The New Normal | Digital Asset Corporate Actions

Considering Overstock.com’s Recent Digital Stock Dividend and its Implications for Securities Lending

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Digital assets and distributed ledger technologies (DLT) are among the developments challenging the financial services industry's status quo. As the cloud of novelty and mysticism around the technology dissipates, it is clear that innovation has the potential to transform from end-to-end—across market participants and even how the industry operates. Securities lending participants must ensure an infrastructure that is prepared for emerging technologies such as digital assets, digital asset dividends, corporate actions, and DLT alternative trading systems.

To examine, inform, and facilitate an industry approach for adopting these new technologies, **RMA's Financial Technology & Automation Committee** (the "**Committee**") commissioned this white paper and an industry survey to study and begin formulating a roadmap. This case study illustrates and benchmarks the industry's current position and readiness for digital assets, while providing insight on the reactions by market participants with respect to Overstock.com's recent digital dividend.

Background

On May 19, 2020, Overstock.com completed the first issuance of its Digital Voting Series A-1 Preferred Stock "Series A-1" (**OSTKO**), a digital dividend championing the use of digital assets. This digital issuance was the first of its kind.[i]

Considering the resulting actions by securities lending market participants, the approach to handling this type of issuance may need to evolve and become more deliberate. Orchestrating a one-off mini-close-out, restricting lending, selling off entire positions, and opening accounts at the tZero alternative trading system (ATS) worked as stopgaps, but the industry must come together to provide a strategic and consistent solution for the future.

In reflection, the securities lending industry was able to weather this event by overcommunicating with market participants and handholding during the transaction lifecycle. This ultimately curtailed a lot of activity. But what if several large cap blue chips issue a digital asset dividend simultaneously, and decide to institute seek licenses for their own alternative trading system?

Currently, the industry could not replicate its Overstock.com response. What does the industry need to do to enable a better operational model? This line of questioning and thought-provoking discussion is exactly what Overstock.com CEO Jonathan Johnson and Chairwoman Allison H. Abraham wanted.

> "…the securities lending industry was able to weather this event…. [but] could not replicate its Overstock.com response. ***What does the industry need to do to enable a better operational model?"***

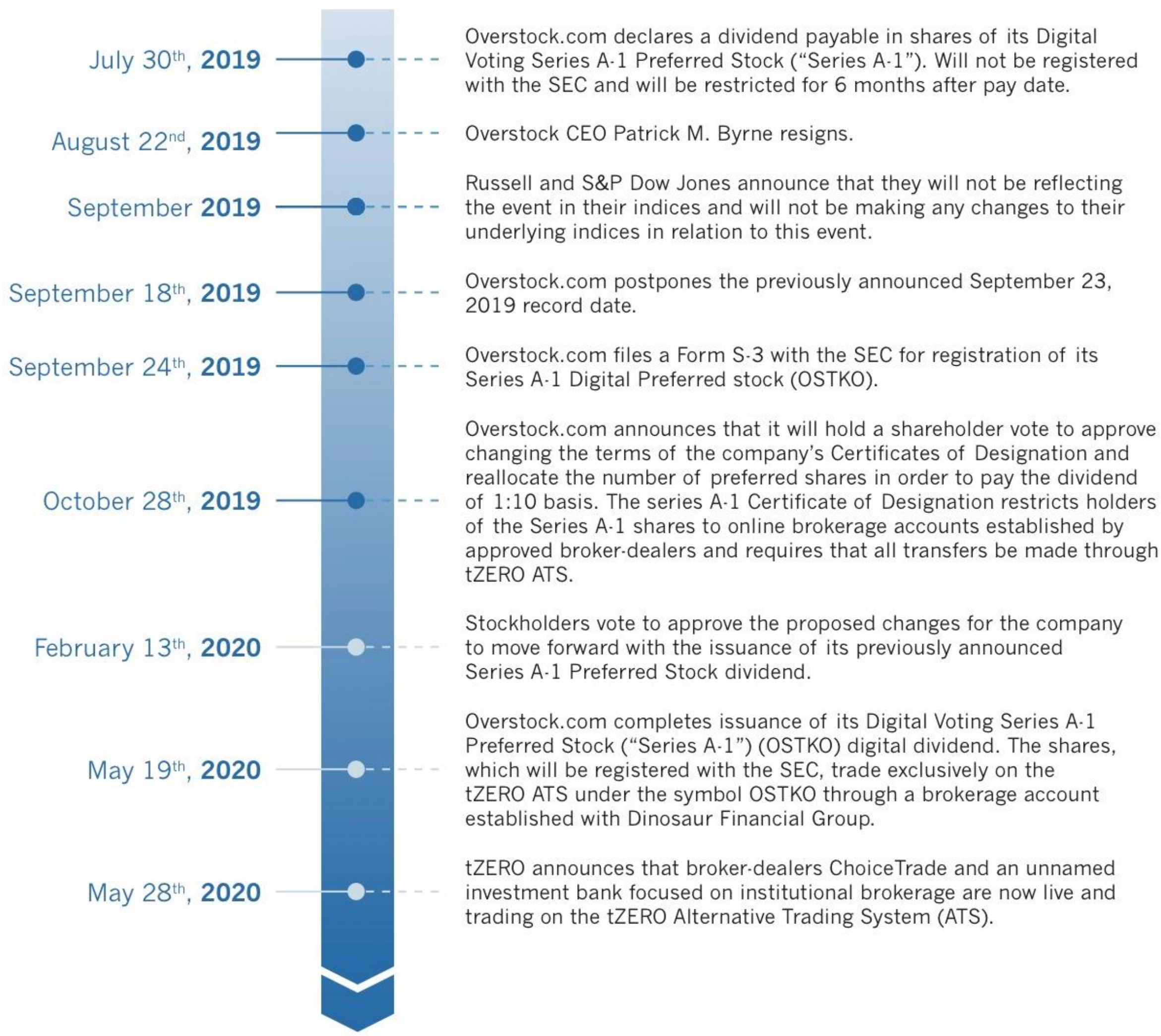
They noted:

