the conditions that contributed to the Company Action Level and include the insurer's proposed plans for increasing its risk-based capital in order to satisfy the No Action Level. The failure to provide the NY DFS with a risk-based capital plan on a timely basis or the inability of the NY DFS and the insurer to mutually agree on an appropriate risk-based capital plan could trigger a Regulatory Action Level outcome, subject to the insurer's right to a hearing on the issue.
- Regulatory Action Level: Insurer's total adjusted capital is less than 150% but greater than 100% of the Authorized Control Level. When at this level, an insurer generally must provide a risk-based capital plan to the NY DFS and be

subject to examination or analysis by the NY DFS to the extent it deems necessary, including such corrective actions as the NY DFS may require.

- Authorized Control Level: Insurer's total adjusted capital is less than 100% but greater than 70% of the Authorized Control Level. At this level, the NY DFS generally could take remedial actions that it determines necessary to protect the insurer's assets, including placing the insurer under regulatory control.

- Mandatory Control Level: Insurer's total adjusted capital is less than 70% of the Authorized Control Level. At this level, the NY DFS generally is required to take steps to place the insurer under regulatory control, even if the insurer is still solvent.

As of December 31, 2016, APIC was required to maintain at least $25.8 million of risk-based capital to satisfy the No Action Level (the highest of the above levels). As of December 31, 2016, APIC maintained $30.5 million of risk-based capital. The NY DFS may increase the required levels of risk-based capital in the future, and we anticipate that we will need to maintain greater amounts of risk-based capital if our pet enrollment continues to grow. Additionally, if our risk-based capital falls below the Company Action Level, we may be in breach of various contractual relationships, including, for example, with the unaffiliated general agents for which we write pet insurance policies, which may give such parties the ability to cancel their contracts with us and/or sue us for damages related to our risk-based capital levels, which could have a material adverse effect on our financial condition.

We may require additional capital to meet our risk-based capital requirements, pursue our business objectives and respond to business opportunities, challenges or unforeseen circumstances. If capital is not available to us at any time, our business, operating results and financial condition may be harmed.

We may require additional capital to meet our risk-based capital requirements, operate or expand our business or respond to unforeseen circumstances. Additional funds may not be available when we need them, on terms that are acceptable to us, or at all. If we raise additional funds through the issuance of equity or convertible securities, the percentage ownership of holders of our common stock could be significantly diluted and these newly issued securities may have rights, preferences or privileges senior to those of holders of our common stock. Further, volatility in the credit or equity markets may have an adverse effect on our ability to obtain debt or equity financing or the cost of such financing. Similarly, our access to funds may be impaired if regulatory authorities or rating agencies take negative actions against us. If a combination of these factors were to occur, our internal sources of liquidity may prove to be insufficient and, in such case, we may not be able to successfully obtain additional financing on favorable terms. If funds are unavailable to us on reasonable terms when we need them, we may be unable to meet our risk-based capital requirements, train and support our employees, support Territory Partners, maintain the competitiveness of our technology, pursue business opportunities, service our existing debt, pay claims or acquire new members, any of which could have an adverse effect on our business, operating results and financial condition.

If we fail to comply with the numerous laws and regulations that are applicable to the sale of a pet medical plan, our business and operating results could be harmed.

The sale of a pet medical plan, which is considered a type of property and casualty insurance in most jurisdictions, is heavily regulated by each state in the United States, in the District of Columbia, in Puerto Rico and by Canadian federal, provincial and territorial governments. In the United States, state insurance regulators are charged with protecting policyholders and have broad regulatory, supervisory and administrative powers over our business practices. Because we do business in all 50 states, the District of Columbia, all Canadian provinces and territories and Puerto Rico, compliance with insurance-related laws, rules and regulations is difficult and imposes significant costs on our business. Each jurisdiction's insurance department typically has the power, among other things, to:

- grant and revoke licenses to transact insurance business;
- conduct inquiries into the insurance-related activities and conduct of agents and agencies and others in the sales, marketing and promotional channels;
- require and regulate disclosure in connection with the sale and solicitation of insurance policies;
- authorize how, by which personnel and under what circumstances insurance premiums can be quoted and published and an insurance policy sold;
- approve which entities can be paid commissions from carriers and the circumstances under which they may be paid;
- regulate the content of insurance-related advertisements, including web pages, and other marketing practices;
- approve policy forms, require specific benefits and benefit levels and regulate premium rates;
- impose fines and other penalties; and
- impose continuing education requirements.

