

## Riverboat Gambling: Section 401(k), Cryptocurrency, Prudence, and FTX

To the Editor:

In a recent letter to Fidelity Investments CEO Abigail Johnson,<sup>1</sup> Sens. Richard J. Durbin, D-Ill., Elizabeth Warren, D-Mass., and Tina Smith, D-Minn., called upon Fidelity to cease marketing bitcoin investment funds to 401(k) plans for participants' retirement accounts. The recent "implosion of FTX," the senators stated, makes "abundantly clear" the "serious problems" of "the digital asset industry."<sup>2</sup> The senators' recent letter follows up an earlier missive this summer to Ms. Johnson<sup>3</sup> similarly highlighting that bitcoin is "a volatile, illiquid, and speculative asset," inappropriate for the retirement savings of 401(k) participants.

The senators were right this summer to criticize cryptocurrency as a 401(k) investment class, and they are right now to renew this criticism. It did not take the travails of FTX<sup>4</sup> to demonstrate the imprudence of cryptocurrency for 401(k) investment menus. 401(k) trustees and investment committees are legally bound by the fiduciary duty of prudence when they construct investment menus for 401(k) participants. In light of crypto's novelty and the failure of defined benefit trustees to embrace cryptocurrency investments, bitcoin and other cryptocurrencies were not prudent investments for 401(k) participants, even before the FTX debacle.

While Fidelity itself is not a fiduciary, it markets cryptocurrencies<sup>5</sup> to 401(k) trustees and investment committees that are fiduciaries, bound by the legal duty of prudence. It should not have taken the FTX meltdown to make clear the imprudence for 401(k) purposes of crypto as an

investment category. But that meltdown should establish for even the most ardent crypto proponents that bitcoin and other similar electronic currencies are too risky and novel to belong in 401(k) investment menus. Crypto, as the senators indicate, should not be marketed to 401(k) trustees and investment committees.

### ERISA's Fiduciary Duty of Prudence

Central to the legal framework governing 401(k) and other retirement plans is the fiduciary duty of prudence. That duty, derived from the common law of trusts,<sup>6</sup> is codified by section 404 of the Employee Retirement Income Security Act of 1974. ERISA section 404 requires that an ERISA fiduciary must "discharge his duties with respect to a plan . . . 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."<sup>7</sup>

This fiduciary duty of prudence applies not only to the trustees of 401(k) and other retirement plans but to any person "to the extent . . . he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."<sup>8</sup>

Thus, for ERISA purposes, the members of a 401(k) investment committee who design a retirement plan's menu of investment choices are fiduciaries by virtue of the discretionary authority these members exercise in constructing the investment menu. ERISA consequently obligates

<sup>1</sup> Letter to Fidelity Investments CEO Abigail Johnson from Sens. Durbin, Warren, and Smith (Nov. 21, 2022).

<sup>2</sup> *Id.*

<sup>3</sup> Letter to Fidelity Investments CEO Abigail Johnson from Sens. Durbin, Warren, and Smith (July 26, 2022).

<sup>4</sup> See, e.g., David Yaffe-Bellany, "FTX Assets Still Missing as Firm Begins Bankruptcy Process," *The New York Times*, Nov. 23, 2022; Alexander Saeedy and Jonathan Randles, "Sizable Amount of FTX Assets Missing," *The Wall Street Journal*, Nov. 23, 2022, at A1.

<sup>5</sup> See notes 25 and 26, *infra*, and accompanying text.

<sup>6</sup> *Tibble v. Edison International*, 135 S. Ct. 1823, 1828 (2015) ("An ERISA fiduciary's duty is derived from the common law of trusts. In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts.") (internal quotation marks and citations deleted). For an overview of the common law fiduciary duties, see Stewart E. Sterk and Melanie B. Leslie, *Estates and Trusts: Cases and Materials* 673-733 (2019).

<sup>7</sup> ERISA section 404(a)(1), 29 U.S.C. section 1104(a)(1). ERISA is codified both in the IRC, title 26 of the U.S. Code, and in title 29 of the U.S. Code, which pertains to labor laws. Following conventional practice, I provide for each labor provision of ERISA both its ERISA designation and its corresponding U.S. Code designation. See John H. Langbein et al., *Pension and Employee Benefit Law* 77-79 (2015); Lawrence A. Frolik and Kathryn L. Moore, *Law of Employee Pension and Welfare Benefits* 19-20 (2012).

