MSCI ESG Governance Metrics Methodology Summary Guide for Corporate Issuers

MSCI ESG Research LLC

ESG Issuer Communications

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Contents

INTRODUCTION

ESG Issuer Communications is the main point of contact for all companies in the MSCI ESG Research coverage universe. This guidance document provides a summary overview of the ESG Governance Metrics methodology, and a list of frequently asked questions about this methodology. For questions pertaining to other MSCI ESG Research reports, or our company interaction process in general, please refer to our General FAQ. This guidance will be updated periodically.

MSCI ESG GOVERNANCE METRICS OVERVIEW

MSCI ESG Governance Metrics provides corporate governance research and data on over 10,000 public companies worldwide. The assessment model is based on a set of unique metrics organized into four individual scoring key issues (ownership & control, board, pay and accounting).[1]

- **Ownership & Control**: The ownership structure of an issuer represents one of the most fundamental dimensions of governance risk. A clear understanding of the relative strengths and weaknesses of the various ownership models and control structures presented by issuers can help identify the most relevant governance concerns faced by investors. The most common principal-agent concerns are applicable primarily to widely held companies with highly dispersed ownership. For closely held companies, however, governance risk is more often a function of the identity and degree of control wielded by the company's dominant shareholders.
- **Board**: The Board key issue is scored primarily based on the board's independence from management, and on various measures of board skills and diversity, and overall board effectiveness. Negative impact governance-related events such as delisting threats or bankruptcies, securities litigation or regulatory investigations, or malfeasance or fraud involving individual executives or directors, are also included in this section. While not generally applicable to most companies, and thus not assigned a separate component ranking, such event-based metrics can have a significant impact on a company's overall governance scoring.

[1] For additional information please see the MSCI ESG Governance Metrics Methodology, available online via ESG Manager, or by request.

- **Pay**: CEO and other executive pay practices are evaluated for all companies, including, where disclosed, specific pay figures. Pay is scored primarily based on how well incentives have been linked to performance, and on levels of pay relative to peers, as well as specific key features of a company's overall pay plan design.
- **Accounting:** The Accounting key issue evaluates the consistency and transparency of a company's reported financials as they pertain to the company's governance, and as an indicator of potential accounting risk. The Accounting key issue focuses on the following key areas of concern:
    - ***Accounting Risks*** - Three categories of accounting risk form the basis of this portion of the Accounting key issue assessment: Revenue Recognition, Expense Recognition and Asset-Liability Valuation This assessment is based on a purely quantitative, statistical analysis of underlying accounting ratios.
    - ***Accounting Events*** – The Accounting key issue also takes into consideration certain negative-impact events, including late filings, accounting investigations, auditor report or internal control concerns and various types of restatements and special charges.

SCORING PROCESS

The Governance Metrics Corporate Governance score is an absolute assessment of a company's governance strength or weakness, using a 0-10 point scoring scale. Each company starts with a "perfect 10" overall score, to which scoring deductions are applied based on the assessment of a proprietary set of individual key metrics, which are organized into four key issues (Ownership & Control, Board, Pay and Accounting).

Similarly calculated 0-10 scores are also provided for each of these four key issues but these scores are calculated independently of the overall Corporate Governance Score, which is based on the total number of scoring deductions for all four key issues, as shown in the scoring deductions table provided in each company's report.

The corporate governance scoring process is fully automated and applied consistently to all companies. Input data is collected and reviewed on an ongoing basis throughout the year, automatically updating the key metrics that drive our overall assessments and scores. Data flows into the model are subject to different timings, depending on the nature of the data, but are generally well-aligned with corporate disclosure and news.

FREQUENTLY ASKED QUESTIONS

BOARD

1. What are MSCI ESG Research's director overboarding standards?

MSCI ESG Research's criteria may be stricter than local regulatory requirements or a company's own definition. Per MSCI ESG Research methodology, there are two standards:

An **executive director** is considered over-boarded if he/she serve on a total of three or more boards (including the rated company) of companies included in the MSCI ESG Research coverage universe, including both equity and debt issuers.

A **non-executive director** is considered over-boarded if he/she serves on a total of four or more boards (including the rated company) of companies included in the MSCI ESG Research coverage universe, including both equity and debt issuers.

2. What is the process and criteria used to determine whether a director's prior board service raises concerns regarding a current's board integrity? Does this key metric have an expiration date?

The Board Integrity key metric identifies directors whose prior board service includes a company that was involved in a corporate bankruptcy or other major loss of shareholder value. Directors are only flagged if their board service began at least one full year prior to the triggering event. This key metric does not have an expiration date.

