JOURNAL of PENSION BENEFITS

Issues in Administration, Design, Funding, and Compliance
Volume 29 • Number 1 • Autumn 2021

Multiple Employer Plans

Bitcoin for Fiduciaries—Part 2

To many people, Bitcoin and other cryptocurrencies are a science fiction delusion or a digital Tulipomania. But this is changing, and fiduciaries need to know what to do about it. This column has two parts. Part 1 focused on the nature of cryptocurrencies and their place in the regulatory scheme. Part 2 examines crypto through the lens of fiduciary law and practice.

By Pete Swisher

Pete Swisher is Founder and President of Waypoint Fiduciary LLC, and is known nationally for his work on retirement plan governance. He is a prolific writer and speaker for the financial community and was the founding Chair of NAPA's government affairs committee. In 1988 he graduated with a degree in Linguistics from the University of Virginia, where he was selected for the prestigious Echols Scholar Program. He served in the first Gulf War as Executive Officer of a US Marine infantry company. He lives with his family in the horse country of Central Kentucky, and can be reached at *pete.swisher@waypointfiduciary.com*.

Disclosure: In Part 1 [*see* "Multiple Employer Plans," *Journal of Pension Benefits*, Spring 2021, p.40.] *I disclosed that I owned Bitcoin and encouraged readers to buy some so that the price would go up and I could be rich. Sadly, I must now disclose that I subsequently sold my Bitcoin prematurely and suffered from FOMO for months as Bitcoin doubled, but then it crashed 50 percent so I feel better. Now I wonder when I should buy back in. Thus, speaks Everyman.*

One thing investment professionals tend to have in common is the conviction that other people are doing it wrong. The other guy's asset allocation is flawed. Advising the use of actively managed funds is either a moral obligation or a fraud. And incorporating crypto-assets (crypto) into an investment portfolio is viewed by some as selling Ponzi schemes and others as a wise, asymmetric hedge.

The dichotomy is important. Exploring a proper fiduciary view of crypto is not possible unless we acknowledge that fiduciary principles are forever catching up. They evolve today and get codified 30 years from now. But the modern world moves too fast for that, and any generation younger than X will have a tendency to ignore and bypass the Old Fiduciary inclination to brand crypto as uniformly imprudent.

The thesis of this column is that fiduciaries need to advise clients on crypto (whether pro or con) and begin incorporating this advice into prudent investment strategies now, long before case law, statute, and regulation will have a chance to provide meaningful guidance. That means we need to use the guidance we already have. To lay the groundwork for crypto-advising, this column begins with some facts and perspective and moves on to a discussion of the fiduciary framework.

What Happens if Everyone Buys a Little Bitcoin?

Advisors are beginning to guide clients on crypto-assets and to suggest maximum portfolio allocations. In general, the recommended maximum allocation to crypto is 2 to 6 percent. [*See*, *e.g.*, *https://www.investors.com/etfs-and-funds/personal-finance/bitcoin-price-plays-how-much-should-you-invest-not-much-advisors-warn/?src=A00220*] This does not mean that *allocations* are being recommended, only that *maximums* are being recommended. Advisors, as they should, are being cautious in how they frame any guidance concerning crypto.

As a thought experiment, what would happen if everyone invested 2 percent of their portfolios in crypto? According to "All of the World's Money and Markets in One Visualization" [available at *https://www.visualcapitalist.com/all-of-the-worlds-money-and-markets-in-one-visualization-2020/*], there is roughly $80 trillion of stocks and $190 trillion of bonds in the world, or about $270 trillion of total investment assets other than real estate, cash, and derivatives. If 2 percent of that total were in crypto, that would be over $5 trillion. Total crypto market capitalization [*https://coinmarketcap.com/charts/*] has moved from roughly $200 billion in 2020 to roughly $1.5 trillion as of this writing—an astonishing upswing that suggests that investors already have begun buying into putting a portion of their money in crypto.

In other words, whether it is prudent or not, and whether a fiduciary is prudent to recommend it or not, it is happening. And $1.5 trillion is not far, in crypto terms, from the $5 trillion thought experiment level, or even from the $15 trillion suggested by a 6 percent allocation.

