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Fiduciary Considerations for Cryptocurrency Investments in 401(k) Plans

For participants seeking to diversify the investments in their retirement plan accounts, especially in recessionary times, the ability to invest contributions in cryptocurrency and other digital assets is alluring. Plan sponsors and fiduciaries must act prudently when it comes to offering these types of investment options, and should continue to monitor legal developments in this area.

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The idea of a digital, cryptographic, anonymous electronic cash system has been around since at least the early 1980s. David Lee Chaum, who is touted as the godfather of cryptocurrency, proposed the idea of a computer-type network vault system where consensus on transactions would be built, verified in a distributed ledger where data

is shared across a network, and chained in a block. Not until 2008, with advancements in the Internet and technology, is the enigmatic Satoshi Nakamoto credited with devising the first blockchain database with protocols to solve the double spending problem of a cryptocurrency being spent more than once, and Bitcoin launched soon thereafter. Recent statistics note that there are over 20,000 types of cryptocurrency that have been created (a number that continues to fluctuate), with Bitcoin being among the most commonly known. The other cryptocurrencies known as “altcoins,” and different blockchain platforms, consensus algorithms to secure transactions, wallets, and exchanges are flourishing. Cryptocurrencies are known as digital assets, but digital assets also include various types of tokens, such as utility and security tokens, and non-fungible tokens.

With the 2008 financial crash, the pandemic, and the rise of inflation, there are proponents of a decentralized financial transaction system who argue that cryptocurrencies and digital assets are the future of money in a digital economy, which, in its purest form, can replace centralized currency controlled by the government and central banks. In such an economy, peer-to-peer transactions are conducted over the internet without going through any middlemen, eliminating high banking fees, and providing a means for the unbanked people of the world to download a wallet and move money and transact business to equalize participation in the economy. Another aspect of the proponents’ argument is that, since 1971, when President Nixon cancelled the direct conversion of the US dollar to gold, a system of fiat monies has been used globally with variable exchange rates between the major currencies, which is not backed by any commodity such as gold or silver, and is declared by a decree of government to be legal tender. Fiat money has value because individuals who use it agree on its value and they trust it will be accepted to transact business (which is a similar concept for blockchain transactions). Further, hyperinflation can cause fiat money to greatly lose its value should the issuing government or central bank cease to continue to guarantee its value, and hyperinflation has led to the collapse of many economies around the world.

Yet, there also are many skeptics of the digital asset and cryptocurrency market and whether it has any real value. There are ongoing debates by lawmakers as to how to regulate cryptocurrencies and digital assets, so that innovation is not stifled, but, at the same time, there are rules of the road so that a financial system

is not created that could cause an economic catastrophe, investors are protected, and the standing of the US dollar globally is not eroded. In his September 15, 2022, testimony before the United States Senate Committee on Banking, Housing and Urban Affairs, Chairperson Gary Gensler of the US Securities and Exchange Commission (SEC) remarked that, when President Roosevelt suspended the use of the gold standard in 1933, the US securities laws became the gold standard, and there will be many legislative efforts related to the cryptocurrency markets, including registration requirements for many cryptocurrency intermediaries.

Legal Developments Concerning Cryptocurrency and Retirement Plans

We are faced with another point in history where our concepts of money are evolving and it is difficult to apply current laws and regulations while this change is ongoing. Currently, neither the Employee Retirement Income Security Act of 1974 (ERISA) nor the Internal Revenue Code of 1986 (the Code) specifically prohibit cryptocurrency as an investment option in 401(k) plans, and there are debates as to whether non-fungible tokens are collectibles that would not be permissible investments. [See IRC § 408(m)] One of the initial priorities of lawmakers is to properly define terms, parties and assets in this space, and the appropriate regulatory frameworks. On March 9, 2022, President Biden issued an Executive Order on Ensuring Responsible Development of Digital Assets (Order) addressing six key priorities:

1. consumer and investor protection;
2. promotion of financial stability;
3. countering illicit finance;
4. US leadership in the global financial system and economic competitiveness;
5. financial inclusion; and
6. responsible innovation.

