

Daunting Challenges Threaten Overstock's Crypto-Deal

Disclosure Insight® reports provide commentary and analysis on public company interactions with investors and with the SEC. They are heavily reliant on our expertise in using the Freedom of Information Act.

Summary and Opinion: Between crypto-mania, regulatory pressure, and even history, we see a mix so daunting, so expansive, that it's hard imagine Overstock's cryptocurrency deal survives, at least not in its present form. If it does survive, then investors will have every right to cheer. For now, you can put us in the category of those in no hurry to order the pom-poms yet.

Overstock.com and the fight over whether CEO Patrick Byrne is a born-again saint, or the unrepentant rot-in-hell sinner, took a new turn on 01-Mar-2018, when the company announced what appears to us as an informal SEC investigation. The Overstock SEC investigation was first disclosed the same day the *Wall Street Journal* reported that "scores of subpoenas" were issued by the SEC regarding cryptocurrencies. There's a distinction here that's subtle, yet important. You see, subpoenas are only issued as part of a formal SEC investigation. But the language used in disclosing Overstock's SEC probe is what tells us that matter was informal. That suggests the SEC was targeting Overstock individually, even before those scores of subpoenas went out. With that comes heightened company-specific risk for Overstock.

Given the mania surrounding cryptocurrencies and Initial Coin Offerings (ICO's), and the very nasty fighting that has taken place over social media regarding Mr. Byrne's saint-versus-sinner status, we think the SEC had no choice but to now bore-in on every representation made by Mr. Byrne regarding his Preferred Equity Tokens offering. The complexity will be carefully scrutinized. Mr. Byrne's history when it came to dealing with his detractors, as well as any impression he left with SEC investigators from earlier investigations, will also weigh heavy. When you add to the mix the SEC's sensitivity to avoiding another Bernie Madoff type embarrassment, it's not hard to see why the SEC served notice to the legal community to

behave itself when advising cryptocurrency/ICO clients or be held complicit for not having done so. In the balance of this note we parse company disclosures about the SEC probe and walk through why we think Overstock poses more risk than supporters may recognize. We include excerpts from our vast document library as comparisons.

If you are a fan of Overstock, we suggest you get your arms around this concept first: We think Overstock disclosed its SEC probe when it did for one simple reason: management judged it represents an exposure sufficiently material that had to be disclosed. While the *Wall Street Journal* story about "scores of subpoenas" gave great cover (investors tend to be less concerned about industry-wide probes than company specific ones), getting to the bottom of why management deemed its SEC exposure material is an exercise in diligence best done sans emotion or hyperbole. If you cannot independently assess why this management team felt compelled to disclose its SEC probe, you are left with an exposure that management thinks material, but you cannot analyze. We generally recommend investors avoid those scenarios.

Overstock doesn't just have SEC investigative risk. Have you looked at all the regulatory "dialogues" that were disclosed in the Overstock Private Placement Offering Memorandum? Relevant excerpts, from the 01-Mar-2018 update appear further below, but here's your teaser –

"PRO Securities and SpeedRoute, two subsidiaries of the Company, are registered broker-dealers and are subject to extensive regulation ... PRO Securities is involved in an ongoing dialogue with regulatory authorities ... SpeedRoute is involved in an ongoing dialogue with regulatory authorities."

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Patrick Byrne's history for investigations and controversy could hurt Overstock today. One does not need to look far to find those accusing Overstock CEO Patrick Byrne of being "overly enthusiastic" regarding his company, including his cryptocurrency-centric vision for it today. But "dirty tricks" is another term we heard – and still hear – when it comes to Mr. Byrne and his approach to detractors. We have no opinion on the man, but we would be remiss if we failed to warn that this history could easily come into play with regulators today. It also suggests the SEC will now put his every word to the test.

To be clear, we have no idea what SEC personnel think of Mr. Byrne. But his history is simply too colorful to be ignored by SEC staff. You can be sure investigators today will go into the SEC's archive to review records from investigations and controversies past.

