

# **MSCI ESG Focus Indexes Methodology**

August 2024

## Contents

<b>1. Introduction .....</b>	<b>3</b>
<b>2. Constructing the Indexes .....</b>	<b>4</b>
2.1 Defining the Underlying Universe .....	4
2.2 Defining the Exclusion Criteria .....	4
2.2.1 Controversial Business Involvement Criteria .....	4
2.2.2 Companies Involved in Red Flag ESG Controversies .....	4
2.3 Defining the Optimization Constraints .....	5
2.4 Determining the Optimized Index .....	5
2.5 Treatment of Unrated Companies .....	6
<b>3. Maintaining the Indexes .....</b>	<b>7</b>
3.1 Quarterly Index Reviews .....	7
3.2 Ongoing Event-Related Maintenance .....	7
<b>4. MSCI ESG Research .....</b>	<b>9</b>
4.1 MSCI ESG Ratings .....	9
4.2 MSCI ESG Controversies .....	9
4.3 MSCI ESG Business Involvement Screening Research .....	9
4.4 MSCI Climate Change Metrics .....	9
<b>Appendix I: Controversial Business Involvement Criteria .....</b>	<b>11</b>
<b>Appendix II: Optimization Constraints .....</b>	<b>13</b>
<b>Appendix III: Methodology Set .....</b>	<b>16</b>
<b>Appendix IV: Changes to this Document .....</b>	<b>17</b>

## 1. Introduction

The MSCI ESG Focus Indexes (the 'Indexes') are designed to maximize their exposure to positive environmental, social and governance (ESG) factors while exhibiting risk and return characteristics similar to those of the underlying market capitalization weighted index. The Indexes are constructed by selecting constituents of a market capitalization weighted index (the 'Parent Index') through an optimization process that aims to maximize exposure to ESG factors for a target tracking error budget under certain constraints.

The Indexes are sector-diversified and target companies with high ESG ratings in each sector. Companies involved in Tobacco, Controversial Weapons, Fossil Fuel Extraction and Thermal Coal Power are not eligible for inclusion in the Indexes<sup>1</sup>.

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<sup>1</sup> The Indexes are governed by a set of methodology and policy documents ("Methodology Set"), including the present index methodology document. Please refer to Appendix III for more details.

## 2. Constructing the Indexes

Constructing the Indexes involves the following steps:

- Defining the underlying universe
- Defining the exclusion criteria
- Defining the optimization constraints
- Determining the optimized portfolio

### 2.1 Defining the Underlying Universe

The underlying universe for the Indexes is defined by the constituents of the MSCI Global Investable Market Indexes ("GIMI").

### 2.2 Defining the Exclusion Criteria

The Indexes use company ratings and research provided by MSCI ESG Research<sup>2</sup> to determine eligibility for index inclusion.

#### 2.2.1 Controversial Business Involvement Criteria

The Indexes use MSCI ESG Business Involvement Screening Research and MSCI Climate Change Metrics to identify companies that are involved in the following business activities. Companies that meet the business involvement criteria are excluded from the Indexes. Please refer to Appendix I for details on these criteria.

- Controversial Weapons
- Tobacco
- Fossil Fuel Extraction
- Thermal Coal Power

#### 2.2.2 Companies Involved in Red Flag ESG Controversies

Companies assessed as having involvement in ESG controversies that are classified as Red Flags (MSCI ESG Controversy Score of 0) are excluded from the Indexes. A Red Flag indicates an ongoing Very Severe ESG controversy implicating a company directly through its actions, products, or operations.

<sup>2</sup> See section 4 for further information regarding ESG and climate data used in the Indexes that MSCI Limited and MSCI Deutschland GmbH source from MSCI ESG Research LLC, a separate subsidiary of MSCI Inc. MSCI ESG Research is solely responsible for the creation, determination and management of such data as a provider to MSCI Limited and MSCI Deutschland GmbH. MSCI Limited and MSCI Deutschland GmbH are the benchmark administrators for the MSCI indexes.