While the U.S. federal government does not directly regulate the insurance industry, federal legislation and administrative policies can also affect us. Congress and various federal agencies periodically discuss proposals that would provide for federal oversight of insurance companies. We cannot predict whether any such laws will be enacted or the effect that such laws would have on our business. We also do business in all ten provinces and three territories of Canada. The provincial and territorial insurance regulators have the power to regulate the market conduct of insurers and insurance intermediaries, and the licensing and supervision of insurance agents, brokers, and adjusters, along with enforcement rights, including the right to assess administrative monetary penalties in certain provinces. Insurance companies are also regulated at the federal level in Canada, and the Insurance Companies Act prohibits a foreign entity from insuring risks in Canada unless it is authorized by an Order made by the Superintendent of Financial Institutions (Canada) permitting it to do so.

Due to the complexity, periodic modification and differing interpretations of insurance laws and regulations, we have not always been, and we may not always be, in compliance with them. New insurance laws, regulations and guidelines also may not be compatible with the manner in which we market and sell subscriptions to our medical plan in all of our jurisdictions and member acquisition channels, including over the Internet. Failure to comply with insurance laws, regulations and guidelines or other laws and regulations applicable to our business could result in significant liability, additional department of insurance licensing requirements, the revocation of licenses in a particular jurisdiction or our inability to sell subscriptions to our medical plan, which could significantly increase our operating expenses, result in the loss of our revenue and otherwise harm our business, operating results and financial condition.

Moreover, an adverse regulatory action in one jurisdiction could result in penalties and adversely affect our license status or reputation in other jurisdictions, including due to the current requirement that adverse regulatory actions in one jurisdiction be reported to other jurisdictions. Even if the allegations in any regulatory or other action against us ultimately are determined to be unfounded, we could incur significant time and expense defending against the allegations, and any related negative publicity could harm consumer and third-party confidence in us, which could significantly damage our brand.

In addition, we have received, and may in the future receive, inquiries from regulators regarding our marketing and business practices. These inquires may include investigations regarding a number of our business practices, including the manner in which we market and sell subscriptions to our medical plan and the manner in which we write policies for any unaffiliated general agent. Any modification of our marketing or business practices in response to regulatory inquiries could harm our business, operating results or financial condition.

A regulatory environment that limits rate increases may adversely affect our operating results and financial condition. Many states, including New York, have adopted laws or are considering proposed legislation that, among other things, limit the ability of insurance companies to effect rate increases or to cancel, reduce or not renew insurance coverage with respect to existing policies, and many state regulators have the power to reduce, or to disallow increases in premium rates. Most states, including New York, require licensure and regulatory approval prior to marketing new insurance products. Our practice has been to regularly reevaluate the price of our medical plan subscriptions, with any pricing changes implemented at least annually, subject to the review and approval of the state regulators, who may reduce or disallow our pricing changes. Such review has often in the past resulted, and may in the future result, in delayed implementation of pricing changes and prevent us from making changes we believe are necessary to achieve our targeted claims payout ratio, which could adversely affect our operating results and financial condition. In addition, we may be prevented by regulators from limiting significant pricing changes, requiring us to raise rates more quickly than we otherwise may desire. This could damage our reputation with our members and reduce our retention rates, which could significantly damage our brand, result in the loss of expected revenue and otherwise harm our business, operating results and financial condition.

In addition to regulating rates, certain states have enacted laws that require a property-casualty insurer, which includes a pet insurance company, conducting business in that state to participate in assigned risk plans, reinsurance facilities, joint underwriting associations (JUAs), Fair Access to Insurance Requirements (FAIR) plans and wind pools. In these markets, if the state reinsurance facilities, wind pools, FAIR plans or JUAs recognize a financial deficit, they may in turn have the ability to assess participating insurers, adversely affecting our operating results and financial condition if we are a part of such state reinsurance facilities, wind pools, FAIR plans or JUAs. Additionally, certain states require insurers to participate in guaranty funds for impaired or insolvent insurance companies. These funds periodically assess losses against all insurance companies doing business in the state. Our operating results and financial condition could be adversely affected by any of these factors.