The attorneys are on notice to behave themselves. When it comes to doing those things some might perceive as being on the cutting edge of technology, product development, or a word we long-ago grew tired of, "disruption", it often takes talented legal minds to help the visionary entrepreneur safely navigate a path. That's why we found it troubling that the SEC recently issued a pre-emptive warning to the legal profession to behave itself when advising cryptocurrency/ICO clients. We have not seen that before. That tells us that counsel advising clients in this space had better be squeaky clean. We have no view on the counsel used by Overstock in helping Mr. Byrne execute on his cryptocurrency vision. But one has to imagine they may be feeling a touch less creative, or willing to push boundaries for a client than might have been the case prior to the SEC warning.

"The SEC has left no doubt that it is focused on ICOs used to raise capital, and particularly on the lawyers who provide advice on securities law issues attendant to these offerings." - William F. Johnson, March 01, 2018, "[Gatekeepers Beware: SEC Escalates Danger for ICO Counsel](#)"

The Legacy of Bernie Madoff. Yes, even Bernie Madoff will be a factor here. It's important to not discount the embarrassment felt by the SEC for having been perceived to miss Bernie Madoff's shenanigans. Perhaps not as visceral as the JFK assassination is in the institutional memory of the Secret Service, the memory of having "missed" Bernie Madoff is nonetheless part of the SEC's institutional memory and will surely influence its cryptocurrency investigative efforts today.

Parsing the Overstock SEC probe disclosure: The Overstock SEC probe was disclosed the same day the *Wall Street Journal* reported that "scores of subpoenas" were issued by the SEC regarding cryptocurrencies. This is consistent with earlier statements and speech-making by SEC officials warning the agency had concerns in this space. However, the timing of Overstock's disclosure of an SEC probe may have also led to a sense of misplaced complacency among Overstock investors; that is, some may believe a big industry sweep surely isn't as meaningful as would be a targeted SEC investigation of the company itself. We can't know, but this timing may have even been deliberate on the company's part to keep investors from recognizing the Overstock SEC investigation is, in fact, a targeted, informal inquiry. Here's the language in Overstock's disclosure about the SEC investigation worth focusing on –

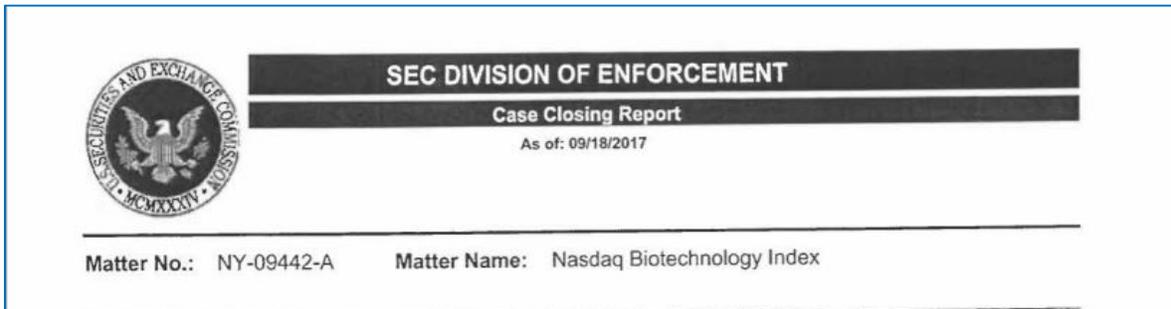
From an update to a tZERO Preferred Equity Tokens Confidential Offering Memorandum, as of March 01, 2018 –

*"In February 2018, the Division of Enforcement of the SEC informed the Company that it is conducting an **investigation in the matter Re: Overstock.com, Inc. (NY-9777)** and requested that the Company **voluntarily provide certain documents** related to the Offering and the Tokens in connection with its investigation. The Company is in the process of responding to this document request and will cooperate with the SEC in connection with its investigation. [Emphasis added]"*

The term "**voluntarily provide certain documents**" tells you this is an informal probe, at least it was as of Feb-2018. Subpoenas are not issued in informal probes as the information is being "voluntarily" produced. The specific titling, "**in the matter of Overstock.com**", tells you this is a company-specific investigation being conducted out of the SEC's New York office.

