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Will Wall Street Embrace Overstock's Digital Securities?

Law360, New York (May 26, 2015, 3:45 PM ET) -- Last month, Overstock.com revealed the first major step in its quest to develop a decentralized stock exchange. Overstock filed a Form S-3 with the U.S. Securities and Exchange Commission, indicating it would issue up to \$500 million in digital securities under the prospectus.[1] Nearly a year after first revealing its intention to establish a platform to trade so-called cryptosecurities, Overstock became the first company to seek regulatory approval for such an offering.

The form utilized by Overstock in this offering, the S-3, is the most simplified registration form for securities offerings. The S-3 is typically referred to as a "shelf" registration. Shelf registration statements are popular among eligible companies; they allow more flexibility in offering securities by enabling companies to respond quickly to fluctuating markets and by incorporating certain periodic reports by reference in the prospectus to avoid frequent amendments. In addition, the SEC has historically been less likely to review and comment on shelf registration statements.

While it is highly unlikely Overstock will avoid review by the SEC, given the novelty of the digital security offering, Overstock gains significant flexibility by filing a shelf registration statement using Form S-3. If Overstock encounters significant roadblocks in creating the digital securities and trading platform, or if the securities are not successful, the shelf registration limits the potential adverse impact to Overstock's stock price.

Historically, Overstock and its CEO, Patrick Byrne, have been vocal critics of Wall Street and have been advocates of new technologies. Byrne famously sued several Wall Street firms, claiming the firms had engaged in illegal naked short-selling techniques to manipulate stock prices. In January 2014, Overstock became the first major retailer to accept the cryptocurrency, bitcoin. Byrne has now set his sights on digital securities as a means to compete with — and even eliminate — traditional securities trading.

Overstock's S-3, filed on April 24, 2015, lists particular risks associated with the proposed digital securities offering. The digital shares "would be uncertificated and represented exclusively as book-entries on a cryptographically-secured distributed ledger." In other words, the securities would be held using a method similar, and likely nearly identical, to the bitcoin platform.



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In its brief six-year history, bitcoin has grown from a currency used for dubious activities to a relatively widely accepted currency that can be used for everything from online shopping to pizza. Overstock is undoubtedly banking that digital securities will be viewed as legitimate investment vehicles following the surprisingly successful bitcoin model.

The most interesting — and innovative — aspect of Overstock's offering is the use of distributed ledger technology. Bitcoin implemented and legitimized distributed ledger technology. The distributed ledger is, at its most basic, a decentralized way to verify transactions. Using bitcoin as an example, a user who wants to spend a certain amount of bitcoins would use a bitcoin wallet, which is included on a shared public ledger or "block chain," to broadcast a transaction to another user, the payee. The wallet uses a private key or "seed" to sign transactions and verify that the spender owns that wallet. The transaction is then confirmed by the network using a process called "mining," which first validates the transaction, checking that the digital signatures are correct, and then achieves consensus by demonstrating the miner has invested computing resources. The mining process, which is a mathematical process more complex than the basic explanation here, takes approximately 10 minutes using the bitcoin network, a peer-to-peer network of "mining" computers.

The distributed ledger has obvious advantages in financial markets. As Overstock notes in the prospectus, the distributed ledger allows for near-instantaneous settlement of transactions — a great improvement over the current three-day settlement system. Digital securities would also eliminate the practice of broker-dealers holding securities in "street name" on behalf of the investor. Digital securities would presumably allow transparency between issuers and investors, as well as possibly decrease or eliminate delays in issuing dividends and interest payments.

To implement trading for these proposed digital securities, Overstock has proposed an alternative trading system (ATS), which would be subject to regulation by the SEC. In September 2014, Patrick Byrne announced Overstock's intent to create its own trading platform, or decentralized stock market, called Medici. Medici would allow trading of cryptosecurities from Overstock and other future issuers. In May 2015, Overstock disclosed its purchase of a 25 percent share in the New Jersey-based alternative trading system, PRO Securities, which is registered with the SEC as an ATS. PRO Securities is also a part of the National Market System, an over-the-counter trading system sponsored by the NASD. This strongly suggests Overstock intends to offer digital securities on the Medici platform as soon as it gains SEC approval.

Despite the likely implementation of digital securities, the concerns with their issuance and trade are not frivolous. Security is a constant concern, given the lack of a clearing corporation or other third party to verify the transaction. The brief history of bitcoin suggests that these particular security concerns may be overblown, as mining has been largely successful in verifying transactions. However, bitcoin exchanges have failed and taken their customers' currency with them. While the cryptosecurity itself may not be insecure, its ownership may be. For example, one might say that a dollar is not a security risk, but it is a theft risk, whether it is in a pocket or in a bank. Digital securities might offer additional avenues for theft or fraud, and new, untested trading platforms may not inspire investor confidence in an untraditional product.

Somewhat ironically, transfer of cryptosecurities may actually be slower than traditional securities. Traditional public-equity trading systems are extremely efficient and provide nearly instant transfers. Using the distributed ledger could take several minutes for verification. Once a trade is completed using the distributed ledger, however, it is completely settled. Traditional trading systems, as noted above, may be instant but require three days for settlement. Patrick Byrne and others believe that the delay between completion of the trade and settlement creates loopholes that traders exploit. The distributed ledger would eliminate these loopholes.

Overstock and other digital security proponents see the distributed ledger as the future of transparent, reliable, decentralized trading. Wall Street has begun to embrace some aspects of bitcoin technology, backing various startups related to bitcoin. Despite bitcoin's rather murky beginnings, including the exploitation of its anonymity for criminal purposes, there is a bright future for many of its features. Distributed ledger technology can provide features many investors seek — transparency, efficiency and reliability. Despite these features, however, digital securities present many unknowns, and these benefits may not outweigh the real and perceived risks for investors.

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[1] <http://www.sec.gov/Archives/edgar/data/1130713/000104746915003890/a2224281zs-3.htm>

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