

# The Banking Law Journal

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# Heads or Tails? Making Sense of Crypto-Tokens Issued by Emerging Blockchain Companies

*Jeremy A. Herschaft and Michelle Ann Gitlitz\**

*This article explores the use of two types of digital assets: the “security token” to attract capital, and the “utility token” to carry out business interactions.*

Over the past 18 months, members of the international maritime community have expressed a keen interest in exploring how 21st century blockchain technology can modernize the ancient world of seaborne commerce. Blockchain has in turn spawned many novel business ideas from various start-up companies throughout the marine industry. These new business ventures all generally seek to employ blockchain to streamline the logistics process and to provide greater security and transparency to the commercial endeavor.

At the same time, these companies are setting a new course through uncharted waters with respect to how they 1) generate startup capital, and 2) propose to conduct day-to-day business in the electronic, digital asset (or crypto) realm.

This article explores these dual business components using two types of digital assets: the “security token” to attract capital, and the “utility token” to carry out business interactions. Both are well suited for the maritime area, though maritime blockchain startup companies should be mindful of the regulatory requirements for implementing tokens into their business in the United States.

## **BASIC PRINCIPLES**

The business of shipping has modernized dramatically over the last quarter-century, but in many respects the parties to a shipping transaction remain “siloed” in their positions along the commercial chain. For example, entities involved in an international shipping transaction (such as the seller, carrier,

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broker, non-vessel owning common carrier, receiver, cargo/marine insurers, and associated intermediary banking institutions) remain compartmentalized; they rarely communicate simultaneously.

Each entity has its own system of records and methods of verification concerning their specific portion of the deal (the proverbial private accounting “ledger”). To complicate things further, the parties—who each have different ledgers that are not necessarily in sync or collectively accurate—all look to centralized institutions (such as banks) that are trusted to separately issue letters of credit and/or verify that funds are in place so that the deal can go forward. There are many aspects of this structure that create the potential for inaccuracies and error, as well as the ever-present risk of a fraudulent party wreaking havoc along some portion of the commercial chain.

Blockchain technology seeks to upend this current segmented format by using a powerful electronic database—which can necessarily be tailored to the industry, contracting parties, and deal at issue—to decentralize the entire process and provide all parties with access to a single “master electronic ledger” for each transaction. Cryptography used in the blockchain technology secures the data on the master ledger, making it difficult for any one party to manipulate the contents of the ledger without approval from all other parties, or for third parties not involved in the transaction to access the ledger. As new information becomes available concerning the transaction (e.g., vessel progress, the exchange of bills of lading, the movement of currency, etc.), new electronic entries (or “blocks”) are added to the ledger, which are linked to prior blocks in the chain of transactions that all parties can observe in real time. Blockchain also allows a very high level of privacy with respect to the parties to the transaction, and it can be tailored to only involve the key participants of the deal (thus reducing the risk of third-party scams). In this fashion, the blockchain ledger has the potential to unify all key parties to the transaction and dramatically streamline the way in which maritime business is conducted.

### **RECENT MARITIME BLOCKCHAIN INNOVATIONS, SECURITY TOKEN OFFERINGS, AND UTILITY TOKENS**

Blockchain has already received considerable attention from many larger, traditional maritime commercial concerns. For example, Maersk has already partnered with IBM to create a far-reaching blockchain program for its liner trade. Of course, many new maritime startup companies also hope to be a part of the maritime blockchain revolution. Most of these new companies similarly focus their business models on the basic components of the marine supply chain, such as the movement of containers, the exchange of bills of lading, the tracking of cargoes and vessels and carrier availability, and the tracing of marine

bunker fuels, etc. However, in contrast to long-established maritime concerns with ample funds to support a “blockchain initiative,” these emerging maritime blockchain companies often do not have significant amounts of startup capital beyond a tight circle of private investors. Regardless, the way in which these new companies propose to generate their startup capital is novel: they seek to create a company-specific cryptocurrency “coin” to drive their initial funding. This is a radical concept, as it seeks to shift startup capital away from established fiat currencies and traditional stock certificates to an electronic security token model where interests in a company are issued in compliance with state and federal securities laws—but in a digital format.

In an Initial Public Offering (“IPO”), a private maritime startup company seeking capital might “go public” by offering shares of its newly issued stock to the market and/or institutional investors, and these share offerings would be regulated by the U.S. Securities and Exchange Commission (“SEC”), which among other things is responsible for protecting investors and regulating securities. Alternatively, a private startup company might seek capital from a smaller group of investors who meet certain asset and/or income requirements (“accredited investors”) and issue securities using a specific exemption to the federal securities laws for private transactions (which is beyond the scope of this article). In the latter case, the securities offering is not reviewed or approved by the SEC like an IPO.