Based on comparing Overstock's disclosure language to that which we know the SEC uses when titling its broad-based investigations, we are left to conclude the SEC has been investigating the company in a more targeted manner than investors may recognize. If so, this suggests the risk is higher than the company lets on. Further diligence is recommended. On the following pages we show examples of what the titles look like in broad-based SEC investigations.

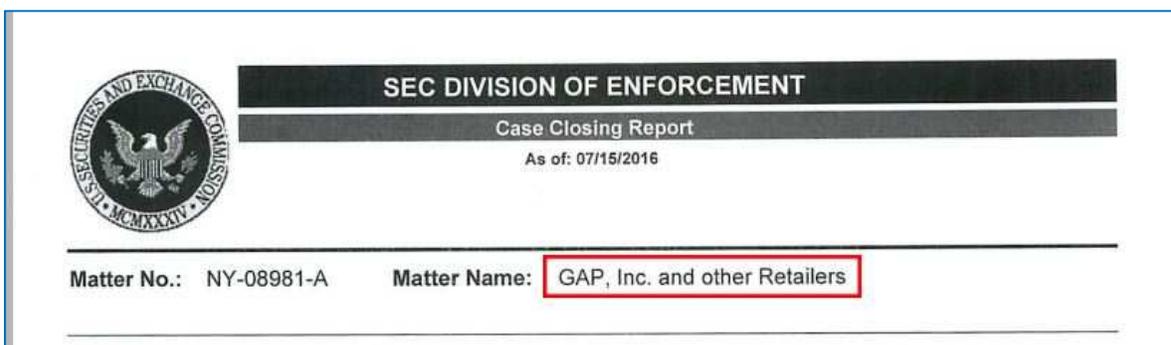
The following documents are from an industry-wide probe that recently took place in the biotechnology industry. Seven subpoenas were sent to different companies as part of this matter titled, "Nasdaq Biotechnology Index". **This is the format we believe the SEC probably used when it sent those "scores of subpoenas" in its ICO investigation.** Compare that to Overstock's disclosure which, according to the company, is titled, "... in the matter Re: Overstock.com, Inc." The language Overstock cited in its disclosure about its investigation is more typical of the language the SEC uses when an investigation is focused solely on one company and/or person.



The Commission has information that tends to show that from at least January 1, 2013:

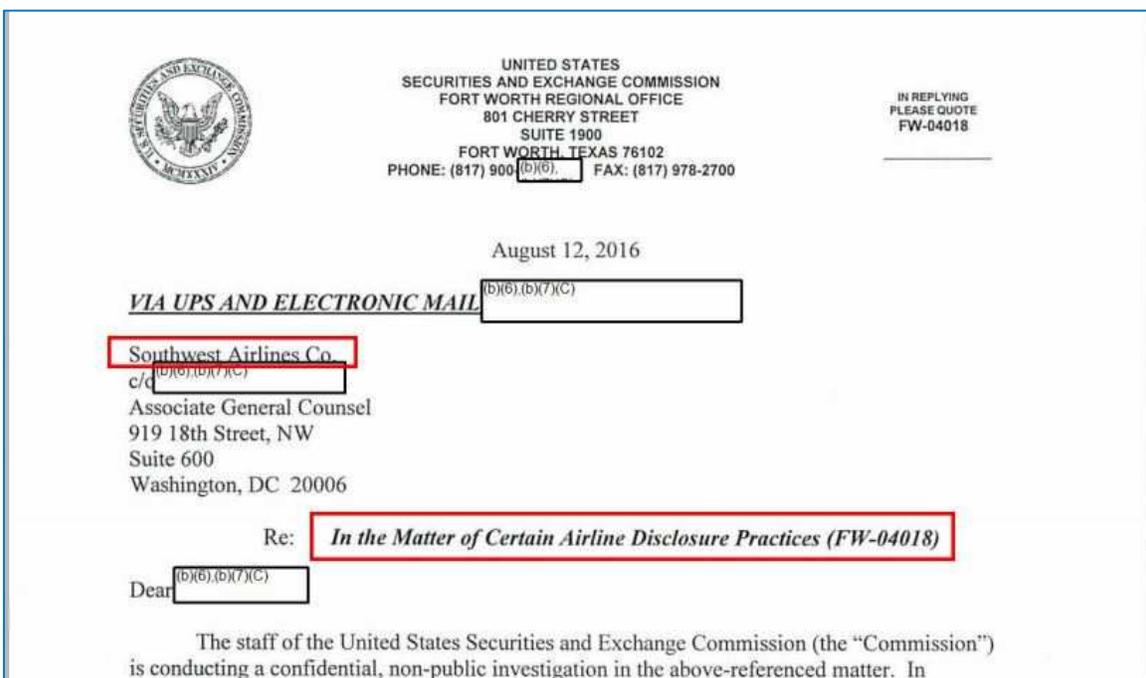
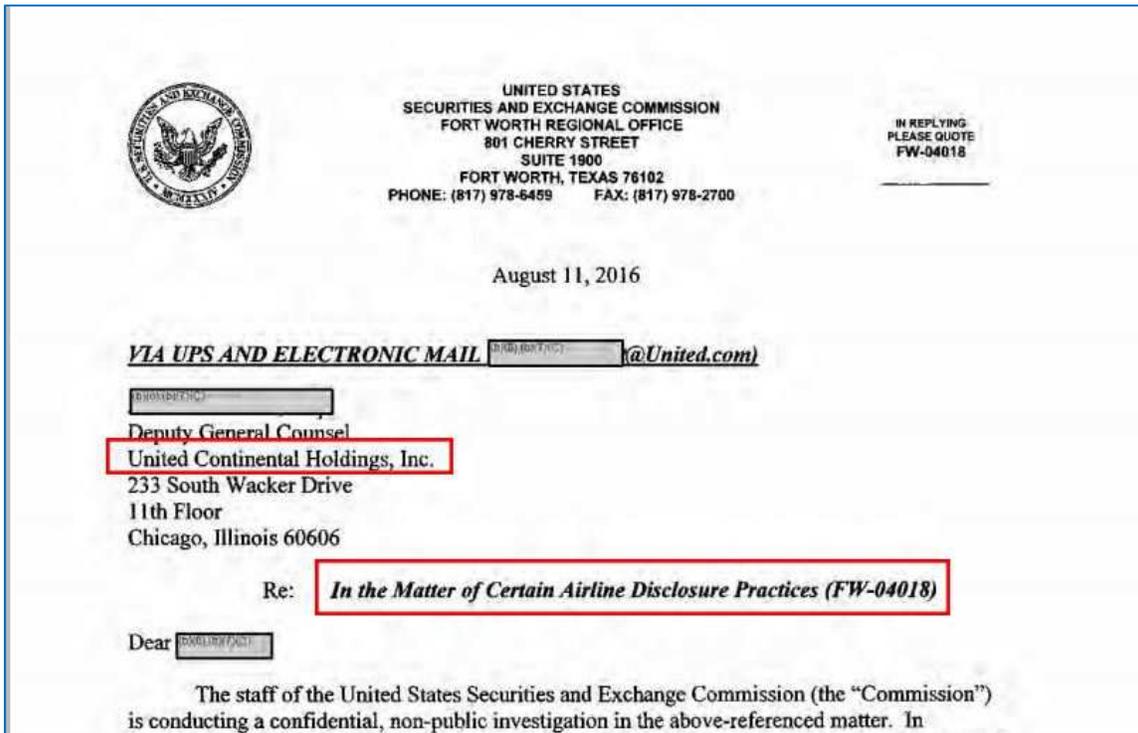
A. In possible violation of Section 9(a)(2) of the Exchange Act, Alder, Amphastar, Radius Health, Relypsa, Sage, Tetrphase, and Zafgen, their officers, directors, employees, partners, subsidiaries and/or affiliates, and/or other persons or entities, directly or indirectly, may have effected, alone or with one or more other persons, a series of transactions in the securities of certain issuers listed on the NASDAQ, creating actual or apparent active trading in such securities, or raising or depressing the price of such securities, for the purpose of inducing the purchase or sale of such securities by others.

Below we again see an industry-wide investigation that took place, this time in the retail space. In the following example Gap, Inc. is individually named, but only as part of an investigation into "Gap, Inc. and other Retailers".



