DIGITAL RIVER INC /DE
Form 10-Q
August 07, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2012

OR

¨ **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 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	41-1901640
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

10380 BREN ROAD WEST

MINNETONKA, MINNESOTA 55343

(Address of principal executive offices)

(952) 253-1234

(Registrant s telephone number, including area code)

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 filing requirements for the past 90 days. Yes x No ¨

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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (as defined in Exchange Act Rule 12b-2). See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

The number of shares of common stock outstanding at July 1, 2012, was 35,618,269 shares.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DIGITAL RIVER, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	(Unaudited) June 30, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 421,542	$ 497,193
Short-term investments	222,481	223,349
Accounts receivable, net of allowance of $4,919 and $4,613	71,892	64,811
Deferred tax assets	8,447	8,532
Prepaid expenses and other	40,789	35,719
Total current assets	765,151	829,604
Property and equipment, net	47,274	51,537
Goodwill	278,355	281,858
Intangible assets, net of accumulated amortization of $88,625 and $85,542	14,644	18,324
Long-term investments	84,462	99,047
Deferred income taxes	20,964	21,433
Other assets	6,577	8,973
TOTAL ASSETS	$ 1,217,427	$ 1,310,776
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 169,195	$ 243,410
Accrued payroll	13,137	17,523
Deferred revenue	10,712	8,633
Other accrued liabilities	41,323	42,577
Total current liabilities	234,367	312,143
NON-CURRENT LIABILITIES		
Senior convertible notes	353,805	353,805
Other liabilities	15,206	12,556
Total non-current liabilities	369,011	366,361
TOTAL LIABILITIES	603,378	678,504
STOCKHOLDERS EQUITY		
Preferred stock, $.01 par value; 5,000,000 shares authorized; no shares issued or outstanding	0	0
Common stock, $.01 par value; 120,000,000 shares authorized; 48,928,207 and 47,248,765 shares issued	489	472
Treasury stock at cost; 13,309,938 and 11,741,310 shares	(364,718)	(340,946)

Additional paid-in capital	720,891	708,941
Retained earnings	276,706	271,769
Accumulated other comprehensive income (loss)	(19,319)	(7,964)
Total stockholders equity	614,049	632,272
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,217,427	$ 1,310,776

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data; unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenue	$ 90,774	$ 92,520	$ 193,217	$ 190,705
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	3,069	3,856	6,697	8,019
Network and infrastructure	12,932	12,477	25,689	25,089
Sales and marketing	39,818	39,492	82,844	77,198
Product research and development	15,416	18,106	31,419	33,726
General and administrative	11,856	10,867	24,522	21,623
Depreciation and amortization	4,950	5,559	10,289	10,964
Amortization of acquisition-related intangibles	1,743	2,205	3,592	4,327
Total costs and expenses	89,784	92,562	185,052	180,946
Income (loss) from operations	990	(42)	8,165	9,759
Interest income	996	1,753	2,135	3,228
Interest expense	(2,254)	(2,243)	(4,494)	(4,500)
Other income (expense), net	1,030	672	733	538
Income (loss) before income taxes	762	140	6,539	9,025
Income tax expense (benefit)	562	(151)	1,602	1,715
Net income (loss)	$ 200	$ 291	$ 4,937	$ 7,310
Net income (loss) per share basic	$ 0.01	$ 0.01	$ 0.15	$ 0.20
Net income (loss) per share diluted	$ 0.01	$ 0.01	$ 0.15	$ 0.19
Shares used in per-share calculation basic	33,453	37,436	33,629	37,415
Shares used in per-share calculation diluted	33,561	37,981	33,821	38,105

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands; unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income (loss)	$ 200	$ 291	$ 4,937	$ 7,310
Other comprehensive income (loss):				
Unrealized foreign exchange gain (loss) on the revaluation of investments in foreign subsidiaries	(17,702)	6,170	(7,697)	23,800
Unrealized gain (loss) on investments	(3,256)	255	(6,287)	1,169
Tax benefit (expense)	1,087	(265)	2,629	(556)
Other comprehensive income (loss)	(19,871)	6,160	(11,355)	24,413
Comprehensive income (loss)	$ (19,671)	$ 6,451	$ (6,418)	$ 31,723

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Six Months Ended June 30,	
	2012	2011
OPERATING ACTIVITIES		
Net income (loss)	$ 4,937	$ 7,310
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of acquisition-related intangibles	3,592	4,327
Provision for doubtful accounts	900	684
Depreciation and amortization	10,289	10,964
Debt issuance cost amortization	987	998
Stock-based compensation expense	12,192	10,686
Excess tax benefits from stock-based compensation	(103)	(1,474)
Deferred and other income taxes	48	1,151
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(8,434)	(3,754)
Prepaid and other assets	(5,598)	(2,236)
Accounts payable	(72,606)	(23,684)
Deferred revenue	4,917	(675)
Income tax payable	2,061	(1,939)
Other accrued liabilities	(5,029)	(29,241)
Net cash provided by (used in) operating activities	(51,847)	(26,883)
INVESTING ACTIVITIES		
Purchases of investments	(80,602)	(191,634)
Sales of investments	88,501	83,646
Purchases of equipment and capitalized software	(6,150)	(9,136)
Net cash provided by (used in) investing activities	1,749	(117,124)
FINANCING ACTIVITIES		
Debt issuance costs	0	(342)
Exercise of stock options	1,509	315
Sales of common stock under employee stock purchase plan	1,300	1,251
Repurchase of common stock	(20,242)	0
Repurchase of restricted stock to satisfy tax withholding obligation	(3,530)	(5,756)
Excess tax benefits from stock-based compensation	103	1,474
Net cash provided by (used in) financing activities	(20,860)	(3,058)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(4,693)	14,433
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(75,651)	(132,632)
CASH AND CASH EQUIVALENTS, beginning of period	497,193	565,086
CASH AND CASH EQUIVALENTS, end of period	$ 421,542	$ 432,454

SUPPLEMENTAL DISCLOSURES		
Cash paid for interest on senior convertible notes	$ 3,505	$ 3,505
Cash paid for income taxes	$ 1,867	$ 2,275

See accompanying notes to consolidated financial statements.

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1. BASIS OF PRESENTATION

The unaudited consolidated financial statements included herein reflect all adjustments, including normal recurring adjustments, which in our opinion are necessary to fairly state our consolidated financial position, results of operations and cash flows for the periods presented. These consolidated financial statements should be read in conjunction with our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2012, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2012. The December 31, 2011, information was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles (GAAP) in the United States.

Summary of Significant Accounting Policies

A detailed description of our significant accounting policies can be found in our most recent Annual Report filed on Form 10-K for the fiscal year ended December 31, 2011. There were no material changes in significant accounting policies during the quarter ended June 30, 2012.

Revenue

A detailed description of our revenue recognition policy can be found in our most recent Annual Report filed on Form 10-K for the fiscal year ended December 31, 2011. Revenue was $90.8 million and $92.5 million for the three months ended June 30, 2012 and 2011, respectively. For the six months ended June 30, 2012 and 2011, revenue was $193.2 million and $190.7 million, respectively. Revenue for the six months ended June 30, 2012, included a $0.7 million client settlement associated with a prior period.

Restricted Cash

Restricted cash consists of cash and cash equivalents that are held in escrow accounts and restricted by agreements with third parties for a particular purpose. Restricted cash and cash equivalents are included in current assets under Prepaid expenses and other on our Consolidated Balance Sheets, and are recorded at fair value. As of June 30, 2012 and December 31, 2011, we had $0.4 million and $1.5 million of restricted cash, respectively.

Software Development

Costs to develop software for internal use are required to be capitalized and amortized over the estimated useful life of the software. For the three months ended June 30, 2012 and 2011, we capitalized $1.5 million and $1.1 million related to software development, respectively. For the six months ended June 30, 2012 and 2011, we capitalized $2.8 million and $3.1 million related to software development, respectively. This capitalization is related to the development of our enterprise resource planning (ERP) system, new data management and reporting infrastructure, and enhancements to our commerce platforms. We expect these investments to drive long-term revenue enhancements, operational efficiencies across the organization, and provide further competitive differentiation.

Foreign Currency Translation

Substantially all of our foreign subsidiaries use the local currency of their respective countries as their functional currency. Assets and liabilities are translated at exchange rates prevailing at the balance sheet dates. Revenues, costs and expenses are translated at the average exchange rates for the reported period. Gains and losses resulting from translation are recorded as a component of Accumulated other comprehensive income (loss) within stockholders' equity. Gains and losses resulting from foreign currency transactions are recognized as Other income (expense), net .

We are exposed to market risk from changes in foreign currency exchange rates. Our primary risk is the effect of foreign currency exchange rate fluctuations on the U.S. dollar value of foreign currency denominated operating sales and expenses. We are also exposed to financial risk related to exchange rate translation losses (or gains) associated with economic interests that are denominated in a foreign currency. The risk of translation losses due to foreign exchange volatility is partially mitigated by the use of foreign exchange forward contracts with maturities of less than three months. These derivative transactions are not designated as hedges and are adjusted to fair value through income each period. The principal exposures mitigated were euro, pound sterling and Australian dollar currencies. For the three and six months ended June 30, 2012 and 2011, the gain/loss on derivative settlements was immaterial. The notional amounts held at period end and the underlying gain/loss were determined to be immaterial when compared to our overall cash and cash equivalents and the net income (loss) reported for the respective

periods.

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Our foreign currency contracts contain credit risk to the extent that our bank counterparties may be unable to meet the terms of the agreements. We minimize such risk by limiting our counterparties to major financial institutions of high credit quality.

Recent Accounting Pronouncements

ASU 2011-04 Fair Value Measurements: In May 2011, the FASB issued ASU 2011-04. This update provides amendments to ASC Topic 820 Fair Value Measurements and Disclosures by creating a uniform framework for applying fair value measurements principles and clarified existing guidance in U.S. GAAP. The amendments called for additional disclosures regarding quantitative information about the significant unobservable inputs used for all Level 3 measurements, information about the sensitivity of a fair value measurement categorized within Level 3 of the fair value hierarchy to changes in unobservable inputs and any interrelationships between those unobservable inputs and a description of the valuation process. Additionally, disclosures are required when current use of the non-financial assets measured at fair value differs from its highest and best use, any transfers from Level 1 and Level 2 and the hierarchy classification for items whose fair value is not recorded on the balance sheet but disclosed in the footnotes. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011, and is to be completed on a prospective basis. We have adopted the new disclosure requirements as of the period ended March 31, 2012, and it did not have a material impact on our Consolidated Financial Statements.

ASU 2011-05 Comprehensive Income: In June 2011, the FASB issued ASU 2011-05. This amendment requires nonowner changes in stockholders equity, reclassifications and all other items affecting comprehensive income be presented in either a single continuous statement or in two separate but consecutive statements for all periods presented. The amendments do not change the items that must be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income (loss). Subsequently, the FASB issued ASU 2011-12, which indefinitely deferred the provision within ASU 2011-05 requiring presentation of reclassification adjustments out of accumulated other comprehensive income. Both ASUs were effective for interim and annual periods beginning after December 15, 2011, and are to be completed on a retrospective basis. We have adopted the new disclosure requirements as of the period ended March 31, 2012, and it did not have a material impact on our Consolidated Financial Statements.

ASU 2011-08 Goodwill Impairment Testing: In September 2011, the FASB issued ASU 2011-08. Under this amendment, qualitative factors are first assessed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that goodwill is impaired. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step goodwill impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing it against the carrying amount. ASU 2011-08 is effective for interim and annual periods beginning after December 15, 2011. We adopted ASU 2011-08 as of the period ended March 31, 2012, and it did not have a material impact on our Consolidated Financial Statements.

We have determined that all other recently issued accounting standards will not have a material impact on our Consolidated Financial Statements, or do not apply to our operations.

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2. NET INCOME (LOSS) PER SHARE

The following table summarizes the computation of basic and diluted net income (loss) per share (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income (loss) per share basic				
Net income (loss) basic	$ 200	$ 291	$ 4,937	$ 7,310
Weighted average shares outstanding basic	33,453	37,436	33,629	37,415
Net income (loss) per share basic	$ 0.01	$ 0.01	$ 0.15	$ 0.20
Net income (loss) per share diluted				
Net income (loss) basic	$ 200	$ 291	$ 4,937	$ 7,310
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	0	0	0	0
Net income (loss) diluted	$ 200	$ 291	$ 4,937	$ 7,310
Weighted average shares outstanding basic	33,453	37,436	33,629	37,415
Dilutive impact of non-vested stock and options outstanding	108	545	192	690
Weighted average shares outstanding diluted	33,561	37,981	33,821	38,105
Net income (loss) per share diluted	$ 0.01	$ 0.01	$ 0.15	$ 0.19

Options to purchase 1,496,936 and 714,705 shares for the three months ended June 30, 2012 and 2011, respectively, and 1,496,936 and 708,142 shares for the six months ended June 30, 2012 and 2011, respectively, were not included in the computation of diluted net income (loss) per share because their effect on diluted net income (loss) per share would have been anti-dilutive.