Regulations that require individuals or entities that sell pet insurance to be licensed may be interpreted to apply to our business, which could require us to modify our business practices.

Insurance regulators generally require that each individual who transacts pet insurance business on our behalf must maintain a valid license in one or more jurisdictions. These requirements are subject to a variety of interpretations between jurisdictions. We may not interpret and apply the requirements in the same manner as all applicable regulators, and, even if we have, the requirements or regulatory interpretations of those requirements may change. Regulators have in the past and may in the future determine that any of our personnel or referral sources were selling subscriptions to our medical plan on our behalf and need to be licensed in a particular jurisdictions. If such persons were not in fact licensed in any such jurisdiction, we could become subject to conviction for an offense or the imposition of an administrative penalty and liable for significant penalties and would likely be required to modify our business practices and sales and marketing programs, or license the affected individuals, which may be impractical or costly and time-consuming to implement. Any modification of our business or marketing practices in response to regulatory licensing requirements could harm our business, operating results or financial condition.

Most insurance legislation requires entities that solicit the sale of pet insurance to be validly licensed in the applicable jurisdiction. If an insurance regulator were to determine that any entity soliciting the sale of a medical plan on our behalf did not hold the required license, we may have to modify our business practices or marketing efforts, or license the affected entities, which may be costly and time-consuming to implement.

We are subject to numerous laws and regulations, and compliance with one law or regulation may result in non-compliance with another.

We are subject to numerous laws and regulations that are administered and enforced by a number of different governmental authorities, each of which exercises a degree of interpretive latitude, including, in the United States, state insurance regulators, state securities administrators, state attorneys general and federal agencies including the SEC, Internal Revenue Service and the U.S. Department of Justice. Consequently, we are subject to the risk that compliance with any particular regulator’s or enforcement authority’s interpretation of a legal issue may not result in compliance with another’s interpretation of the same issue, particularly when compliance is judged in hindsight. In addition, there is risk that laws and regulations or any particular regulator’s or enforcement authority’s interpretation of a legal issue may change over time to our detriment, or that changes in the overall legal environment may, even absent any particular regulator’s or enforcement authority’s interpretation of a legal issue changing, cause us to change our views regarding the actions we need to take from a legal risk management perspective, thus necessitating changes to our practices that may, in some cases, increase our costs and limit our ability to grow or to improve the profitability of our business. Further, in some cases, these laws and regulations are designed to protect or benefit the interests of a specific constituency rather than a range of constituencies. For example, state insurance laws and regulations generally are intended to protect or benefit purchasers or users of insurance products, not holders of securities, which generally is the jurisdiction of the SEC. In many respects, these laws and regulations limit our ability to grow or to improve the profitability of our business.

Regulation of the sale of medical insurance for cats and dogs is subject to change, and future regulations could harm our business and operating results.

The laws and regulations governing the offer, sale and purchase of medical insurance for cats and dogs are subject to change, and future changes may be adverse to our business. For example, if a jurisdiction were to increase our risk-based capital requirements or alter the requirements for obtaining or maintaining an agent’s license in connection with the enrollment of a member in our medical plan, it could have a material adverse effect on our operations. Some states in the United States have adopted, and others are expected to adopt, new laws and regulations related to the insurance industry. It is difficult to predict how these or any other new laws and regulations will impact our business, but, in some cases, changes in insurance laws, regulations and guidelines may be incompatible with various aspects of our business and require that we make significant modifications to our existing technology or practices, which may be costly and time-consuming to implement and could also harm our business, operating results and financial condition.

