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Employee Benefit Plan Review

Is the Crypto Winter Finally Starting to Thaw?

By Gary D. Blachman

Cryptocurrency and other digital assets are among the most controversial investment products to emerge in recent years. With the potential for "outsized profits" it is no wonder that retirement plan participants want the ability to invest in cryptocurrency as part of their personal retirement strategy. However, the U.S. Department of Labor's (DOL) recent guidance, Compliance Assistance Release No. 2022-01 (Crypto Guidance), makes the investment of retirement plan assets in cryptocurrency more complicated. The DOL's Crypto Guidance warns 401(k) fiduciaries to "exercise extreme care" before allowing plan participants to invest plan assets in cryptocurrencies due to perceived "significant risks and challenges to participants' retirement accounts, including significant risks of fraud, theft, and loss." Further, to protect the interests of 401(k) plan participants and beneficiaries, the DOL announced that it intends to investigate 401(k) plans that offer cryptocurrency as an investment option to protect plan participants from these risks.

For years, crypto industry insiders have speculated as to what tech advances would unleash the institutional money that was seemingly content to sit on the sidelines. The DOL's "cautionary" guidance on the use of cryptocurrency in 401(k) plans appears for the moment to indicate the crypto winter persists. However, several weeks after the DOL released this informal guidance, Fidelity Investment Inc. (Fidelity) announced that it will begin allowing 401(k) participants to invest up to 20% of their savings into bitcoin by year-end. Fidelity's decision to plunge into the choppy waters and invest in blockchain and cryptocurrency clearly reflects the bullish excitement and potential for many investors who are eager to participate in this emerging opportunity. These and other recent developments in the financial services industry may actually be a sign that the crypto winter is experiencing the first signs of a major thaw.

Expanded Fiduciary Duties?

The DOL's Crypto Guidance is the first time the DOL has provided guidance on whether cryptocurrencies are appropriate plan investments. The DOL raises the question of whether 401(k) plan fiduciaries can satisfy their fiduciary duties if participants are allowed to invest their account balances in cryptocurrencies. The Employee Retirement Income Security Act of 1974 (ERISA) is the federal law that governs most qualified retirement plans, and requires a plan fiduciary to discharge his or her duties solely in the interest of the plan's participants and beneficiaries. The plan fiduciaries responsible for the operation of the plan must exercise "prudence" when selecting the investment options offered to plan participants. This "prudent expert standard of care" requires plan fiduciaries to consult with appropriate experts when making investment decisions if the fiduciary lacks the necessary expertise. Plan fiduciaries also own an ongoing duty of care, which requires them to continuously monitor a plan's investments and remove imprudent investments. Plan fiduciaries must diversify plan investments to protect the plan from the risk of large losses, unless it is clearly prudent not to do so under the circumstances.

The DOL noted that a fiduciary's duty under ERISA is the "highest known to the law." A fiduciary who breaches those duties is personally liable for any losses to the plan resulting from that breach. As such, a fiduciary's consideration of whether to include an option for participants to invest in crypto is subject to these responsibilities. The DOL cited the recent U.S. Supreme Court opinion in *Hughes v. Northwestern University*,[1] when it noted, "even in a defined-contribution plan where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options." The failure to remove imprudent investments is a breach of fiduciary duty.

Historically, the DOL has communicated that the prudence of an investment option depends on the facts and circumstances and, except in a few very specific circumstances (e.g., artwork, antiques, gems and certain other collectibles), ERISA does not actually prohibit any particular types of investments. As such, this makes the level of caution expressed by the DOL relative to cryptocurrency even more noteworthy.

Crypto Guidance

The DOL's announcement applies to cryptocurrencies and other virtual digital assets, which include "tokens," "coins," "crypto assets" and any derivatives. At the outset, the Crypto Guidance warns fiduciaries to "exercise extreme care before they consider" adding a cryptocurrency option to a 401(k) plan's investment menu. It is important to note that the DOL urged "extreme care" when considering a cryptocurrency investment option, as this appears to be a higher standard than the current ERISA requirement of exercising "prudence" when selecting a potential investment. The DOL does not elaborate on whether extreme care differs from prudence, and this has caused significant concern among a growing number of crypto fans.