The unissued shares underlying our 2004 senior convertible notes, 199,828 shares for both the three and six months ended June 30, 2012 and 2011, were excluded for the purposes of calculating GAAP diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive. The unissued shares underlying our 2010 senior convertible notes, 7,022,027 shares for both the three and six months ended June 30, 2012 and 2011, were excluded for the purposes of calculating GAAP diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive.

3. FAIR VALUE MEASUREMENTS

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three categories:

Level 1 Observable inputs such as quoted prices in active markets;

Level 2 Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

Quoted prices for similar assets or liabilities in active markets;

Quoted prices for identical or similar assets in less active markets than Level 1 investments;

Inputs other than quoted prices that are observable for assets or liabilities; and

Inputs that are derived principally from or corroborated by other observable market data.

Level 3 Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management s estimate of market participant assumptions.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

The fair value hierarchy requires the use of observable market data when available. In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Our assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability. The Company s policy is to recognize transfers between levels at the end of the quarter.

The following table sets forth by level within the fair value hierarchy, our financial assets that were accounted for at fair value on a recurring basis at June 30, 2012 and December 31, 2011, (in thousands), according to the valuation techniques we used to determine their fair values. There have been no transfers of assets between the fair value hierarchies presented below:

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	Total	Fair Value Measurements Level 1	Level 2	Level 3
Balance as of June 30, 2012				
Cash and cash equivalents	$ 421,542	$ 421,542	$ 0	$ 0
Restricted cash	351	351	0	0
U.S. government sponsored entities	38,119	0	38,119	0
Corporate bonds	170,533	170,533	0	0
Asset-backed securities	13,829	0	13,829	0
Market basis equity investments	2,304	2,304	0	0
Auction rate securities	50,612	0	0	50,612
Total assets measured at fair value	$ 697,290	$ 594,730	$ 51,948	$ 50,612
Balance as of December 31, 2011				
Cash and cash equivalents	$ 497,193	$ 497,193	$ 0	$ 0
Restricted cash	1,524	1,524	0	0
U.S. government sponsored entities	25,999	0	25,999	0
Corporate bonds	176,561	176,561	0	0
Asset-backed securities	20,789	0	20,789	0
Market basis equity investments	1,566	1,566	0	0
Auction rate securities	65,338	0	0	65,338
Total assets measured at fair value	$ 788,970	$ 676,844	$ 46,788	$ 65,338

The following table is a reconciliation of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3 inputs) (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Short-term Investments	Long-term Investments	Total
Balance as of December 31, 2010	$ 0	$ 83,678	$ 83,678
Total gains or losses (realized/unrealized) included in other comprehensive income	0	735	735
Purchases	0	0	0
Issuances	0	0	0
Settlements	0	(19,075)	(19,075)
Transfers in and/or out of Level 3	0	0	0
Balance as of December 31, 2011	$ 0	$ 65,338	$ 65,338
Total gains or losses (realized/unrealized) included in other comprehensive income	0	(7,726)	(7,726)
Purchases	0	0	0
Issuances	0	0	0
Settlements	0	(7,000)	(7,000)
Transfers in and/or out of Level 3	0	0	0
Balance as of June 30, 2012	$ 0	$ 50,612	$ 50,612

The following methods and assumptions were used to estimate the fair value of each class of financial instrument. There have been no changes in the valuation techniques used by the Company to fair value our financial instruments:

Cash and Cash equivalents. Consist of cash on hand in bank deposits, highly liquid investments, primarily high grade commercial paper and money market accounts. The fair value was measured using quoted market prices and is classified as Level 1. The carrying amount approximates fair value.

Restricted Cash. Consist of cash and cash equivalents that are held in escrow accounts and restricted by agreements with third parties for a particular purpose. The carrying amount approximates fair value and is classified as Level 1.

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U.S government sponsored entities. Consist of Fannie Mae, Freddie Mac and Federal Home Loan Bank investment grade bonds that are traded in less active markets than Level 1 investments. The fair value of these bonds is classified as Level 2. The contractual maturity of these investments is within three years.

Corporate Bonds. Consist of investment grade corporate bonds that trade with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these bonds was measured using quoted market prices and is classified as Level 1. The contractual maturity of these investments is within three years.

Asset-backed Securities. Consist of securities backed by automobile loan receivables that are traded in less active markets than our Level 1 investments. The fair value is classified as Level 2. The contractual maturity of these investments is within one year.

Market Basis Equity Investments. Consist of available for sale equity securities that trade with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these investments was measured using quoted market prices and is classified as Level 1.

Auction Rate Securities. As of June 30, 2012, we held $64.5 million of auction rate securities (ARS) at par value which we have recorded at $50.6 million fair value. As of December 31, 2011, we held $71.5 million of ARS at par value which was recorded at $65.3 million fair value. The ARS are student loans over-collateralized and guaranteed by the U.S. government. Almost all of these securities continue to fail at auction due to continued illiquid market conditions.

Due to the illiquid market conditions, we recorded a temporary fair value reduction of our ARS in the amount of $13.9 million (21.6 % of par value) as of June 30, 2012, under Accumulated other comprehensive income (loss) , compared to a $6.2 million temporary fair value reduction as of December 31, 2011 (8.6% of par value). The discounted cash flow model we used to value these securities included the following assumptions:

	June 30, 2012	December 31, 2011
Unobservable inputs		
Redemption period (in years)	7.0	7.0
Credit ratings	BB + to AAA	AAA - to AAA
Penalty coupon rate	1.0% to 1.5%	1.0% to 1.5%
Weighted average annualized yield	1.2%	1.5%
Risk adjusted discount rate	3.5% to 15.5%	3.9% to 10.9%

Management makes estimates and assumptions about the ARS, which can be sensitive to changes and effect the determination of fair value. An increase in the length of redemption period or an increase in the discount rate assumption would decrease our fair value. Also, a decrease in the securities credit ratings would decrease our fair value.

The portfolio had a weighted average maturity of 27.8 years and 27.5 years as of June 30, 2012 and December 31, 2011, respectively. We continue to believe that we will be able to liquidate at par over time. We do not intend to sell the investments prior to recovery of their amortized cost basis nor do we believe it is more likely than not we may be required to sell the investments prior to recovery of their amortized cost basis. Accordingly, we treated the fair value decline as temporary. We anticipate we will have sufficient cash flow from operations to execute our business strategy and fund our operational needs. We believe that capital markets are also available if we need to finance other investing alternatives.

We classify our ARS as Level 3 long-term investments until we receive a call or partial call on the securities. Upon receipt of a call or partial call, we classify the securities subject to the call or partial call, as Level 1 short term investments. As of June 30, 2012 and December 31, 2011, our entire ARS portfolio was classified as Level 3 long-term investments. In the six months ended June 30, 2012, we liquidated $7.0 million of ARS due to full or partial calls at par. During the year ended December 31, 2011, we liquidated $19.1 million of ARS due to full or partial calls at par.

Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, they are not measured at fair value on an ongoing basis but are subject to fair value adjustments only in certain circumstances like evidence of impairment. During the three and six months ended

June 30, 2012 and 2011, we had no significant measurements of assets or liabilities at fair value on a nonrecurring basis subsequent to their initial recognition.

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The aggregate carrying value and fair value of the Company s cost method equity investments at June 30, 2012 and December 31, 2011, was $31.5 million and $32.1 million, respectively, and is included under Long-term investments on the Consolidated Balance Sheets. We have evaluated the investments for impairment and we believe that the entity valuations completed at acquisition and the investee's subsequent performance against those projections indicates that the acquisition price continues to represent fair value.

As of June 30, 2012 and December 31, 2011, the fair value of our $345.0 million 2.0% fixed rate 2010 senior convertible notes was valued at $322.1 million and $285.1 million, respectively, based on the quoted fair market value of the debt. As of June 30, 2012 and December 31, 2011, the fair value of our $8.8 million 1.25% fixed rate 2004 senior convertible notes was valued at $8.4 million and $8.6 million, respectively, based on the quoted fair market value of the debt. Our debt is classified as Level 3 and we determine fair value based on a market approach.

4. INVESTMENTS

As of June 30, 2012 and December 31, 2011, our available-for-sale securities consisted of the following (in thousands):

			Gross Unrealized Losses			Maturities/Reset Dates	
	Cost	Gross Unrealized Gains	Less than 12 Months	Greater than 12 Months	Fair Value	Less than 12 Months	Greater than 12 Months
Balance as of June 30, 2012							
U.S. government sponsored entities	$ 38,119	$ 6	$ (6)	$ 0	$ 38,119	$ 31,120	$ 6,999
Corporate bonds	170,121	457	(45)	0	170,533	70,254	100,279
Asset-backed securities	13,821	8	0	0	13,829	13,829	0
Market basis equity investments	2,304	0	0	0	2,304	0	2,304
Auction rate securities	64,525	0	0	(13,913)	50,612	0	50,612
Total available-for-sale securities	$ 288,890	$ 471	$ (51)	$ (13,913)	$ 275,397	$ 115,203	$ 160,194
Balance as of December 31, 2011							
U.S. government sponsored entities	$ 26,000	$ 4	$ (5)	$ 0	$ 25,999	$ 20,004	$ 5,995
Corporate bonds	176,797	374	(610)	0	176,561	63,452	113,109
Asset-backed securities	20,795	2	(8)	0	20,789	20,789	0
Market basis equity investments	1,566	0	0	0	1,566	0	1,566
Auction rate securities	71,525	0	0	(6,187)	65,338	0	65,338
Total available-for-sale securities	$ 296,683	$ 380	$ (623)	$ (6,187)	$ 290,253	$ 104,245	$ 186,008

We consider the fair value decline of our investments in U.S. government sponsored entities, and corporate bonds to be temporary, as we do not intend to sell the investments and it is not likely that we will be required to sell the investments before recovery of their amortized cost basis. See Note 3 Fair Value Measurements, regarding the fair value decline in auction rate securities.

Realized gains or losses on investments are recorded in our Consolidated Statements of Operations within Other income (expense), net . Upon the sale of a security classified as available for sale, the security s specific unrealized gain (loss) is reclassified out of Accumulated other comprehensive income (loss) into earnings based on the specific identification method. In the three and six months ended June 30, 2012 and 2011, the reclassifications from Accumulated other comprehensive income (loss) to net assets were immaterial related to securities settled at par within the periods. Realized gains and losses on sales of investments were immaterial in the three and six months ended June 30, 2012 and 2011.

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5. STOCK-BASED COMPENSATION

The following table summarizes stock-based compensation expense related to employee stock options, restricted stock awards and employee stock purchases recognized (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Costs and expenses				
Direct cost of services	$ 58	$ 118	$ 118	$ 233
Network and infrastructure	368	345	732	592
Sales and marketing	2,129	2,116	4,297	3,876
Product research and development	953	781	1,688	1,491
General and administrative	2,723	2,371	5,357	4,494
Stock-based compensation included in costs and expenses	$ 6,231	$ 5,731	$ 12,192	$ 10,686

6. INCOME TAXES

The provision (benefit) for income taxes is composed of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Current tax expense (benefit):				
United States	$ 1,471	$ (1,120)	$ 1,349	$ 42
International	(909)	969	253	1,673
Total current provision for income taxes	$ 562	$ (151)	$ 1,602	$ 1,715
Tax Rate	73.8%	(108.2)%	24.5%	19.0%

There is uncertainty of future realization of the deferred tax assets resulting from tax loss carryforwards due to anticipated limitations. Therefore, a valuation allowance was recorded against the tax effect of such tax loss carryforwards. At June 30, 2012, the Company has a valuation allowance on approximately $3.6 million of deferred tax assets related to operating losses and $0.2 million of deferred tax assets related to other tax attributes as we believe it is more likely than not that these deferred tax assets will not be realized. Any future release of this valuation allowance will reduce expense.

As of June 30, 2012, we had $10.7 million of unrecognized tax benefits, excluding related interest. All of these unrecognized tax benefits would affect our effective tax rate if recognized. As of June 30, 2012, we had approximately $0.7 million of accrued interest related to uncertain tax positions. Due to the potential resolution of examinations currently being performed by taxing authorities and the expiration of various statutes of limitation, it is reasonably possible that the balance of our gross unrecognized tax benefits may change within the next twelve months by a range of zero to $2.7 million.