In contrast to these traditional fundraising formats, many blockchain startup companies (including some maritime startup companies) are now electronically manufacturing their own company-unique “tokens” and then offering these tokens to the public. These offerings are sometimes referred to as Initial Coin Offerings (“ICOs”). The token-manufacturing process can be accomplished online with the assistance of a few savvy computer programmers using blockchain technology. In general, once the tokens are created, the startup company will offer a set number of company-specific tokens to the market in exchange for startup capital. However, in the United States, when a company raises capital through a token offering in this fashion, those tokens are generally considered securities. Thus, the nomenclature for this type of offering is now commonly known as a Security Token Offering (“STO”). As discussed below, STOs must comply with U.S. state and federal securities laws. Putting aside these regulatory issues for the moment, it is easy to appreciate that the streamlined nature of the STO (versus the more traditional and laborious methods of an IPO or private equity crowdsource) may be appealing to the 21st century maritime marketplace.

Companies are now issuing STOs relying on an aforementioned exemption to the federal securities law, or they have attempted to issue STOs pursuant to



a more streamlined public offering using the SEC’s “Regulation A+.” Regulation A+ offerings require SEC review and approval. A number of proposed Regulation A+ security token offerings have been filed with the SEC, but to our knowledge, none have been approved as of yet. These offerings are to fund their startup capital and the sale of the token is structured as an ownership stake in the startup, similar to traditional equity securities.

Maritime blockchain companies can also electronically issue utility tokens, which are not capital-raising security tokens, but are instead used to facilitate specific transactions and access custom applications directly on the maritime startup company’s online platform. For example, a maritime blockchain container booking startup’s unique utility token could be used to book shipping containers on that company’s website, or a utility token created by a bill of lading registration startup could be used to add a bill of lading onto that company’s specific bill of lading blockchain database. The utility token therefore has great potential to electronically streamline the entire maritime logistics chain.

## **U.S. REGULATORY PARADIGM FOR TOKEN OFFERINGS**

Whether labeled a security token or utility token, tokens in general are now being closely scrutinized by the SEC and various other U.S. and international regulatory authorities. In July 2017, the SEC issued an investigative report (the “DAO Report”) asserting that digital tokens—depending on how they are issued and the purpose of the issuance—may be securities and therefore subject to the agency’s jurisdiction based on existing paradigms for the essence of securities. Since then, the SEC has begun exercising more active oversight of virtual currency activities in a variety of ways, including through enforcement actions and investigations, and has begun providing additional guidance to market participants about the appropriate classification of virtual currencies.

The U.S. Commodities Futures Trading Commission (“CFTC”) has also exercised jurisdiction over virtual currencies that fall within the ambit of the commodities regulators, particularly when fraud is allegedly involved. Virtual currencies have been determined to be commodities under the Commodity Exchange Act in certain circumstances. While its regulatory oversight authority over commodity cash markets is limited, the CFTC maintains general anti-fraud and manipulation enforcement authority over virtual currency cash markets as a commodity in interstate commerce.

The Federal Trade Commission (“FTC”) has also asserted jurisdiction to protect consumers from deceptive marketing schemes involving virtual currencies. The Consumer Financial Protection Bureau (“CFPB”) has issued a consumer advisory warning consumers about the risks of virtual currencies. Finally, the

Internal Revenue Service (“IRS”) has issued guidance that virtual currency is treated as property for U.S. federal tax purposes and has been aggressive in pursuing proper reporting and payment of cryptocurrency gains by taxpayers. On the state level, several states have established or begun to develop regulatory frameworks concerning virtual currency, particularly in connection with money transmission and securities offerings. Accordingly, among the SEC, CFTC, FTC, CFPB, IRS, and state regulators, there are many regulatory considerations to be had in creating, transacting, and otherwise dealing in and with virtual currencies.

## **CONCLUSION**

Security and utility tokens represent exciting new concepts for the maritime industry. However, whether a maritime company offers a security token or a utility token, it must be mindful of the various U.S. state and federal laws that apply to token offerings and issuances—even if those tokens may arguably not be securities. These are uncharted electronic waters, and it will be interesting to witness what effect, if any, the “token phenomenon” will ultimately have on the maritime arena as it adapts to meet the demands of modern international commerce.