

# **MSCI USA Broad ESG Index**

*Methodology*

**July 2010**

## 1. INTRODUCTION

The MSCI USA Broad ESG Index is a free float-adjusted market capitalization weighted index designed to provide exposure to companies that have high Environmental, Social and Governance (ESG) performance. The MSCI USA Broad ESG Index aims to target sector weights that reflect the relative sector weights of the underlying index to limit the systematic risk introduced by the ESG selection process.

Please refer to the Appendix for the description of the transition of the FTSE KLD US All Cap Sustainability Index to the MSCI USA Broad ESG Index.

## 2. ESG RESEARCH FRAMEWORK

MSCI's ESG research framework generates an analysis and rating of each company's management of its environmental, social and governance performance. The rating criteria address a company's ESG performance in the context of five categories, covering key corporate stakeholders.

- **Environment** – rate a company's management of its environmental challenges, including its effort to reduce or offset the impacts of its products and operations.
- **Community and Society** – measure how well a company manages its impact on the communities where it operates, including its treatment of local population, its handling of human rights issues and its commitment to philanthropic activities.
- **Employees and Supply Chain** – assess a company's record of managing employees, contractors and suppliers. Issues of particular interest include labor-management relations, anti-discrimination policies and practices, employee safety, and the labor rights of workers throughout the company's supply chain.
- **Customers** – measure the quality and safety record of a company's products, its marketing practices, and any involvement in regulatory or anti-competitive controversies.
- **Governance and Ethics** – address a company's investor relations and management practices, including company sustainability reporting, board accountability and business ethics policies and practices.

MSCI applies its proprietary ESG rating framework to each company by selecting the ESG rating criteria most relevant to each firm. To evaluate a company, analysts review more than 500 data points and score more than 100 indicators. MSCI expresses a company's ESG performance as a numerical score and on a letter-based rating scale. The ratings fall on a nine-point scale from AAA to C. Scores and ratings are not normalized across individual industries or the overall company universe. This means that one industry may have no companies that receive any "A" ratings, while another industry may have no companies with "C" ratings.

For more details on ESG scores and ratings, please refer to <http://www.kld.com/research/>

## 3. CONSTRUCTING THE MSCI USA BROAD ESG INDEX

### 3.1. Underlying Universe

The selection universe for the MSCI USA Broad ESG Index is defined by the constituents of the MSCI USA IMI Index.

### **3.2. Eligibility Criteria**

All constituents of the MSCI USA IMI Index having a company level rating of “B” or above are eligible for inclusion in the MSCI USA Broad ESG Index.

Companies for which a rating is not available are not eligible for inclusion in the MSCI USA Broad ESG Index.

### **3.3. Index Construction**

The MSCI USA Broad ESG Index targets 50% of the free float-adjusted market capitalization of each Global Industry Classification Standard (GICS®) sector of both the Standard size segment and the Small Cap size segment of the MSCI USA IMI Index.

## **4. MAINTAINING THE MSCI USA BROAD ESG INDEX**

### **4.1. Annual Index Review**

The MSCI USA Broad ESG Index is maintained with the objective of providing exposure to companies that have high ESG performance while seeking to achieve index stability. The composition of the MSCI USA Broad ESG Index is reviewed on an annual basis in May to coincide with the May Semi-Annual Index Review of the MSCI Global Investable Market Indices. The changes are implemented at the end of May. Ratings used for the annual index review are taken as of the end of April.

At the annual index review, the composition of the MSCI USA Broad ESG Index is reassessed in order to target 50% free float-adjusted cumulative market capitalization of each sector of both the Standard size segment and the Small Cap size segment of the MSCI USA IMI Index. For each sector in each size segment, the constituents of the underlying Index are first ranked based on the company level ESG Score and then by decreasing free float adjusted market capitalization.<sup>1</sup> Constituents for the ESG index are then selected in the following order till the 50% coverage by cumulative free float adjusted market capitalization target is reached

- Companies in the top 35%
- ‘A’ rated companies in the top 50%
- Current index constituents in the top 65%
- Remaining Companies in the eligible universe

The above rules are applied sequentially so the ESG index includes companies with high ESG performance, while minimizing turnover.

Any existing index constituent whose rating falls to “CCC” or lower is deleted from the MSCI USA Broad ESG Index.

### **4.2. Quarterly Index Reviews**

The MSCI USA Broad ESG Index is also reviewed on a quarterly basis to coincide with the regular Index Reviews (Semi-Annual Index Review in November and Quarterly Index Reviews in February and August) of the MSCI Global Investable Market Indices. The changes are implemented at the end of February, August and November. Ratings used for the quarterly index reviews will be taken as of the end of the month preceding the Index Review, i.e., October, January and July.

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<sup>1</sup> As a reminder, each company’s ESG performance is expressed as a numerical score and a corresponding letter rating.

At the quarterly index reviews, any existing index constituent whose rating falls to “CCC” or lower is deleted from the MSCI USA Broad ESG Index. Additions to the index are only considered in those sectors where the resulting free float adjusted market capitalization coverage does not meet the 50% target. Market price movements may cause small deviations in the sector coverage between two index reviews and so a buffer of 10% [or 5 percentage points] is used to define under-representation, in order to minimize turnover. Companies are added only in those sectors where the current market capitalization coverage is less than 45%, till the 50% target is reached. A company must have a rating of “B” or higher to be considered for addition to the index.

### 4.3. Ongoing Event-Related Maintenance

The MSCI Corporate Events Methodology is applied for the maintenance of the MSCI USA Broad ESG Index between Index Reviews. New additions to the MSCI USA IMI index due to corporate events will not be added simultaneously to the MSCI USA Broad ESG Index, but may be considered for inclusion at the following Index Review. However, companies deleted from the MSCI USA IMI index between Index Reviews are also deleted at the same time from the MSCI USA Broad ESG Index. The technical details relating to the handling of specific corporate event types can be found in the MSCI Corporate Events Methodology book available at: [http://www.msibarra.com/products/indices/international\\_equity\\_indices/gimi/stdindex/methodology.html](http://www.msibarra.com/products/indices/international_equity_indices/gimi/stdindex/methodology.html)

**Appendix: Transition**

The transition of the FTSE KLD US All Cap Sustainability Index to the MSCI USA Broad ESG Index will coincide with the MSCI August 2010 Index Review that will be implemented as of the close of business on August 31, 2010. The FTSE KLD US All Cap Sustainability Index has a target sector representation of 65%.

As a part of the transition, the target sector representation of the MSCI USA Broad ESG Index will be reduced from 65% to 50% of the parent index market capitalization to bring it in line with the design used for the MSCI World ESG Index. The reduction of the target sector representation from 65% to 50% will take place in four phases over the next four Index Reviews in order to minimize turnover.

The details of the transition plan are mentioned below:

<b>Index Review</b>	<b>Target Sector Representation</b>
August 2010	Hold at 65%
November 2010	60%
February 2011	55%
May 2011	50%

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