7. COMMITMENTS AND CONTINGENCIES

Litigation

DDR Holdings, LLC (DDR Holdings) has brought a claim against us and several other defendants regarding U.S. Patents Nos. 6,629,135 (the 135 patent), 6,993,572 (the 572 patent), and 7,818,399 (the 399 Patent), which are owned by DDR Holdings. These patents claim e-commerce outsourcing systems and methods relating to the provision of outsourced e-commerce support pages having a common look and feel with a host s

website. The case was filed in the U.S. District Court for the Eastern District of Texas on January 31, 2006. The complaint seeks injunctive relief, declaratory relief, damages and attorneys fees. We have denied infringement of any valid claim of the patents-in-suit, and have asserted counter-claims which seek a judicial declaration that the patents are invalid and not infringed. After a delay due to DDR Holdings request for re-examination of the 135 and 572 patents, in October 2010 the Court granted DDR Holdings unopposed motion to lift the stay in the litigation. Digital River and DDR are currently completing the discovery phase of the litigation and are engaged in pre-trial preparation. We intend to vigorously defend ourselves in the DDR Holdings matter, however, no assurances can be given at this time as to the ultimate outcome of this case, or the range of potential loss should the outcome be unfavorable.

In December 2010, a lawsuit was filed against a number of software companies, including us, by Uniloc USA, Inc. and Uniloc Singapore Private Limited in the United States District Court for the Eastern District of Texas. The complaint seeks monetary damages in unspecified amounts and permanent injunction based upon claims for alleged patent infringement. We are at an early stage of this matter. While we intend to vigorously defend this matter, we cannot predict the timing or ultimate outcome, nor estimate a range of loss, if any, for this matter.

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We are subject to legal proceedings, claims and litigation arising in the ordinary course of business. While the final outcome of these matters is currently not determinable, we believe there is no ordinary course litigation pending against us that is likely to have, individually or in the aggregate, a material effect on our consolidated financial position, results of operation, stockholders equity or cash flows. Because of the uncertainty inherent in litigation, it is possible that unfavorable resolutions of these lawsuits, proceedings and claims could exceed the amount we have currently reserved for these matters.

From time to time, we are involved in other disputes or regulatory inquiries that arise in the ordinary course of business. Any claims or regulatory actions against us, whether meritorious or not, could be time consuming, result in costly litigation, damage awards, injunctive relief or increased costs of doing business through adverse judgment or settlement, require us to change our business practices in expensive ways, require significant amounts of management time, result in the diversion of significant operational resources or otherwise harm our business. These matters are subject to inherent uncertainties and management s view of these matters may change in the future.

Third parties have from time-to-time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We have been notified of several potential patent disputes, and expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity. We have in the past been forced to litigate such claims. We may also become more vulnerable to third-party claims as laws, such as the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are interpreted by the courts and as we expand geographically into jurisdictions where the underlying laws with respect to the potential liability of online intermediaries like ourselves are either unclear or less favorable. These claims, whether meritorious or not, could be time consuming and costly to resolve, cause service upgrade delays, require expensive changes in our methods of doing business, or could require us to pay damages or enter into costly royalty or licensing agreements.

Indemnification Provisions

In the ordinary course of business we have included limited indemnification provisions in certain of our agreements with parties with whom we have commercial relations. Under these contracts, we generally indemnify, hold harmless and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by any third party with respect to our domain names, trademarks, logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In certain agreements, including both agreements under which we have developed technology for certain commercial parties and agreements with our clients, we have provided an indemnity for other types of third-party claims. To date, no significant costs have been incurred, either individually or collectively, in connection with our indemnification provisions.

In addition, we are required by our credit card processors to comply with credit card association operating rules, and we have agreed to indemnify our processors for any fines they are assessed by credit card associations as a result of processing payments for us. The credit card associations and their member banks set and interpret the credit card rules. Visa, MasterCard, American Express or Discover could adopt new operating rules or re-interpret existing rules that we or our credit card processors might find difficult to follow. We also could be subject to fines or increased fees from MasterCard and Visa.

Commitments and Guarantees

At certain times, we enter into agreements where a letter of credit is required to ensure payment of future obligations by counterparties, such as our credit card processors and international taxing jurisdictions. Upon withdrawal, we are obligated to fund the executor bank on demand. We have not set aside specific funds to cover this potential obligation as we can generally recover these costs from our clients. If drawn upon, we expect to fund this commitment with cash and cash equivalents. There was $3.3 million in undrawn letters of credit as of June 30, 2012 and December 31, 2011, respectively.

8. DEBT

2010 Senior Convertible Notes

On November 1, 2010, we sold and issued $345.0 million in aggregate principal amount of senior convertible notes (2010 Notes), in a private, unregistered offering. The 2010 Notes are unsecured obligations and rank equally with all of our existing and future senior unsecured debt. The 2010 Notes were sold at their total principal amount. The 2010 Notes bear interest at the rate of 2.00% per annum from the date of issuance, payable semi-annually on May 1 and November 1, commencing on May 1, 2011. The 2010 Notes will mature, unless earlier repurchased, redeemed or converted in accordance with their terms, on November 1, 2030.

Holders have the right to convert some or all of the 2010 Notes at any time prior to the maturity date into shares of our common stock at the initial conversion rate of 20.3537 shares per $1,000 in principal amount of the 2010 Notes, which is equal to an initial conversion price of approximately $49.13 per share. At the initial conversion rate, assuming the conversion

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of all $345.0 million in aggregate principal amount, the 2010 Notes may be converted into approximately 7,022,027 shares of our common stock. We will adjust the conversion price if certain events occur, as specified in the related indenture, such as the issuance of our common stock as a dividend or distribution or the occurrence of a stock subdivision or combination. If we undergo certain types of fundamental changes, as defined in the indenture, on or before November 1, 2015, we will be required to pay a fundamental change make-whole premium on 2010 Notes converted in connection with such make-whole fundamental change by increasing the conversion rate. The amount of the fundamental change make-whole premium, if any, will be based on our common stock price and the effective date of the make-whole fundamental change.

At any time on or after November 1, 2015, and prior to the maturity date, we may redeem for cash some or all of the 2010 Notes at a redemption price equal to the principal amount of the 2010 Notes to be redeemed, plus accrued and unpaid interest to, but excluding, the redemption date.

Holders have the right to require us to repurchase some or all of their 2010 Notes for cash on each of November 1, 2015, November 1, 2020 and November 1, 2025, at a repurchase price equal to the principal amount of the 2010 Notes to be repurchased, plus accrued and unpaid interest to, but excluding, the relevant repurchase date. If we undergo certain types of fundamental changes prior to the maturity date, holders of the 2010 Notes will have the right, at their option, to require us to repurchase some or all of their 2010 Notes at a repurchase price equal to the principal amount of the 2010 Notes being repurchased, plus accrued and unpaid interest to, but excluding, the repurchase date.

2004 Senior Convertible Notes

In 2004, we sold and issued $195.0 million in aggregate principal amount of 1.25% senior convertible notes due January 1, 2024 (2004 Notes), in a private, unregistered offering. The 2004 Notes were sold at their principal amount. On January 5, 2009, we announced that the majority of the holders of the 2004 Notes exercised the option to require us to repurchase those Notes on January 2, 2009. Notes with an aggregate principal amount of approximately $8.8 million remain outstanding. Holders of the remaining outstanding 2004 Notes have the right to require us to repurchase their 2004 Notes prior to maturity on January 1, 2014 and 2019.

We are required to pay interest on the 2004 Notes on January 1 and July 1 of each year so long as the 2004 Notes are outstanding. The 2004 Notes bear interest at a rate of 1.25% and, if specified conditions are met, are convertible into our common stock at a conversion price of $44.063 per share. The 2004 Notes may be surrendered for conversion under certain circumstances, including the satisfaction of a market price condition, such that the price of our common stock reaches a specified threshold; the satisfaction of a trading price condition, such that the trading price of the 2004 Notes falls below a specified level; the redemption of the 2004 Notes by us, the occurrence of specified corporate transactions, as defined in the related indenture; and the occurrence of a fundamental change, as defined in the related indenture. The initial conversion price is equivalent to a conversion rate of approximately 22.6948 shares per $1,000 of principal amount of the 2004 Notes. We will adjust the conversion price if certain events occur, as specified in the related indenture, such as the issuance of our common stock as a dividend or distribution or the occurrence of a stock subdivision or combination.

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

The discussion in this Quarterly Report contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed below. Additional factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section entitled Risk Factors, included in Item 1A of Part II of this Quarterly Report. When used in this document, the words believes, expects, anticipates, intends, plans, and similar expressions, are intended to identify certain of these forward-looking statements. However, these words are not the exclusive means of identifying such statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. The cautionary statements made in this document should be read as being applicable to all related forward-looking statements wherever they appear in this document. We have no obligation to update the matters set forth herein, whether as a result of new information, future events or otherwise.

Overview

We provide end-to-end global cloud-commerce, payments and marketing solutions to a wide variety of companies in software, consumer electronics, computer games, video games and other markets. We offer our clients a broad range of services that enable them to quickly and cost effectively establish an online sales channel capability and to subsequently manage and grow online sales on a global basis while mitigating risks. Our services include design, development and hosting of online stores and shopping carts, store merchandising and optimization, order management, denied parties screening, export controls and management, tax compliance and management, fraud management, digital product delivery via download, physical product fulfillment, subscription management, online marketing including e-mail marketing, management of affiliate programs, paid search programs, payment processing services, website optimization, web analytics and reporting, and CD production and delivery.

Our products and services allow our clients to focus on promoting and marketing their products and brands worldwide while leveraging our investments in technology and infrastructure to facilitate the purchase of products through their online websites. When shoppers visit one of our clients' branded websites they are transferred to an online commerce store and/or shopping cart operated by us on our commerce platforms. Once on our system, shoppers can browse for products and make purchases online. We typically are the seller of record for transactions through our client branded stores. After a purchase is made, we either deliver the product digitally via download over the Internet or transmit instructions to a third party for physical fulfillment of the order. We also typically process the buyer's payment as the merchant of record, including collection and remittance of applicable taxes and compliance with various regulatory matters. We have invested substantial resources to develop our cloud-commerce and marketing platforms, including direct-to-buyer software, and we provide access and use of our platforms to our clients as a service as opposed to selling the software to be operated on their own in-house computer hardware. Our cloud-commerce store solutions range from simple remote control models to more comprehensive online store models.

In addition to the services we provide that facilitate the completion of an online transaction, we also offer services designed to increase traffic to our clients' websites and the associated online stores and to improve the sales productivity of those stores. Our services include paid search advertising, search engine optimization, affiliate marketing, store optimization, multi-variant testing, web analytic services and e-mail optimization. All of our services are designed to help our clients acquire customers more effectively, sell to those customers more often and more efficiently, and increase the lifetime value of each customer.

Additionally, through our Digital River World Payments subsidiary, we offer a full range of payment processing services to clients. These services include multiple payment methods, fraud management, tax management, cloud-based billing and other payment optimization services.

On May 8, 2012, we entered into with Microsoft Corporation (Microsoft), in the ordinary course of business, the Third Omnibus Amendment to the Microsoft Operations Digital Distribution Agreement (the Third Omnibus Amendment). The Third Omnibus Amendment extends the term of Microsoft Operations Digital Distribution Agreement to a date no earlier than March 1, 2014. Additionally, the Third Omnibus Amendment contemplates the expansion of the business relationship whereby we will build, host and manage the Microsoft Store, an e-commerce store that supports the sale and fulfillment of Microsoft and third party software as well as consumer electronics products, to customers throughout the world. The Third Omnibus Amendment contemplates us providing e-commerce services in connection with Microsoft Store on a global basis in addition to maintaining and expanding our role as a reseller of Microsoft products via Digital River s existing online stores in addition to new stores offering physical media.

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We view our operations and manage our business as one reportable segment, providing outsourced commerce solutions globally to a variety of companies, primarily in the software and consumer electronics product markets.

We were incorporated in Delaware in February 1994. Our headquarters are located at 10380 Bren Road West, Minnetonka, Minnesota and our telephone number is 952-253-1234.

General information about us can be found at www.digitalriver.com under the Company/Investor Relations link or follow the Company on Twitter at twitter.com/digitalriverinc. Our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments or exhibits to those reports, are available free of charge through our website as soon as reasonably practicable after we file such reports with the Securities and Exchange Commission.

Results of Operations

The following table sets forth certain items from our Consolidated Statements of Operations as a percentage of total revenue for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenue	100.0%	100.0%	100.0%	100.0%
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	3.4	4.2	3.5	4.2
Network and infrastructure	14.2	13.5	13.3	13.2
Sales and marketing	43.9	42.7	42.9	40.5
Product research and development	17.0	19.5	16.3	17.7
General and administrative	13.1	11.7	12.7	11.3
Depreciation and amortization	5.4	6.0	5.3	5.7
Amortization of acquisition-related intangibles	1.9	2.4	1.8	2.3
Total costs and expenses	98.9	100.0	95.8	94.9
Income (loss) from operations	1.1		4.2	5.1
Interest income	1.1	1.9	1.1	1.7
Interest expense	(2.5)	(2.4)	(2.3)	(2.4)
Other income (expense), net	1.1	0.7	0.4	0.3
Income (loss) before income taxes	0.8	0.2	3.4	4.7
Income tax expense (benefit)	0.6	(0.1)	0.8	0.9
Net income (loss)	0.2%	0.3%	2.6%	3.8%

REVENUE. Our revenue was $90.8 million for the three months ended June 30, 2012, compared to $92.5 million for the same period in the prior year, a decrease of $1.7 million or 1.9%. For the six months ended June 30, 2012, revenue totaled $193.2 million, an increase of $2.5 million, or 1.3%, from revenue of $190.7 million for the same period in the prior year.