Failure to comply with federal, state and provincial laws and regulations relating to privacy and security of personal information, and civil liabilities relating to breaches of privacy and security of personal information, could create liabilities for us, damage our reputation and harm our business.
A variety of U.S. and Canadian federal, state and provincial laws and regulations govern the collection, use, retention, sharing and security of personal information. We collect and utilize demographic and other information from and about our members when they visit our website, call our contact center and apply for enrollment in our medical plan. Further, we use tracking technologies, including “cookies,” to help us manage and track our members’ interactions and deliver relevant advice and advertising. Claims or allegations that we have violated applicable laws or regulations related to privacy and data security could in the future result in negative publicity and a loss of confidence in us by our members and our participating service providers, and may subject us to fines by credit card companies and the loss of our ability to accept credit and debit card payments. In addition, we have posted privacy policies and practices concerning the collection, use and disclosure of member data on our website. Several Internet companies have incurred penalties for failing to abide by the representations made in their privacy policies and practices. In addition, our use and retention of personal information could lead to civil liability exposure in the event of any disclosure of such information due to hacking, viruses, inadvertent action or other use or disclosure. Several companies have been subject to civil actions, including class actions, relating to this exposure.
We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols for personal information imposed by law, regulation, self-regulatory bodies, industry standards and contractual obligations. Such laws, standards and regulations, however, are evolving and subject to potentially differing interpretations, and federal, state and provincial legislative and regulatory bodies may expand current or enact new laws or regulations regarding privacy matters. We are unable to predict what additional legislation, standards or regulation in the area of privacy and security of personal information could be enacted or its effect on our operations and business.
Government regulation of the Internet and email could adversely affect our business.
The laws governing general commerce on the Internet remain unsettled and it may take years to fully determine whether and how existing laws such as those governing insurance, intellectual property, privacy and taxation apply to the Internet. In addition, the growth and development of the market for electronic commerce and Internet-related pet medical plan advertisements and transactions may prompt calls for more stringent consumer protection laws that may impose additional burdens on companies conducting business and selling subscriptions to a pet medical plan over the Internet. Any new laws or regulations or new interpretations of existing laws or regulations relating to the Internet could harm our business and we could be forced to incur substantial costs in order to comply with them, which would harm our business, operating results and financial condition.
Additionally, we use email to market our services to potential members and as a means of communicating with our existing members. The laws and regulations governing the use of email for commercial purposes continue to evolve and the growth and development of the market for commerce over the Internet may lead to the adoption of additional legislation. On July 1, 2014, legislation became effective in Canada that, among other things, prohibits the sending of commercial electronic messages without the express or implied consent of the recipient, subject to certain exceptions. Failure to abide by this new legislation could lead to significant administrative monetary penalties and, as of July 1, 2017, civil liability exposure, including through class actions. We have incurred, and will continue to incur, expenses to comply with electronic messaging laws. If new laws or regulations are adopted, or existing laws and regulations are interpreted, to impose additional restrictions on our ability to send email to our members or potential members, we may not be able to communicate with them in a cost-effective manner. In addition to legal restrictions on the use of email for commercial purposes, Internet service providers, email service providers and others attempt to block the transmission of unsolicited email, commonly known as “spam.” Many Internet and email service providers have relationships with organizations whose purpose it is to detect and notify the Internet and email service providers of entities that the organization believes is sending unsolicited email. If an Internet or email service provider identifies email from us as “spam” as a result of reports from these organizations or otherwise, we could be placed on a restricted list that will block our emails to members or potential members. If we are restricted or unable to communicate by email with our members and potential members as a result of legislation, blockage or otherwise, our business,

operating results and financial condition would be harmed.

Applicable insurance laws regarding the change in control of our company may impede potential acquisitions that our stockholders might consider to be desirable.

We are subject to statutes and regulations of the state of New York that generally require that any person or entity desiring to acquire direct or indirect control of APIC obtain prior regulatory approval. These laws may discourage potential acquisition proposals and may delay, deter or prevent a change in control of our company, including through transactions, and in particular unsolicited transactions, that some of our stockholders might consider to be desirable. Similar laws or regulations may also apply in other states in which we may operate.

Our segregated account in Bermuda, WICL segregated account AX, could be adversely impacted by regulatory compliance of a third party.

Wyndham Insurance Company (SAC) Limited (WICL) is a class 3 insurer regulated by the Bermuda Monetary Authority (BMA). WICL's ability to continue operations and pay dividends could impact the ability of our segregated account to do the same. WICL's failure to meet regulatory requirements set forth by the BMA could result in our inability to transact business with WICL segregated account AX. Further, WICL could be limited from allowing dividends to be paid out of segregated account AX in the event of adverse regulatory actions.

We will continue to incur significantly increased costs and devote substantial management time as a result of operating as a public company.