The DOL's guidance identifies the following concerns that fiduciaries should consider relative to cryptocurrency in 401(k) plans:

1. *Speculative and volatile investments*: The DOL states that the Securities and Exchange Commission has cautioned that investment in cryptocurrency "is highly speculative" and subject to "extreme price volatility." Additionally, the DOL cautioned that the extreme volatility can have a devastating impact on participants with large investments in cryptocurrency. According to the DOL, there are several factors that could contribute to the volatility, such as the valuation process, fictitious trading practices, and widely published reports of theft and fraud, among other factors.
2. *The challenge for plan participants to make informed investment decisions*: The DOL noted that cryptocurrencies are often presented to investors as innovative investments that provide "unique potential for outsized profits," resulting in participants having high return expectations with little appreciation for the unique risks and volatility associated with cryptocurrencies. The DOL comments that "it can be extraordinarily difficult, even for expert investors, to evaluate these assets and separate the facts from the hype." The DOL is concerned that plan fiduciaries who are charged with the duties of prudence and loyalty, and include cryptocurrency as a plan investment, are essentially telling plan's participants that "investment experts have approved the cryptocurrency option as a prudent option for plan participants" and that "This can easily lead plan participants astray and cause losses."
3. *Custodial and recordkeeping concerns*: Unlike traditional plan assets that are held in trust or custodial accounts, the DOL notes that cryptocurrencies generally exist as lines of computer code in a digital wallet. The DOL states that because cryptocurrencies are not held in a similar manner as traditional plan assets in trust or custodial accounts, they are vulnerable to hackers and theft.
4. *Valuation concerns*: The DOL expressed concerns about the reliability and accuracy of cryptocurrency valuations. Currently, there is no agreement as to how cryptocurrency should be valued and different intermediaries may use inconsistent valuation methodologies as compared to traditional investment products.
5. *Evolving regulatory environment*: Because the law around cryptocurrency is still evolving, some market participants may be "operating outside of existing regulatory frameworks or not complying with them." The DOL states fiduciaries "will have to include" an analysis of how regulatory requirements may apply to "issuance, investments, trading, or other activities and how those regulatory requirements might affect investments by participants in 401(k) plans." Fiduciaries would have to take care not to accidentally participate in illegal transactions. Further, the use of cryptocurrency in illegal commerce could impact 401(k) plan participants, for example, if law enforcement agencies shut down a platform or restrict the use of a particular cryptocurrency.

Because of these and related concerns, the Crypto Guidance warns that the DOL expects to conduct an investigative program on plans that offer participants cryptocurrency products. Further, the DOL provides a clear and definite warning to plan fiduciaries:

> The plan fiduciaries responsible for overseeing such investment options or allowing such investments through brokerage windows should expect to be questioned about how they can square their actions with their duties of prudence and loyalty in light of the risks described above.

While the focus of this guidance is on 401(k) plans, the DOL's warnings also extend to plans and plan fiduciaries responsible for allowing cryptocurrency investments through self-directed brokerage windows. This is extremely concerning because historically plan fiduciaries did not have an obligation to monitor the underlying investments in a brokerage window. The DOL's potential expansion of fiduciary duties to encompass the investment options in brokerage windows also raises practical concerns. For example, brokerage windows maintain thousands of investment options and it would be unrealistic to require plan fiduciaries to monitor and screen for cryptocurrency investments outside of the core fund options. Further guidance from DOL is needed on this issue.

Fidelity's Crypto Program

Shortly after the Crypto Guidance, Fidelity pushed back and announced that it expected to implement a Bitcoin investment option that allowed participants to invest up to 20% of their accounts in cryptocurrencies. Fidelity's decision is beyond the scope of the DOL's guidance because the DOL's regulatory authority only reaches fiduciaries that exercise direct control over retirement plans, not service providers like Fidelity that market products to them. Essentially, this pushes the decision whether to offer cryptocurrency to the plan sponsors and administrators who serve as plan fiduciaries. Fidelity isn't the first company to give 401(k) participants access to cryptocurrency assets.

Another industry provider, ForUsAll Inc., has linked workers with cryptocurrency exchanges through brokerage windows for several years. Fidelity takes a different approach with its Digital Asset Accounts product, which doesn't rely on outside exchanges or brokerage windows. Instead, Fidelity will hold onto the digital assets itself so that their value will reflect "institutional grade" securities.