Investments versus Investment Technologies

Bitcoin represents over half of the crypto market, but not every crypto investment is like bitcoin. As noted in Part 1 of this column, virtually any asset on the planet can be "tokenized" or placed in a cryptographic wrapper for electronic sale and exchange. A recent, high profile example of this is the rise of non-fungible tokens (NFTs), the most spectacular of which was the sale at auction by Christie's on March 11, 2021, of a digital artwork NFT for $69 million. ["Beeple Sold an NFT for $69 Million," available at *https://www.theverge.com/2021/3/11/22325054/beeple-christies-nft-sale-cost-everydays-69-million*]

The implication of tokenization is that crypto-wrappers can become a new way to trade assets—including stocks, bonds, and real estate—that currently trade by traditional means. Thus, while the current crypto market cap is mostly represented by novel assets like Bitcoin (BTC) and Ethereum (ETH), a growing portion is gold and other assets, repackaged. Crypto also represents a source for the ability to find and trade previously illiquid and difficult-to-find assets.

The framework for crypto investing, therefore, goes far beyond Bitcoin—crypto is a new medium for buying, selling, lending, and receiving interest on assets of all kinds. A portion of the investment discussion, therefore, is purely operational. Yet "operations" is something that most investment advisors shy away from—they view it as something that happens in back offices and home offices and does not concern them. But the back-office mechanics are important for fiduciaries to understand with respect to crypto.

Operational Challenges of Crypto

It is beyond the scope of this discussion to provide a thorough analysis of all operational issues with respect to crypto investing, but here are a few key focus areas for fiduciaries.

Custody

Who should hold the keys? The private key to a crypto account is like a password that you can never "recover"—lose the password and you lose your account forever. In this way, it is like a physical key, but not really—after all, if you lose the physical key to a lockbox, you can physically break into the lockbox,

or get someone to pick the lock. But losing your private key is more like losing both the physical key and the lockbox itself.

If this sounds scary, it should. One report, for example, estimates that 20 percent of Bitcoin is permanently lost. [available at *https://blog.chainalysis.com/reports/bitcoin-market-data-exchanges-trading*] Safe custody and trading is the foundation on which the modern investment infrastructure rests. Crypto, at present, is mostly held and traded via private exchanges and "wallets" (custody accounts online or in physically segregated—that is, disconnected from the Internet—storage media). Crypto has its own infrastructure, and that infrastructure is not yet safe by modern standards.

As large institutions step increasingly into the crypto space, custody is at the heart of their offerings.

Risk Transfer

If your money is in the bank and gets stolen, with few exceptions, your money is protected and you are made whole—you have transferred most of your risk to the bank. The bank, in turn, has transferred much of its risk to insurers. We tend to take these risk transfers for granted in modern investment accounts, but they are simply not present in many crypto arrangements today.

Trading

As with custody, crypto has its own trading infrastructure. Any programmer hypothetically can create a private exchange and an infinite number of cryptocurrencies in his mom's basement. As a practical matter, a number of large, well-known exchanges manage most of the trades, and some of them appear to offer much of the safety and reliability of mainstream securities exchanges, but risks abound overall.

Trade Mechanics

It can be quite difficult to trade crypto directly. For example, the DEGEN Index token is a sort of crypto index fund that invests in multiple decentralized finance (DEFI) projects, and the instructions for trading it go something like this:

- **Method 1—The Easy Way**: Transfer funds from your bank account to an exchange and buy some ETH. Transfer the ETH to one of the two or three wallets that allow you to store the coins involved (because not every wallet can be used with every coin, so you need multiple wallets), then use the wallet software to link to the right exchange (because most exchanges trade a limited number of coins, so crypto investors need multiple exchanges), then exchange the ETH for DEGEN, which you will then store in your wallet.
- **Method 2—The Hard Way**: Mint your own tokens at net asset value (NAV) by providing liquidity via a particular liquidity pool for one or more of the underlying index tokens as part of a complex, multi-step process.

Needless to say, this process is simply not happening for most people, though direct investment in Bitcoin, ETH, and other major tokens is easier than in this complex example. But just as it is important for fiduciaries to understand underlying mechanics of mutual funds, collective investment funds (CIFs), and exchange-traded funds (ETFs), it will be important for fiduciaries to understand how funds and platforms are accomplishing crypto trades.