## 2.3 Defining the Optimization Constraints

Constituents are selected to maximize exposure to higher ESG scores, subject to maintaining risk and return characteristics similar to the Parent Index. ESG scores are normalized and used in the optimization process. Optimization maximizes the Index's exposure to ESG scores for a given predicted tracking error. The following predicted tracking error targets are used for the construction of the Indexes:

No.	ESG Focus Index	Parent Index	Predicted Tracking Error
1	MSCI EAFE ESG Focus Index	MSCI EAFE Index	0.5%
2	MSCI EM (Emerging Markets) ESG Focus Index	MSCI EM Index	1.0%
3	MSCI USA ESG Focus Index	MSCI USA Index	0.5%
4	MSCI World ESG Focus Index	MSCI World Index	0.5%
5	MSCI Taiwan ESG Focus Index	MSCI Taiwan Index	1.0%
6	MSCI ACWI ESG Focus Index	MSCI ACWI Index	0.5%
7	MSCI AC Asia ex Japan ESG Focus Index	MSCI AC Asia ex Japan Index	1.0%
8	MSCI ACWI ex USA ESG Focus Index	MSCI ACWI ex USA Index	0.5%
9	MSCI USA Small Cap ESG Focus Index	MSCI USA Small Cap Index	0.75%
10	MSCI Canada ESG Focus Index	MSCI Canada Index	2.5%

Optimization is a quantitative process that considers the market capitalization weights from the Parent Index, ESG scores and additional constraints to select and weight the constituents of the Index.

Normalization of the ESG scores allows the optimization process to assess each score in the context of the overall distribution of the ESG scores.

Please refer to Appendix II for the Optimization constraints.

## 2.4 Determining the Optimized Index

The Indexes are constructed using the Barra Open Optimizer in combination with the relevant Barra Equity Model. The optimization uses universe of eligible securities and the specified optimization objective and constraints to determine the constituents of the Indexes.

## 2.5 Treatment of Unrated Companies

Companies not assessed by MSCI ESG Research on data for any of the following MSCI ESG Research products are not eligible for inclusion in the Indexes:

- MSCI ESG Ratings
- MSCI ESG Controversies
- MSCI Business Involvement Screening Research (BISR)

## 3. Maintaining the Indexes

### 3.1 Quarterly Index Reviews

The Indexes are rebalanced on a quarterly basis to coincide with the regular Index Reviews in February, May, August and November of the MSCI Global Investable Market Indexes. The changes are implemented at the end of February, May, August and November. The pro forma indexes are in general announced nine business days before the effective date.

ESG scores used for the Quarterly Index Reviews will be taken as of the end of the month preceding the Index Review, i.e., January, April, July and October.

At each Index Review, the optimization process outlined in Section 2 is implemented. Companies can only be added to the Indexes only at regular Index Reviews.

In general, MSCI uses MSCI ESG Research data<sup>3</sup> (including MSCI ESG Ratings, MSCI ESG Controversies, MSCI ESG Business Involvement Screening Research, and MSCI Climate Change Metrics) as of the end of the month preceding the Index Reviews. For some securities, such data may not be published by MSCI ESG Research by the end of the month preceding the Index Review. For such securities, MSCI will use ESG data published after the end of month, when available.

### 3.2 Ongoing Event-Related Maintenance

The general treatment of corporate events in the Indexes aims to minimize turnover outside of Index Reviews. The methodology aims to appropriately represent an investor's participation in an event based on relevant deal terms and pre-event weighting of the index constituents that are involved. Further, changes in index market capitalization that occur as a result of corporate event implementation will be offset by a corresponding change in the Variable Weighting Factor (VWF) of the constituent.

Additionally, if the frequency of Index Reviews in the Parent Index is greater than the frequency of Index Reviews in the Indexes, the changes made to the Parent Index during intermediate Index Reviews will be neutralized in the Indexes.

The following section briefly describes the treatment of common corporate events within the Indexes.

No new securities will be added (except where noted below) to the Indexes between Index Reviews. Parent Index deletions will be reflected simultaneously.

#### EVENT TYPE

#### EVENT DETAILS

#### New additions to the Parent Index

A new security added to the parent index (such as IPO and other early inclusions) will not be added to the index.

#### Spin-Offs

All securities created as a result of the spin-off of an existing Index constituent will be added to the Index at the time of event implementation. Reevaluation for

<sup>3</sup> See section 4 for details of data sourced from MSCI ESG Research used in the Indexes.

continued inclusion in the Index will occur at the subsequent Index Review.

