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Expert Q&A on Cryptocurrency and Retirement Plans

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An Expert Q&A with Allison Itami, Zach Isenhour, and David Levine, Groom Law Group, Chartered, discussing cryptocurrency and retirement plans. This Expert Q&A explores the legal and practical issues retirement plan sponsors should consider.

What is cryptocurrency and why might retirement plans be interested in offering it as an investment?

Cryptocurrency is a digital representation of value (other than a representation of a US dollar or a foreign currency) that uses cryptography to secure transactions that are recorded on a distributed ledger, such as blockchain with the popular cryptocurrency Bitcoin. Retirement plans and their plan sponsors may be interested in offering cryptocurrency as an investment when plan participants request them as an option.

Is cryptocurrency legally permitted as a 401(k) plan investment option under ERISA and the Code?

The Internal Revenue Code (Code) and the Employee Retirement Income Security Act of 1974 (ERISA) do not prohibit the use of cryptocurrency as an investment option in a 401(k) plan. The only 401(k) investment options that ERISA explicitly prohibits are employer securities (see Practice Note, Employer Securities and Employer Real Property in Qualified Retirement Plans) and certain investments made in related parties (see Practice Note, Prohibited Transactions and Exemptions Under ERISA and the Code). The Code bans individually directed accounts from investing in life insurance and certain collectibles, including some coins.

The fact that ERISA and the Code do not explicitly prohibit cryptocurrency as a 401(k) investment option does not mean that a plan sponsor's choice to offer cryptocurrency as an investment option will be considered prudent under ERISA (see Practice Note, ERISA Fiduciary Duties: Overview).

ERISA Section 404(a)(1)(B) (29 U.S.C. § 1104(a)(1)(B)) requires that plan fiduciaries act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Some assert that this standard could act as a barrier to implementing cryptocurrency-based investment options within a 401(k) plan.

In mid-2021, Department of Labor (DOL) officials informally made similar comments, but the DOL has not issued any formal rule or guidance to date. While no one factor determines whether including cryptocurrency as an investment for a 401(k) plan is prudent, some courts have considered volatility a factor when examining other investment choices. Given Bitcoin's volatility during Q2 2021, as measured by its annualized 30-day volatility, some have asserted that Bitcoin does not belong in a 401(k) plan.

Is it becoming increasingly common for 401(k) plans to permit investment in cryptocurrency?

We first became aware of certain, typically smaller, 401(k) plans or recordkeepers facilitating cryptocurrency as a 401(k) investment option in 2020 and into early 2021. However, this is a new trend that has not yet become widespread. On the other hand, cryptocurrency has gained more traction as a potential investment option in Individual Retirement Accounts (IRAs).

We are aware of two plans or systems that currently offer cryptocurrency as a 401(k) investment option. In June 2021, a retirement investment platform for small businesses introduced an alternate 401(k) investment platform that includes cryptocurrency. Participating plan participants have access to more than 50 cryptocurrencies through a brokerage window that uses CoinBase, a cryptocurrency exchange, to facilitate investment transactions. In late 2020, a 401(k) recordkeeper facilitated Bitcoin as a 401(k) investment option that plan sponsors could offer. The custodian for the 401(k) cryptocurrency offering currently includes Bitcoin as an investment option in its 401(k) plan.

What are the risks for plan fiduciaries that permit cryptocurrency as a 401(k) plan investment option?

The risks for plan fiduciaries permitting cryptocurrency as a 401(k) plan investment depend on the option selected for implementing the cryptocurrency offering, either as a designated investment alternative (DIA) or through a self-directed brokerage window (SDBW) (see Practice Note, Brokerage Windows for Defined Contribution Plans).

To understand the risks, we recommend that potential adopters focus on three key ERISA concepts:

- **Section 404(c) limits.** ERISA Section 404(c) (29 U.S.C. § 1104(c)) limits fiduciary liability for the individual investment decisions of plan participants within an individual-directed retirement plan. However, ERISA Section 404(c) does not relieve a fiduciary from its duty to prudently select and monitor any designated investment alternative that the plan offers. This means that a fiduciary's liability could be limited for an individual's choice to invest in the cryptocurrency option but not for offering the cryptocurrency as an investment option. (See ERISA Section 404(c) Checklist).
- **Offering cryptocurrency as a DIA.** Retirement plan fiduciaries may choose to offer cryptocurrency as a DIA within a 401(k) plan. DIAs typically are mutual funds or collective investment trusts. While DIAs have expanded to include managed accounts that offer exposure to other 401(k) investment offerings, such as private equity or hedge funds, some advisors and other providers have expressed concerns about cryptocurrency. These concerns are often based on the fact that a DIA requires ongoing monitoring and has selection obligations and risks. DIAs that offer exposure to private equity or hedge funds typically have the participant's investment managed by a professional, and the investment is limited to a certain percentage of a participant's account. A professional management sleeve for cryptocurrency investments is not widely available now, but we would not be surprised to see such an offering emerge in the near future.
- **Offering cryptocurrency through an SDBA.** ERISA plan fiduciaries face the least amount of risk in deciding to offer cryptocurrency as an investment option through a 401(k) plan's SDBA. While the DOL has noted that fiduciaries are subject to ERISA's duty of prudence when selecting an SDBA provider, informal guidance tacitly supports the view that plan sponsors make a settlor decision when they decide to offer a brokerage window with a 401(k) plan. However, characterizing the plan sponsor's choice as a settlor decision has limits and could be at odds with some plan sponsors' tendency to educate participants on the risks of cryptocurrency investments and limit their investment within an SDBA.

The concept of prudence is largely tied to industry standards and approaches taken by other plan sponsors, which means prudence determinations for cryptocurrency are more difficult to make while it remains an unusual 401(k) investment option. Regulators like the Securities and Exchange Commission (SEC) also may eventually weigh in on the role of cryptocurrency in retail investor portfolios.

If a plan sponsor wants to offer cryptocurrency as an investment option, what steps should it take?

While no hard and fast best practice exists, a plan sponsor likely should:

- Decide on the form in which the investment will be offered (as a DIA or through an SDBA). We recommend that a cryptocurrency investment not serve as a plan DIA.
- Collaborate with the plan's service providers, including the recordkeeper, SDBA provider, cryptocurrency custodians, and a cryptocurrency exchange to facilitate transactions for the investment. The plan sponsor should consider the fees and relationships among these entities.
- Focus on process items, especially loyalty, prudence, and prohibited transactions.

Are there any additional considerations for plan sponsors that offer cryptocurrency as a 401(k) plan investment option?

A plan sponsor might consider a number of issues before offering a cryptocurrency investment option within their 401(k) plan, including:

- Cybersecurity. Cryptocurrencies present cybersecurity considerations that may be novel for a retirement plan that has no blockchain experience (see Cybersecurity for Retirement Plans Toolkit).
- Indicia of ownership considerations, especially for cryptocurrencies that are not based in or held within the US (see Practice Note, ERISA Fiduciary Duties: Overview: Indicia of Ownership).
- Cryptocurrency performance generally, including volatility, and whether or not cryptocurrency is a prudent investment.
- Fees for plan service providers (for example, custodian and exchange fees).
- The potential for future regulations or sub-regulatory guidance from the DOL or SEC that could affect the use of cryptocurrency as a 401(k) plan investment.