Warnings Signs Ahead: Cryptos in 401k Plans?

By Bill Hastie

Since its beginnings in 2008 with Bitcoin, cryptocurrency has changed the investing landscape forever. Since that time, the industry has grown to more than 10,000 "cryptos" by March 2022. This explosive growth is most noteworthy from March 2020 with a total market capitalization of $179 billion to November 2021 when it reached its high of over $3 trillion. But if anything characterizes cryptocurrency, is its price volatility — and by mid-May 2022, the total market had plunged to just over $1.3 trillion.

Despite its volatility, its popularity continues to grow with several exchange-traded products coming on the market making it much easier for the small investor to join the craze. It was only a matter of time before 401k plan participants would seek cryptos as an available investment in their retirement plans. Earlier this year, Fidelity, the largest provider of 401k plans in the nation, announced it would soon be offering a product line that would make cryptos an available investment in their 401k plans.

Fidelity's announcement came as great news to some 401k plan participants, while it was a cause for concern to retirement plan advisors. This buzz in the industry did not take long to catch the attention of the Department of Labor (DOL) with equal concern. On March 10, 2022, the DOL issued a Compliance Assistance Release, "401(k) Plan Investments in Cryptocurrencies." The first paragraph of this release reads, "In recent months, the Department of Labor has become aware of firms marketing investments in cryptocurrencies to 401k plans as potential investment options for plan participants. The Department cautions plan fiduciaries to exercise extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants."

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The DOL went on to list the following risk factors with this introductory statement, "These investments present significant risks and challenges to participants' retirement accounts, including significant risks of fraud, theft, and loss for all the following reasons:

- Speculative and volatile investments
- The challenge for plan participants to make informed investment decisions
- Custodial and recordkeeping concerns
- Valuation concerns
- Evolving regulatory environment

In the development of a 401k plan's investment options, crypto investments would most likely be purchased through a "brokerage window" which makes investments available that otherwise are not part of traditional 401k plan options. For years, the DOL has required plan sponsors to develop and implement a prudent process for selecting, monitoring and replacing (as needed) plan investment options. Now the DOL is saying that plan sponsors have some responsibility to vet investment options offered through a brokerage window.

Without question, the DOL is placing the responsibility for prudently selecting all plan investments squarely on the shoulders of the plan sponsor. An additional requirement for plan investments is the broad range requirement which states that each option must be diversified, offer risk/return characteristics different from the others, and offer diversification for a participant's overall portfolio when combined.

That brings back the DOL's first concern about the speculative nature of cryptocurrency and warrants the distinction of risk vs. speculation. In most cases, investment (non-market) risk can be reduced through diversification and the range of possible returns are fairly well understood. Portfolio risk can be increased/decreased by adding or removing the correlation (investments moving together or in opposite directions) among individual portfolio holdings. On the other hand, speculative risk cannot be calculated or diversified, and its range of possible returns is far greater. It's looking for a quick, substantial gain and is willing to take a huge loss in doing so. Take flipping a coin for example, you either double your money or lose everything in the matter of seconds. Risk is appropriate for 401k plans, speculation is not.

The issue of cryptos in 401k plans has even been taken up by the U.S. Senate, and two very different points of view have been expressed to the DOL. Elizabeth Warren (D-Mass) and Tina Smith (D-Minn) have taken the position that plan sponsors and investment advisors have the responsibility to provide plan participants with prudent, long-term investment advice while controlling risk seeking to secure their retirement nest egg. Tommy Tuberville (R-AL) introduced the Financial Freedom Act that, if enacted, would prohibit the DOL from issuing any regulation or guidance limiting what a plan participant could invest in through a brokerage window, and to give safe harbor fiduciary protection to plan sponsors for the investments that participants purchase through a brokerage window. This debate is far from over, but the DOL will have the final word. CG