<sup>8</sup> ERISA section 3(21)(A), 29 U.S.C. section 1002(21)(A).

these investment committee members to construct the investment menu prudently.<sup>9</sup>

The duty of prudence imposes upon fiduciaries both the procedural obligation to make decisions carefully and the substantive duty to make decisions that are objectively prudent.<sup>10</sup> Such objective prudence requires “caution”<sup>11</sup> and “conservatism.”<sup>12</sup> The standard of objective prudence requires that a proposed 401(k) investment option come from a category that is generally accepted<sup>13</sup> — that is, is long-standing and widely embraced. ERISA’s prudent man is not a riverboat gambler — or the 21st century equivalent.

Critical to the prudence inquiry in the 401(k) context are the investment choices of professional defined benefit plan managers.<sup>14</sup> Defined benefit pensions are, for purposes of ERISA section 404 and its rule of prudence, “enterprises”<sup>15</sup> “like”<sup>16</sup> 401(k) plans. Like 401(k) plans, defined benefit pensions are tasked with managing retirement savings. For 401(k) arrangements, the investment choices of professional defined benefit managers are important signals of prudence. Professional defined benefit trustees are ERISA’s “prudent man”<sup>17</sup> whose decisions should guide the choices of 401(k) trustees. Even before FTX, defined benefit trustees and investment managers have

avoided bitcoin and other cryptocurrency investments, thereby signaling the imprudence of crypto as a class for 401(k) investment menus.

### Investments of Defined Benefit Fiduciaries

Professionally managed defined benefit pensions hold their assets in a variety of investment categories, including stocks, bonds, real estate (including real estate investment trusts), private equity, and hedge funds.<sup>18</sup> Conspicuously missing from this list is cryptocurrency.

In part, the reluctance of defined benefit fiduciaries to invest in bitcoin and in other cryptocurrencies reflects the novelty of these investments. Bitcoin was only created in 2009.<sup>19</sup> Other cryptocurrencies have even briefer histories. In contrast, the investment forms that predominate in the defined benefit universe have passed the test of time.

Real estate is, of course, among the most traditional of investments. REITs were first authorized in 1960.<sup>20</sup> At that time, REITs were new and novel, but they are not today.

Similarly, common stocks are today conventional, a prudent investment class. It was not always so. An earlier age viewed common stocks as too speculative for the prudent investor.<sup>21</sup>

Bitcoin and other cryptocurrencies may be in the early stages of similarly achieving status over time as a prudent investment class. Or episodes like FTX and the warnings of respected figures<sup>22</sup> may indicate that bitcoin and other cryptocurrencies will, like tulips, never become established, prudent investments.

Only time will tell. And passing the test of time takes time.

Of course, that an investment category is prudent does not mean that every particular offering within that category is prudent. REITs are

<sup>9</sup> Labor Department reg. section 2550.404c-1(d)(2)(iv), 29 C.F.R. section 2550.404c-1(d)(2)(iv) (confirming a “fiduciary[’s] . . . duty to prudently select and monitor any service provider or designated investment alternative offered under” any plan providing for participant-directed investing); DOL reg. section 2550.404c-5(b)(2), 29 C.F.R. section 2550.404c-5(b)(2) (confirming in the context of “qualified default investment alternatives” a fiduciary’s duty “to prudently select and monitor any qualified default investment alternative under the plan”); DOL reg. section 2550.404a-1(b)(1)(i), 29 C.F.R. section 2550.404a-1(b)(1)(i) (as amended) (applying duty of prudence to the formation of “investment . . . menu[s]” for participant-directed plans); DOL reg. section 2550.404a-1(b)(2)(i), 29 C.F.R. section 2550.404a-1(b)(2)(i) (as amended) (same).

<sup>10</sup> *Brotherston v. Putnam Investments LLC*, 907 F.3d 17, 39 (1st Cir. 2018); *Renfro v. Unisys Corp.*, 671 F.3d 314, 322 (3d Cir. 2011); *Ramos v. Banner Health*, 461 F. Supp. 3d 1067, 1129 (D. Colo. 2020).