> *The goal is that as regulators and market participants become increasingly comfortable with DLT/blockchain technology, it will gradually play a larger role in the overall process to the benefit of investors, regulators, and other market participants…The successful issuance of the Dividend will demonstrate to other issuers and market participants that this technology is scalable and has significant benefits to all market participants.*[ii]

Market participants must learn from this corporate action and prepare to adapt for the possibility of others.

Background and Barriers to Entry for Digital Assets

In late 2017, as a result of the growing value of cryptocurrencies, interest in digital assets within the traditional asset lending space was high. It was realized that digital assets have "the potential not only to add new asset types but to make existing processes more efficient, and to create entirely new roles as well as adding new techniques such as smart contracts."[iii]



Fast-forward to April 2020. Despite this interest, security tokens were traded on only two exchanges—OpenFinance and tZERO—and with limited liquidity. These activity levels can be attributed to:

1. **Regulatory Barriers to Entry**
   A company seeking to launch an ATS to issue a security token requires a regulator (such as the SEC) to approve a license. This is a slow and expensive process with no guaranteed return on investment.[iv]

2. **Investor Interest**
   Although there is neither a universal consensus nor the data to evidence the long-term benefits of financial services DLT-based infrastructure, the individual and industry benefits from use-cases—and instances where such DLT solutions have been deployed—are known. In the case of tokenized/crypto assets, benefits include instant settlement cycles via smart contract and the reduction in fails and back office exceptions arising from reconciliation. As market participants become increasingly comfortable with DLT, the quantifiable and qualitative benefits will become clearer. Whether those benefits will be realized from the start or only gained after reaching critical mass remains to be seen. It could be argued that DLT will only add another channel and data standard that would have to be rationalized among the disparate current-state infrastructure.

Overstock.com navigated through regulatory obstacles and barriers, although not unscathed, to issue a non-native asset. It is important to note that the main success of this milestone could be that Overstock.com owns the ATS, tZero. tZero issued the digital token against Overstock.com's common stock at a 1:10 ratio. Some market participants have seen Overstock.com's digital dividend in a different light, calling the corporate action transaction processing more cumbersome and less efficient.[v]

What Is the Impact of this Disruptive Event?

As is often the case with disruptive events, the issues that may arise must be considered.

On this note, RMA's Financial Technology & Automation Committee surveyed leading market participants to better understand just how disruptive this event has been for the securities lending industry.

