IT’S NOT YOUR PARENTS’ INVESTMENT LINEUP ANYMORE

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Agenda

- Investment Considerations for an ERISA Fiduciary
- ESG (Environmental, Social, Governance) Investments
- Private Equity Investments
- Cryptocurrency Investments
- Concluding Observations
Investment Considerations for the ERISA Fiduciary
ERISA section 404(a)(1) fiduciary standards

- ERISA section 404(a)(1) provides the “prudent person” standard of care that a fiduciary must use in the discharge of his or her duties solely in the interest of plan participants and beneficiaries and -
  - for the **exclusive purpose** of providing benefits and defraying reasonable expenses of administering the plan
  - with the **care, skill, prudence, and diligence** under the circumstances then prevailing that a prudent person would use
  - by **diversifying the investments of the plan** to avoid the risk of large losses
  - in **accordance with the plan documents**

- These basic fiduciary standards apply to the fiduciary’s decision to allow ESG, private equity, or cryptocurrency investments in the plan’s lineup
ERISA section 402(b)(1) requirement for a plan to establish and carry out a funding policy and method

- The funding policy and method is an ERISA requirement
- An investment policy statement is optional
- Funding policy considerations for these unique types of investments
  - How does the investment further the purposes of the plan?
  - What is the risk of loss and opportunity for gain?
  - How does the investment affect the diversification of the portfolio?
  - Impact of liquidity and return on the plan’s cash flow needs
  - Projected return of investments compared with funding objectives
  - Nature of the plan – defined benefit vs. defined contribution
  - If the plan is DC, are the investments in the core lineup or available in an SDBA?
ESG Investments

(Environmental, Social, Governance)
What are ESG investments?

• Could be a single stock or a mutual fund

• Investments that are selected for social, environmental, or corporate governance benefits they create in addition to investment return

• Example of a funding policy provision on the use of ESG investments –
  • No plan assets invested in stocks of oil companies
  • Investments in green energy companies are to be encouraged, provided the economics of the investments make sense
Background: Final rule on prudence and loyalty in selecting plan investments and exercising shareholder rights

• Final rule allowing ESG (Environmental, Social, Governance) considerations in selecting plan investments issued 11/22/2022

• The 2020 Rules
  • Financial factors in selecting plan investments
  • Fiduciary duties regarding proxy voting and shareholder rights
  • Became effective in January 2021

• President Biden’s Executive Orders

• DOL review of 2020 Rules and Enforcement Policy

• 2021 Notice of Proposed Rulemaking (NPRM)
Details: Final rule on prudence and loyalty in selecting plan investments and exercising shareholder rights

• Overview of the Final Rule
  • Duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors
  • When a plan’s assets include shares of stock, the fiduciary duty to manage plan assets includes the management of shareholder rights related to those shares

• Changes to Clarify Permissibility of Consideration of ESG Factors
  • Risk and return analysis may include economic effects of climate change and other ESG considerations on the particular investment or investment course of action

• Changes to Qualified Default Investment Alternative (QDIA) Provisions
  • Standards applied to QDIAs no different from those applied to other investments
  • Fiduciary is to focus on risk and return factors and not subordinate interests of participants and beneficiaries to objectives unrelated to provision of benefits
More Details: Final rule on prudence and loyalty in selecting plan investments and exercising shareholder rights

• The Tiebreaker Test
  • Fiduciaries may consider collateral benefits (i.e., other than investment returns)
  • Competing investments must serve the financial interests of the plan
  • Special documentation requirements for collateral benefits are removed

• Investment Alternatives in Participant-Directed Individual Account Plans
  • Participants’ non-financial preferences may be taken into account

• Provisions on Shareholder Rights including Proxy Voting
  • Modifies the 2020 rules on proxy voting

• Effective and Applicability Dates
  • Effective 60 days after publication of final rule in the Federal Register
  • One year delay in applicability for certain proxy voting rules
Private Equity Investments
Similar to a mutual fund or hedge fund, a private equity fund is a pooled investment vehicle where the adviser pools together the money invested in the fund by all the investors and uses that money to make investments on behalf of the fund.