### **Merger/Acquisition**

For Mergers and Acquisitions, the acquirer's post event weight will account for the proportionate amount of shares involved in deal consideration, while cash proceeds will be invested across the Index.

If an existing Index constituent is acquired by a non-Index constituent, the existing constituent will be deleted from the Index and the acquiring non-constituent will not be added to the Index.

### **Changes in Security Characteristics**

A security will continue to be an Index constituent if there are changes in characteristics (country, sector, size segment, etc.) Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

Further detail and illustration regarding specific treatment of corporate events relevant to this Index can be found in the MSCI Corporate Events Methodology book under the sections detailing the treatment of events in Capped Weighted and Non-Market Capitalization Weighted indexes.

The MSCI Corporate Events methodology book is available at:  
<https://www.msci.com/index/methodology/latest/CE>.



## 4. MSCI ESG Research

The Indexes are products of MSCI Inc. that utilize information such as company ratings and research produced and provided by MSCI ESG Research LLC (MSCI ESG Research), a subsidiary of MSCI Inc. In particular, the Index uses the following MSCI ESG Research products: MSCI ESG Ratings, MSCI ESG Controversies, MSCI ESG Business Involvement Screening Research, and MSCI Climate Change Metrics. MSCI Indexes are administered by MSCI Limited and MSCI Deutschland GmbH.

### 4.1 MSCI ESG Ratings

MSCI ESG Ratings aim to measure entities' management of environmental, social and governance risks and opportunities. MSCI ESG Ratings use a weighted average key issue calculation that is normalized by industry to arrive at an industry-adjusted ESG score (0-10), which is then translated to a seven-point scale from 'AAA' to 'CCC', indicating how an entity manages relevant key issues relative to industry peers.

The MSCI ESG Ratings methodology can be found at: <https://www.msci.com/legal/disclosures/esg-disclosures>.

### 4.2 MSCI ESG Controversies

MSCI ESG Controversies provide assessments of controversies concerning the potential negative environmental, social, and/or governance impact of company operations, products and services. The evaluation framework used in MSCI ESG Controversies is designed to be consistent with international norms represented by the UN Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and the UN Global Compact. MSCI ESG Controversies Score falls on a 0-10 scale, with "0" being the most severe controversy.

The MSCI ESG Controversies methodology can be found at: <https://www.msci.com/legal/disclosures/esg-disclosures>.

### 4.3 MSCI ESG Business Involvement Screening Research

MSCI ESG Business Involvement Screening Research (BISR) aims to enable institutional investors to manage environmental, social and governance (ESG) standards and restrictions reliably and efficiently.

For more details on MSCI ESG Business Involvement Screening Research, please refer to <https://www.msci.com/legal/disclosures/esg-disclosures>.

### 4.4 MSCI Climate Change Metrics

MSCI Climate Change Metrics provide climate data & tools to support institutional investors seeking to integrate climate risk & opportunities into their investment strategy and processes. This includes investors seeking to achieve a range of objectives, including measuring and reporting on climate risk exposure, implementing low carbon and fossil fuel-free strategies, alignment with temperature pathways and factoring climate change research into their risk management processes, in particular through climate scenario analysis for both transition and physical risks.



The dataset spans across the four dimensions of a climate strategy: transition risks, green opportunities, physical risks and 1.5° alignment.

For more details on MSCI Climate Change Metrics, please refer to <https://www.msci.com/climate-solutions>.

## Appendix I: Controversial Business Involvement Criteria

### • Tobacco

Companies which meet the following Tobacco involvement criteria are excluded from the Indexes

- All companies classified as “Producer” or “Licensor”
- All companies classified as “Distributor”, “Retailer”, or “Supplier” that earn 15% or more of revenues from tobacco products
- All companies classified as “Ownership by a Tobacco Company” or “Ownership of a Tobacco Company”

### • Controversial Weapons

Companies which meet the following Controversial Weapons criteria are excluded from the Indexes

