Common ground: new report provides standard definitions for key responsible investment terms

November 20, 2023

Introduction

Word nerds, rejoice! Through an international initiative led by the PRI, CFA Institute and Global Sustainable Investment Alliance, a report has been issued that:

- proposes common definitions for each of **Screening, ESG Integration, Thematic Investing, Stewardship,** and **Impact Investing -** five key terms commonly used in responsible investment;
- lists and explains the essential elements of each definition; and
- provides guidance for using the term in practice.

The report also provides the starting reference points for these standardized definitions. This initiative began in response to a 2021 report by the International Organization of Securities Commissions (IOSCO), which stressed the need for the global investment industry to establish common terms and definitions to ensure consistency throughout the global asset management industry.

The Canadian Securities Administrators (CSA) have yet to announce whether they will embrace these standardized terms, but, given their general acknowledgement of the importance of standardized terminology that is interoperable with international standards, it is likely that the CSA will lend support to this initiative. Throughout this article, we comment on the general alignment of these definitions with the way in which the terms are used in CSA Staff Notice 81-334 *ESG-Related Investment Fund Disclosure* (ESG Staff Notice).

Screening

Definition: “applying rules based on defined criteria that determine whether an investment is permissible”.

Essential elements:

- Applying rules

- Based on defined criteria
- That determine whether an investment is permissible.

Screening is a process for determining which investments are and aren't permitted in a portfolio. These rules can be set by clients, the investment team, regulators, or others – in any event, they are often subject to compliance oversight. Screens might include compliance requirements (i.e., fixing a set time period for selling any investments that cease to meet the screen criteria).

Screening strategies and criteria should be described in precise, plain language, and criteria should be consistently applied. This can be achieved by providing a definition that contains the distinguishing elements of the screen. Managers are also directed to the CFA Institute's "Global ESG Disclosure Standards for Investment Products", which includes criteria for disclosure regarding screens that are critical to a product's investment strategy or key characteristics.

BLG Commentary: The report's definition and guidance on screening is not materially different from the CSA's treatment of the concept in the ESG Staff Notice. Managers should ensure that the screening criteria are clearly and consistently defined in both the product's regulatory disclosure documents and any marketing materials. Additionally, if screening is used, that product's continuous disclosure should provide updates on the use of screens.

ESG integration

Definition: Ongoing consideration of ESG factors within an investment analysis and decision-making process with the aim to improve risk-adjusted returns.

Essential elements:

- Ongoing consideration of ESG factors
- Within an investment analysis and decision-making process
- With the aim to improve risk-adjusted returns

ESG factors are any qualitative or quantitative information pertaining to environmental, social, or governance topics. Because ESG integration is based on the belief that not all such factors are reflected in asset prices, it involves exploring information sources that provide insight into these factors. This requires identifying and assessing ESG risks and opportunities relevant to an investment as part of the mosaic of information used in the investment process, weighing that information, and making a decision about the investment. Consideration of ESG factors does not imply that there are restrictions on the universe of investible securities, that ESG factors are given more or less consideration than other factors, that all ESG factors are considered equally, or that the resulting portfolio will have any particular characteristics.

ESG factors can be considered in nearly every type of investment strategy and can be considered using numerous techniques at various stages. However, ESG Integration requires that ESG factors are considered during both the analytical and the decision-making components of the investment process: it must occur both when performing the

fundamental analysis of a security *and* when asset allocation or portfolio construction decisions are made. **Consideration of ESG factors outside of the investment analysis and decision-making components of the investment process is not ESG integration.**

ESG Integration does not preclude any investment activity but must be pursued with the aim to improve risk-adjusted returns. For this reason, only ESG factors that are material to risk and return need to be reflected in decision-making. As your BLG lawyer will often tell you, materiality needs to be assessed on a case-by-case basis; for ESG factors, it will depend on the fund's investment objectives, time horizon and the specifics of the investment.

Surprisingly, the report suggests that when communicating to general audiences, managers should avoid using the term "ESG integration" at all, due to its vagueness. Instead, it recommends using plain language to describe how ESG factors are considered in the investment process; if using the term is unavoidable, it should be clearly defined. It should not be used as an umbrella term for multiple approaches. Caution should be taken to avoid implying that the consideration of ESG factors will always deliver a higher risk-adjusted return.

BLG Commentary: The meaning of "ESG integration" has been a hot topic in the interpretation of the ESG Staff Notice, with earlier regulatory approaches conflating products that merely consider ESG information in the investment process, with products that have specific and targeted ESG-related investment strategies. To that end, the establishment of a clear definition is very much welcome, though the definition is somewhat different from how the term was used in the ESG Staff Notice. Specifically, the articulation that ESG factors are considered by investors as part of the "mosaic" of information used in the investment process is critical in establishing that ESG Integration is fundamentally different from other, more-involved ESG investment approaches. This is generally more consistent with the recently-developed regulatory concept of "ESG consideration" funds (i.e., where ESG factors are considered in an investment process, but may only play a limited role or may be only one of many inputs).

Thematic investing

Definition: selecting assets to access specified trends.