As a side note, consider what might happen to overall crypto market caps when trading gets easier.

Trading Costs

Costs can be substantial. For example, coinbase.com is one of the best-known exchanges and charges 1.49 percent per trade for most coin purchases and sales. A "round trip" (the buy plus the eventual sell) costs almost 3 percent.

In the case of multi-step transactions like those described for DEGEN above, there can be fees at each step, and Method 1 for buying DEGEN involves some "slippage" whereby the coins are actually being purchased at a premium (or discount) to NAV. Also, on any exchange—just as in modern stock exchanges—there is usually a bid-ask spread. As with stocks, the less liquid the asset, the higher the spread.

One of the advantages of mutual funds, CIFs, ETFs, and major investment firms overall is that they aggregate trades. For example, if 1,000 people sell on a day when 1,000 buy, the fund can "match" the sell trades against the buy trades so that there is no actual trade outside of the fund, and, therefore, no market trading cost or spread. Buys and sells also can be aggregated, when they occur, to reduce trade cost after matching. These cost advantages can be emulated by funds that hold crypto, but the infrastructure is young, and it may take time for costs to come down.

Cybersecurity

The crypto infrastructure is the Wild West compared to modern banks and securities exchanges,

and security is the primary operational concern. Hacks and other cybersecurity breaches are fairly common in crypto, though this will improve with time. This subject was discussed in more detail in Part 1.

Account Linkages

Another part of the modern investment architecture that matters to investors is the way accounts can be viewed or traded in tandem via a single interface. A portfolio of 10 crypto-assets, by contrast, might be held in three different wallets and traded on three different exchanges with no way to view or trade all ten assets simultaneously. One way to think of this is that crypto platforms are not "open architecture" because no single platform gives access to all or even most available tokens.

Rebalancing

Trading costs and the lack of easy account linkages make rebalancing an expensive and time-consuming process.

Tax Reporting

Crypto-assets are property and sales are taxed accordingly, but reporting is a manual process that requires the crypto investor to proactively track certain trades manually and, where available, download trade records to use for tax filing and records.

Tax-Loss Harvesting

As with rebalancing, the mechanics of managing any sales to generate tax losses are challenging and the costs can be high.

Analogy—ETFs and CIFs

In the early days of the growth of CIFs (often referred to as Collective Investment Trusts or CITs) as an alternative to mutual funds, fiduciaries pointed out several concerns:

- CIFs were less transparent than mutual funds
- It was difficult to obtain timely, correct data
- In some cases, the funds were not valued daily

Similarly, in the early days of the use of ETFs, the infrastructure for incorporating such funds had a variety of complexities and trading problems.

The point is that ETFs and CIFs are nothing more than different wrappers we use for "funds," and crypto has the ability to provide yet another type of wrapper. And just like in the early days of ETFs and CIFs in 401(k) plans, we can expect operational hurdles. If the benefits of overcoming those hurdles outweigh the costs and risks, crypto-wrapped funds will see growth just like we have seen in recent years with CIFs.

Technological Structure vs. Regulatory Structure

A crypto-wrapped fund is a technology solution to the problem of creating an investment fund. This is not a speculative notion—such funds already exist. For example, the DEGEN Index token mentioned above is a "fund" or tokenized pool consisting of eleven underlying tokens. The point is that crypto offers an alternative underlying technology structure for investment funds. But this is a technology issue, and the regulatory structure is a completely different issue. Regardless of how you trade them, mutual funds, ETFs, and CIFs are regulatory structures that could be applied to crypto. The nature of a fund's underlying technology and regulatory structures are appropriate due diligence subjects for fiduciaries.

Are ETFs the Answer?

Much of the operational challenge of crypto revolves around the fact that the crypto custody and trading infrastructure is still new and full of risks. There are several ways this can and likely will evolve:

1. The crypto infrastructure grows and improves over time.
2. Mainstream banks, exchanges, and securities firms build out their own infrastructure for crypto.
3. Crypto-assets are simply packaged for easy trading via the existing traditional infrastructure, such as through ETFs.