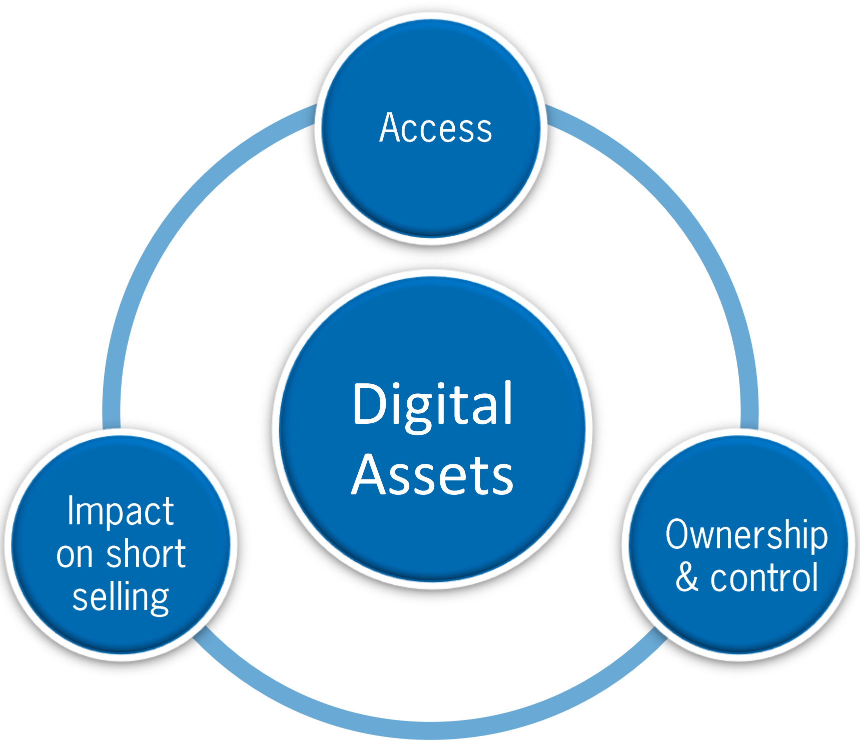
"Overstock.com navigated through regulatory obstacles and barriers, although not unscathed, to issue a nonnative asset."

In light of the Committee's objective to examine, inform, synthesize, and facilitate an approach to adopt new technologies as an industry—and utilizing Overstock.com's digital dividend as a case study—the Committee polled the securities lending industry. The findings are summarized below:

54% of agent lenders who owned Overstock.com shares decided to recall outstanding loans and restrict lending

- The survey was sent to 39 market participants, including agent lenders and borrowers. Thirty-one responded.
- Fifty-four percent of agent lenders who owned Overstock.com shares decided to recall outstanding loans and restrict lending over record date. In most cases, this course of action was driven by concerns over the operational processing of such a distribution far exceeding its inherent value.
- Forty-six percent of lenders who owned Overstock.com shares decided to continue lending over record date. Eighty-two percent of these lenders received cash in lieu payments. No respondents said they received digital assets as a manufactured dividend. While the processing of these cash in lieu payments was deemed straightforward, there were challenges regarding the valuation of the digital asset, legal terms, and client communication.
- Eighty percent of borrowers did not borrow over record date. This was driven by two main reasons: Half the respondents mentioned this was an internal decision not to be exposed to this distribution. The other half saw their shorts covered prior to record date.

In synthesizing thematic issues, areas of most concern to market participants can be categorized as follows:



Access

Publicly traded shares normally are freely tradable across exchanges. Broker-dealers have their established network, piping, routers, and dealers to achieve best execution. However, that status quo is being disrupted because of a condition of the OSTKO digital dividend: The holders must trade the asset exclusively on the tZERO ATS. GTS CEO Ari Rubenstein personified the feeling of much of Wall Street when he said, "America's market system is not based on dictating the trading venue and charging exorbitant fees."[vi]

Limiting trading to one venue (with a limited number of broker-dealers as of this writing) may prompt fair criticism that making the sale of such securities difficult and expensive is to the detriment of investors. However, regulators may see this as a longer-term play, franchising investors and purposefully allowing tZero and Overstock to be a "positive disrupter."[vii]