Our commerce revenues are driven primarily by global commerce and payment services provided to a wide variety of companies in the software, consumer electronics, computer games and other markets. Commerce revenues include revenues generated from Microsoft. All other non-commerce revenue or support business revenue is driven primarily by our e-mail and affiliate marketing businesses.

For the three months ended June 30, 2012, the $1.7 million decrease in revenue was driven primarily by an increase in commerce revenue of $3.6 million, which includes a $0.7 million client settlement associated with a prior period. This commerce revenue increase was partially offset

by a decrease in our support business revenue of $2.9 million and foreign exchange unfavorability of $2.4 million compared to the same period in the prior year. For the six months ended June 30, 2012, the $2.5 million increase in revenue was driven primarily by an increase in commerce revenue of $11.8 million partially offset by a decrease in support business revenue of $6.2 million and foreign exchange unfavorability of $3.1 million compared to the same period in the prior year.

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International sales were approximately 46.7% and 46.7% of total sales in the three and six month periods ended June 30, 2012, compared to 46.1% and 46.2% for the same periods in the prior year.

DIRECT COST OF SERVICES. Direct cost of services primarily includes costs related to product fulfillment, backup CD production, delivery solutions and certain client-specific costs. Direct cost of service expenses were $3.1 million for the three months ended June 30, 2012, compared to $3.9 million for the same period in the prior year. Direct cost of service expenses were $6.7 million for the six months ended June 30, 2012, compared to $8.0 million for the same period in the prior year. The decreases for both periods were primarily attributable to lower CD production and delivery costs.

As a percentage of revenue, direct cost of services was 3.4% and 3.5% for the three and six months ended June 30, 2012, compared to 4.2% and 4.2% for the same periods in the prior year.

NETWORK AND INFRASTRUCTURE. Our network and infrastructure expenses primarily include costs to operate and maintain our technology platforms, customer service, data communication and data center operations. Network and infrastructure expenses were $12.9 million and $12.5 million for the three months ended June 30, 2012 and 2011, respectively. Network and infrastructure expenses were $25.7 million and $25.1 million for the six months ended June 30, 2012 and 2011, respectively. The increases for both periods were mainly due to higher data communication related costs.

As a percentage of revenue, network and infrastructure expenses were 14.2% and 13.3% for the three and six months ended June 30, 2012, compared to 13.5% and 13.2% for the same periods in the prior year.

SALES AND MARKETING. Our sales and marketing expenses include credit card transaction and other payment processing fees, personnel and related costs, advertising, promotional and product marketing expenses, credit card chargebacks and bad debt expense. Sales and marketing expenses were $39.8 million and $39.5 million for the three months ended June 30, 2012 and 2011, respectively. Sales and marketing expenses were $82.8 million and $77.2 million for the six months ended June 30, 2012 and 2011, respectively. The increases for both periods were primarily driven by increased payment processing costs and credit card chargebacks associated with our commerce revenue.

As a percentage of revenue, sales and marketing expenses were 43.9% and 42.9% in the three and six months ended June 30, 2012, compared to 42.7% and 40.5% for the same periods in the prior year.

PRODUCT RESEARCH AND DEVELOPMENT. Our product research and development expenses include costs associated with design, development and enhancement of our technology platforms and related systems. Research and development costs are expensed as incurred, except certain internal-use software development costs eligible for capitalization and costs directly associated with preparing a client website launch eligible to be deferred and amortized over the life of the sites associated revenue streams. Product research and development expenses were $15.4 million and $18.1 million for the three months ended June 30, 2012 and 2011, respectively. Product research and development expenses were $31.4 million and $33.7 million for the six months ended June 30, 2012 and 2011, respectively. The decreases in both periods were primarily due to a reduction in workforce related costs.

As a percentage of revenue, product research and development expenses were 17.0% and 16.3% in the three and six months ended June 30, 2012, compared to 19.5% and 17.7% for the same periods in the prior year.

GENERAL AND ADMINISTRATIVE. Our general and administrative expenses primarily include executive, finance, human resources and other administrative workforce and other related expenses, fees for professional services, bank fees, insurance costs and non-income related taxes. General and administrative expenses were $11.9 million and $10.9 million for the three months ended June 30, 2012 and 2011, respectively. General and administrative expenses were $24.5 million and $21.6 million for the six months ended June 30, 2012 and 2011, respectively. The increases in both periods mainly due to higher workforce related costs and professional fees.

As a percentage of revenue, general and administrative expenses were 13.1% and 12.7% for the three and six months ended June 30, 2012, compared to 11.7% and 11.3% for the same periods in the prior year.

DEPRECIATION AND AMORTIZATION. Our depreciation and amortization expenses include the depreciation of computer equipment, office furniture, the amortization of purchased and internally developed software and leasehold improvements. Computer equipment, software and furniture are depreciated under the straight-line method using three to seven year lives and leasehold improvements are amortized over the shorter of the life of the asset or the remaining length of the lease. Depreciation and amortization expense was $5.0 million and $5.6 million for the three months ended June 30, 2012 and 2011, respectively. Depreciation and amortization expense was $10.3 million and $11.0 million for the six months ended June 30, 2012 and 2011, respectively.

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As a percentage of revenue, depreciation and amortization was 5.4% and 5.3% for the three and six months ended June 30, 2012, compared to 6.0% and 5.7% for the same periods in the prior year.

AMORTIZATION OF ACQUISITION-RELATED INTANGIBLES. Amortization of acquisition-related intangibles consists of the amortization of intangible assets such as customer relationships, technology and trade names acquired in business combinations. Amortization of acquisition-related intangible assets was $1.7 million and $2.2 million for the three months ended June 30, 2012 and 2011, respectively. Amortization of acquisition-related intangible assets was $3.6 million and $4.3 million for the six months ended June 30, 2012 and 2011, respectively. The decrease for the six months ended June 30, 2012, was driven primarily by intangible assets becoming fully amortized and the impairment recorded in the fourth quarter of 2011, as reported in the 2011 Form 10-K.

As a percentage of revenue, amortization of acquisition-related intangibles was 1.9% and 1.8% for the three and six months ended June 30, 2012, compared to 2.4% and 2.3% for the same periods in the prior year.

INTEREST INCOME. Our interest income represents the total of interest income on our cash, cash equivalents, short-term investments and certain long-term investments. Interest income was $1.0 million and $1.8 million for the three months ended June 30, 2012 and 2011, respectively. Interest income was $2.1 million and $3.2 million for the six months ended June 30, 2012 and 2011, respectively.

INTEREST EXPENSE. Our interest expense includes the total of cash and non-cash interest expense attributable to our outstanding convertible debt. For the three months ended June 30, 2012, interest expense was $2.3 million, which included $0.5 million of debt financing cost amortization, compared to interest expense of $2.2 million, which included $0.5 million of debt financing cost amortization, for the same period in the prior year. For the six months ended June 30, 2012, interest expense was $4.5 million, which included $1.0 million of debt financing cost amortization, compared to interest expense of $4.5 million, which included $1.0 million of debt financing cost amortization, for the same period in the prior year.

OTHER INCOME (EXPENSE), NET. Our other income (expense), net includes foreign currency transaction gains and losses, asset disposal gains and losses, other-than-temporary impairment of investments and dividend income. Other income (expense), net was income of $1.0 million and $0.7 million for the three months ended June 30, 2012 and 2011, respectively. Other income (expense), net was income of $0.7 million and $0.5 million for the six months ended June 30, 2012 and 2011, respectively. The increase in other income is primarily driven by an increase in dividend income.

INCOME TAXES. For the three months ended June 30, 2012 and 2011, our tax expense was $0.6 million and our tax benefit was $0.2 million, respectively. For the three months ended June 30, 2012, our tax expense consisted of approximately $1.5 million of U.S. tax expense and $0.9 million of foreign tax benefit. Both the US tax expense and the foreign tax benefit were largely due to provision-to-return items, recorded as discrete events in the current quarter. For the three months ended June 30, 2012 and 2011, the tax rate was 73.8% and (108.2%), respectively. The high tax rate for the current quarter was due to the discrete items and the negative tax rate for the comparative quarter in the prior year was due to the reduction in the estimated annual effective tax rate.

For the six months ended June 30, 2012 and 2011, our tax expense was $1.6 million and $1.7 million, respectively. For the six months ended June 30, 2012, our tax expense consisted of approximately $1.3 million of U.S. tax expense and $0.3 million of foreign tax expense. For the six months ended June 30, 2012 and 2011, the tax rate was 24.5% and 19.0%, respectively.

Off Balance Sheet Arrangements

None.

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Liquidity and Capital Resources

Cash Flows (in thousands)	Six Months Ended June 30, 2012	2011
Cash provided by (used in):		
Operating activities	$ (51,847)	$ (26,883)
Investing activities	1,749	(117,124)
Financing activities	(20,860)	(3,058)
Effect of exchange rate changes on cash and cash equivalents	(4,693)	14,433
Net increase (decrease) in cash and cash equivalents	$ (75,651)	$ (132,632)

Operating Activities

As of June 30, 2012, we had $421.5 million of cash and cash equivalents, approximately 44% of which are held by our international subsidiaries. If funds held by our international subsidiaries were repatriated to the U.S. we would incur a U.S. tax liability that is not currently accrued in our financial statements. However, cash and cash equivalents held in the U.S. are sufficient to fund our current and anticipated domestic operations. As a result, we do not anticipate any local liquidity restrictions that would preclude us from funding our expansion or operating needs and do not foresee a need to repatriate any earnings.

As of June 30, 2012 and December 31, 2011, we had $644.0 million and $720.5 million in cash, cash equivalents and short-term investments, respectively. Excluding client payables and client receivables, we had $542.6 million and $542.9 million in net short-term liquidity as of the end of June 30, 2012 and December 31, 2011, respectively.

Our primary source of internal liquidity is our operating activities. Net cash used in operations for the six months ended June 30, 2012, of $51.8 million was primarily the result of net income adjusted for non-cash expenses offset by balance sheet changes such as a decrease in accounts payable and accrued liabilities and an increase in accounts receivable and prepaid and other assets. Net cash used in operations for the six months ended June 30, 2011, of $26.9 million was primarily the result of net income adjusted for non-cash expenses offset by balance sheet changes such as a decrease in accounts payable and other accrued liabilities.

Investing Activities

Net cash provided by investing activities for the six months ended June 30, 2012, was $1.7 million and was the result of net sales of investments of $7.9 million and purchases of equipment and capitalized software of $6.2 million. Net cash used in investing activities for the six months ended June 30, 2011, was $117.1 million and was the result of net purchases of investments of $108.0 million and purchases of equipment and capitalized software of $9.1 million.

Financing Activities

Net cash used in financing activities for the six months ended June 30, 2012, was $20.9 million. This was primarily driven by $20.2 million cash used in the repurchase of common stock, $3.5 million cash used in the repurchase of restricted stock to satisfy tax withholding obligations and proceeds of $1.5 million were provided by the exercise of stock options. Net cash used in financing activities for the six months ended June 30, 2011, was $3.1 million. This was primarily driven by $5.8 million cash used in the repurchase of restricted stock to satisfy tax withholding obligations, proceeds of $1.3 million were provided by the sale of stock under the employee stock purchase plan and proceeds of $1.5 million were provided by the excess tax benefit from stock-based compensation.

Effect of Exchange Rate Changes

For the six months ended June 30, 2012, changes in foreign currency rates resulted in a $4.7 million decrease in our cash and cash equivalents. Exchange rate changes increased our cash and cash equivalents by $14.4 million during the six months ended June 30, 2011. The change is due to foreign currency volatility on our international entity balance sheet exposures, primarily from the euro.

Auction Rate Securities

As of June 30, 2012, we held $64.5 million of auction rate securities (ARS) at par value which we have recorded at $50.6 million fair value. As of December 31, 2011, we held $71.5 million of ARS at par value which was recorded at $65.3 million fair value. The ARS are student loans over-collateralized and guaranteed by the U.S. government. Almost all of these securities continue to fail at auction due to continued illiquid market conditions.

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Due to the illiquid market conditions, we recorded a temporary fair value reduction of our ARS in the amount of $13.9 million (21.6 % of par value) as of June 30, 2012, under Accumulated other comprehensive income (loss) , compared to a $6.2 million temporary fair value reduction as of December 31, 2011 (8.6% of par value). The discounted cash flow model we used to value these securities included the following assumptions:

	June 30, 2012	December 31, 2011
Unobservable inputs		
Redemption period (in years)	7.0	7.0
Credit ratings	BB+ to AAA	AAA - to AAA
Penalty coupon rate	1.0% to 1.5%	1.0% to 1.5%
Weighted average annualized yield	1.2%	1.5%
Risk adjusted discount rate	3.5% to 15.5%	3.9% to 10.9%

Management makes estimates and assumptions about the ARS, which can be sensitive to changes and effect the determination of fair value. An increase in the length of redemption period or an increase in the discount rate assumption would decrease our fair value. Also, a decrease in the securities credit ratings would decrease our fair value.