The first path is likely because there is momentum, and there are people in the world who like the idea of disintermediating traditional financial firms—which is, after all, one of the stated goals of the crypto movement. [*See*, *e.g.*, the manifestos mentioned in Part 1.] Today's alternative custody and trading infrastructure for crypto, therefore, is unlikely to go away.

The second path is already happening. Large financial firms are actively working on crypto projects, including creating their own coins, blockchains, and exchanges.

The third path also is already happening. For example, Canadian regulators have approved multiple ETFs for trading on Canadian exchanges, and

several applications are under review by the Securities Exchange Commission (SEC) for crypto ETFs in the United States. The advantage of the ETF approach is that it puts the custody, trading, and infrastructure problems in the hands of the fund managers, then just lets the funds trade on existing exchanges under existing rules. It is widely speculated that a proliferation of crypto ETFs would lead to substantial growth in the overall crypto market capitalization, BTC and ETH in particular.

ETFs are not the sole answer to the operational challenges, but they are clearly poised to play a major role in the growth of the crypto movement. Fiduciaries will need to understand how to evaluate such funds for operational as well as investment concerns.

Online Gambling with "Altcoins"

Nothing highlights crypto's potential for unregulated speculative excess better than "altcoins," so named because they are alternatives to mainstream ticker symbols like BTC and ETH. Altcoins are also affectionately called, "Sh**coins." I know a young altcoin enthusiast who tracks coins via an app called PooCoin. Here is a July 29, 2021, Tweet from @poocoin_token on Twitter: "$POOCOIN has reached 50k holders! Thank you everyone for your continued support of PooCoin.app and it's [sic] native token." At the risk of being viewed as a grammar snob, the "[sic]" sort of says it all.

Altcoins owe their existence to the fact that the code for many crypto-assets is public—it is "open source" programming. Anyone can create their own altcoin, and there are thousands of them, with more created almost daily. The classic Cinderella altcoin story is that of Dogecoin—created as a joke by two engineers in 2013 and now a media darling and a favorite of Elon Musk and Snoop Dogg.

There is no plausible investment thesis for purchasing most of these tokens except for technical analysis by day traders or swing traders, most of whom are essentially engaging in a form of online gambling by attempting to time the highs and lows. The coins themselves, in most cases, "go to zero" (or nearly so) in value when traders lose interest and move on.

The point of drawing distinctions between altcoins and more mainstream tokens such as Bitcoin and Ethereum is that such distinctions matter significantly for fiduciaries. Conservative fiduciaries may tend to inappropriately generalize this sort of "poocoin" speculative behavior to all crypto-assets.

The Fiduciary Framework for Investing in Crypto-Assets

The framework of statute, regulatory guidance, and case law by which fiduciaries can navigate crypto-assets is easy to define: it is exactly the same framework we apply to any other asset. The reasons for this are simple:

1. Fiduciary principles are just that—principles. We can apply them broadly.
2. There is no crypto-specific case law, and it will be many years before we have any.

The following discussion highlights principles and rules important to crypto rather than broadly summarizing fiduciary law.

Common Law Is History

Common law is literally history. It is a collection of precedents and principles from court cases reaching back centuries. The crypto movement is too new to be part of that history, so case law is mostly devoid of crypto-specific guidance. It will take a decade or three for there to be enough precedent-establishing litigation around crypto for fiduciaries to reach the level of certainty they have regarding things such as stocks and modern portfolio theory. By that time, crypto will be old news.

Exhibit 1—The Evolution of Fiduciary Thinking

First Restatement	1935	Only high quality bonds are prudent for fiduciary accounts
Second Restatement	1959	A modest quantity of blue chip stocks may be included
Third Restatement plus model state Acts*	1992-2007	Diversified portfolios are prudent
Fourth Restatement	2040+	Cryptoassets managed by quantum computers are prudent
*Especially the Uniform Prudent Investor Act (UPIA) and the Uniform Trust Code (UTC)		

The Restatement of the Law, Fourth, Trusts

The classic resource for the principles drawn from centuries of case law is the American Law Institute's (ALI) *Restatement of the Law* series. In the case of trust and fiduciary law, *Restatement of the Law, Third, Trusts*, published starting in 1992, is the most current edition. For ease of use, commentators often refer to the "third restatement of trust" or simply "third restatement." The history of the three restatements of trust shows how fiduciary thinking changes over time. (*See* Exhibit 1.)