Maybe tZero and Overstock's digital play is seen as contributing to competitive pricing and discouraging unfair practices. Though, if the latter is true, others will follow, potentially forcing broker-dealers to subscribe to a number of actions—one being subscription to new ATSs. Alternatively, will broker-dealers be compelled to disclose that they cannot trade certain securities that pose a risk to their margin and reputation?[viii]

Impact on Short Selling

During his tenure, former Overstock.com CEO Patrick Byrne openly combatted short sellers. Intentional or not, the digital asset distribution triggered short covers that coincided with a very steep rally days before the initial record date of September 2019, thereby pointing towards a short squeeze.[ix]

The theory behind a squeeze comes down to the obligation a short seller faces to pass dividends back to the lender of the shares. Back in September 2019, there were many unanswered questions on how to pass on a digital dividend, which in turn triggered several market participants to take actions to reduce risks related to this distribution—including lenders recalling shares out on loan ahead of record date.

When the distribution eventually took place in May 2020, market participants took different approaches to handle this event. Some agreed to receive an equivalent value in cash of the digital dividend.[x] Others decided not to lend OSTK over record date, thereby reducing the liquidity available in that name.

Ownership of Stock

A well-known benefit of using DLT solutions is the inherent "chain" of ownership, transactions, and transparency. Today, while the custodial market share may be owned by a few of the world's largest custodians, the market is still saturated with many other custodians and transfer agents. They have different systems, standards, and channels, resulting in ambiguity with respect to security ownership. That is amplified in securities lending when securities are lent, sold, and substituted. The Dole Food buyout, where 49,164,415 shares were claimed when only 36,793,758 shares were outstanding, is an example. The resulting disputes regarding shareholder ownership resulted in a $115,700,000 settlement.[xi]

This case reveals the existing infrastructure around ownership is outdated, creating risk for both brokers and shareholders alike. A distributed ledger provides an effective real-time track record of ownership, making it easy to attribute relevant entitlements such as dividend payments. In the case of Dole Food, relevant short sellers could have been easily identified—saving significant time and expense (though the issue of enforcing payment would still be a problem).

What Now?

The industry must come together, considering that digital assets may be the new normal, and decide how best to prepare. Understanding how to influence change at your organization and discussing solutions is a starting point. Organizations must build a perspective on how it affects securities finance and how to align themselves accordingly. RMA's Financial Technology & Automation Committee is seizing this as an opportunity to not only solve an industry issue of processing digital dividends, but also to consider creating an industry playbook on how to tackle other new issues of first impression as they inevitably occur in this ever-disruptive industry.

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[i] https://www.forbes.com/sites/robertanzalone/2020/05/18/does-the-way-we-track-stock-ownership-cost-us-money-overstocks-digital-dividend-uses-blockchain-to-prove-a-point/#68e0920854c8

[ii] https://www.coindesk.com/overstock-is-set-to-finally-pay-out-its-digital-security-shareholder-dividend

[iii] https://www.issanet.org/e/pdf/2019-11_ISSA_Report_Crypto-Assets_Moving_from_Theory_to_Practice.pdf

[iv] https://www.forbes.com/sites/jeffkauflin/2019/05/21/security-tokens-were-supposed-to-transform-crypto-so-far-theyve-flopped/#382ae73841a2

[v] https://www.coindesk.com/after-lawsuits-and-delays-overstock-hands-shareholders-digital-dividend

[vi] https://www.bloomberg.com/news/articles/2020-05-18/overstock-fights-wall-street-over-new-dividend-amid-400-rally

[vii] https://www.forbes.com/sites/robertanzalone/2020/05/29/tzero-announced-new-broker-dealers-trading-on-its-blockchain/#377103a97678

[viii] https://www.bloomberg.com/news/articles/2020-05-18/overstock-fights-wall-street-over-new-dividend-amid-400-rally

[ix] https://nypost.com/2019/09/17/ex-overstock-ceo-planned-crypto-dividend-to-thwart-short-sellers/

[x] https://nypost.com/2019/09/17/ex-overstock-ceo-planned-crypto-dividend-to-thwart-short-sellers/

[xi] https://www.nytimes.com/2017/03/21/business/dealbook/dole-case-illustrates-problems-in-shareholder-system.html