The portfolio had a weighted average maturity of 27.8 years and 27.5 years as of June 30, 2012 and December 31, 2011, respectively. We continue to believe that we will be able to liquidate at par over time. We do not intend to sell the investments prior to recovery of their amortized cost basis nor do we believe it is more likely than not we may be required to sell the investments prior to recovery of their amortized cost basis. Accordingly, we treated the fair value decline as temporary. We anticipate we will have sufficient cash flow from operations to execute our business strategy and fund our operational needs. We believe that capital markets are also available if we need to finance other investing alternatives.

We classify our ARS as Level 3 long-term investments until we receive a call or partial call on the securities. Upon receipt of a call or partial call, we classify the securities subject to the call or partial call, as Level 1 short term investments. As of June 30, 2012 and December 31, 2011, our entire ARS portfolio was classified as Level 3 long-term investments. In the six months ended June 30, 2012, we liquidated $7.0 million of ARS due to full or partial calls at par. During the year ended December 31, 2011, we liquidated $19.1 million of ARS due to full or partial calls at par.

Commitments and Guarantees

At certain times, we enter into agreements where a letter of credit is required to ensure payment of future obligations by counterparties, such as our credit card processors and international taxing jurisdictions. Upon withdrawal, we are obligated to fund the executor bank on demand. We have not set aside specific funds to cover this potential obligation as we can generally recover these costs from our clients. If drawn upon, we expect to fund this commitment with cash and cash equivalents. There was $3.3 million in undrawn letters of credit at June 30, 2012 and December 31, 2011.

Application of Critical Accounting Policies

Critical Accounting Estimates and Policies

A detailed description of our significant accounting policies can be found in our most recent Annual Report filed on Form 10-K for the fiscal year ended December 31, 2011. There were no material changes in significant accounting policies during the quarter ended June 30, 2012.

Recent Accounting Pronouncements

Information regarding recently issued accounting standards is included in Note 1 to the Consolidated Financial Statements.

Item 3. Qualitative and Quantitative Disclosure about Market Risk

Interest Rate Risk

Our portfolio of cash equivalents, short-term and long-term investments is maintained in a variety of securities, including government agency obligations and money market funds. Investments are classified as available-for-sale securities and carried at their market value with cumulative unrealized gains or losses recorded as a component of Accumulated other comprehensive income (loss) within stockholders equity. A sharp rise in interest rates could have an adverse impact on the market value of certain securities in our portfolio. We do not currently hedge our interest rate exposure and do not enter into financial instruments for trading or speculative purposes.

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At June 30, 2012, we had long-term debt of $353.8 million associated with our Senior Convertible Notes, which are fixed rate instruments. The market value of our long-term debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest and declining in periods of increasing rates of interest.

Foreign Currency Risk

Growth in our international operations will incrementally increase our exposure to foreign currency fluctuations as well as other risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures and other regulations and restrictions.

Foreign exchange rate fluctuations may adversely impact our consolidated results of operations as exchange rate fluctuations on transactions denominated in currencies other than our functional currencies result in gains and losses that are reflected in our Consolidated Statements of Operations. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency-denominated transactions will result in increased net revenues and operating expenses. Conversely, our net revenues and operating expenses will decrease when the U.S. dollar strengthens against foreign currencies.

Transaction Exposure

The Company enters into short-term foreign currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. Changes in the fair value of these derivatives, as well as re-measurement gains and losses, are recognized in current earnings in Other income (expense), net . Foreign currency transaction gains and losses were a gain of $0.1 million and a gain of $0.1 million in the three months ended June 30, 2012 and 2011, respectively. Foreign currency transaction gains and losses were a loss of $0.2 million in the six months ended June 30, 2012, and immaterial in the six months ended June 30, 2011.

Translation Exposure

Foreign exchange rate fluctuations may adversely impact our consolidated financial position as the assets and liabilities of our foreign operations are translated into U.S. dollars in preparing our Consolidated Balance Sheets. These gains or losses are recognized as an adjustment to stockholders' equity which is reflected in our Consolidated Balance Sheets under Accumulated other comprehensive income (loss) .

Other Market Risks

Investments in Auction Rate Securities

At June 30, 2012, we held approximately $64.5 million of ARS at par. In light of current conditions in the ARS market as described in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations , in this Quarterly Report on Form 10-Q, we may incur temporary unrealized losses, or other-than-temporary realized losses, in the future if market conditions persist and we are unable to recover the investment principal in our ARS.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We are committed to maintaining disclosure controls and procedures designed to ensure that information required to be disclosed in our periodic reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, 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 June 30, 2012. The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that such information is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on their evaluation of our disclosure controls and procedures as of June 30, 2012, our Chief Executive Officer and our Chief Financial Officer concluded that as of that date, our disclosure controls were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

We have been converting to a new enterprise resource planning (ERP) system. Implementation of the ERP system has occurred in phases. During the quarter ended June 30, 2012, no new phases of the new ERP system were implemented. There were no changes in the Company s internal control over financial reporting (as defined in Rule 13a 15(f) and 15d 15(f) under the Exchange Act) during the quarter ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Limitations on the Effectiveness of Controls

Our management, including the Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining an adequate system of internal control over financial reporting. This system of internal accounting controls is designed to provide reasonable assurance that assets are safeguarded, transactions are properly recorded and executed in accordance with management s authorization and financial statements are prepared in accordance with generally accepted accounting principles. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We have provided information about legal proceedings in which we are involved in Note 7 to the Consolidated Financial Statements in Part I, Item 1.

Item 1A. Risk Factors

The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently deem immaterial also may impair our business operations. Our business, financial condition or results of operations could be materially adversely affected by any of these risks and the value of our common stock could decline due to any of these risks, and you could lose all or part of the money you paid to buy our common stock. The following discussion of our risk factors should be read in conjunction with the consolidated financial statements and related notes thereto, and management s discussion and analysis, contained in this report, and the risk factors contained in our Annual Report on Form 10-K for the year ended December 31, 2011. Our business is also subject to general risks and uncertainties that affect many other companies. In addition, the current global economic climate amplifies many of these risks.

This report also contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks faced by us described below and elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2011.

Risks Related to Our Business

We may experience significant fluctuations in our revenues, operating results, growth rate and stock price.

Our quarterly and annual revenues, operating results, and growth rate have fluctuated significantly in the past and are likely to do so in the future due to a variety of factors, some of which are outside our control. As a result, we believe that quarter-to-quarter and year-to-year comparisons of our revenue and operating results are not necessarily meaningful, and that these comparisons may not be accurate indicators of future performance. If our annual or quarterly operating results fail to meet the guidance we provide to securities analysts and investors or otherwise fail to meet their expectations, the trading price of our common stock may be impacted.

Factors that may affect our revenues, operating results, continued growth, and our stock price include the risks described elsewhere herein, as well as the following:

Client Development and Retention. We generate revenue by providing services to a wide variety of companies, primarily in the software and high-tech products markets. Therefore, it is important to our ongoing success that we maintain our key client relationships and, at the same time, both develop new client relationships and increase the number and type of products offered through our services. If we cannot develop and maintain satisfactory relationships with software and digital products publishers, manufacturers of consumer electronics and other goods, online retailers and online channel partners on acceptable commercial terms, or if clients elect to end their relationships with us and we are unable to generate sufficient additional revenue to compensate for the loss of those relationships, we will likely experience a decline in revenue and operating profit. New product verticals or market segments, and further penetration of existing product verticals and market segments, may require us to work with companies which have a limited operating history or greater risks than more established companies. This may result in the offering of products which are subject to higher chargeback rates or legal exposure and may generally expose us to greater legal and/or business risk. We may not be able to fully anticipate, mitigate or control all such risks. In the event claims are brought against us in connection with products offered by clients, especially clients with a limited operating history, weak sales, or who are or may become insolvent or bankrupt, we may not be successful in seeking indemnification for such claims from such clients and may be ultimately responsible for such claims. In the event a client becomes insolvent or bankrupt, we may not be successful in obtaining and retaining all amounts owed to us by that client.

We also depend on our clients to create and support products that consumers will purchase. We generally purchase products for resale from consignment or from distributors at the time of the resale to the consumer, and do not maintain an inventory of products

available for sale. If we are unable to obtain sufficient quantities of products for any reason, or if the quality of service provided by these publishers and manufacturers falls below a satisfactory level, we could also experience a decline in revenue, operating profit and consumer satisfaction, and our reputation could be harmed.

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Our contracts with our clients are generally one to two years in duration, with an automatic renewal provision for additional one-year periods, unless we are provided with a written notice before the end of the contract. Some of our contracts are for longer periods, but may provide for early termination upon certain notice. For example, we recently amended our contract with Microsoft to extend the term through March 1, 2014, but the amendment did not modify the previously negotiated termination provisions. We have no material long-term or exclusive contracts or arrangements with any clients that guarantee the availability of products. Clients that currently supply products to us may not continue to do so, and we may be unable to establish new relationships with clients to supplement or replace existing relationships. Clients may elect to cease offering certain products through online commerce, or cease allowing us to resell certain of their products. A client who believes we have failed to deliver the contractually-required services and benefits could terminate their agreements and bring claims against us for substantial damages, these claims could exceed the level of any insurance coverage that may be available to us, and if successful could adversely affect our operating results and financial condition. If an existing significant customer elects to end their relationship with us or if our sales of a significant customer s products materially decreases, our revenue would decline and it may have a material adverse effect on our business, financial condition, results of operations, growth rate and stock price.

In addition, a limited number of our other software and physical goods clients contribute a large portion of our annual revenue. If any one of these key contracts is not renewed or otherwise terminates, or if revenues from these clients decline for any other reason (such as competitive developments), our revenue would decline and our ability to sustain profitability would be impaired. For example, please see the risk factor below regarding the termination of Microsoft s e-commerce agreement with us.

Dependence on Key Personnel and Employee Turnover. Our future success significantly depends on our ability to continue to identify, attract, hire, train, retain and motivate highly skilled personnel, including the continued services and performance of our senior management. Competition for these personnel is intense, particularly in the Internet industry. Our performance also depends on our ability to retain and motivate our key technical employees who are skilled in maintaining our proprietary technology platforms. The loss of the services of any of our executive officers or key employees could harm our business if we are unable to effectively replace that officer or employee, or if that person should decide to join a competitor or otherwise directly or indirectly compete with us. Employee turnover may increase in light of the risks, uncertainties, expenses, delays and difficulties associated with operating a business in a relatively rapidly changing industry and environment. Further, we may need to incur additional operating expenses and divert other management time in order to search for a replacement for members of senior management or personnel with specialized skills.

Organizational Changes. In order to remain competitive and to control our costs, we have implemented in the past, and may be required to implement in the future, organizational changes within our company, such as the consolidation of e-commerce platforms or offices, utilization of subcontractors or outsourcing relationships, reorganization of business units, and reductions in force. We may incur significant costs in order to implement organizational changes to achieve efficiencies in our cost structure in the long term. Failure to effectively manage our subcontractors and outsourcing relationships may harm our business. These organizational changes may impact our ability to execute our business plans and could affect our operating results.

Operating Expenses. Our operating expenses are based on our expectations of future revenue. These expenses are relatively fixed in the short-term. If our revenue for a quarter falls below our expectations and we are unable to quickly reduce spending in response, our operating results for that quarter would be harmed.

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Infrastructure. The introduction by us of new websites, web stores or services, new features and functionality, and the continued upgrading, development and maintenance of our systems and infrastructure to meet emerging market needs, leverage technical innovations, and remain competitive in our service and product offerings, may require a substantial investment of our resources and result in significant capital expenditures and operating costs and expose us to additional risk and legal liability despite efforts to control such risks and liabilities.

Fluctuations in Demand. Our quarterly and annual operating results are subject to fluctuations in demand for the products or services offered by us or our clients, such as personal computer software and consumer electronics. In particular, sales of personal computer software represented a significant portion of our revenues in recent years, and continue to be very important to our business. The introduction of products and services competitive to those offered by our current clients may materially adversely affect our revenues. In addition, revenue generated by our software and digital commerce services is likely to fluctuate on a seasonal basis that is typical for the markets for our clients products, including the software publishing, consumer electronics, and computer and video games markets. Softening or weakening of traditionally high-volume periods, such as the holiday season, can materially adversely affect our revenues and operating results.

Changes in the E-commerce Industry. The nature of our business and the e-commerce industry in which we operate has undergone, and continues to undergo, rapid development and change. For example, new protocols or technologies and new rules and regulations applicable to our business and the e-commerce industry can be introduced which could affect the ways in which e-commerce operates and products are sold online. It may be difficult for us to predict or adjust our business in light of such developments. Thus, our chances of financial and operational success should be evaluated in light of the risks, uncertainties, expenses, delays and difficulties associated with operating a business in a relatively rapidly changing industry and environment. If we are unable to address these issues, we may not be financially or operationally successful.