In the Meantime, What Does Common Law Tell Us About How to Handle Crypto-assets?

A "fourth restatement" will arrive only when there are lots of court cases yielding new principles and the ALI gets around to summarizing them. In the meantime, the first nine sections of the Uniform Prudent Investors Act (UPIA) provide an excellent (and short) template. Below are some key provisions for purposes of the crypto discussion.

Section 2: Standard of Care. Section 2 discusses the basic rule that a trustee (and, therefore, any fiduciary) should manage assets "…as a prudent investor would, by considering the purposes…and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution."

Section 2(c): "Among circumstances that a trustee shall consider." "…(2) the possible effect of inflation or deflation; …(4) the role that each investment…plays with the overall trust portfolio"; …(5) the expected total return from income and the appreciation of capital; …(7) needs for liquidity, regularity of income, and preservation or appreciation of capital."

The arguments put forth for inclusion of crypto-assets in a portfolio, especially Bitcoin, have included Bitcoin's potential ability to hedge against inflation and the devaluation of fiat currencies. Some have described it as a "chaos hedge" and an "asymmetric bet"—a small investment to be made as insurance against the possibility of a broad financial collapse. The bet is "asymmetric" in that a small investment might provide a disproportionate benefit. In this way, it might resemble a put option, which becomes worthless at expiration if not needed but pays off handsomely if needed.

A small allocation to BTC, it is argued, can hedge against various risks prudently with due consideration of the role that it plays in the portfolio and its volatile total return, which consists of zero income (generally speaking) and wildly fluctuating capital value, not unlike gold. Keeping the investment small protects liquidity, income, and the overall portfolio capital.

Bitcoin is sometimes described as "digital gold," and some commentators have suggested that demand for BTC is drawing investment demand away from actual gold. Thus, to the degree a fiduciary believes gold has a place in a prudent portfolio, a similar argument might be applied to Bitcoin.

This is not to say that fiduciaries should necessarily believe any or all of this, only that this would be an argument for BTC under Section 2 of the UPIA.

Section 3: Diversification. Both the UPIA and ERISA provide for considerably more leeway with respect to diversification than most investment professionals would suspect. For example, multiple court cases have found no breach of the ERISA duty of diversification despite 50 to 90 percent of portfolios having been invested in just one to three individual securities or real properties [*e.g.*, *Jones v. O'Higgins,* 736 F. Supp. 1243 (N.D.N.Y. 1990); *Etter v. J. Pease Construction Co.*, 963 F.2d 1005 (7th Cir. 1992), *Metzler v. Graham*, 112 F.3d 207 (5th Cir. 1997)].

For the foreseeable future, the fiduciary discussion around crypto relates to the hypothetical 2 to 6 percent allocation to Bitcoin, Ethereum, and perhaps a handful of other crypto-assets. Make such an allocation based on reasonable asset allocation methodology and there is little risk of being found to have violated a fiduciary diversification requirement. More important, there is an argument to be made that Bitcoin and/or other crypto-assets will improve portfolio diversification mathematically.

A typical maximum portfolio allocation to any single security is 3 to 5 percent. In other words, many fiduciaries say that a stock portfolio, for example, should not have more than 5 percent in any one stock. There is therefore an argument that this same limit should apply to individual crypto-assets except in deliberately concentrated portfolios. Some investment commentators, however, view BTC as "digital gold" and believe it plays a similar role in a portfolio, and that allocations above five percent are prudent for gold, and, therefore, possibly for BTC.

Section 7: Investment Costs. Nearly two decades of fee litigation have taught the retirement plan community to tread carefully with even small allocations to expensive investments, such as hedge funds, no

matter how strong the investment merits. Whatever the merits of such litigation, it is clear that a fiduciary decision to include higher cost assets brings business risk to a fiduciary separate from the actual fiduciary considerations.

ERISA and Innovation

ERISA plans are the last place you will find anything new. There are multiple reasons for this, including the nature of ERISA's prohibited transaction provisions and the rise of fee litigation.

