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A NEW TYPE OF QUALITY CONTROL – THE DEPARTMENT OF LABOR WARNS FIDUCIARIES AGAINST INCLUDING CRYPTO ASSETS IN RETIREMENT PLANS

The U.S. Department of Labor ("DOL") recently warned ERISA plan fiduciaries to "exercise extreme care" before including cryptocurrency assets and crypto-based products as potential investment options in 401(k) retirement plans. The DOL articulated a number of "serious concerns" the agency perceives regarding the prudence of including cryptocurrency assets in such plans, and cautioned that plan fiduciaries that do so should expect to be asked to defend the appropriateness of their decisions. The DOL has focused on the appropriateness of crypto assets for retirement plans right after the Supreme Court decided the *Hughes* v. *Northwestern* case earlier this year.[1] The *Hughes* Court held that plan fiduciaries cannot leave bad investment options mixed in the investment lineup with good options.[2] The DOL's crypto asset warning appears to characterize crypto as a "bad option."

THE DOL'S RELEASE

The U.S. Employee Retirement Income Security Act of 1974 ("ERISA") requires fiduciaries of retirement plans to adhere to ERISA's high standards of care, prudence, diligence, and skill. The DOL guides fiduciaries on how to best uphold these duties in a rapidly developing financial sector by issuing these releases, and its most recent release is no exception.

In its March 10, 2022 Compliance Assistance Release,[3] the DOL announced that plan fiduciaries who do make crypto options available in a retirement plan "should

[1] For a more thorough explanation of the *Hughes* decision and what it means for ERISA plan fiduciaries, *see* https://www.cliffordchance.com/briefings/2022/02/investor-choice-is-not-enough--supreme-court-expands-risks-for-e.html.

[2] *Hughes v. Northwestern*, 142 S.Ct. 737, 742 (2022).

[3] Employee Benefits Security Administration, *401(k) Plan Investments in "Cryptocurrencies*," Compliance Assistance Release No. 2022-01 (Mar. 10, 2022), https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01.

expect to be questioned about how they can square their actions with their duties of prudence and loyalty." While the release specifically references "cryptocurrencies," it states that the same reasoning and principles also apply to a wide range of "digital assets" including those marketed as "tokens," "coins," "crypto assets," and any derivatives of these.

The release explained that the DOL had "in recent months . . . become aware of" employers including crypto assets in 401(k) plans. The release shows the DOL's concern.

The DOL emphasized that cryptocurrency is presently at an "early stage in [its] history," noting that investments in crypto assets present a variety of "significant risks and challenges" to retirement accounts, including risks of "fraud, theft, and loss." The DOL articulated at least five reasons for this view:

- *First*, the DOL warned that crypto assets are "speculative and volatile investments," and emphasized that the "[e]xtreme volatility" of crypto investments can have a "devastating impact" on plan participants, "especially those approaching retirement."
- *Second*, plan participants are less likely to have the knowledge about crypto necessary to make sound investment decisions. Because crypto assets are often described as offering the "potential for outsized profits," uninformed investors may choose those assets "with great expectations of high returns and little appreciation of the risks the investments pose." Plan participants may view crypto's inclusion in the plan offerings as an endorsement of their potential value, when in reality, it is extraordinarily difficult for even expert investors to evaluate cryptocurrencies' value.
- *Third*, because of the unique infrastructure of cryptocurrency accounts, losing the password to an account could result in a loss of access to the asset forever. Similarly, some crypto assets "can be vulnerable to hackers and theft."
- *Fourth*, the DOL cautioned that it can be very difficult for plan participants to evaluate crypto assets and make informed decisions about their retirement plan accounts, noting that "none of the proposed models for valuing cryptocurrencies are as sound or academically defensible as traditional discounted cash flow analysis for equities or interest and credit models for debt."
- *Finally*, the agency emphasized that the regulatory framework surrounding crypto is still "evolving," and that "some market participants may be operating outside of" or "not complying with" existing regulatory frameworks. The sale of cryptocurrencies could constitute the unlawful sale of securities in unregistered transactions, or the crypto assets could be used in illegal activities, which may lead to law enforcement agencies restricting access to that asset. Many of these concerns have been identified by other U.S. regulators, including the Securities and Exchange Commission.[4]

4 *See, e.g.,* Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market, SEC Division of Investment Management (May 11, 2021) available at https://www.sec.gov/news/public-statement/staff-statement-investing-bitcoin-futures-market.

WHAT THIS MEANS FOR FIDUCIARIES

There may be an evolving popular consensus that cryptocurrency has gone "mainstream": a Bitcoin-based exchange-traded-fund is now available to investors, and crypto brokerages advertised during the Super Bowl.

The DOL's release makes plain that the agency is skeptical that crypto assets are a sufficiently mature asset class to be prudently included as an option in 401(k) plans, the backbone of retirement savings in the U.S. In some ways, the DOL's concern for the risk that plan participants are drawn to crypto assets by their "unique potential for outsized profits" resembles similar concerns expressed in the DOL's December 2021 Supplemental Statement regarding the use of private equity investment alternatives in 401(k) plans. There, the agency cautioned plan fiduciaries considering such investment alternatives and urged them to weigh opportunities for "diversification and enhanced investment returns" against concerns that private equity investments "tend to be more complicated, with longer time horizons" and have less liquidity than "traditional" retirement plan investment options.

The DOL's release affirms that—whether based on the number or type of investment options included in a plan—the agency is clearly concerned with the quality of *each* investment included in a retirement plan. We note that the DOL's release comes shortly after the *Hughes* decision.

The release also demonstrates the DOL's notable discomfort with self-directed brokerage windows. To the extent that cryptocurrencies have found their way into 401(k) plans at all, they have done so through "self-directed brokerage windows." These windows are often found in many 401(k) plans, allowing participants to use their accounts to invest in assets or products not found in the investment lineup assembled, monitored and maintained by plan fiduciaries. Historically, plan fiduciaries have not taken responsibility or been held responsible for the investment choices participants have made through their self-directed brokerage windows. The DOL's release telegraphs that this likely will change.

Fiduciaries should use extreme caution when including crypto assets in retirement plan investment options. Fiduciaries should note the issues related to crypto assets that we have discussed and should be aware of the DOL's promise that it will investigate and question fiduciaries who allow crypto assets in retirement plans. Not only will an investigation bring the risk of legal action by the DOL, but it also has the potential to impose a considerable cost, both monetarily and reputationally, to fiduciaries caught in the DOL's crosshairs.

If you are a fiduciary and have not examined your plan recently, contact us for a thorough risk assessment of your retirement plan.

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