

“Challenges For Fiduciaries Adding Crypto To 401(k) Plans,” *Law360*

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In an article for *Law360*, Partner Alexis Bates and Associates Andy Osborne and Erin Murphy examine the evolving landscape of cryptocurrency investments in 401(k) retirement plans, and the potential challenges of including these assets among 401(k) offerings because of the fiduciary risks they present under the Employee Retirement Income Security Act (ERISA).

The authors anticipated the Department of Labor’s recent move to rescind guidance cautioning against crypto investments in 401(k) plans and a more general change in the government’s approach. In the midst of these governmental shifts and increasing demand for crypto offerings, the authors balance the various challenges fiduciaries face when carrying out their ERISA obligations in managing 401(k) plans.

Key challenges that crypto investments present include: accurately valuing digital assets, general volatility in crypto markets, evolving regulatory uncertainty, cybersecurity and custody risks, and market manipulation and misconduct.

As the popularity of cryptocurrencies like bitcoin and ethereum continues to grow, and as the current administration promises to foster growth in the digital asset space, investors may become increasingly interested in seeking exposure to cryptocurrencies in their 401(k) retirement accounts.

An estimated \$9 trillion in U.S. assets are currently held in 401(k) plans, but very few of these plans permit investments in crypto. Of those that have begun offering crypto as an investment option, most do so only through a brokerage window.

Thus far, retirement plan fiduciaries have indeed been encouraged to steer clear of including cryptocurrency assets in plan portfolios because of the significant fiduciary risk under the Employee Retirement Income Security Act.

However, the Financial Freedom Act, S.B. 1222, which was introduced in the U.S. Senate in April, aims to encourage the inclusion of assets like cryptocurrency among investment options.

Loosening restrictions on crypto may increase the interest and demand from investors to add these options to their retirement portfolios, which fiduciaries will have to balance against their obligations under ERISA.

Fiduciary Duty Under ERISA

ERISA imposes stringent duties on retirement plan fiduciaries, including the duties of prudence, loyalty and adherence to plan documents.

The duty of prudence, in particular, requires fiduciaries to act with the care, skill, prudence and diligence of a prudent person acting under similar circumstances, including while selecting and monitoring the performance of fund assets.

Fiduciary breach cases under ERISA that allege violations of these duties have exploded in the past decade. As such, every decision a plan fiduciary makes about the choice of funds or assets for 401(k) plans is fraught with potential litigation risk.

A few recent case trends include allegations that plans overpaid their service providers, included more expensive fund share classes than necessary, misallocated forfeited assets or maintained allegedly underperforming funds for too long.

The participants' alleged losses in these cases can be as little as \$5 or \$10 per person per year, and can result in settlements of tens of millions of dollars, depending on the size of the plan.

It's easy to imagine the litigation risk of similar fiduciary breach liability theories based on the volatility of crypto-assets, if they were to be offered in a plan.

The U.S. Department of Labor previously expressed that it had "serious concerns" about fiduciaries adding cryptocurrency to their plans, and recommended that they refrain from doing so.

Specifically, in 2022, the DOL issued Compliance Assistance Release No. 2022-01, titled "401(k) Plan Investments in 'Cryptocurrencies.'" In the notice, it took a strong stance against investing 401(k) assets in cryptocurrencies, highlighting concerns about the "significant risks of fraud, theft, and loss."

The DOL raised several risks, including that crypto investments are speculative and volatile, making it difficult for plan participants to make informed investment decisions. The guidance also highlighted concerns about recordkeeping, valuation and a rapidly evolving regulatory environment.

On the legal liability side, any of these risks may expose fiduciaries to allegations of imprudence for

offering crypto investments, whether the crypto market is up or down. The challenges for fiduciaries include the following.

Valuation Difficulties

Crypto often lacks consistent and reliable pricing mechanisms. ERISA fiduciaries must be able to accurately value plan assets for reporting and fee calculation purposes.

Volatility and Suitability

Crypto markets are known for dramatic price swings. Their speculative nature raises questions about whether such investments are appropriate for long-term retirement savings.

Regulatory Uncertainty

The legal status of many cryptocurrencies is still evolving. The current administration has indicated a significant move away from targeting the crypto community for offering and registration rule violations. However, to date, this has taken the form of public statements and policy memoranda, rather than legislation.

Moreover, regulators still intend to pursue instances of fraud, abuse and customer harm. Thus, even in this new environment, fiduciaries face an evolving target in terms of compliance.