I wrote about one aspect of ERISA's tendency to stifle innovation in the Spring 2015 *Journal of Pension Benefits,* ["Benchmarking: What is it Good For?"], making the point that ubiquitous, backward-looking data and rigid fund categorizations suppress investment innovation, because the view has been promoted that the only suitable investments for ERISA plans are certain categories of funds with five-year track records. Try to squeeze a little Bitcoin into *that* worldview.

But ERISA Protects Workers

On the other hand, ERISA does what it must: Establish a safe environment for retirement savings and income, and the crypto market is perfect for abuse today, because it is still mostly unregulated. For example, price manipulation by traders is still mostly legal with crypto-currencies.

Overall, the slow-to-change mindset created by the prohibited transaction provisions, litigation risks, benchmarking mentality, and legitimate need to protect participants makes ERISA plans a tricky place for crypto fans.

ERISA Provisions Important for Crypto

ERISA lists four fiduciary duties: (1) loyalty, (2) prudence, (3) diversification, and (4) following the plan's governing documents. [ERISA § 404(a)(1)] Loyalty and following the plan's documents have no special, added significance in the crypto context. For purposes of ERISA's fiduciary duties, therefore, crypto is an issue of prudence [ERISA § 404(a)(1)(B)] and diversification [ERISA § 404(a)(1)(C), discussed previously].

Another important ERISA provision for crypto purposes is Section 404(b), which requires custody solutions within the reach of US courts: "…no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States."

It is worth noting, because the question does arise, that there is no prohibition against holding crypto-assets in ERISA plans. ERISA and Department of Labor (DOL) regulations do not contain lists of permitted and impermissible assets. Crypto is allowed. The question is, "Is it prudent?"

The DOL's Prudence Regulation

The prudence regulation [Labor Reg. § 2550.404a-1] is a short rule, similar in nature and scope to Section 2 of the UPIA. Highlights:

> A fiduciary must give "…appropriate consideration to those facts and circumstances that…the fiduciary knows or should know are relevant…" and act accordingly.

"Appropriate consideration" includes:

- Risk of loss and opportunity for gain versus other available investments, in the context of the overall purposes of the plan or portfolio
- Diversification
- Liquidity
- Projected portfolio return relative to funding objectives.

In summary, legal guidance on fiduciary prudence provides a principles-based blueprint for evaluating crypto recommendations.

The Business of Fiduciary Asset Allocation

"Prudence," for roughly the past 40 years, has meant buying and holding a 60 percent stock, 40 percent bond portfolio, with variations for age and risk tolerance. Advisors often rely on the "Brinson" study [Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," *The Financial Analysts Journal*, July/August 1986], published over 30 years ago, to support that "asset allocation accounts for 90 percent of performance." That study was highly influential in creating the structure of the modern business of investment advice.

In the defined contribution retirement plan business, we tend to look at things like derivatives as beyond the pale—not to be even considered. Yet it is possible, with options, to obtain substantial upside exposure to stocks without risking huge drawdowns, or to hedge against such drawdowns. Options have a cost, and, on average, it pays better to simply buy, hold, and periodically rebalance a diversified portfolio

of assets without derivatives. But, as the old saying goes, if your head is in an oven and your feet are in a bucket of ice water, it does not mean that, on average, you are comfortable.

Institutional investors know this and routinely engage in hedging. Defined benefit plans and the owners of large asset pools like foundations and endowments routinely use alternative investments like options, hedge funds, private equity, and private debt. Studies may differ on how effective these strategies are, but the point is that the world's most sophisticated asset owners and fiduciaries seem to think these things are a good idea—yet fiduciaries tend to forbid 401(k) participants to get anywhere near them.

Part of the issue is liquidity—if everyone on the planet hedged, there would be no one to take the other side of the trade. The system thus depends upon a large mass of people either speculating—so that prudent hedgers have counterparties—or passively relying on their assets to grow. But one thing that is available even in a world without hedging or derivatives is the ability to buy any asset that might appreciate. Thus—and this is the crucial point—when we, as fiduciaries, choose to deny participants access to an investment, we had best be sure this is the right thing to do.