Other Factors. Additional industry risks that may affect our revenues, operating results, continued growth and our stock price include:

Competitive developments, including the introduction of new products and services and the announcement of new client and strategic relationships by our competitors;

Changes that affect our clients or the viability of their product lines, and client decisions to delay new product launches, invest in e-commerce initiatives, utilize the services of a competitor, or internalize their currently outsourced e-commerce operations;

The cost of compliance with U.S. and foreign laws, rules and regulations relating to our business, including the potential effect of new laws, rules and regulations, or interpretations of existing laws, rules and regulations, that affect our business operations or otherwise restrict or affect online commerce and/or the Internet as a whole, as well as our compliance with the rules and policies of entities whose services are critical for our continued operations, such as banks and credit card associations;

Our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments or results of operations or other developments related to those acquisitions, and our ability to successfully integrate and manage acquired businesses;

Required changes in generally accepted accounting principles and disclosures;

Sales or other transactions involving our common stock or our convertible notes;

General macroeconomic conditions, including severe downturns or recessions in the United States and elsewhere, global unrest, terrorist activities and particularly those economic conditions affecting the e-commerce and retailer industries; and

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Conditions or trends in the Internet and online commerce industries in the United States and around the world, including slower-than-anticipated growth of the online market as a vehicle for the purchase of software products, changes in consumer confidence in the safety and security of online commerce, and changes in the usage of the Internet and e-commerce.

The following risks may also have a material adverse impact on our business, financial condition, results of operations and stock price:

Our stock price is volatile.

The stock market as a whole and the trading prices of companies in the electronic commerce industry in particular, has been notably volatile. The operating results of companies in the electronic commerce industry have experienced significant quarter-to-quarter fluctuations. This broad market and industry volatility could significantly reduce the price of our common stock at any time, without regard to our own operating performance.

The market price for our common stock has varied between a high of $19.10 and a low of $13.81 in the six months ended June 30, 2012. This volatility may affect the price at which you could sell your common stock. Our stock price is likely to continue to be volatile and subject to significant price and volume fluctuations in response to market and other factors; variations in our quarterly operating results from our expectations or those of securities analysts or investors; downward revisions in securities analysts estimates; and announcement by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments.

In addition, the price of our common stock may be impacted by the short sales and actions of other parties who may disseminate misleading information about us in an effort to profit from fluctuations in the price of our common stock. Further, the price of our common stock may be impacted by the announcement of the financial results or other decisions by our larger clients whose products represent a significant portion of our sales. For example, the price of our common stock experienced a significant decline on October 12, 2009 in connection with the announcement by us that Symantec had informed us that it has elected not to renew its e-commerce agreement with us.

A material decline in the price of our common stock may result in the assertion of certain claims against us, and/or the commencement of inquiries and/or investigations against us. A prolonged decline in the price of our common stock could result in:

A reduction in the liquidity of our common stock and a reduction in our ability to raise capital and the inability for you to obtain a favorable selling price for your shares;

An event or circumstance that drives us to determine that it is more likely than not that the fair value of our one reporting segment is less than its carrying amount and record an impairment to our goodwill.

Any reduction in our ability to raise equity capital in the future may force us to reallocate funds from other planned uses and could have a significant negative effect on our business plans and operations.

The termination of our e-commerce agreement with Microsoft may materially adversely affect our business, financial condition or results of operations and stock price.

Sales of products for one client, Microsoft, accounted for approximately 27.7% of our revenue in 2011. In addition, a limited number of other software and physical goods clients contribute a large portion of our annual revenue. If any one of these key contracts is not renewed or otherwise terminates, or if revenues from these clients decline for any other reason (such as competitive developments), our revenue would decline and our ability to sustain profitability would be impaired. If our contract with Microsoft is not renewed, renegotiated or otherwise terminated, or if revenues from Microsoft decline for any other reason, our revenue and our ability to sustain profitability could be materially adversely impaired.

Loss of our credit card acceptance privileges, or changes to payment networks, fees, rules or practices, would seriously hamper our ability to process the sale of merchandise and materially adversely affect our business.

The payment by consumers for the purchase of goods and services through our e-commerce systems is typically made by credit card or similar payment method. As a result, we must rely on banks and payment processors to process transactions, and must pay a fee for this service. From time to time, credit card associations may increase the per-transaction fees that they charge. In addition, reductions in the volume of transactions processed by us may

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result in increased per-transaction processing fees. Any such increased fees will increase our operating costs and reduce our profit margins. We also are required by our processors to comply with credit card association operating rules, and we have agreed to reimburse our processors for any fines they are assessed by credit card associations as a result of processing payments for us. The credit card associations and their member banks set and interpret the credit card rules. Visa, MasterCard, American Express, Discover and other card associations whose cards we accept could adopt new operating rules or re-interpret existing rules that we, or our processors, might find difficult to follow. Although we have been able to successfully switch to new payment processors in the past, such migrations require significant attention from our personnel, and may not achieve the anticipated cost savings or other desired results. Any disputes or problems associated with our payment processors could impair our ability to give customers the option of using credit or debit cards to fund their payments. If we were unable to accept credit or debit cards or other widely accepted forms of payment, our business would be seriously damaged. We also could be subject to fines or increased fees from Visa and MasterCard if we fail to detect that our clients are engaging in activities that are illegal or activities that are considered high risk, primarily the sale of certain types of digital content, or if the percentage of our sales transactions subject to chargeback increases as an absolute percentage of our overall transaction volume. We may be required to expend significant capital and other resources to monitor these activities.

Security breaches could hinder our ability to securely transmit confidential information and could materially affect our reputation, business operations, operating results and financial condition.

Our business depends in large part on the secure transmission of confidential information over public networks, including customers credit card and other payment account information, and the secure storage of confidential information. We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary for secure transmission of confidential information, such as customer credit and debit card numbers. While we take significant steps to protect the security of confidential information in our possession, we cannot guarantee our security measures will prevent security breaches, or that future advances in computer and software capabilities and encryption technology, new cryptography tools and discoveries, and other events will enable us to prevent the breach or compromise of our security even if implemented by us. Further, the technology utilized in credit and debit cards, and the systems used for the transmission of payment card transactions, are controlled by the payment card industry, and vulnerabilities in these systems and technology can place payment card data at risk.

Any breach or compromise of our security or one of our clients, vendors or service providers could have a material adverse effect on our reputation, business, operating results and financial condition, dissuade existing and new clients from using our services, dissuade customers from transacting business through our systems, and expose us to significant costs, fines, losses, litigation, governmental investigations and liabilities. A party who circumvents our security measures or the security measures of our clients, vendors or service providers could misappropriate proprietary information or interrupt our operations. We may be required to expend significant capital and other resources to protect against security breaches or address problems caused by such breaches. Security breaches could expose us to lawsuits from affected persons and companies, and to governmental inquiries. Concerns over the security of the Internet and other online transactions and the privacy of users could deter people from using the Internet to conduct transactions that involve transmitting personally identifiable and other confidential information, inhibiting the growth of our business.

We are exposed to foreign currency exchange risk.

Sales outside the United States accounted for approximately 46.7% of our total sales in the six months ended June 30, 2012. A significant portion of our cash and marketable securities are held in non-U.S domiciled countries, primarily Ireland and Germany. The results of operations of, and certain of our intercompany balances associated with, our internationally focused websites are exposed to foreign exchange rate fluctuations. Upon translation, net sales and other operating results from our international operations may differ materially from expectations, and we may record significant gains or losses on the re-measurement of intercompany balances. If the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions will result in increased net revenues and operating expenses. Similarly, our net revenues and operating expenses will decrease if the U.S. dollar strengthens against foreign currencies. As we have expanded our international operations, our exposure to exchange rate fluctuations has become more pronounced. We may enter into short-term currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. The use of such hedging activities may not offset more than a

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portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates. See Item 3 of Part I of this Form 10-Q for information demonstrating the effect on our consolidated statements of operations from changes in exchange rates versus the U.S. dollar.

Failure to enhance and expand our technology, systems and business offerings to accommodate increased traffic and to remain competitive could reduce demand for our services and impair the growth of our business.

We periodically enhance and expand our technology and transaction-processing systems, network infrastructure and other technologies to accommodate increases and spikes in the volume of traffic on our technology platforms due to factors including launches of new products and new commerce websites on our technology platforms, and seasonal fluctuations in consumer demand. To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our e-commerce platforms and the underlying network infrastructure, and develop and introduce new business offerings and programs. Any inability to enhance and expand our existing technology, transaction-processing systems or network infrastructure to manage such increased traffic and traffic spikes may cause unanticipated systems disruptions, slower response times and degradation in client services, including impaired quality and speed of order fulfillment. Failure to manage increased traffic and traffic spikes or an inability to maintain our competitiveness could harm our reputation and significantly reduce demand for our services, which would impair the growth of our business. If we incur significant costs without adequate results, or are unable to adapt rapidly to technological changes, we may fail to achieve our business plan. We may be unable to improve and increase the capacity of our network infrastructure sufficiently or to anticipate and react to expected or unexpected increases in the use of the platform to handle increased volume, or to obtain needed related services from third party suppliers. Our network and our suppliers networks may be unable to maintain an acceptable data transmission capability, especially if demands on our platform increase. We may fail to use new technologies effectively or fail to adapt our proprietary technology and systems to client requirements or emerging industry standards.

If we are unable to enter into, achieve desired results from, or maintain our marketing and promotional agreements with third party marketing or technology providers to generate sales traffic and sales for our clients, our ability to generate revenue and our business could be adversely affected.

We have entered into multiple marketing and promotional agreements and operate certain affiliate networks and programs which are designed to increase both traffic to the e-commerce stores we operate and the number of customers purchasing products through such stores, including agreements with search engine providers, display advertising networks, comparison shopping engines, affiliate networks, operators of websites and marketing technology providers. Our ability to attract new clients and retain existing clients is based in part on our ability to generate increased traffic or better conversion rates resulting in increased online sales of their products through these agreements and programs. If we are unable to enter into such agreements on favorable terms, are unable to achieve the desired results under these agreements and programs, are unable to maintain these relationships, or fail to generate sufficient traffic or generate sufficient revenue from purchases pursuant to these agreements and programs, our ability to generate sales and our ability to attract and retain our clients may be impacted, negatively affecting our business and operating results.

New obligations to collect or pay transaction taxes could substantially increase the cost to us of doing business.

Many of the laws and regulations regarding the application of sales tax, use tax, value added tax (VAT) or other similar transaction taxes predate the growth of the Internet and online commerce. The application of transaction taxes to interstate and international sales over the Internet is complex and evolving. We currently collect taxes on certain product and service offerings in tax jurisdictions where we have taxable presence. A successful assertion by one or more tax jurisdictions that we should collect or were obligated to collect transaction taxes on the products we sell could harm our results of operations. The imposition by state and local governments of various taxes upon Internet commerce and related e-commerce activities could create administrative burdens for us, put us at a competitive disadvantage if they do not impose similar obligations on all of our online competitors, and decrease our future sales.

Changes in our tax rates could affect our future results.

Our future effective tax rates could be favorably or unfavorably affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of our deferred tax assets and liabilities, or by

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changes in tax laws or their interpretation. As of June 30, 2012, we had net deferred tax assets of $30.3 million. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our results of operations and financial condition.

Failure to properly manage and sustain our expansion efforts could strain our management and other resources.

Through acquisitions and organic growth, we are rapidly and significantly expanding our operations, both domestically and internationally. We will continue to expand further to pursue growth of our service offerings and customer base. This expansion increases the complexity of our business and places a significant strain on our management, operations, technical performance, financial resources, and internal financial control and reporting functions, and there can be no assurance that we will be able to manage it effectively. Our personnel, systems, procedures and controls may not be adequate to effectively manage our future operations, especially as we employ personnel in multiple domestic and international locations. We may not be able to hire, train, retain and manage the personnel required to address our growth. Failure to effectively manage our growth opportunities could damage our reputation, limit our future growth, negatively affect our operating results and harm our business.

Our international expansion efforts may not be successful in generating additional revenue.

We sell products and services to consumers outside the United States and we intend to continue expanding our international presence. In the six months ended June 30, 2012, our sales to international consumers represented approximately 46.7% of our total sales. Continued expansion into international markets, particularly the European and Asia-Pacific regions, requires significant resources that we may fail to recover through generating additional revenue. Conducting business internationally is subject to risks that may have a material adverse effect on our ability to increase or maintain foreign sales, including:

- Changes in regulatory requirements and tariffs;
- Difficulties in staffing and managing foreign subsidiary operations, and the increased costs of international operations;
- Uncertainty of application of, and the burden and cost of complying with, local, commercial, tax, privacy and other laws and regulations;
- Reduced protection of intellectual property rights;
- Difficulties in physical distribution and logistics for international sales;
- Higher incidences of credit card fraud and difficulties in accounts receivable collection;
- Difficulties in transferring funds from certain countries;
- Difficulties in enforcing contracts against international clients, especially in emerging markets;
- Lower rates of Internet usage in certain countries, especially in emerging markets;
- Different employer/employee relationships, the existence of workers councils, and the possibility of unionization of our workforce outside the United States, particularly in Europe;
- Political, social and economic instability and constraints on international trade; and
- Import and export license requirements and restrictions of the United States and every other country in which we operate.