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Finally, as can be seen in each case shown on this page, both Southwest Airlines and United Continental Holdings were sent letters as part of a broader industry-wide investigation titled, "In the Matter of Certain Airline Disclosure Practices". A similar letter went to Delta Airlines as well. Again, this is not the language Overstock said was used for its investigation (remember, according to the company, their probe is titled, "... in the matter Re: Overstock.com, Inc.").



Supplemental Data:

This section includes excerpts from an update to a tZERO Preferred Equity Tokens Confidential Offering Memorandum, as of March 01, 2018.

Disclosure of the SEC probe –

“In February 2018, the Division of Enforcement of the SEC informed the Company that it is conducting an investigation in the matter Re: Overstock.com, Inc. (NY-9777) and requested that the Company voluntarily provide certain documents related to the Offering and the Tokens in connection with its investigation. The Company is in the process of responding to this document request and will cooperate with the SEC in connection with its investigation.

While the SEC is trying to determine whether there have been any violations of the federal securities laws, the investigation does not mean that the SEC has concluded that anyone has violated the law. Also, the investigation does not mean that the SEC has a negative opinion of any person, entity, or security.

The following excerpts speak to broader regulatory exposure at Pro Securities and SpeedRoute –

PRO Securities and SpeedRoute, two subsidiaries of the Company, are registered broker-dealers and are subject to extensive regulation.

Broker-dealers are subject to extensive regulatory requirements under federal and state laws and regulations and self-regulatory organization SRO rules. PRO Securities and SpeedRoute are registered with the SEC as broker-dealers under the Exchange Act and in the states in which they conduct securities business and are members of FINRA. PRO Securities and SpeedRoute are subject to regulation, examination and disciplinary action by the SEC, FINRA and state securities regulators, as well as other governmental authorities with which they are registered or licensed or of which they are a member. On February 22, 2018, the SEC’s New York Regional Office notified PRO Securities that it is conducting an examination of PRO Securities. Any failure of PRO Securities or SpeedRoute to comply with all applicable rules and regulations could have a material adverse effect on the Company’s operations and financial conditions.

PRO Securities is involved in an ongoing dialogue with regulatory authorities ...

PRO Securities has been and remains involved in ongoing discussions with regulatory authorities about the operation of the PRO Securities ATS utilizing the Existing tZERO Software Platform and various matters relating to the regulated entities involved. While many of the discussions have been relatively informal, PRO Securities has also received and responded to multiple inquiries from regulators, including FINRA and the SEC. In an unrelated matter, PRO Securities (in addition to SpeedRoute) has been named in a FINRA investigatory matter in which FINRA has conducted on the record interviews of two senior officers of tZERO. Any failure of PRO Securities to satisfy FINRA, the SEC or any other regulatory authority that PRO Securities is in compliance with all applicable rules and regulations could have a material adverse effect on the Company’s operations and financial conditions. See “—SpeedRoute is involved in an ongoing dialogue with regulatory authorities” for additional information about SpeedRoute ...

SpeedRoute is involved in an ongoing dialogue with regulatory authorities.

SpeedRoute has been, and remains involved, in ongoing discussions with regulatory authorities similar to those described in the preceding risk factor. In addition, in December 2017, SpeedRoute received a letter from FINRA stating that the Department of Enforcement at FINRA has received a referral from the staff of FINRA’s Department of Market Regulation relating to rules applicable to supervision and required supervisory procedures for review of certain potential trading activity, such as pre-arranged trades or wash trades. SpeedRoute continues to have discussions with FINRA about other matters, including a matter related to potential violations of FINRA rules relating to Order Audit Trail System reporting and trading practice matters and has received document requests from FINRA in connection with certain ongoing matters. Further, in an unrelated matter, SpeedRoute (in addition to PRO Securities) is also named in a FINRA investigatory matter in which FINRA has conducted on the record interviews of two senior officers of tZERO. Any failure of SpeedRoute to satisfy FINRA, the SEC or any other regulatory authority that SpeedRoute is in compliance with all applicable rules and regulations could have a material adverse effect on tZERO’s operations and

financial condition and a material adverse effect on us. See “—PRO Securities is involved in an ongoing dialogue with regulatory authorities” for additional information about PRO Securities.