The Order recognizes that the digital assets market has grown significantly across the globe, with 16 percent of adult Americans having purchased digital assets that reached a market capitalization of \$3 trillion in November 2021, and that digital assets present many opportunities for US leadership in the global financial system. But, the Order acknowledges that they also pose real risks, as evidenced by the May 2022 crash of the stablecoin TerraUSD (UST) and its staking token Luna, and the subsequent wave of insolvencies that eliminated more than \$600 billion of investor and consumer funds. Thus, the Order seeks

a whole-of-government approach to address the risks and harness the benefits of digital assets and their underlying technology, and conceives of a US Central Bank Digital Currency (CBDC), a digital form of the US dollar. The CBDC would be intended to enable a payment system that is more efficient, provide a foundation for further technological innovation, facilitates faster cross-border transactions, be environmentally sustainable, promote financial inclusion and equity by enabling access for a broad set of consumers, foster economic growth and stability, protect against cyber and operational risks, safeguard the privacy of sensitive data, minimize risks of illicit financial transactions, and help preserve US global financial leadership.

On March 10, 2022, the Department of Labor's (DOL) Employee Benefits Security Administration (EBSA) issued Compliance Assistance Release No. 2022-01 on 401(k) Plan Investments in "Cryptocurrencies" (CAR No. 2022-01). In CAR No. 2022-01, EBSA advised that it has serious concerns about the prudence of a fiduciary's decision to expose a 401(k) plan's participants to direct investments in cryptocurrencies, or other products whose value is tied to cryptocurrencies, and (as subsequently explained informally) sought to *remind* fiduciaries to use "extreme care" when prudently deciding whether to offer these investment options. EBSA opines that these investments present significant risks and challenges to participants' retirement accounts, including fraud, theft, and loss, for reasons such as the speculative and volatile nature of these investments, the difficulty for plan participants to make informed investment decisions, custodial and recordkeeping concerns for these types of investments, valuation concerns, and an evolving regulatory environment. EBSA also warned that it expects to conduct an investigative program aimed at plans that offer participant investments in cryptocurrencies and related products, and to take appropriate action to protect the interests of plan participants and beneficiaries. 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.

Following the release of CAR No. 2022-01, there were several developments, including backlash on the CAR No. 2022-01's reference to an extreme care standard as indicating a modification to the fiduciary prudent standard of care set forth under ERISA, as well as the implied new obligations for fiduciary

oversight of investments made through self-directed brokerage windows. The responses to CAR No. 2022-01 include:

- On April 12, 2022, 11 trade associations wrote to the DOL, requesting that CAR No. 2022-01 be withdrawn and that guidance be developed via the appropriate rulemaking process.
- In a May 4, 2022 letter, Senators Elizabeth Warren and Tina Smith asked a large recordkeeper to respond to several questions regarding its decision to add Bitcoin to its 401(k) investment menu as a designated investment alternative.
- On May 5, 2022, Senator Tommy Tuberville introduced the Financial Freedom Act of 2022 (S. 4147) in the Senate and similarly, on May 20, 2022, H.R. 7860, was introduced by Representative Byron Donalds in the House to prohibit the Secretary of Labor from constraining the range or type of investments that may be offered in individual account plans to participants and beneficiaries who exercise control over their accounts.
- On June 2, 2022, FORUSALL filed suit seeking to vacate CAR No. 2022-01 on the grounds that the guidance violated the Administrative Procedure Act. The DOL filed a motion to dismiss this action on September 12, 2022 (Motion to Dismiss).
- On June 7, 2022, a provision in S. 4356, The Lummis-Gillibrand Responsible Financial Innovation Act introduced by Senators Kirsten Gillibrand and Cynthia Lummis, would require the Government Accountability Office (GAO) to examine by March 1, 2023, the use of cryptocurrency and digital assets in retirement plans, including the potential benefits to diversification and return for a retirement portfolio, and to provide a report to several Senate and House Committees, the Secretary of the Treasury, and the Secretary of Labor.
- In a June 15, 2022, letter, Representative Richard Neal asked the GAO to examine the use of cryptocurrency in retirement plans.
- On July 26, 2022, Senators Elizabeth Warren, Richard Durbin and Tina Smith wrote again to a large recordkeeper regarding their disapproval of plan sponsors being allowed to offer retirement plan participants the ability to invest in Bitcoin and seeking a reply.
- On September 29, 2022, Senator Pat Toomey, Senator Tim Scott and US Representative Peter Meijer introduced the Retirement Savings