What We Force 401(k) Investors to Buy and Hold

Fiduciaries and regulators routinely deny access to a wide variety of assets in 401(k) and 403(b) plans, including private equity, private debt, real estate, precious metals and other commodities, initial public offerings, and the ability to invest in individual securities. And crypto-assets, of course. We insist that these investors be mostly passive investors in a curtailed list of assets.

Conventional wisdom on behavioral finance tells us that we should deny 401(k) participants access to full diversification and the ability to hedge:

- Participants do worse when you give them more choices, so we should give them fewer.
- Participants don't understand alternative assets and will misuse them, so they shouldn't have access to them.
- Most people are lousy traders so we shouldn't let them trade.

The data behind the conventional wisdom is sound (participants really do make worse choices when they have more of them, misunderstand and misuse complex investments, and trade poorly), but are the conclusions right? Are fiduciaries right to withhold choice in a participant-directed retirement program?

The Future of Self-Direction

The broad ability to self-direct retirement assets is not unique to the United States, but is uncommon elsewhere in the world. And trends toward pooling are strong even in the United States. Multiple employer plans (MEPs), including the new pooled employer plans (PEPs), are just one example. The growing volume of plan investments held in target date funds (TDFs) and professionally managed accounts is another trend toward pooling. In short, there are trends even in the United States toward reduction in participants' ability to self-direct.

The counterweights to this trend are technology and the culture of generations after Gen X. Millennials are accustomed to having choice and like to have it available even when they prefer to be advised. Technology is making it increasingly possible for retirement solutions to deliver a broad range of strategies, including crypto, to individual accounts. Financial technology (fintech) firms catering to Millennials are creating a beachhead for use of crypto in employer-based retirement plans. But inclusion of crypto-assets in ERISA-governed defined contribution retirement plans will otherwise be slow to come, and will likely start with small allocations within specialty funds and managed accounts, as opposed to direct investments.

The main proving ground for crypto-assets in the retirement system—and perhaps for the future of self-direction—will be individual retirement accounts (IRAs), solo-401(k)s, and plans in the micro/small business market.

Conclusion: Including Crypto-Assets in Retirement Accounts

We can define several paths for adding crypto to retirement investment accounts:

- **Pure self-direction in nonfiduciary personal accounts**. A business owner's solo 401(k) or an individual's IRA or taxable portfolio are almost the sole way to access crypto in retirement accounts today. Such options are proliferating rapidly.
- **"Micro" plans**. 401(k) and IRA-based plans for very small businesses, especially those with younger, technology-oriented employees, are a growing beachhead for inclusion of crypto in employer-based plans.

- **A crypto allocation in a pooled, trustee-directed account**. For example, a defined benefit plan might make a small crypto investment.
- **A crypto allocation in a unitized managed account or fund option**. The fund or account can hold a small crypto-asset allocation without including crypto as a designated investment alternative (DIA).
- **As a DIA.** Selected by a fiduciary as a participant investment option.

The fiduciary considerations are simple to summarize:

1. Consider the litigation risk.
2. Treat crypto like any other asset, applying prudence and diversification rules from the common law and ERISA as appropriate, with special attention to the operational infrastructure and risks.

Prudence requires considering the circumstances, and, for crypto-assets, that means paying attention to operational factors such as custody, trading mechanics and costs, and how funds investing in crypto handle those operational issues. Evolving bank-style regulation such as "know your customer" (KYC) rules, as discussed in Part 1, will provide a significant and necessary boost to fiduciaries' ability to gain comfort on the operational issues.

In a 2020 interview, Bitcoin investor Raoul Pal said that "an enormous wall of money" was heading for Bitcoin and that a $1 million valuation might happen by 2025. [Online interview between Daniela Cambone of Stansberry Research and Raoul Pal, October 7, 2020] The $1 million figure is the sort of stardust that gets people excited but is not useful to fiduciaries. But the wall of money is clearly materializing. Institutions are pouring huge resources into crypto, including as investors, and we are still in very early days.

No opinions are offered as to whether crypto will actually make direct investors any money in the long run, but this point is clear: one thing a fiduciary does not want to be in this environment is uninformed. ■