Unlike mutual funds or hedge funds, however, private equity firms often focus on long-term investment opportunities in assets that take time to sell with an investment time horizon typically of 10 or more years.

Different investment strategies of private equity fund managers.

Private equity funds not registered with SEC; lack of public disclosure.

Typically, open only to accredited investors and qualified clients.

Direct vs. indirect investment in private equity.
Accredited investor
[investor.gov]

• Under the federal securities laws, only persons who are accredited investors may participate in certain securities offerings

• Who is an accredited investor?
  • Income in excess of $200,000 ($300,000 if a spousal investment); or
  • Net worth over $1M (with or without spouse), excluding primary residence; or
  • Holds in good standing a Series 7, 65, or 82 license

• Other categories (non-individuals) of accredited investors
  • Any trust with assets in excess of $5M (not formed specifically to purchase the subject securities) that is directed by a “sophisticated person”
  • Any entity in which all of the equity owners are accredited investors
DOL information letter on private equity
June 3, 2020

• Currently, there is no regulatory guidance from DOL on use of private equity in ERISA-qualified retirement plans
• Groom Law Group letter request asking DOL for guidance on use of private equity investments as a component of a managed asset account
  • DOL reiterated the basic fiduciary duties under ERISA sections 403 and 404
  • Plan fiduciary must evaluate risks and benefits with each investment alternative
  • Does the private equity investment increase diversification?
  • Is the fund containing private equity professionally managed?
  • Does the use of private equity in the managed account offer sufficient liquidity?
  • Additional considerations for use of private equity investments in participant-directed individual account plans vs. defined benefit, professionally-managed plans
DOL supplemental statement on private equity
December 21, 2021

• Highlights of the Information Letter, as restated in the Supplement
  • Fiduciaries would not violate ERISA secs. 403 and 404 by offering a professionally-managed asset allocation fund with a private equity component
  • Fiduciaries must determine that the investment is both prudent and in the best interest of the participants and beneficiaries

• Performance calculations must be carefully analyzed because they are not standardized; issue of adequacy of investment disclosures

• Does the fiduciary have the skills, knowledge, and experience to make a determination on the private equity investment?

• DOL caution on the extent of the application of the Information Letter
Observations on the use of private equity in ERISA – Qualified Retirement Plans

- Facts of the Information Letter dealt with a defined contribution 401(k) plan, but DOL confirmed that private equity may also be used in DB plans.
- Difference between offering an investment fund that includes private equity and allowing participants to purchase private equity through their own SDBAs (participant must be an accredited investor).
- Extreme vetting required – can a plan fiduciary do this alone?
- Plan’s funding policy must specifically allow for private equity.
- Use in defined benefit and defined contribution plans, contrasted.
- Private equity is not a magic bullet to increase investment return.
Cryptocurrency Investments
Brief description of cryptocurrency [cryptocurrencyfacts.com]

- Cryptocurrency is a general name referring to all encrypted decentralized digital currencies like Bitcoin
- Cryptocurrency uses cryptography to create coins and secure transactions
- There are a number of cryptocurrencies traded on cryptocurrency exchanges, and the growing popularity of cryptocurrency means that despite volatile prices, market caps and values are growing every year
- Popular cryptocurrencies include the original Bitcoin, Ethereum’s Ether, and Litecoin
- Cryptocurrency is legal and taxable in the US, but it isn’t legal tender
Cryptocurrency architecture

- Blockchains – continuously growing list of records linked and secured by cryptography
- Nodes – computers that connect to a cryptocurrency network
- Timestamping – used to “prove” the validity of transactions added to the blockchain ledger without the need of a trusted third party
  - Proof-of-work scheme. Uses hashing algorithms
  - Proof-of-stake scheme. Requests users to show ownership of a certain amount of currency
- Mining – a validation of transactions; miners awarded new cryptocurrency
- Wallets – store keys (addresses) which are used to receive or spend the crypto
- Exchanges – allow customers to trade cryptocurrencies for other assets

ERISA considerations associated with cryptocurrency

• No provision in ERISA directly speaks to the use of cryptocurrency in an ERISA-qualified retirement plan

• Ownership of the asset
  • ERISA section 403(a) requires all assets to be held in trust and owned by trustees
  • No fiduciary may maintain the indicia of ownership of any plan assets outside the jurisdiction of U.S. District Courts – where are the cryptocurrency assets?