- Cluster Bombs  
MSCI ESG Research’s cluster bomb research identifies public companies that are involved in the production of cluster bombs and munitions, or the essential components of these products.
- Landmines  
MSCI ESG Research’s landmines research identifies public companies that are involved in the production of anti-personnel landmines, anti-vehicle landmines, or the essential components of these products.
- Depleted Uranium Weapons  
MSCI ESG Research’s depleted uranium weapons research identifies public companies involved in the production of depleted uranium weapons and armor.
- Chemical and Biological Weapons  
MSCI ESG Research’s chemical and biological weapons research identifies public companies that are involved in the production of chemical and biological weapons, or the essential components of these products.
- Blinding Laser Weapons  
MSCI ESG Research’s blinding laser weapons research identifies public companies that are involved in the production of weapons utilizing laser technology to cause permanent blindness.
- Non-Detectable Fragments  
MSCI ESG Research’s non-detectable fragments research identifies public companies that are involved in the production of weapons that use non-detectable fragments to inflict injury.
- Incendiary Weapons (White Phosphorus)  
MSCI ESG Research’s incendiary weapons research identifies companies that are involved in the production of weapons using white phosphorus.

#### Involvement criteria:

- Producers of the weapons
- Producers of key components of the weapons (only applies to cluster bombs, landmines, depleted uranium weapons as well as chemical and biological weapons)
- Ownership of 20% or more of a weapons or components producer

The minimum limit is raised to 50% for financial companies having an ownership in a company that manufactures controversial weapons or key components of controversial weapons

- Owned 50% or more by a company involved in weapons or components production

#### Revenue limits:

- Any identifiable revenues, i.e., zero tolerance

For details please refer to the MSCI Global ex Controversial Weapons Indexes Methodology at <https://www.msci.com/index/methodology/latest/XCW>

### • Fossil Fuel Extraction

- All companies deriving 5% or more aggregate revenue (either reported or estimated) from thermal coal mining and unconventional oil and gas extraction.
  - *Thermal Coal Mining:* Revenue from the mining of thermal coal (including lignite, bituminous, anthracite and steam coal) and its sale to external parties. It does not cover revenue from metallurgical coal; coal mined for internal power generation (e.g. in the case of vertically integrated power producers); intra-company sales of mined thermal coal; and revenue from coal trading
  - *Unconventional Oil & Gas Extraction:* Revenue from oil sands, oil shale (kerogen-rich deposits), shale gas, shale oil, coal seam gas, and coal bed methane. It does not cover all types of conventional oil and gas production including Arctic onshore/offshore, deep water, shallow water and other onshore/offshore.

### • Thermal Coal Power

- All companies deriving 5% or more revenue (either reported or estimated) from thermal coal-based power generation.

## Appendix II: Optimization Constraints

At each Quarterly Index Review, the following optimization constraints are used to ensure replicability and investability:

### Optimization Constraints

No.	Parameter	EAFE	EM	USA	WORLD	TAIWAN	ACWI
1	Predicted Tracking Error	0.5%	1.0%	0.5%	0.5%	1.0%	0.5%
2	Min Constituent Weight	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
3	Constituent Active Weight	+/-2%	+/-2%	+/-2%	+/-2%	+/-2%	+/-2%
4	Security Weight as a Multiple of its weight in the Parent Index	20	20	20	20	20	20
5	Active Sector Weights	+/-5%	+/-5%	+/-5%	+/-5%	+/-5%	+/-5%
6	Active Country Weights*	+/-5%	+/-5%		+/-5%		+/-5%
7	One Way Turnover during May and November Index Review	10%	10%	10%	10%	10%	10%
8	One Way Turnover during Feb and Aug Index Review	5%	5%	5%	5%	5%	5%
9	Specific Risk Aversion	0.075	0.075	0.075	0.075	0.075	0.075
10	Common Factor Risk Aversion	0.0075	0.0075	0.0075	0.0075	0.0075	0.0075

### Optimization Constraints (continued)

No.	Parameter	AC ASIA EX JP	ACWI EX USA	USA SMALL CAP	CANADA
1	Predicted Tracking Error	1.0%	0.5%	0.75%	2.5%
2	Min Constituent Weight	0.1%	0.1%	0.1%	0.1%
3	Constituent Active Weight	+/-2%	+/-2%	+/-2%	+/-2%
4	Security Weight as a Multiple of its weight in the Parent Index	20	20	20	20
5	Active Sector Weights	+/-5%	+/-5%	+/-5%	+/-5%
6	Active Country Weights*	+/-5%	+/-5%		
7	One Way Turnover during May and November Index Review	10%	10%	10%	10%
8	One Way Turnover during Feb and Aug Index Review	5%	5%	5%	5%
9	Specific Risk Aversion	0.075	0.075	0.075	0.075
10	Common Factor Risk Aversion	0.0075	0.0075	0.0075	0.0075