Essential elements:

- Selecting assets
- To access
- Specified trends

Thematic Investing is used by some investors to access specific trends they believe will shape the medium-to-long-term trajectory of the economy and result in higher returns on capital, while others seek to diversify their portfolio, hedge against specific risks, or to increase their association with certain trends. A thematic investor can focus on one trend, or several related trends. Trends tend to be medium-to-long-term in duration, regional or global in scope, and cross-cutting with respect to industry and sector

boundaries. Examples of ESG trends include climate change, renewable energy, and the shift to a more circular economy. However, thematic investing differs from constructing a portfolio with a particular focus – there must be a nexus to a specified trend or trends.

The report stresses that a "thematic investing" approach must be able to demonstrate (a) the trends that are considered when selecting assets, (b) how the assets in a portfolio are connected to those trends, and (c) how those trends relate to economic, technological, demographic, cultural, political, environmental, social and/or regulatory dynamics.

BLG Commentary: This definition is generally consistent with how "thematic investing" is used in the ESG Staff Notice. If a thematic investing approach is used for a product, we recommend that the related disclosure in the regulatory disclosure documents and marketing materials use plain and clear language to specifically identify and describe the trend(s) that the product seeks to access and how its holdings are connected to those trends.

Stewardship

Definition: The use of investor rights and influence to protect and enhance overall long-term value for clients and beneficiaries, including the common economic, social and environmental assets on which their interests depend.

Essential elements:

- The use of investor rights and influence;
- To protect and enhance overall long-term value for clients and beneficiaries, including the common economic, social and environmental assets on which their interests depend.

Investors have rights and other means of influencing the behaviour of investees and other parties, such as serving on boards or nominating directors, portfolio company engagement, litigation, or lobbying policymakers. Stewardship is using influence to protect and enhance overall value for clients and beneficiaries. "Overall value" can include a portfolio's market value, long-term value creation capabilities at a firm or macroeconomic level, and the common assets (including environmental, natural, and social assets) that underpin all economies.

The use of influence to promote short-term performance, or the performance of particular issuers, industries or markets without regard to overall value, does not constitute stewardship. The term "stewardship" shouldn't be used to refer to activities such as proxy voting or engagement, unless these actions are undertaken to protect and enhance overall value for clients and beneficiaries.

BLG Commentary: As the report notes, it is important not to conflate <u>all</u> attempts to influence the behaviour of portfolio companies or other parties with stewardship, unless the essential elements of the definition are met. The ESG Staff Notice references proxy voting and/or shareholder engagement as forming potential aspects of stewardship but

had not expressly required additional actions to constitute stewardship. It will be important for the regulators to be able to distinguish between simple proxy voting in compliance with the manager's fiduciary obligations to a fund, and a fund's use of proxy voting for the broader purpose of protecting and enhancing overall value.

Impact investing

Definition: Investing with the intention to generate positive, measurable social and/or environmental impact alongside a financial return.

Essential elements:

- Investing with the intention
- To generate
- Positive, measurable social and/or environmental impact
- Alongside a financial return.

The report's guidance states that the term "Impact Investing" should not be used unless there is an intention to generate a positive, measurable social and/or environmental impact, alongside a financial return. Additionally, the term should only be used when a portfolio manager can credibly identify its contributory/catalytic role in generating this impact. The guidance also refers investors to the CFA Institute's global ESG disclosure standards regarding impact investing.

The purpose of Impact Investing is to generate positive, measurable impacts by pursuing two distinct objectives: (a) an improvement in social and/or environmental conditions, and (b) a return on capital. **An intention to generate this impact, along with a financial return, does not guarantee these outcomes.**

The impacts of the investment approach must be measurable and require accounting for whether the intended improvements actually occur. Accounting can be based on generally-accepted metrics for measurement and management (such as IRIS+, published by the Global Impact Investing Network) or other metrics, such as those used by the Global Reporting Initiative (GRI) or the Future-Fit Business Benchmark.

BLG Commentary: Impact investing isn't philanthropy – it pursues a financial return in addition to a measurable, positive social or environmental impact. However, managers must have a clear conception of how the fund seeks to be a catalyst in generating positive change. This will enable better communication of the key aspects of its approach in a fund's regulatory disclosure documents and marketing materials. Regulators will expect to see reports on a fund's success in implementing an impact investing strategy in the fund's continuous disclosure documents (such as MRFPs), and managers should ensure that the standard by which the strategy's success is measured is disclosed in clear and plain language.

Key takeaways

- Key industry organizations have started to align on how ESG concepts are defined and interpreted, but these definitions and interpretations must be consistently used by industry in order for the investing public to benefit.
- It is important for managers to use plain, clear and consistent language when describing any of the defined terms, whether in regulatory disclosure documents or marketing materials.
- While the definitions and interpretations of the five Responsible Investment approaches set out in the report are mostly in line with how they have been understood by the CSA, Canadian regulators have not yet indicated that they accept or endorse these definitions, or that they will look to them for interpretive guidance. Until endorsed by the CSA, the defined terms and guidance in the report should be looked to as "best practice", whereas compliance with regulatory expectations is an ongoing obligation.

If you have any questions about this report, or would like assistance with incorporating the guidance into your fund's marketing materials or regulatory disclosure documents, please contact one of the authors or your usual BLG Investment Management lawyer.

For more information about ESG, please visit BLG's dedicated webpage on our ESG practice and expertise.

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