LEGAL UPDATE

The SEC Fires All Guns Against a Crypto Platform - Plan Fiduciaries Should Take Note

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The SEC announced in November 2023 that it has charged Payward Inc. and Payward Ventures, Inc. (together "Kraken", an online crypto platform) with a litany of securities registration failures and other alleged wrongdoing which took place since 2018. In a straightforward press release (the "SEC Release"), the chief securities regulator laid out its view of what is wrong with Kraken, which may be a typical crypto provider:

"Through its platform's services, Kraken allegedly:

- Provides a marketplace that brings together the orders for securities of multiple buyers and sellers using established,

non-discretionary methods under which such orders interact, and thus operates as an exchange;

- Engages in the business of effecting securities transactions for the accounts of Kraken customers, and thus operates as a broker;
- Engages in the business of buying and selling securities for its own account without an applicable exception, and thus operates as a dealer; and
- Serves as an intermediary in settling transactions in crypto asset securities by Kraken customers, and acts as a securities depository, and thus operates as a clearing agency."

Those statements read like a primer on the subject of SEC-required registrations. The SEC Release went on to explain:

> "In case after case, we've seen the consequences when individuals and businesses tout and offer crypto investments outside of the protections provided by the federal securities laws: investors lack the disclosures they deserve and are harmed when they don't receive them," said Gurbir S. Grewal, Director of the SEC's Division of Enforcement. "Today, we take another step in protecting retail investors by shutting down this unregistered crypto staking program, through which Kraken not only offered investors outsized returns untethered to any economic realities, but also retained the right to pay them no returns at all. All the while, it provided them zero insight into, among other things, its financial condition and whether it even had the means of paying the marketed returns in the first place."

SEC Registration is expensive and time-consuming, and requires a large and sophisticated staff, detailed recordkeeping, large technology investment, and ongoing disclosures. As Mr. Grewal noted, however, it is these very activities that help guide and protect the public in their investment choices.

Why then would plan fiduciaries clamor to offer crypto through their 401(k) plans? Is it a prudent decision to offer unregistered securities through unregistered vehicles to plan participants who are not likely to be sophisticated investors? The DOL has already cautioned plan fiduciaries to "exercise extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants." (*See*, Compliance Assistance Release No. 2022-01, the "DOL Release.") Fiduciaries are well-reminded of the basic responsibilities imposed on them by ERISA. The DOL Release provides a nice summation of those duties:

> When defined contribution plans offer a menu of investment options to plan participants, the responsible fiduciaries have an obligation to ensure the prudence of the options on an ongoing basis. Fiduciaries may not shift responsibility to plan participants to identify and avoid imprudent investment options, but rather must evaluate the designated investment alternatives made available to participants and take appropriate measures to ensure that they are prudent. As the Supreme Court recently explained, 'even in a defined-contribution plan where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options.' The failure to remove imprudent investment options is a breach of duty.

Each investment option on a 401(k) plan menu (including a brokerage window that gives access to crypto) should be selected in accordance with the duty of prudence under ERISA. Prudence requires a fiduciary to 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." Courts have interpreted this duty as requiring plan fiduciaries to conduct an independent investigation of the merits of each of the plan's selected investments as seen in the context of the overall portfolio. (*See, e.g.*, Donovan v. Cunningham, 716 F.2d. 1455 (5th Cir. 1983), cert. denied, 469 U.S. 1072 (1984)).

Each investment choice in the plan menu must be a prudent investment option. (Preamble to DOL regulations under ERISA Section 404(c), 57 Fed. Reg. 46922 (Oct. 13, 1992)). Appropriate consideration should be given to all relevant factors concerning a particular investment, including the role the investment fund will play in the plan's investment menu and a consideration of the risk of loss and the opportunity for gain. (*See*, 29 C.F.R. 2550.404a-1(b)(1)). The fiduciary should consider all relevant information concerning the fund, highlighting both the merits and possible drawbacks. The fee structure should be fully vetted and understood. A fiduciary's duties do not end with selecting a fund. They have a duty to monitor their plan's investments or investment menu choices at regular intervals to ensure that each investment remains prudent. The investment review process should be properly documented.

Plan service providers, such as a custodian for the investment, should be similarly vetted. An early-to-market crypto recordkeeper, ForUsAll, filed suit against the DOL, claiming that the "extreme care" warning in the DOL Release was an "arbitrary and capricious attempt to restrict the use of cryptocurrency in defined contribution retirement plans…" The court rejected those claims and dismissed the suit. (*See*, ForUsAll Inc. v. U.S. Department of

Labor et al, 22-cv-1551 (CRC) (D.D.C. Aug. 29, 2023)). The opinion reasons that, "the Release does not extend fiduciary obligations to a previously duty-free domain or alter existing obligations in any way. It merely states that plans offering cryptocurrency options through their brokerage windows should be prepared to explain how those actions comport with their duties of prudence and loyalty—whatever those duties are."

Plan fiduciaries should be prepared to document how this can be accomplished without financial disclosures and the investment information presented in a prospectus and other documents required for registered securities. Is it prudent to place faith in the seller or holder of crypto who does not go through the rigors of registration? While some registered broker-dealers are now offering crypto to 401(k) plans through registered exchange-traded funds, a fiduciary must still weigh the risk of loss against the opportunity for gain from these highly volatile investments.

The SEC's new enforcement activity should be a clear warning to not only unregistered crypto providers and the advisers who recommend crypto investments, but also to retirement plan fiduciaries who approve those investments. The DOL announced—through the DOL Release—its plan to initiate a new investigative program for plans that offer crypto, whether as a direct investment or through brokerage windows.

Stay tuned for the next regulatory axe to fall.

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