

## Securities Regulation Daily Wrap Up, SECURITIES OFFERINGS— SEC publishes staff comments on Overstock.com’s digital securities filing, (Jan. 19, 2016)

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When Overstock.com, Inc. filed its Form S-3 with the SEC nearly a year ago it was clear the company’s proposed issuance of digital securities would be innovative, and that it might generate comments from the agency’s staffers given the planned use of rapidly developing and complex, yet potentially highly efficient, technologies to facilitate the new shares. Overstock’s registration is another example of how the financial services industry has embraced the technologies behind virtual currencies, if not the digital currencies themselves.

The SEC recently published extensive staff comments on Overstock’s filing that questioned nearly every aspect of the company’s plans, but with special focus on the overall use of digital technologies, the mechanics of trading digital shares, and cybersecurity and privacy. The published dialogs are listed below:

- SEC letters to Overstock: May 21, 2015; July 10, 2015; August 28, 2015; October 23, 2015; November 5, 2015; November 23, 2015.
- Overstock’s replies: June 15, 2015; July 31, 2015; October 9, 2015; October 20, 2015; November 5, 2015; November 10, 2015; November 24, 2015; November 24, 2015; December 7, 2015.

**Basic questions.** The SEC staff opened with many general questions about the key features of overstock’s digital securities as described in several iterations of its registration statement leading up to its amended Form S-3. Overstock replied that it would use technologies common to virtual currencies (e.g., the Bitcoin Blockchain) to validate transactions in its digital securities.

For settlement reasons, Overstock explained that its digital securities would be traded via a closed system on an alternative trading system (ATS) in order to avoid pricing discrepancies that may result between the company’s digital and traditional shares. Digital securities, for example, would not be pegged to the company’s shares traded via a national market system (NMS), which means their prices could vary from the national best bid or offer. Moreover, digital shares could face additional challenges versus traditional shares due to low trading volume or poor liquidity. The use of an ATS also means there would be no minimum price or listing standards typical of NMS-traded shares.

**Framework for digital shares.** During the comment letter dialogs, much of overstock’s digital securities plans remained open in some important details, but with the effectiveness of its Form S-3, those gaps have closed. In terms of how shares would be traded, Overstock will use the Pro Securities LLC ATS (Overstock told the SEC staff it has a minority stake in the firm), while the only broker-dealer involved, DriveWealth, LLC, will use licensed technology from tØ.com to interact with the ATS and it will share customer information with issuer or its transfer agent for purposes of book entry. The purpose of the technology license is to streamline clearance and settlement, but Overstock’s risk factors note that this and other technologies involved are “novel and untested” regarding digital securities.

One aspect of Overstock’s digital securities plan that drew extra scrutiny involved whether Delaware corporate law allowed the issuance of uncertificated shares that employ book entry under certain scenarios. The company said its counsel had advised that this was allowed under Section 158 of the Delaware General Corporation Law.

The SEC staff also flagged an item from Overstock’s Form 10-Q. The company developed a new product called the Preborrow Assured Token (PAT) and the staff wanted to know if this product was a security. Overstock said PATs did not relate to its registration statement, but that PATs were to be digital securities intended to let their holders meet Regulation SHO’s locate requirements. The PATs would be issued by a special purpose entity

and sold via an auction on the ATS to sophisticated investors, such as qualified institutional buyers, qualified purchasers, and accredited investors. The PATs also would rely on multiple Securities Act exemptions.

**Cybersecurity and privacy.** The SEC staff asked on several occasions how Overstock will deal with privacy and cybersecurity issues. In its initial reply, Overstock noted that the distributed ledger part of the digital shares infrastructure is public, raising at least the potential for ongoing cybersecurity and privacy worries.

In one reply, the company explained that share owners would be identified in the public distributed ledger and in the proprietary ledger (a definitive ownership record). According to Overstock, digital securities can trade in a manner that is more secure than traditional brokerage accounts but, in any event, privacy and other risks are no greater than would be the case regarding an online brokerage account for traditional securities.

Moreover, Overstock said there was no material risk associated with using the Bitcoin Blockchain. This technology, said the company, is a mathematical validation tool that is low risk because it only has a “corroboration function.”

Companies: Overstock.com, Inc.; Pro Securities LLC; SpeedRoute, LLC; DriveWealth, LLC; Continental Stock Transfer & Trust Company; tO.com

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