Business and Organization

On December 1, 2014, Medici Inc. (“Medici”) was incorporated in the State of Utah, as a wholly owned subsidiary of Overstock.com (“Overstock”), to focus on development of commercial applications of blockchain and financial technology. Pursuant to an agreement dated November 21, 2014, on July 16, 2015, Overstock transferred 24.9% of its shares of Medici to a third-party. On August 26, 2015, the third-party transferred 5.9% of the shares back to Overstock and redistributed some of its shares to other individuals or entities, in connection with the acquisitions described below in Note 4 — Acquisitions, Goodwill, and Acquired Intangible Assets. On October 21, 2016, Medici formally changed its name to t0.com, Inc. On February 3, 2017, Overstock transferred its 81.0% ownership of t0.com, Inc. to its wholly owned subsidiary, Medici Ventures, Inc. As of December 31, 2017, Overstock indirectly owns 81.0% of t0.com, Inc. and the remaining 19.0% of t0.com, Inc. is held by 27 other individual or entity shareholders many of whom are employees or former employee of t0.com, Inc. (the “Company”).

As used herein, “we,” “our” and similar terms include t0.com, Inc. and its subsidiaries, unless the context indicates otherwise.

We obtained an indirect non-controlling interest in two registered broker dealers, SpeedRoute, LLC (“SpeedRoute”) and PRO Securities, LLC (“PRO Securities”), through the acquisition of certain assets of Cirrus Technologies, LLC (“Cirrus Technologies”) during the third fiscal quarter of 2015 and subsequently obtained a 100% direct ownership interest in these two broker dealers in a transaction that closed in the first fiscal quarter of 2016 (see Note 4 — Acquisitions, Goodwill, and Acquired Intangible Assets).

SpeedRoute is an electronic, agency-only Financial Industry Regulatory Authority, Inc. (“FINRA”) registered broker dealer that provides connectivity for its customers to U.S. equity exchanges as well as off-exchange sources of liquidity, such as dark pools. All of SpeedRoute’s customers are registered broker dealers. SpeedRoute does not hold, own, or sell securities.

PRO Securities is a FINRA-registered broker dealer that owns and operates the PRO Securities alternative trading system (“PRO Securities ATS”), which is registered with the Securities and Exchange Commission (“SEC”) as an alternate trading system, or ATS. The PRO Securities ATS is not regulated as an exchange, but is a licensed venue for matching buy and sell orders. The PRO Securities ATS is a closed system available only to its broker dealer subscribers. PRO Securities does not accept orders from non-broker dealers, nor does it hold, own or sell securities ...

... SpeedRoute has been, and remains involved, in ongoing discussions with regulatory authorities, including related to rules applicable to supervision and required supervisory procedures for review of certain potential trading activity, such as pre-arranged trades or wash trades and to Order Audit Trail System (OATS) reporting and trading practice matters. SpeedRoute has received and responded to inquiries from FINRA and the SEC.

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“Disclosure Games®” is a term we use to highlight those public companies engaging in disclosure practices that in our opinion may be misleading, confusing, evasive, or otherwise lacking the transparency needed for investors to make well-informed investment decisions regarding a potentially material exposure.

If we alert you to existence of an undisclosed SEC probe, that means we filed a Freedom of Information Act (FOIA) request with the SEC on the company in question and have a response, in black-and-white, on government letterhead that supports our statement. The only thing we know at this time is that the probe(s) somehow pertains to the conduct, transactions, and/or disclosures of the companies referenced.

New SEC investigative activity could theoretically begin or end after the date covered by the latest information in this report which would not be reflected here. The SEC did not disclose the details on investigations referenced herein. All we know is that they somehow pertain to the conduct, transactions, and/or disclosures of the companies referenced above. Companies with undisclosed SEC investigations are maintained on our Watch List of companies with undisclosed SEC probes.

The SEC reminds us that its assertion of the law enforcement exemption should not be construed as an indication by the Commission or its staff that any violations of law have occurred with respect to any person, entity, or security.

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