<sup>11</sup> Restatement of Trusts (3rd) section 90, comment e.

<sup>12</sup> *Id.*, comment e(1).

<sup>13</sup> DOL reg. section 2550.404c-5(e)(4), 29 C.F.R. section 2550.404c-5(e)(4).

<sup>14</sup> Edward A. Zelinsky, “Is Bitcoin Prudent? Is Art Diversified? Offering Alternative Investments to 401(k) Participants,” 54 *Conn. L. Rev.* 509, 524-525 (2022).

<sup>15</sup> ERISA section 404(a)(1), 29 U.S.C. section 1104(a)(1).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Zelinsky, *supra* note 14, at 528-543.

<sup>19</sup> Eric D. Chason, “A Tax on the Clones: The Strange Case of Bitcoin Cash,” 39 *Va. Tax Rev.* 1, 4, 15 (2019).

<sup>20</sup> Real Estate Investment Trust Act of 1960, P.L. 86-779, 74 Stat. 998, section 10(a) (adding to the IRC the provisions pertaining to REITs).

<sup>21</sup> Sterk and Leslie, *supra* note 6, at 708-710.

<sup>22</sup> See, e.g., Yun Li, “Charlie Munger Says Crypto Is a Bad Combo of Fraud and Delusion — ‘Good for Kidnappers,’” CNBC, Nov. 15, 2022.

today a prudent investment category for ERISA purposes after two generations of experience with REITs and the widespread embrace of REITs by defined benefit fiduciaries. But a particular REIT may not withstand scrutiny because its fees are too high or its holdings are insufficiently diversified.

We are not yet at the stage where crypto investments have, for 401(k) purposes, earned the categorical mantle of prudence, enabling fiduciaries to consider particular assets within the class. Perhaps at a future date, cryptocurrencies will, as a class, be deemed prudent, permitting 401(k) trustees and investment committees to consider particular crypto products for their respective investment menus. Or, as others suggest,<sup>23</sup> that date may never come because of crypto's inherent nature.

In short, in the 401(k) setting, the FTX story is not about FTX but is about crypto as a general investment category. That defined benefit trustees shun crypto as a class tells us that 401(k) plans, subject to the same ERISA rule of prudence, should similarly eschew cryptocurrencies — at least for today, perhaps forever.

### Fidelity's Marketing

Fidelity may retort that it is not an ERISA fiduciary. It does not decide what investments will be included in any particular 401(k) menu. Fidelity merely makes bitcoin available for those who want to buy it.

However, Fidelity, as the senators observe,<sup>24</sup> markets bitcoin explicitly as an investment suitable for 401(k) plans. Under the heading "Crypto in the Workplace,"<sup>25</sup> Fidelity announces: "Did you know? In 2022, Fidelity announced the first product that allows employers to let individuals invest a portion of their retirement savings in bitcoin through a 401(k) plan."<sup>26</sup>

This statement can be viewed as a direct appeal to 401(k) trustees and investment committees to place Fidelity's bitcoin fund on the menu of investments available to their plans'

participants. Or this statement may be understood as Fidelity encouraging 401(k) participants to press their respective plans' fiduciaries to embrace bitcoin as a permissible investment.

Either way (and both interpretations of Fidelity's marketing strategy may be correct), Fidelity is ultimately urging that ERISA fiduciaries embrace imprudent crypto investments.

### Conclusion

Durbin, Warren, and Smith are right that bitcoin and other cryptocurrencies are too novel to be deemed prudent investments for 401(k) and other ERISA purposes. Even before FTX, it was clear that bitcoin and other cryptocurrencies were too untested for retirement savings purposes, as confirmed by the nearly universal refusal of defined benefit trustees to invest in crypto. In a post-FTX world, even adherents of cryptocurrencies should see that, in the 401(k) context and in other retirement savings settings, crypto as a class is not prudent.

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<sup>23</sup> *Id.*

<sup>24</sup> November 21 letter, *supra* note 1.

<sup>25</sup> Fidelity Investments, "Crypto Investing, the Fidelity Way."

<sup>26</sup> *Id.*