We may be unable to successfully and cost-effectively market, sell and distribute our services in foreign markets. Doing so may be more difficult or take longer than anticipated especially due to international challenges, such as language barriers, currency exchange issues and the fact that the Internet infrastructure in some foreign countries may be less advanced than the U.S. Internet infrastructure. As international e-commerce grows, our competition will continue to intensify. If we are unable to successfully expand our international operations, or manage this expansion, our operating results and financial condition could be harmed.

Implementing our acquisition and strategic partnership strategy could result in dilution and operating difficulties leading to a decline in revenue and operating profit.

A key element of our business strategy involves expansion through the acquisitions of businesses, assets, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. In the last five years we acquired or invested in 11 companies. We continually evaluate and explore strategic opportunities as they arise, including business

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combination transactions, strategic partnerships, and the purchase or sale of assets, including tangible and intangible assets such as intellectual property. We have acquired, and intend to continue engaging in strategic acquisitions of businesses, technologies, services and products.

Acquisitions, strategic investments and strategic partnership agreements may require significant capital infusions, typically entail many risks, and could result in unforeseen difficulties, disruptions, distractions, and expenditures in assimilating and integrating with the operations, personnel, technologies, products and information systems of acquired companies or businesses. We have in the past and may in the future experience delays in the timing and successful completion of such activities. These challenges are magnified as the size of the acquisition increases. Furthermore, these challenges would be even greater if we acquired a business or entered into a business combination transaction with a company that was larger and more difficult to integrate than the companies we have historically acquired. Moreover, the anticipated benefits of any acquisition or strategic investment may not be realized. If a significant number of clients of the acquired businesses cease doing business with us, we would experience lost revenue and operating profit, and any synergies from the acquisition may be lost. In addition, key personnel of an acquired company may decide not to work for us. The acquisition of another company or its products and technologies may also require us to enter into a geographic or business market in which we have little or no prior experience. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt, contingent liabilities, amortization of intangible assets or impairment of goodwill. Acquisitions could also result in a dilutive impact to our earnings.

Our clients sales cycles and the implementation process for our commerce solution are time-consuming, which may cause us to incur substantial expenses and expend management time without generating corresponding consumer revenue, which would impair our cash flow.

We market our services directly to software publishers, online retailers, consumer electronics companies and other prospective customers. These relationships are typically complex and take time to finalize. Due to operating procedures in many organizations, a significant amount of time may pass between selection of our products and services by key decision-makers, the signing of a contract, and the launch of a revenue-generating commerce store. The period between the initial client sales call and the signing of a contract with significant sales potential is difficult to predict and typically ranges from six to twelve months, and completion of the implementation process typically ranges from one to four months. If at the end of a sales effort a prospective client does not purchase our products or services, we may have incurred substantial expenses and expended management time that cannot be recovered and that will not generate corresponding revenue. As a result, our cash flow and our ability to fund expenditures incurred during the sales cycle and implementation process may be impaired. We can incur substantial front-end costs to launch client sites and it may require a substantial time before those costs are recouped by us, if at all.

We may become liable for fraudulent, improper or illegal uses of our platforms and services.

In recent years revenues from our self-service platforms have grown as a percentage of our overall business, and we plan to continue to emphasize our self-service e-commerce solutions. These platforms typically have an automated structure that allows customers to sign up for and use our e-commerce services without significant participation from Digital River personnel. Despite our efforts to contractually prohibit the sale of inappropriate and illegal goods and services and our efforts to detect the same, the remote control nature of these platforms increases the risk that transactions involving the sale of unlawful goods or services or the violation of the proprietary rights of others may occur before we become aware of them. Furthermore, unscrupulous individuals may offer for sale, or attempt to purchase, illegal products via such platforms under innocuous names, further frustrating our attempts to prevent inappropriate use of our services. Failure to detect inappropriate or illegal uses of our platforms by third parties could expose us to a number of risks, including fines, increased fees or termination of services by payment processors or credit card associations, risks of lawsuits and governmental investigations, and civil and criminal penalties.

Compliance with and changes to applicable laws, rules, regulations, and certification requirements, may substantially increase our costs of doing business, limit our activities, or otherwise adversely affect our ability to offer our services.

We are subject to the same international, federal, state and local laws as other companies conducting business over the Internet. Because our services are accessible worldwide, and we facilitate sales of products to customers worldwide, international jurisdictions may claim that we are required to comply with their laws, rules and

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regulations. Laws regulating Internet companies outside of the United States may be less favorable than those in the United States, giving greater rights to consumers, content owners and users. Compliance with international, federal, state and local laws may be costly or may require us to change our business practices or restrict our service offerings relative to those provided in the United States. As our services are available over the Internet in multiple states and foreign countries, these jurisdictions may claim that we are required to qualify to do business as a foreign corporation in each state or foreign country. Failure to qualify as a foreign corporation in a required jurisdiction could subject us to taxes and penalties and could result in our inability to enforce contracts in these jurisdictions. Laws, rules and regulations applicable to our business include areas such as:

- User privacy with respect to adults and minors;
- Our ability to collect and/or share necessary information that allows us to conduct business on the Internet;
- Export compliance;
- Pricing, taxation, and regulatory fees;
- Fraud;
- Advertising;
- Intellectual property rights;
- Information security;
- Quality of products and services;
- Recycling of consumer products; and
- Our investments in other companies.

Our acceptance of credit cards and similar payment methods requires us to maintain certain certifications, most notably Payment Card Industry (PCI) Level 1 compliance. Maintaining this certification requires an annual audit by a qualified third party auditor and a review and assessment of our security controls and a significant commitment of internal resources. Our loss of such certification may result in our inability to process credit card transactions and have a material adverse effect on our ability to do business.

Violation of any laws, rules or regulations applicable to our business could result in fines or other actions by regulatory agencies, increased costs of doing business, reduced profits, or restrictions on our ability to conduct business such as our ability to export products or bans on our ability to offer certain services. In addition, any significant changes, developments, or new interpretations of laws, rules, and regulations applicable to our business will increase our costs of compliance and may further restrict our overseas client base, may require significant management and other resources to respond appropriately, and may harm our operating results.

Failure to protect our intellectual property may jeopardize our competitive position and require us to incur significant expenses to enforce our rights.

We rely on a combination of patent, copyright, trademark, service mark and trade secret laws, and contractual restrictions with our employees and other parties with which we do business, to protect our proprietary rights and to limit access to and disclosure of our proprietary information. We also seek to protect our proprietary position by filing U.S. patent applications related to our proprietary technology, inventions and improvements that are important to the development of our business, and the registration of our trademarks and service marks in the U.S. and internationally.

The steps we have taken to protect our proprietary rights may be inadequate and third parties may infringe or misappropriate our trade secrets, trademarks and similar proprietary rights. Our contractual arrangements and the other steps taken by us to protect our intellectual property may not prevent misappropriation of our technology or deter independent third-party development of similar technologies. We may not be able to successfully obtain patents or trademarks for our technologies or brands. Effective protection of our intellectual property rights may not be available in every country in which our services are made available online, or cost-effective for us to obtain on a worldwide basis. Any significant failure on our part to protect our intellectual property could make it easier for our competitors to offer similar services and thereby adversely affect our market opportunities. In addition, litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Litigation could result in substantial costs and diversion of management and technical resources.

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Claims against us related to infringement of other parties intellectual property rights, by our products and services or the products we resell or deliver, could require us to expend significant resources, enter into unfavorable licenses, pay damages, prevent us from using certain technology, or require us to change our business plans.

From time to time we are notified of potential patent disputes, and expect that we will increasingly be subject to the assertion of patent infringement claims against us and/or our customers as our services expand in scope and complexity. We have been, and from time-to-time may be, named as a defendant in lawsuits claiming that we have, in some way, violated the intellectual property rights of others. For example, we are currently a party to patent litigation in the United States District Court for the Eastern District of Texas brought against us and various other defendants by DDR Holdings, LLC, seeking injunctive and monetary relief. More information on the DDR Holdings litigation and other pending intellectual property claims against us can be found in the Legal Proceedings section of this Form 10-Q.

Litigation over patents and other intellectual property rights is not uncommon with respect to e-commerce technologies, and often involves patent holding companies or other adverse patent owners who have no relevant product revenues and against whom our own patents may therefore provide little or no deterrence.

Claims may be made against us for negligence, copyright or trademark infringement, products liability or other theories based on the nature and content of software products or tangible goods that we deliver electronically and physically. Because we did not create these products, we are generally not in a position to know the quality or nature of the content of these products.

Any assertions or prosecutions of intellectual property claims could require us to expend significant financial, managerial and personnel resources. Although we carry general liability insurance and typically require that our customers indemnify us against consumer claims, our insurance and indemnification measures may not cover potential claims of this type, may not adequately cover all costs incurred in defense of potential claims, or may not reimburse us for all liability that may be imposed. We may elect to self-insure against certain claims. The defense of any claims, with or without merit, could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product enhancement delays or require that we develop non-infringing technology or enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may be unavailable on terms acceptable to us or at all. In the event of a successful claim of infringement against us and our failure or inability to develop non-infringing technology or license the infringed or similar technology on a timely basis, we may be unable to continue to pursue our current business plan. We expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity, and our results of operations and financial condition could be materially adversely affected.

We are subject to regulations relating to consumer privacy.

We collect and maintain customer data from our customers, which subjects us to increasing international, federal and state regulations related to online privacy and the use of personal user information. Congress has enacted anti- spam legislation with which we must comply when providing email campaigns for our clients. Legislation and regulations are pending in various domestic and international governmental bodies that address online privacy protections. Several governments have proposed, and some have enacted, legislation that would limit the use and transfer of personal user information or require online service providers to establish privacy policies. In addition, the U.S. Federal Trade Commission (FTC) has urged Congress to adopt legislation regarding the collection and use of personal identifying information obtained from individuals when accessing websites, including both adults and minors.

Even in the absence of laws requiring companies to establish these procedures, the FTC has settled several proceedings resulting in consent decrees in which Internet companies have been required to establish programs regarding the manner in which personal information is collected from users and provided to third parties. We could become a party to a similar enforcement proceeding. These regulatory and enforcement efforts could limit our collection of and/or ability to share with our clients demographic and personal information from customers, which could adversely affect our ability to comprehensively serve our clients.

The European Union has adopted a privacy directive that regulates the collection and use of information that identifies an individual person, and in January 2012 released proposed revisions to its privacy framework. These regulations may inhibit or prohibit the collection and sharing of personal information in ways that could harm our

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clients or us. Failure to comply with member state implementations of these directives may result in fines, private lawsuits and enforcement actions. These enforcement actions can include interruption or shutdown of operations relating to the collection and sharing of information pertaining to citizens of the European Union. Other countries including the United States have introduced or may seek to expand their existing data privacy laws, rules and regulations, which could require us to expend significant resources to implement procedures and processes to ensure our compliance.

System failures, outages or errors could reduce the attractiveness of our service offerings.

We provide commerce, marketing and delivery services to our clients and consumers through our proprietary technology transaction processing and client management systems. These systems also maintain an electronic inventory of products and gather consumer marketing information. The satisfactory performance, reliability and availability of the technology and the underlying network infrastructure are critical to our operations, level of client service, reputation and ability to attract and retain clients. We have experienced periodic interruptions and have identified errors, affecting all or a portion of our systems, which we believe will continue to occur from time-to-time. While we attempt to correct every system error we identify, not all errors may be identified or corrected. Any systems damage, errors, or interruption that impairs our ability to accept and fill client orders could result in an immediate loss of revenue to us, and could cause some clients to purchase services offered by our competitors. In addition, frequent systems failures could harm our reputation.

Although we maintain system redundancies in multiple physical locations, our systems and operations are vulnerable to damage or interruption from:

- Fire, flood, natural disasters, and other events beyond our control;
- Defects introduced by 3rd party technology;
- Defects introduced by outsourced services;
- 3rd party and outsourced services technology failure due to defects in hardware and or firmware;
- Catastrophic hardware failure of 3rd party;
- Catastrophic hardware failure of outsourced service provider;
- Errors introduced by software and or hardware maintenance;
- Operator negligence, improper operation by, or supervision of, employees, physical and electronic break-ins, misappropriation, computer viruses and similar events; and
- Power loss, computer systems failures, denial-of-service attacks and Internet and telecommunications failure.