3. What criteria is used to determine if a board is considered entrenched?

There are four different scenarios which trigger this key metric.

- More than 35% of the board has a tenure greater than 15 years;
- More than 22% of the board has a tenure greater than 15 years and more than 15% of the directors are over 70;

- There are more than four directors whose tenure is greater than 15 years;
- There are more than four directors who are over 70.

4. Our company has had a majority voting policy in place for several years. Why is the company still flagged for this?

MSCI ESG Research has a strict standard for majority voting policies in director elections that flag plurality, plurality plus resignation and majority plus resignation standards as falling short of MSCI's minimum standards, which require that a director who does not receive a majority of votes cast depart from the board immediately.

5. What is the required threshold and relevant time period that results in the flagging of the "Significant votes against directors" key metric? What is considered "significant"?

This key metric is flagged if one or more directors receive a "negative" or "withheld" shareholder vote equal to or in excess of 10% at the most recently reported election by a company (or in certain markets on the discharge of the directors). A "negative vote" includes against, withhold or abstain votes.

6. What is the process and criteria used to determine whether a director is considered an industry expert?

In general, a board member's biography must disclose that they are a company executive, or an executive at another company with the same Global Industry Classification Standard (GICS) industry code.

7. What is the process and criteria used to determine whether a director is considered a financial expert?

In general, a board member's biography must disclose that they have financial or accounting expertise. MSCI ESG Research looks for designations such as CFO, CPA, etc., and also reviews the director's previous and current positions and duties.

8. What is the process and criteria used to determine whether a director has risk management experience?

In general, a board's member prior experience must include a specific reference to risk management in the director's published bio. See general criteria below:

- ***Risk Officer/Manager*** - Public or Private Company or a Division/Subsidiary of such firm
- ***Executive with Risk Management*** - (such as CFO, Managing Director) tasked with specific Risk Management duties
- ***Insurance Company CEO***
- ***Risk Consultant*** - Principal, Executive or Partner or Consultant in a risk consulting firm or practice
- ***Public Sector Risk Management***
- ***Risk Academic***
- ***Executive Level Risk Committee Member*** - this must not be a Board Level committee, but rather a committee that operationally manages risks at the executive level

Professions Not Acceptable as Sole Consideration:

- CEO or CFO, in general
- Membership on a board level risk committee or risk subcommittee of another company
- Membership on an advisory risk committee of a profit or non-profit organization
- Senior military positions and senior political positions
- Professorships in business, finance, or economics
- Director described as having risk expertise or who is described as a 'risk consultant'
- Executive-level position in accounting

9. What is the process used to determine the director or executive's age?

The director or executive's age is based on the date of birth as per company disclosure. If only the birth year is provided, the default birth date is the first of January. If only the individual's age is disclosed, the document's publication year is used to determine and assign an estimated year of birth.

10. Director independence – can you share more information for the criteria in assessing non-executive director independence? Specifically:

- *What are your criteria in assessing the independence of non-executive directors who have been appointed by specific shareholders?*

Non-executive directors who sit on the board as shareholder appointees are marked as **not** Independent of Other Interests (special shareholder representatives). These individuals remain Independent of Management unless the shareholder being represented holds 30% or more voting rights in the company **and** the non-executive director has either effective control of or is an executive of that same majority shareholder.

- *What are the criteria used in assessing the independence of former executives?*

A "cooling-off" period is not applied to former executives. They remain permanently non-independent, per MSCI Governance Metrics methodology.

- *What are the criteria used for assessing directors as non-independent due to issuer assessment?*

This criteria is used for cases when the company classifies the director as non-independent of management's interests but does not disclose a specific reason for such classification.

- *How are employee representatives assessed for independence?*

Employee representatives are assessed as Independent of Management but not Independent of Other Interests. In the assessment of key metrics relating to board and committee independence they are therefore considered to be independent. For the Board Chair and Lead Independent Director key metrics, however, they are assessed as not independent.

11. Why is our company flagged for "leadership concerns"? What is the issue of concern?

This key metric is flagged when there are concerns that a leader has extraordinary influence over a board. This includes situations where, for example (but this is not an exhaustive list):

- an Executive Chairman serves alongside a CEO,

- the Chairman is a former CEO or CFO,
- the Founder remains on the Board but not as Chair or CEO, or
- There are unregistered directors providing leadership direction.

12. Do two-tier boards score lower? What if this structure is mandated by local corporate law?

Our methodology does not penalize two-tier boards, which are common in Germany, Austria, Netherlands, Poland and France. Our scoring methodology is explicitly designed to provide a fair comparison between companies regardless of home market standards.