Modernization Act, which includes a provision to clarify that plan fiduciaries do not breach their fiduciary duties solely by selecting or monitoring investment options that include a range of asset classes, including digital assets. Nothing in ERISA currently limits the asset classes that may be included in a plan, and this proposed amendment to Section 404(a) of ERISA would make clear that Congress intends to let plan fiduciaries and their investment professionals prudently determine the appropriate range of asset classes.

Plan Fiduciary Considerations to Offer Access to Cryptocurrency Investments in Their Retirement Plan at This Time

With this background, defined contribution plan sponsors and fiduciaries are left in a quandary as to whether it is time to permit access to investments in cryptocurrencies through their retirement plans, or whether to take a wait-and-see approach. Financial institutions are developing and bringing products to market to facilitate these investments, including through digital asset accounts that have been designed to address custody and cybersecurity issues, and through brokerage window models. These options, and others that are created, will undoubtedly be presented to plan fiduciaries for consideration.

As noted in the July 1, 2022, In Focus by the Congressional Research Service on Cryptocurrency in 401(k) Plans, advocates for including cryptocurrency as an investment option in retirement plans provide that it is an appropriate investment option because it is a widely-used asset class outside of retirement plans, it may provide diversification benefits to an investment portfolio, potentially reducing a portfolio's risk without necessarily harming the portfolio's return, and it may spur younger individuals to participate in workplace retirement plans if investment choices include cryptocurrency. Plan participants investing in cryptocurrencies through 401(k) plans can also avoid a taxable event each time a cryptocurrency is sold or exchanged, could defer applicable tax until time of distribution, and no tax would occur on a qualified distribution from a Roth 401(k) plan account.

Yet, while plan fiduciaries are aware of, and have operated under, a prudence standard when selecting and monitoring plan investments, the CAR 2022-01 reference to a standard of "extreme care" with respect to fiduciary decision-making concerning cryptocurrency investments still gave pause. Another concern

raised by plan sponsors and fiduciaries in reaction to the CAR 2022-01 has been whether it suggested a new standard of monitoring investments available through a brokerage window. While plan sponsors and fiduciaries have a duty of prudence and loyalty when choosing the designated investment alternatives to be included in their plans, or in selecting a brokerage window provider, monitoring duties had not historically applied to the investments that participants could choose in a brokerage window. CAR No. 2022-01 seemed to suggest otherwise. Based on subsequent informal comments from DOL, the CAR 2022-01 does not change the standard of care under ERISA Section 404(a)(1)(B), or the long-established duty of prudence in design of brokerage windows and selection of providers. Moreover, according to the DOL's Memorandum of Law in support of its Motion to Dismiss, the CAR 2022-01 does not make new law, but rather it was issued as an interpretive rule on the duty of prudence with respect to cryptocurrency investment options and reminds fiduciaries of their duties as expressed under ERISA and the Supreme Court's decision in *Hughes v. Northwestern University* [142 S. Ct. 737 (2022)], which found that fiduciaries must ensure that each plan investment option offered is prudent. The DOL views the CAR 2022-01 as a reminder of ERISA's principles and its position at this time on cryptocurrency investments, and it can issue new guidance in the future as the markets mature and a regulatory framework develops.

It remains to be seen whether fiduciary liability can be minimized when cryptocurrency investments are available through a brokerage window (where access to cryptocurrencies was not highlighted or promoted), rather than as a designated investment alternative, or via another mechanism such as allowing participants to direct movement of money market funds to these investments or to a digital account, through further delegation of plan investment decisions to an investment manager or via use of managed accounts. Given the fact that all types of plan investments have been the topic of fiduciary breach claims brought in the ongoing litany of 401(k) plan litigation, one can imagine the types of claims that can be brought with respect to cryptocurrency investment options. Plan sponsors should ensure that their plan fiduciaries with investment management authority for the plan have been formally designated, and any delegations of fiduciary responsibility have been properly made so that it is clear who is responsible for providing and monitoring a prudently constructed plan investment lineup and services.

