WINSTON & STRAWN LLP

BLOG

Code of Ethics Considerations (Part II)

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In our last post "Code of Ethics Considerations (Part I)," we concluded that if a registered adviser permits its "access persons" to invest/trade in crypto assets, the adviser must determine whether such assets are ***securities*** that must be included within the scope of its Code of Ethics for purposes of:

- holdings reports and transaction reports; and
- pre-clearance of purchases of securities issued in "initial public offerings" and "limited offerings."

How Can an Adviser Meet These Requirements?

First Possible Solution
Prohibit access persons from investing/trading in crypto assets (or prohibit where the adviser itself invests/trades in crypto assets on behalf of its clients).

The drawbacks:

As crypto assets grow in acceptance and popularity, access persons are likely to put considerable pressure on their employers to permit them to invest/trade in crypto assets.

Moreover, to the extent that traditional debt and equity securities become "digitized" or "virtualized" (see our post here), this solution would have the effect of shutting access persons off from investing and trading in securities that are in every respect "traditional" but for the fact that they have been "digitized" or "virtualized."

Second Possible Solution
Prohibit an access person from investing/trading in any particular crypto asset without pre-clearance, and, in connection with the pre-clearance process, perform a "*Howey* test" assessment of that asset (see our post here) to determine whether it is a "security."

If the adviser determines that the crypto asset in question is a "security," it would then notify the access person that he or she must include such asset in holdings and transaction reports.

The drawback:

As discussed in "When Is a Crypto Asset a "Security," and Why Does That Matter? (Part II)," applying the "*Howey* test" on a case-by-case basis involves an intensive and complicated "facts and circumstances" analysis—an analysis that can produce a conclusion on which reasonable minds can differ. As a result, the SEC can always "second guess" an investment adviser's *Howey* analysis.

Third Possible Solution

Probably the best potential solution: remove any doubt, or the possibility of regulatory "second guessing," by treating ***all*** crypto assets as "securities" for purposes of the adviser's Code of Ethics—except in situations (*e.g.*, Bitcoin and Ether) where the SEC (or high-ranking SEC officials whose judgment is likely to be respected by the SEC itself) has gone on record stating that the assets are not securities.

This solution, like the prior suggestions, is not particularly satisfactory—in this case because it subjects a potentially enormous range of crypto assets to the adviser's Code of Ethics when many of those assets might not be "securities."

Still, at this point in the development of the crypto asset market, it seems to be the most prudent and safe way to proceed.

In addition, if the adviser itself invests/trades in crypto assets on behalf of its clients (regardless of whether they are "securities"), either directly or through investment vehicles managed by the adviser, a sound Code of Ethics should include all of the types of instruments in which the adviser invests/trades on behalf of clients, to monitor for possible conflicts of interest or other legal issues (*e.g.*, trading while in possession of material non-public information, front-running).

Further, depending on the extent and type of the adviser's investments in crypto assets, an adviser should consider requiring pre-clearance of all transactions in such assets, even in cases where such assets are not purchased in initial public offerings or limited offerings.

Even if an adviser does not itself invest/trade in crypto assets on behalf of its clients (regardless of whether they are "securities"), it may wish to monitor the level of employee trading in such assets to determine whether employees are spending an inordinate amount of time during working hours engaging in such trading.

Lack of Brokerage Statements

Although Rule 204A-1 under the IAA does not require SEC-registered advisers to obtain from their access persons duplicate account statements and confirmations relating to their accounts, it generally is considered a "best practice" to do so.

See IAA Release No. 2256, 69 Fed. Reg. at pp. 42697-99 (July 9, 2004) (suggesting certain elements "which we believe all advisers should consider in crafting their own procedures," including "requirements to provide the adviser with duplicate trade confirmations and account statements").

At least in the current state of the evolution of the crypto markets, crypto assets typically are not held in brokerage or similar accounts, so advisers who permit their access persons to invest/trade in crypto assets that are securities generally will need to rely exclusively on reports provided to the adviser by the access persons (together with attestations from the access persons regarding the accuracy and completeness of such reports).

Of course, if an access person holds crypto assets in a brokerage, custodial or similar account, the adviser should require the access person to ensure that duplicate trade confirmations and account statements are provided to the adviser.

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