As a public company, we incur significant legal, accounting and other expenses that we did not incur as a private company. For example, we are subject to the reporting requirements of the Exchange Act, and are required to comply with the applicable requirements of the Sarbanes-Oxley Act, the Dodd-Frank Wall Street Reform and Consumer Protection Act and the JOBS Act, as well as rules and regulations subsequently implemented by the SEC and the stock exchange on which our common stock is listed, including the establishment and maintenance of effective disclosure and financial controls and changes in corporate governance practices. Compliance with these requirements has and may continue to increase our legal and financial compliance costs and will make some activities more time consuming and costly. In addition, from time to time, our management and other personnel need to divert attention from operational and other business matters to devote substantial time to these public company requirements. In particular, we have and will continue to incur significant expenses and devote substantial management effort toward ensuring compliance with the requirements of Section 404 of the Sarbanes-Oxley Act, which will increase when we are no longer an emerging growth company, as defined by the JOBS Act. We cannot predict or estimate the amount of additional costs we may incur as a result of being a public company or the timing of such costs.

We are an emerging growth company and we cannot be certain if the reduced disclosure requirements applicable to emerging growth companies will make our common stock less attractive to investors.

We are an emerging growth company. Under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards until such time as those standards apply to private companies. We have irrevocably elected not to avail ourselves of this exemption from new or revised accounting standards and, therefore, we will be subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

For as long as we continue to be an emerging growth company, we intend to take advantage of certain exemptions from various reporting requirements that are applicable to other public companies including, but not limited to, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, and exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved. We cannot predict if investors will find our common stock less attractive because we will rely on these exemptions. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be more volatile.

We generally will remain an emerging growth company until the earliest of (i) the end of the fiscal year in which the market value of our common stock that is held by non-affiliates exceeds $700 million as of June 30, (ii) the end of the fiscal year in which we have total annual gross revenue of $1 billion or more during such fiscal year, (iii) the date on which we issue more than $1 billion in non-convertible debt in a three-year period or (iv) December 31, 2019, which is the end of the year in which the fifth anniversary of our IPO would occur.

Our reported financial results may be adversely affected by changes in accounting principles generally accepted in the United States.

Generally accepted accounting principles in the United States are subject to interpretation by the Financial Accounting Standards Board, the SEC and various bodies formed to promulgate and interpret appropriate accounting principles. A change in these principles or interpretations could have a significant effect on our reported financial results, could affect the reporting of transactions completed before the announcement of a change and could affect our compliance with financial debt covenants.

Risks Related to Ownership of Our Common Stock

Our actual operating results may differ significantly from our guidance.

From time to time we have released, and may continue to release, guidance in our quarterly earnings conference call, quarterly earnings releases, or otherwise, regarding our future performance that represents our management's estimates as of the date of release. This guidance, which includes forward-looking statements, has been and will be based on projections prepared by our management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party compiles or examines the projections. Accordingly, no such person expresses any opinion or any other form of assurance with respect to the projections.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We intend to state possible outcomes as high and low ranges which are intended to provide a sensitivity analysis as variables are changed but are not intended to imply that actual results could not fall outside of the suggested ranges. The principal reason that we release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such third parties.

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon our guidance in making an investment decision regarding our common stock.

Any failure to successfully implement our operating strategy or the occurrence of any of the events or circumstances set forth in this report could result in the actual operating results being different from our guidance, and the differences may be adverse and material.

If securities or industry analysts do not publish research, or publish inaccurate or unfavorable research, about our business, our stock price and trading volume could decline.

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If one or more of the securities or industry analysts who publish research about us or our business downgrade our stock or publish inaccurate or unfavorable evaluations of our company or our stock, the price of our stock could decline. If one or more of these analysts cease coverage of our company, our stock may lose visibility in the market, which in turn could cause our stock price to decline.

The market price of our common stock has been and is likely to continue to be volatile, and you may be unable to sell your shares at or above the price at which you purchased them.

