

Blog

Final Rule Grants Fiduciaries Greater Flexibility When Considering ESG Options

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Key Observations

- *Fiduciaries will have more flexibility to consider non-pecuniary factors when evaluating investments for their Defined Contribution Plans*
- *Plan Sponsors are not required to alter their investment process*
- *Sponsors who do not pass proxy voting to participants should vote the proxies unless voting would be deemed to have a material cost involved*

Plan fiduciaries interested in offering Environmental, Social and Governance (ESG) investments in their defined contribution plan investment menu have at last received a final regulation (“Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights”) from the Department of Labor (DOL) reframing how fiduciaries may consider ESG factors in their investment decisions. This comes almost two years after the Biden administration’s directive in March 2021 announcing that it would not enforce the more restrictive Trump Era rule. The final rule also gives clarity on how fiduciaries can satisfy their duties while voting proxies for plan investments.

Background

Fiduciaries subject to the Employee Retirement Income Security Act of 1974 (ERISA) are required to adhere to five key duties while fulfilling their fiduciary obligations. Some of these duties require fiduciaries to

- act exclusively in the interest of plan participants and beneficiaries
- act as a prudent expert would
- diversify plan investments

The DOL has long followed the investment standard that participant interests are financially measured, however, different administrations have had varying opinions on what fiduciaries may consider for non-pecuniary factors, including ESG and others, while evaluating investments.

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Changes to Allowable ESG Considerations

Non-Pecuniary Factors: The final rule allows for more flexibility for fiduciaries who may want to consider ESG or other non-pecuniary factors. The final rule goes on to explain that fiduciaries can reasonably determine which factors they believe to be relevant to a risk and return analysis. The final rule also touches on the Qualified Default Investment Alternative (QDIA), reversing previous regulation that QDIAs may not have investment objectives or strategies that are non-pecuniary in nature, such as ESG or climate change focused. While the final rule does clarify that these factors may be considered when evaluating the financial benefits of an investment, it does not prescribe that these factors must be reviewed, so Plan Sponsors are not required to alter their current process for investment review.

Participant Preferences: The final rule adds an additional provision that states Plan Sponsors are allowed to consider participant preferences while constructing the plan's fund menu. While currently most plans that offer ESG investments experience low utilization, this is a welcome sight for some sponsors as recent surveys indicate that 59% of investors who are not currently involved or never new of ESG investing say they are interested in investing in such options.¹

Proxy Voting

The final rule also eliminates the previous regulation's statement that a Plan Sponsor should only vote proxies if the fiduciaries prudently determine the matter will have an economic impact on the investment. While intended to discourage Plan Sponsors from using their corporate influence to favor ESG or political factors, that stance changed the long-standing position from the DOL that sponsors should vote all proxies unless voting would be deemed to have a material cost involved. The final rule also eliminates the two proxy non-voting safe harbors implemented by the previous administration along with special monitoring and specific records requirements.

Now What?

New regulations are generally effective 60 days from publication in the Federal Register, and for many, the final rule may not have an impact on the current oversight of plan investments as the provisions do not require the inclusion of non-pecuniary factors during analysis. Plan Sponsors should take this time to discuss what, if any, approach they may consider on ESG investments, and review their Investment Policy Statement (IPS) to see if any applicable changes may need to be made for either ESG Investments or proxy voting procedures.

As always, please reach out to a member of your Fiducient Advisors' Service Team with any questions.

¹PlanSponsor.com as of August 2021

About the Author



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Scott services institutional clients by providing counsel and guidance on fund menu design, manager selection, vendor due diligence, investment policy statements and performance monitoring. He is also a member of the firm's Defined Contribution Business Council. Scott joined Fiduciary Investment Advisors, LLC in 2014, which combined with Fiducient Advisors in 2020. Prior to joining the firm, Scott was an Investment Consultant at T. Rowe Price. He received a BSBA from the University of Northern Colorado. Scott serves as a Board Member and Treasurer for Mental Health Connecticut, Inc., a nonprofit advocating for improved, expanded and accessible mental health services. In his free time, Scott enjoys family time with his wife and two sons, golfing and traveling.