Industry Groups Not Happy With the DOL

Fidelity is not alone in pushing back on the DOL's Crypto Guidance. Other financial industry groups representing retirement plan sponsors and the U.S. Chamber of Commerce also want the DOL's guidance revoked because it effectively bans cryptocurrencies without the DOL undertaking a formal rulemaking process. According to a letter from 11 industry groups to DOL Acting Assistant Secretary, Ali Khawar, "We are not aware of any legal basis on which the Department can proceed down this path, and this would set a concerning precedent for future announcements by any Administration about what investments are permissible." These groups stressed that they were not expressing an opinion on whether it's appropriate to use cryptocurrency in retirement accounts. According to the DOL, the notice-and-comment rulemaking can easily take a year or two, and as the letter itself notes, investment products tied to crypto are proliferating rapidly. Khawar responded that "The idea that we should defer any measure of clarity for another couple of years doesn't seem like a very good one, for investors or anyone else." Several groups signing the letter include the American Council of Life Insurers, the Insured Retirement Institute, the Investment Company Institute, the Securities Industry and Financial Markets Association and the U.S. Chamber of Commerce.

The First Lawsuit

On June 2, ForUsAll Inc., a 401(k) plan provider, filed the first lawsuit to invalidate the DOL's Crypto Guidance on the grounds that it was issued in violation of the Administrative Procedure Act. This is the same statute that was used by the U.S. Court of Appeals for the Fifth Circuit to invalidate the DOL's Fiduciary Rule. The complaint also asks the court to enjoin the DOL from taking any enforcement action. The lawsuit highlights inconsistencies between previous positions of the DOL, and specifically regarding self-directed brokerage accounts. ForUsAll Inc. asserts that investments in cryptocurrency could be an appropriate plan investment to allow participants to diversify their accounts. Prior the DOL's recent guidance, ForUsAll Inc. had partnered with Coinbase Global Inc., the largest U.S. digital currency exchange platform, to offer an in-plan brokerage window that allows employee investors to transfer up to 5% of their account balance directly into more than 50 different cryptocurrencies.

The complaint mentions that the company met with the Labor Department as it designed the program to set guardrails that protect participants from market volatility. For example, the company includes institutional-grade crypto-investments only, a 5% cap on investments, a quiz to ensure investors know enough about trading and proactive monitoring, and alerts for participants and sponsors.

Where Do Plan Fiduciaries Go from Here?

While the DOL did not ban retirement plans from investing in cryptocurrencies, forcing plans to exercise "extreme care" suggests a new standard for making investment decisions regarding digital currency. And, if the DOL brings self-directed brokerage windows under audit scrutiny, this will herald a colossal change to how plan sponsors have historically treated those types of investment vehicles and greatly increase the potential for litigation. Plan sponsors are already concerned about litigation risk when selecting funds for their 401k plans. While participants may benefit from crypto or other digital asset exposure, the sponsor alone faces the legal risk arising from a charge of imprudence in selecting the "wrong" digital asset for their plan. It appears that the DOL's Crypto Guidance has thrown a blanket on this investment class at a time when it was gaining traction among investors seeking a pathway to offset high inflation and greater diversification.

The DOL's guidance targets not only cryptocurrencies but also other products whose value is tied to cryptocurrencies. It is unclear whether those other products would include funds that have any level of exposure to cryptocurrency or only exposure above some minimum threshold. The DOL's guidance also focuses specifically on 401(k) plan investments in cryptocurrencies and related products. Additional clarity is needed as to whether the guidance also applies to other investments such as IRAs or defined benefit plan investment funds.

At this time, cryptocurrencies do not comprise a significant amount of qualified plan investments. As investor interest in cryptocurrencies continues to grow, retirement plan fiduciaries must understand the fiduciary duties and responsibilities owed to plan participants and beneficiaries. Until there is additional guidance, plan fiduciaries should review their core fund lineups to determine whether any funds have exposure to cryptocurrencies and weigh the risks given the current regulatory environment. Of course, plan fiduciaries should continue to monitor market developments, additional regulatory guidance, and any pending litigation to determine whether cryptocurrencies are appropriate investments for retirement plans.

Note

1. *Hughes v. Northwestern University,* 142 S. Ct. 737, 742 (2022).

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