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Pushing the Envelope: Overstock Seeks SEC Approval for Shelf Offering of Digital Securities

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In a recent filing with the Securities and Exchange Commission, Overstock.com, Inc. expanded its foray into the world of digital currency technology. Announcing plans to issue digital securities, Overstock will be trailblazing its way through unexplored legal territory, raising complex technological and regulatory issues. Filed on April 24, 2015, Overstock's prospectus indicates that the company plans to issue up to $500 million in digital securities utilizing a shelf registration process. The prospectus defines digital securities as "uncertificated securities, the ownership and transfer of which are recorded on a cryptographically-secured distributed ledger [or blockchain] system using technology similar to (or the same as) the distributed ledger technology used for trading digital currencies." Overstock has already embraced the digital currency known as bitcoin, which the company accepts as payment through its online retail store. The digital securities will be traded through an alternative trading system ("ATS"), though none yet exists, rather than through a stock exchange or other national market system. There are, however, numerous investment risks, technological limitations, and legal obstacles attendant to a blockchain-based trading system. In order to initiate and settle a trade on the blockchain, the transaction must be cryptographically verified through an analysis of the corresponding public and private encryption keys. The private key effectively acts as the security holder's signature and is used to initiate or approve transactions. Because the blockchain is public and decentralized, no single party can manipulate the ledger without the other parties cryptographically verifying and approving any proposed changes.

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Blockchain-issued securities have many advantages. One important advantage is that blockchain technology allows for near-instantaneous settlement of trades, as opposed to the T+3 settlement standard utilized by current trading systems. Overstock's plan might also ultimately enhance market transparency. For example, whistleblowers could surveil the marketplace with relative ease, mitigating the likelihood of insider trading activity, as well as other abusive market practices. But

blockchain-issued securities likely won't be able to take full advantage of one of the blockchain's most touted features: anonymity. To satisfy regulators, Overstock's offering requires some centralization (i.e., registration requirements and the consolidation of private keys amongst third-party broker-dealers, as well as within the ATS itself) and traders will be forced to abandon some traditional advantages of the blockchain, which may rile some blockchain purists. In particular, given anti-money laundering and know your customer laws, purchasers will likely be required to forsake the anonymity supplied by the blockchain, which obfuscates the end-user's identity behind their public key.

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A blockchain-based trading system is not without its risks. According to the prospectus, if the system does not attract investor interest, trading volume may be limited, giving rise to liquidity concerns. Thus, security holders could face difficulty in trading their shares in a timely manner, if at all. The prospectus also warns that a small trading volume also increases the ease with which the market price can be manipulated. On the other hand, as noted above, abusive trading practices could also be easier to uncover. Additionally, there are other risks that are particular to blockchain technology. These include the potential for the loss or theft of an individual security holder's private key, the potential for the loss or theft of large numbers of security holders' private keys held by third parties who participate in the ATS, the possibility that undiscovered technological vulnerabilities may exist within the blockchain protocol, and the possibility of a blockchain "fork" or change in the methodology by which transactions are verified.

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Overstock's prospectus contains a comprehensive list of risk disclosures and is very clear about the untested nature of the technology. Despite these potential technological pitfalls and investment risks, the offering's benefits could ultimately outweigh these disadvantages. While Overstock's proposed offering of digital securities offers an intriguing alternative to how corporate securities are currently offered and traded in the public markets, it remains to be seen whether the company will be able to convince the SEC that the markets (to say nothing of the regulators themselves) are ready for the age of digital securities. *This originally appeared as a JD Supra Perspective on May 7, 2015.*

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