#### \* Active Country Weights:

- In case there are countries in the parent index which weigh less than 2.5% in the parent index then for such countries the active country upper bound of +5% is not applicable. When a country weighs less than 2.5% in parent index then the upper bound of country weight in the ESG Focus Index is set at three times of the country's weight in parent index.
- In case the upper bound on country weight is less than the minimum constituent weight constraints, then the upper bound of country weight is relaxed till it is above the minimum constituent weight constraint.
- The country weight constraint also applies on China A Stock Connect listings as a group separately in addition to the usual country weight constraint on China.

**Infeasible Solution** - During the Quarterly and Semi-Annual Index Reviews, in the event that there is no optimal solution that satisfies all the optimization constraints the following process is followed:

1. First, the turnover constraint is relaxed up to a maximum level of 30% in steps of 1% until an optimal solution is found.
2. If a feasible solution is not found in step 1, then the turnover constraint is reset to its original level and the predicted tracking error is relaxed by 0.1%.
3. If a feasible solution is not found in step 2, then the predicted tracking error is maintained at its level from step 2 and the turnover constraint is relaxed up to a maximum level of 30% in steps of 1% until an optimal solution is found.
4. If a feasible solution is not found in step 3, then steps 2 and 3 are repeated iteratively until an optimal solution is found. The predicted tracking error cannot exceed a maximum of 5 times of the original predicated tracking error.
5. In the event that a feasible solution is not found at the maximum predicted tracking error and turnover levels, the Index will not be rebalanced for that index review.

## Appendix III: Methodology Set

The Indexes are governed by a set of methodology and policy documents (“Methodology Set”), including the present index methodology document as mentioned below:

- Description of methodology set – <https://www.msci.com/index/methodology/latest/ReadMe>
- MSCI Corporate Events Methodology – <https://www.msci.com/index/methodology/latest/CE>
- MSCI Fundamental Data Methodology – <https://www.msci.com/index/methodology/latest/FundData>
- MSCI Index Calculation Methodology – <https://www.msci.com/index/methodology/latest/IndexCalc>
- MSCI Index Glossary of Terms – <https://www.msci.com/index/methodology/latest/IndexGlossary>
- MSCI Index Policies – <https://www.msci.com/index/methodology/latest/IndexPolicy>
- MSCI Global Industry Classification Standard (GICS) Methodology – <https://www.msci.com/index/methodology/latest/GICS>
- MSCI Global Investable Market Indexes Methodology – <https://www.msci.com/index/methodology/latest/GIMI>
- MSCI Global ex Controversial Weapons Indexes Methodology – <https://www.msci.com/index/methodology/latest/XCW>
- ESG Factors In Methodology\*

The Methodology Set for the Indexes can also be accessed from MSCI’s webpage <https://www.msci.com/index-methodology> in the section ‘Search Methodology by Index Name or Index Code’.

\* ‘ESG Factors in Methodology’ contains the list of environmental, social, and governance factors considered, and how they are applied in the methodology (e.g., selection, weighting or exclusion). It can be accessed in the Methodology Set as described above.



## Appendix IV: Changes to this Document

### The following sections have been modified as of August 2016:

Section 1: Introduction and other relevant sections

- To implement name change – Index name has been changed from ‘ESG Select’ to ‘ESG Focus’

Section 3.1, 3.3 and Appendix II:

- Added reference to ‘USA ESG Focus’ Index.

### The following sections have been modified as of June 2017:

- The details on the Corporate Events treatment are now included in Section 4.2.

### The following sections have been modified as of July 2017:

Section 3.1, 3.3 and Appendix II:

- Added reference to ‘MSCI World ESG Focus’ Index and ‘MSCI Taiwan ESG Focus’ Index.

### The following sections have been modified as of September 2017:

Section 4.1

- Clarification on use of ESG data for securities whose data would be available after the end of the month preceding Index Review.

### The following sections have been modified as of January 2018:

Appendix III

- Added details on optimization constraints for MSCI USA Small Cap Extended ESG Focus Index.

### The following sections have been modified as of March 2018:

Appendix III

- Added details on exclusion of producers and retailers of civilian firearms from the parent index.