The market price of our common stock has been and is likely to continue to fluctuate widely. Factors affecting the market price of our common stock include:

- variations in our operating results, earnings per share, cash flows from operating activities, and key financial and operational metrics, and how those results compare to analyst expectations;
- forward-looking guidance that we provide to the public and industry and financial analysts related to future revenue and profitability, and any change in that guidance or our failure to achieve the results reflected in that guidance;
- the net increases in the number of members, either independently or as compared with published expectations of industry, financial or other analysts that cover our company;
- changes in the estimates of our operating results or changes in recommendations by securities analysts that elect to follow our common stock;
- announcements of changes to our medical plan, strategic alliances or significant agreements by us or by our competitors;
- announcements by us or by our competitors of mergers or other strategic acquisitions, or rumors of such transactions involving us or our competitors;
- recruitment or departure of key personnel;
- the economy as a whole and market conditions in our industry;
- trading activity by a limited number of stockholders who together beneficially own a majority of our outstanding common stock;
- the number of shares of our stock trading on a regular basis; and
- any other factors discussed in these risk factors.

In addition, if the market for stock in our industry or the stock market in general experiences uneven investor confidence, the market price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The market price of our common stock might also decline in reaction to events that affect other companies within, or outside, our industry even if these events do not directly affect us. Some companies that have experienced volatility in the trading price of their stock have been the subject of securities class action litigation. If we are the subject of such litigation, it could result in substantial costs and a diversion of our management’s attention and resources.

We do not intend to pay dividends on our common stock and, therefore, any returns will be limited to the value of our stock.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain all available funds and any future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. In addition, our ability to pay cash dividends on our common stock is limited by the terms of our credit agreement, APIC’s ability to pay dividends is limited by New York state insurance laws, and WICL Segregated Account AX's ability to pay dividends is limited by our agreements with WICL as well as WICL's regulatory requirements. Any return to stockholders will therefore be limited to the increase, if any, of our stock price.

Our directors and principal stockholders own a significant percentage of our stock and will be able to exert significant control over matters subject to stockholder approval.

Our directors, five percent or greater stockholders and their respective affiliates beneficially hold a significant amount of our outstanding voting stock. Therefore, these stockholders have the ability to influence us through this ownership position. These stockholders may be able to determine all matters requiring stockholder approval. For example, these stockholders may be able to control elections of directors, amendments of our organizational documents, or approval of any merger, sale of assets, or other major corporate transaction. This may prevent or discourage unsolicited acquisition proposals or offers for our common stock that you or other stockholders may feel are in your or their best interest as one of our stockholders.

Provisions in our restated certificate of incorporation, restated bylaws and Delaware law might discourage, delay or prevent a change in control of our company or changes in our management and, therefore, depress the market price of our common stock.

Our restated certificate of incorporation and restated bylaws contain provisions that could depress the market price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions, among other things:

- establish a classified board of directors so that not all members of our board are elected at one time;
- permit only the board of directors to establish the number of directors and fill vacancies on the board;
- provide that directors may only be removed “for cause” and only with the approval of two-thirds of our stockholders;
- require super-majority voting to amend some provisions in our restated certificate of incorporation and restated bylaws;
- authorize the issuance of “blank check” preferred stock that our board could use to implement a stockholder rights plan (also known as a “poison pill”);
- eliminate the ability of our stockholders to call special meetings of stockholders;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- prohibit cumulative voting; and
- establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at annual stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company. Section 203 imposes certain restrictions on mergers, business combinations and other transactions between us and holders of 15% or more of our common stock.

Item 2. Unregistered Sale of Equity Securities and Use of Proceeds
None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Seattle, State of Washington, on this 2nd day of May 2017.

	TRUPANION, INC.
Date: May 2, 2017	/s/ Darryl Rawlings Darryl Rawlings Chief Executive Officer and President (Principal Executive Officer)
Date: May 2, 2017	/s/ Tricia Plouf Tricia Plouf Chief Financial Officer (Principal Financial and Accounting Officer)

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Filed/Furnished Herewith
10.1	First Amendment to Loan and Security Agreement entered into as of March 31, 2017 between Pacific Western Bank, Western Alliance Bank and Trupanion, Inc.	X
31.1	Certification of Principal Executive Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	X
31.2	Certification of Principal Financial Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	X
32.1*	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	X
32.2*	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	X
101.INS	XBRL Instance Document.	X
101.SCH	XBRL Taxonomy Extension Schema Document.	X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	X
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.	X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	X

* This certification is deemed not filed for purpose of Section 18 of the Exchange Act or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act.