Plan fiduciaries that seek to offer access to cryptocurrency investments at this time should be extremely diligent in their decision-making process and prepare for heightened scrutiny of their decisions. Plan fiduciaries should develop a robust diligence process for the selection and monitoring of cryptocurrencies offered in a retirement plan, and include among their considerations:

- Review overall governance procedures, including company board resolutions and plan committee charters, to ensure that proper delegations of fiduciary duty are in place, plan fiduciaries are meeting regularly to carry out their plan fiduciary responsibilities and review plan investment offerings, and that any desired updates to the procedures are made;
- Determine whether enhanced guidelines are warranted in Investment Policy Statements to guide the selection and monitoring decisions for cryptocurrencies;
- Evaluate obtaining advice and recommendations from ERISA 3(21) investment professionals regarding plan investment offerings, whether delegating fiduciary decisions to an ERISA 3(38) investment manager to select and monitor the plan's investment offerings is warranted, or whether participants can obtain access to these investments via a managed account product;
- Document decision-making process around the selection and monitoring of these investments and the related service providers, including whether to offer investment in cryptocurrency as a designated investment alternative, or through a brokerage window design;
- Determine whether to limit the amount that a plan participant can invest in cryptocurrencies to a specified percentage such as 5 percent, 10 percent or 20 percent of a retirement account as a matter of plan design, and how to enforce such asset limits as the valuations fluctuate;
- Consider the impact that these investments may have on the ability of plan participants whose accounts are invested in cryptocurrencies to obtain plan loans and hardship withdrawals under current procedures, or the ability to segregate accounts pursuant to a qualified domestic relations order (QDRO);
- Evaluate volatility issues and the impact that these investments can have on issuance of plan participant account statements, correction of plan errors, processing plan distribution requests, rollovers, payments to beneficiaries upon death, determination and processing of required minimum distributions, small balance cashouts and distributions to missing participants (including custodial issues for passwords and keys for applicable accounts of missing participants), benefit claims, and application of any withholdings or early withdrawal penalties;
- Develop and distribute enhanced plan investment communications and educational materials to participants, and update plan ERISA Section 404(c) disclosures to address cryptocurrency investment issues;
- Assess any impact that plan investments in cryptocurrencies have on plan audit, reporting, or disclosure requirements;
- Review and evaluate any service provider agreement limitations on liability related to cryptocurrency investments or related services;
- Assess whether availability of this asset class in the plan will limit the ability to change service providers in a request for proposal (RFP) process if custody and related services for these investments is not widely available;
- Review cybersecurity considerations for these investments and update plan cybersecurity policies and protocols to incorporate considerations for the availability of these investments through the plan and determine whether any updates are needed for applicable cybersecurity insurance and/or fiduciary liability insurance;
- Evaluate indicia of ownership considerations for these investments;
- Remain mindful that, under *Hughes v. Northwestern University*, ERISA's duty of prudence requires monitoring of all fund offerings and removal of the "imprudent ones"; and
- Monitor new legislation, regulations, and other guidance and update plan documents, disclosures, and procedures accordingly.

Concluding (and Evolving) Thoughts

Despite the volatility of the cryptocurrency market, lawmakers are devoting tremendous resources to construct a regulatory framework for digital assets. While there are many naysayers, there are many indications that our concepts of money will continue to change and evolve to include, or be modified to, a digital form. It is understandable that, given the various questions and challenges, many retirement

plan fiduciaries will not take a leap at this time to offer plan participants access to cryptocurrency investments, especially given the fact that plan fiduciaries can be sued and held personally liable for breach of fiduciary responsibility with respect to plan investment options. Yet, plan fiduciaries overseeing plans for plan sponsors in particular industries with plan participants demanding access to these

investments may take the leap sooner if it is determined to be prudent and in the best interests of those plan participants. It will be imperative to stay abreast of the evolving guidance and to prudently evaluate the considerations related to offering plan participants access to cryptocurrency investments. It is an exciting time for the new frontier in retirement plan investments. ■

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