### The following sections have been modified as of May 2018:

Appendix I

- Controversial Weapons Criteria - Updated to reflect the addition of new screens for blinding lasers, non-detectable fragments and incendiary weapons (while phosphorus)

Appendix III

- Updated to include reference to MSCI EAFE Extended ESG Focus Index, MSCI EM (Emerging Markets) Extended ESG Focus Index, MSCI USA Extended ESG Focus Index and MSCI USA Small Cap Extended ESG Focus Index
- Added clarification to explain index calculation at the February 2018 Quarterly Index Review.

### The following sections have been modified as of June 2018:

Section 3.1, 3.3

- Added reference to ACWI ESG Focus Index.

## Appendix I

- Added optimization constraints for ACWI ESG Focus Index.
- Added clarification on Active Country Weights.

### **The following sections have been modified as of February 2019:**

- Renamed “IVA Ratings” references to “ESG Ratings”
- Renamed “Impact Monitor Controversy Scores” to “ESG Controversies”

## Appendix III

- Added reference to Canada IMI ESG Extended Focus Index.
- Added optimization constraints for Canada IMI ESG Extended Focus Index.

### **The following sections have been modified as of May 2019:**

## Appendix II

- Updated to reflect the additional constraint on China A Stock Connect listings.

### **The following sections have been modified as of February 2020:**

## Appendix III

- Deleted the Appendix as the methodology for the MSCI Extended ESG Focus Indexes has been made available in a separate methodology book

### **The following sections have been modified as of November 2020:**

## Section 3.1: Defining the Underlying Universe

- Moved references to ‘Tobacco’ and ‘Controversial Weapons’ screens to new section 3.2.1
- Moved the list of Parent Indexes to section 3.3

## Section 3.2.1 (new): Controversial Business Involvement Criteria

- Added screens for ‘Fossil Fuel Extraction’ and ‘Thermal Coal Power’

## Section 3.3: Defining the Optimization Constraints

- Added four indexes

## Appendix I: Controversial Business Involvement Criteria

- Added screens for ‘Fossil Fuel Extraction’ and ‘Thermal Coal Power’

## Appendix II: Optimization Constraints

- Added four indexes

### **The following sections have been modified as of February 2021:**

## Appendix I: Controversial Business Involvement Criteria

- Corrected the ‘Fossil Fuel Extraction’ screen

**The following sections have been modified as of February 2022:**

Section 3.3: Defining the Optimization Constraints

Appendix II: Optimization Constraints

- Increased Canada ESG Focus tracking error constraint from 100 bps to 150 bps
- The following sections have been modified as of June 2022:**

Section 3.3: Defining the Optimization Constraints

- Increased Canada ESG Focus tracking error constraint from 150 bps to 250 bps

Appendix I: Controversial Business Involvement Criteria

- Corrected the 'Fossil Fuel Extraction' screen

Appendix II: Optimization Constraints

- Increased Canada ESG Focus tracking error constraint from 150 bps to 250 bps

**The following sections have been modified as of May 2023:**

Section 2.2.2: ESG Controversies Criteria

- Clarified the exclusion criteria for companies involved in ESG Controversies

Section 3: Maintaining the MSCI ESG Focus Indexes

- Methodology book was updated to reflect the transition of the MSCI Global Investable Market Indexes (GIMI) to Quarterly Comprehensive Index Reviews.
- All references to "Semi-Annual Index Reviews" and "Quarterly Index Reviews" of the MSCI GIMI were replaced with "Index Reviews."

Section 4: MSCI ESG Research

- Moved that section after the Section 3 (Maintaining the MSCI ESG Focus Indexes).
- Updated the descriptions of MSCI ESG Research products.

**The following sections have been modified as of January 2024:**

Section 2.5: Treatment of Unrated Companies

- New section replaced section 2.2.3 detailing the treatment of companies with ratings and research not available from MSCI ESG Research

Appendix III: Methodology Set

- Added details on the Methodology Set for the Indexes.

**The following sections have been modified as of February 2024:**

- Appendix II: Optimization Constraints
- Steps clarification for Infeasible Solution

**The following sections have been modified as of August 2024**

- Section 2.4: Added the treatment of companies when business involvement screening research is not available from MSCI ESG Research

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