• Custody
  • Who takes control (custody) of an electronic asset and how is that done?
  • Cryptocurrency is outside the financial system that regulates traditional assets

• Recordkeeping and valuation
  • Unique issues of valuation and accounting
Additional ERISA considerations associated with cryptocurrency

• **Liquidity and diversification**
  • Trustee would have to learn how to buy and sell the cryptocurrency asset and to integrate it with the plan’s funding policy and method

• **Transaction risk**
  • How does the trustee account for transactions that are on a decentralized network that is not regulated by the U.S. government?

• **Regulatory concerns**
  • Potential regulatory issues with the SEC, IRS, and DOL (among others)

• **Fiduciary duty of prudence**
  • Cryptocurrency is not protected by any federal government agency – Hacked accounts? Theft by cyber breach? Who is responsible?
Cryptocurrency 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
- Challenge for plan participants to make informed investment decisions
- Custodial and recordkeeping concerns
- Valuation concerns
- Evolving regulatory environment

**DOL prospective investigations**

- Plan fiduciaries should be prepared to show how allowing cryptocurrency investments in self-directed brokerage accounts (SDBAs) align with fiduciary duties of prudence and loyalty
Use of self-directed brokerage accounts (SDBAs) to purchase cryptocurrency

- SDBAs under ERISA sec. 404(c)
  - Prudence considerations
  - DOL regulations implementing ERISA sec. 404(c)
  - Plan fiduciaries may be held responsible for a brokerage window as a plan feature, but not for individual investment selections by plan participants
  - DOL considers that the fiduciary duty articulated in *Hughes v. Northwestern University* does not extend to participants’ selections in their SDBAs

- Plan fiduciary considerations with respect to SDBAs
  - Review commissions and other fees
  - Review restricted categories of investments under the SDBA
  - Review potential conflicts of interest
  - Fee disclosures, summary plan descriptions, enrollment materials
Cryptocurrency held directly vs. mutual fund

• When assessing holding cryptocurrency as a direct investment vs. a mutual fund or ETF, consider the following:
  • Ownership. The ownership problem is solved by packaging crypto in a fund because the asset owned by the trustee is the fund itself, not the underlying assets of the fund
  • Custody. Again, no problem because the trustee is taking custody of a mutual fund
  • Recordkeeping and valuation. This is just another mutual fund when it comes to recordkeeping and valuation
  • Liquidity and diversification. Assuming that the Fidelity crypto fund is an open-end mutual fund, it should be liquid; however, it would not be diversified
  • Transaction risk. The fund itself would take on the transaction risk

• Whether held directly or as a fund, there are the regulatory concerns and the fiduciary duty of prudence
One approach to avoid the current cryptocurrency dilemma

- One approach to avoid the current cryptocurrency in ERISA-qualified retirement plans issue is for the responsible plan fiduciary to not allow any plan assets to be invested in it at this time.
  - Perhaps at a later time when some of the issues that were discussed have been addressed, but now the potential benefits do not outweigh the fiduciary risk

- Participants in a defined contribution plan with generous distribution terms can elect a distribution of assets, followed by a rollover to a self-directed IRA and subsequent investment in cryptocurrency
  - The appropriate self-directed IRA custodian may allow for investment of IRA assets in cryptocurrency
  - An IRA is generally not subject to ERISA, so the fiduciary considerations applicable to a plan subject to ERISA would not apply
Concluding Observations
Summary

• Prudence considerations by the responsible plan fiduciary
• All three investment categories have unique problems associated with their usage in an ERISA-qualified retirement plan
• Is the prospect of an outsized return worth all the fiduciary risks and administrative costs?
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