Cybersecurity and Custody Risks

The digital nature of these assets introduces unique custodial concerns. For example, losses from hacking, wallet mismanagement or exchange insolvency are difficult to insure and recover.

The DOL has issued guidance for ERISA plans around cybersecurity that outlines best practices, which may not be possible to follow for certain crypto-assets.

Markets and Liquidity

Crypto is often traded in smaller exchanges that may not have sufficient capitalization to backstop losses due to events other than market movement.

Moreover, as with any asset, crypto that is thinly traded may face liquidity crunches at inopportune times, be difficult to value, and be more subject to market manipulation and misconduct.

Potential Changes Ahead

Most plan fiduciaries have heeded the DOL's warning, as the overall portion of retirement funds that are invested in crypto remains very small.

For the most part, those who wish to invest their funds in crypto do so outside their 401(k)'s core investment lineups, accessing a brokerage window to manage their own investments. Fiduciaries are less exposed to potential liability for the choices that investors make in those circumstances.

However, recent events suggest that the tide may be shifting toward including crypto in 401(k) core lineups.

The Financial Freedom Act, introduced by Sen. Tommy Tuberville, R-Ala., aims to reverse the DOL's 2022 guidance by "prohibit[ing] the Secretary of Labor from constraining the range or type of investments that may be offered to participants and beneficiaries of individual retirement accounts who exercise control over the assets in such accounts."

More broadly, the White House has vowed to make the U.S. the "crypto capital of the world." Further, it has signaled its goal of promoting U.S. leadership in digital assets by establishing a new regulatory framework "for market structure, oversight, consumer protection, and risk management," and creating a strategic bitcoin reserve and a U.S. digital asset stockpile.

These announcements touted the security and future potential of digital assets.

Moreover, certain exchanges and institutions have begun to offer exposure to crypto markets without the need to transact in the currencies themselves. As a result, 401(k) plan fiduciaries may have to give the crypto markets a fresh look.

Still, the fiduciary duty to act prudently in selecting and monitoring plan investments has not changed.

On the one hand, fiduciaries may view the positive market and government sentiment as increasing the stability and legitimacy of cryptocurrency. On the other hand, these factors alone do not build a prudence defense for anyone who chooses to invest in these assets.

Even if the DOL's guidance is officially rescinded, the factors it warned of in 2022 have not necessarily dissipated. And even absent the DOL's input, the threat of private litigation for fiduciary breach remains high.

Fiduciaries will therefore still have to seriously consider whether the actual investment risks surrounding particular crypto investments make those investments imprudent.

Many cryptocurrencies remain volatile, with their value hard to estimate. For example, while the markets predicted that the White House's March 7 cryptocurrency summit would boost the value of crypto-assets, many prices only dropped in its wake. In fact, in the one-month period after the summit, the currencies that were selected for the government reserve saw increases of up to 10%, with crashes up to 25%.

This volatility is nothing new, given that these currencies have seen crashes with more than 50% of value lost. However, the prospect of losing up to 50% of the plan beneficiaries' retirement investment so quickly should prompt heightened consideration from a plan fiduciary regarding the risk that this kind of volatility poses.

In addition, a key element of the duty of prudence involves demonstrating that fiduciaries thoroughly investigated an investment before offering it to plan participants. However, the struggle to collect enough data and information to make informed decisions about crypto remains, and a lack of reliable data on which to base an investigation inhibits the ability to assess and oversee the investments.

Reliable valuation continues to be a challenge as well, as there is also no standard approach to forecast future returns of crypto-assets. When valuing traditional assets, such as public stocks and bonds, investors utilize mathematical and statistical models that rely on historical data and trends, based on metrics such as cash flows and debts.

The short and volatile history of crypto, as well as the lack of robust data tied to company performance, frustrates the use of these traditional models. These forecasting challenges may give investors pause before committing plan assets to crypto with confidence.

While investors may have an opportunity to get on the cutting edge of an upturn in crypto investing, they should weigh that opportunity against the serious risks discussed above.

Additionally, whatever recommendations the government may make, fiduciaries must still thoroughly research and investigate all investments of the plans they manage and be mindful of their fiduciary obligations under ERISA.

Update: After this article was submitted but shortly before it was published, the Department of Labor rescinded its 2022 guidance, stating: "By rescinding the 2022 guidance, the department reaffirms its neutral stance, neither endorsing, nor disapproving of, plan fiduciaries who conclude that the inclusion of cryptocurrency in a plan's investment menu is appropriate."

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