We may not carry sufficient business interruption insurance to fully compensate us for losses that may occur.

The listing of our network addresses on anti-spam lists could harm our ability to service our clients and deliver goods over the Internet.

Certain privacy and anti-email proponents have engaged in a practice of gathering, and publicly listing, network addresses that they believe have been involved in sending unwanted, unsolicited emails commonly known as spam. In response to user complaints about spam, Internet service providers have, from time to time, blocked such network addresses from sending emails to their users. If our network addresses mistakenly end up on these spam lists, our ability to provide services for our clients and consummate the sales of digital and physical goods over the Internet could be harmed.

If our internal control over financial reporting or disclosure controls and procedures are not effective, there may be errors in our financial statements that could require a restatement or our filings may not be timely and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in each Annual Report on Form 10-K. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be

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considered relative to their costs. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Over time, controls may become inadequate because changes in conditions or deterioration in the degree of compliance with policies or procedures may occur. Implementation of new technology related to the control system, such as our current ongoing implementation of an SAP Enterprise Resource Planning, or ERP, system, may result in misstatements due to errors that are not detected and corrected during testing. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

As a result, we cannot assure you that significant deficiencies or material weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in significant deficiencies or material weaknesses, cause us to fail to timely meet our periodic reporting obligations, or result in material misstatements in our financial statements. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor reports regarding disclosure controls and the effectiveness of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules proclaimed after that. The existence of a material weakness could result in errors in our financial statements that could result in a restatement of financial statements, cause us to fail to timely meet our reporting obligations and cause investors to lose confidence in our reported financial information, leading to a decline in our stock price.

Developments in accounting standards may cause us to increase our recorded expenses, which in turn would jeopardize our ability to demonstrate sustained profitability.

In January 2002, we adopted new Financial Accounting Standards Board (FASB) guidance that establishes that goodwill and intangible assets with indefinite lives are not amortized, but are to be tested on an annual basis (or more frequently if there are indications that an impairment may be necessary) for impairment and, if impaired, are recorded as an impairment charge in income from operations. As we only have one business segment, goodwill is evaluated based on a single reporting unit. As of June 30, 2012, we had goodwill with an indefinite life of $278.4 million from our acquisitions. At year-end 2011, due to the deterioration in our stock price in the second half of 2011, management completed additional analysis and determined that the fair value of the Company, based upon a discounted cash flow valuation approach, was in excess of book value and no impairment was required. Key assumptions included in the year end 2011 impairment test included our revenue growth rate, discount rate assumptions, and estimates of our future cash flows. Changes in these estimates could change our conclusion regarding an impairment of goodwill in a future period. If our goodwill is determined for any reason to be impaired, the subsequent accounting of the impaired portion as an expense would lower our earnings and jeopardize our ability to demonstrate sustained profitability. In January 2008, we adopted new FASB guidance that requires the reporting of assets at fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of assets can shift significantly and can cause a permanent or temporary impairment.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.

We are incorporated in Delaware. Certain anti-takeover provisions under Delaware law and in our certificate of incorporation and amended and restated bylaws, as currently in effect, may make a change of control of our company more difficult, even if a change in control would be beneficial to our stockholders. Our anti-takeover provisions include provisions such as a prohibition on stockholder actions by written consent, a classified board of directors and the authority of our board of directors to issue preferred stock without stockholder approval. In addition, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which generally prohibits stockholders owning 15% or more of our outstanding voting stock from merging or combining with us in certain circumstances. These provisions may delay or prevent an acquisition of us, even if the acquisition may be considered beneficial by some of our stockholders. In addition, they may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management.

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Risks Related to Our Industry

Because the e-commerce industry is highly competitive and has low barriers to entry, we may be unable to compete effectively.

The market for e-commerce solutions is extremely competitive and we may find ourselves unable to compete effectively. Because there are relatively low barriers to entry in the e-commerce market, we expect continued intense competition as current competitors expand their product offerings and new competitors enter the market. In addition, our clients and partners may become competitors in the future. Increased competition is likely to result in price reductions, reduced margins, longer sales cycles and a decrease or loss of our market share, any of which could negatively impact our revenue and earnings. We face competition from the following sources:

- In-house development of e-commerce capabilities using tools or applications from companies, such as Oracle Corporation (which acquired Art Technology Group, Inc.) and IBM Corporation or through internally developed solutions (e.g. as announced in October 2009, Symantec had elected not to renew its e-commerce agreement with us and migrated its online store traffic to an internally developed e-commerce system, which resulted in the termination of our e-commerce agreement with Symantec on June 30, 2010);

- E-Commerce capabilities custom-developed by companies, such as IBM Global Services and Accenture, Inc.;

- New e-commerce models through which consumers can purchase software products for their computers and computing devices, such as app stores;

- Other providers of outsourced e-commerce solutions, such as cleverbridge AG, eBay, Inc. (which acquired GSI Commerce, Inc.), Avangate BV, asknet Inc. and Arvato, a division of Bertelsmann AG;

- Companies that provide technologies, services or products that support a portion of the e-commerce process, such as payment processing, including CyberSource Corporation (a subsidiary of Visa, Inc.) and PayPal Corp.;

- Companies that offer various online marketing services, technologies and products, including ValueClick, Inc. and Microsoft Advertising (formerly aQuantive, Inc.);

- High-traffic, branded websites that generate a substantial portion of their revenue from e-commerce and may offer or provide to others the means to offer their products for sale, such as Amazon.com, Inc. and Buy.com, Inc.; and

- Web hosting, web services and infrastructure companies that offer portions of our solution and are seeking to expand the range of their offering, such as Network Solutions, LLC, Akamai Technologies, Inc., Yahoo!, Inc., eBay, Inc. and Hostopia.com, Inc.

The online channel partners and the other companies described above may compete directly with us by adopting a business model similar to ours. Many of our competitors have, and new potential competitors may have, more experience developing Internet-based software and e-commerce solutions, larger technical staffs, larger customer bases, more established distribution channels and customer relationships, greater brand recognition and greater financial, marketing and other resources than we have. Some of our clients may also compete with us. In addition, competitors or our clients may be able to develop services that are superior to our services, achieve greater customer acceptance or have significantly improved functionality as compared to our existing and future products and services, which could result in the loss of existing clients and/or our inability to pursue and sign new clients. Our competitors may be able to respond more quickly to technological developments and changes in customers needs. Our inability to compete successfully against current and future competitors could cause our revenue and earnings to decline.

The pace of recovery of US and global economies, and political and economic conditions, may adversely affect our revenue and results of operations and stock price.

The U.S. and other global economies continue to experience slow recovery from the recent recession that affected the economy as a whole, resulting in continued issues with the pace of economic growth, loss of consumer confidence and uncertainty about economic stability, and increased unemployment. U.S. and foreign credit and financial markets continue to experience instability, resulting in increased volatility in the stock market and reduced availability of credit. Our revenue and growth is dependent on the continued growth in demand for our clients products and the continued growth of Internet commerce, and depends significantly on geopolitical economic and business conditions. The continuing effects of this recession and the instability in the credit and financial markets may continue to negatively impact our business and our clients, demand for our clients products, and consumer spending, such as causing delays in new product introductions, changes in client s outsourcing behavior, increasing

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our difficulty in collecting client receivables, and increasing the risk of client bankruptcies and/or interruption or cessation of business, which may have a negative impact on our business, operating results and financial condition. Continuing geopolitical instability in certain countries and regions may affect consumer spending behavior in those countries and regions. Instability in the credit and equity markets increases the risk that the actual amounts realized in the future on our financial instruments and investments may significantly differ from the fair values currently assigned to them. If macroeconomic and market conditions affecting us or our clients remain uncertain, weaken further, or otherwise fail to improve, they may have a material adverse effect on our business, operating results, financial condition and stock price.

Risks Related to the Securities Markets

We may need to raise additional capital to achieve our business objectives, which could result in dilution to existing investors or increase our debt obligations.

We require substantial working capital to fund our business. In February 2009, we filed a shelf registration that would allow us to sell an undetermined amount of equity or debt securities in accordance with the rules applying to well-known seasoned issuers. In addition, we filed an acquisition shelf registration statement for up to approximately 1.5 million shares. On November 1, 2010, we sold and issued $345.0 million in aggregate principal amount of senior convertible notes (2010 Notes), in a private, unregistered offering. If additional funds are raised through the issuance of equity securities, the percentage ownership of our stockholders will be reduced and these equity securities may have rights, preferences or privileges senior to those of our common stock. Our capital requirements depend on several factors, including the rate of market acceptance of our products, the ability to expand our client base, the growth of sales and marketing and opportunities for acquisitions of other businesses. We have experienced significant operating losses and negative cash flow from operations during our operating history and may do so in the future. Additional financing may not be available when needed, on terms favorable to us or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop or enhance our services, take advantage of future opportunities or respond to competitive pressures, which would harm our operating results and adversely affect our ability to sustain profitability.

The investment of our substantial cash balance and our investments in marketable debt securities are subject to risks which may cause losses and affect the liquidity of these investments.

As of June 30, 2012, we held $64.5 million of auction rate securities (ARS) at par value which we have recorded at $50.6 million fair value. The ARS are student loans over-collateralized and guaranteed by the U.S. government and are BB+ to AAA rated. Almost all of these securities continue to fail at auction due to continued illiquid market conditions.

Due to the illiquid market conditions, we have recorded a temporary fair value reduction of our ARS in the amount of $13.9 million (21.6% of par value) as of June 30, 2012, under Accumulated other comprehensive income (loss) .

The investment principal associated with failed auctions will not be accessible until successful auctions occur, a buyer is found outside of the auction process, the issuers establish a different form of financing to replace these securities, or final payments come due according to the contractual maturities of the debt issues. If none of these events occur or if the credit markets deteriorate, we may in the future be required to take a larger fair value discount and may be required to take a permanent impairment resulting in a reduction of earnings and liquidity. We intend to hold our auction rate securities until we can recover the full principal amount and have the ability to do so based on our other sources of liquidity. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On September 7, 2011, the Board of Directors authorized a new share repurchase program of up to $100.0 million of our outstanding shares of common stock (2011 Repurchase Program). Under the 2011 Repurchase Program, the shares may be repurchased in the open market or in privately negotiated transactions. Repurchases are at our discretion based on ongoing assessments of the capital needs of the business, the market price of our common stock and general market conditions.

During the three months ended June 30, 2012, 1,366,996 shares were repurchased under the 2011 Repurchase Program. None of the repurchased shares have been retired.

Set forth below is information regarding the Company s stock repurchases during the three months ended June 30, 2012.

Period		Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plan	Approximate dollar value of shares that may yet be purchased under the plan (in millions)
May 1, 2012	May 31, 2012	682,080	$ 14.58	682,080	$ 10.3
June 1, 2012	June 30, 2012	684,916	$ 15.03	684,916	$ 0.0
Total		1,366,996		1,366,996	

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

See exhibits listed under the Exhibit Index below.

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SIGNATURES

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

Date: August 7, 2012

DIGITAL RIVER, INC.

By: /s/ Stefan B. Schulz
Stefan B. Schulz
Chief Financial Officer
(Principal Financial Officer)

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EXHIBIT INDEX

EXHIBIT NUMBER		DESCRIPTION OF DOCUMENTS
3.1	(1)	Amended and Restated Certificate of Incorporation, as amended, as currently in effect.
3.2	(2)	Amended and Restated Bylaws, as currently in effect.
4.1	(3)	Specimen of Common Stock Certificate.
4.2	(4)	Indenture dated as of June 1, 2004 between Digital River, Inc. and Wells Fargo Bank, N.A. as trustee, including therein the form of the 2004 Note.
4.3	(5)	Indenture dated as of November 1, 2010, between Digital River, Inc. and Wells Fargo Bank, N.A. as trustee, including therein the form of the 2010 Note.
10.1		Third Ominibus Amendment to the Microsoft Operations Digital Distribution Agreement, by and among Digital River, Inc. and Microsoft Corporation effective May 8, 2012.
10.2		Fourth Omnibus Amendment to the Microsoft Operations Digital Distribution Agreement, by and among Digital River, Inc. and Microsoft Corporation effective June 30, 2012.
31.1		Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2		Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1		Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2		Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101		The following financial information from Digital River, Inc. s Quarterly Report on Form 10-Q for the period ended June 30, 2012, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Cash Flows, and (iv) Notes to Consolidated Financial Statements.*

(1) Filed as an exhibit to the Company s Current Report on Form 8-K, filed on June 1, 2006, and incorporated herein by reference.
(2) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2000, filed on March 27, 2001, and incorporated herein by reference.
(3) Filed as an exhibit to our Registration Statement on Form S-1, File No. 333-56787, declared effective on August 11, 1998, and incorporated herein by reference.
(4) Incorporated by reference from the Company s Current Report on Form 8-K filed on July 13, 2004.
(5) Incorporated by reference from the Company s Current Report on Form 8-K filed on November 1, 2010.
* Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be deemed part of a registration statement, prospectus or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filings.