PAY

13. What criteria is used to establish peer groups, and how often are they re-evaluated?

The Pay Peer Groups are utilized in certain key metrics for comparative and benchmarking purposes. These groupings are regenerated every quarter, and companies are assigned to a Pay Peer Group based on three criteria:

1. Industry;
2. Market Capitalization; and
3. Peer Market.

Industry: This is determined based on the company's GICS Industry classification.

Market Capitalization: This is based on the following size references:

	Developed Markets	Emerging Markets
Large Cap	>=USD 10.901 billion	>=USD 5.45 billion
Mid Cap	>=USD 4.04 billion and <USD 10.901 billion	>=USD 2.02 billion and <USD 5.45 billion
Small Cap	>=USD 342 million and <USD 4.04 billion	>=USD 171 million and <USD 2.02 billion
Micro Cap	<USD 342 million	<USD 171 million

Size references are updated annually.

Peer Market: This divides companies into one of three regional peers on the basis of their Home Market designation:

- Developed Americas;
- Other Developed Markets; and
- Emerging Markets.

14. Severance vesting – does this key metric include unvested equity awards, still eligible for vesting upon a CEO's termination, that were awarded pursuant to double–trigger termination provisions?

Yes – this key metric is flagged if upon the termination of the CEO's employment there are unvested equity awards which would then become eligible for vesting.

15. "Significant votes against pay practices". What is the required threshold and relevant time period that results in the flagging of this key metric? What is considered "significant"?

This key metric is flagged if the company's pay policies and/or practices received a "negative" or "withheld" shareholder vote equal to or in excess of 10% at the company's most recently reported election. A "negative vote" includes against, withhold or abstain votes.

16. Flag for executive pay non-disclosure. We disclose aggregate pay data in our public reporting. Why does the report state that we fail to disclose this?

Per the MSCI Governance Metrics methodology, we are seeking granular disclosure of individual pay components, including: salary, short-term incentives, long-term incentives, pensions, other miscellaneous benefits such as perquisites and any one-off payments (e.g. retention awards), for the company's CEO, and for each executive member of the board of directors. The reporting of aggregate totals alone does not meet this standard.

17. What does "fraudulent" mean under clawback policy in the ESG governance metrics assessment/corporate governance key issue?

With respect to clawback types, pursuant to MSCI Governance Metrics methodology, "fraudulent" is taken to mean that the clawback policy can only be applied to individuals who were found responsible for the actions that resulted in a material restatement. Performance-linked clawback policies are considered to be stronger, per MSCI's standards because they give the board the discretion needed to recoup awards given to an individual regardless of whether they were personally involved.

18. Can you explain the "pay linked to sustainability" key metric?

This key metric was added to the MSCI Governance Metrics model in early 2018. It is flagged if a company is considered to have either a high environmental or social impact (due to having greater than a 5% weight on designated ESG Ratings Key Issues) and has not adopted links to sustainability performance in its current incentive pay policies.

This key metric is based on a review of the company's variable pay performance metrics for the inclusion of one or more sustainability-linked performance metrics. In general, the analyst team looks for publicly reported evidence of one of the performance measures disclosed in the compensation report for either the annual or long-term incentive plans being a metric that links directly to sustainability performance.

OWNERSHIP & CONTROL

19. We are fully compliant with local laws/requirements in this area and believe our governance systems are in-line with local market expectations. MSCI ESG Research's governance assessment does not appear to reflect this reality and flags us for various practices that we do not feel are relevant or correct.

Our corporate governance assessments are designed to highlight governance risks that investors are potentially exposed to when they invest. Our scoring methodology is more than a simple, "check-the-box" compliance exercise, and is intended to be globally applied, as many large institutional investor portfolios hold large numbers of regionally- and industry-diverse companies. It is intended to identify outliers on various governance risk factors that go beyond company practices alone, and may even fall outside of the company's direct control. For example, this might include:

- Market-specific ownership structure limitations (not something the company can control)

- The quality of local regulations (not something the company can control).
- Peer performance, as part of our pay and accounting risk assessments (not something the company can necessarily control)
- The track record of individuals on the board (including their performance at other companies)

Please note that the above examples are for illustrative purposes and should not be considered an exhaustive list.

20. MSCI governance data appear to be out-of-date or erroneous, particularly on board/director information. What is the process used to update the company's board composition?

MSCI may conduct multiple governance data updates throughout the year, including: 1) an annual review which is generally published before the company's annual general meeting; 2) voting result updates that reflect post-AGM director changes (typically updated in the second half of the calendar year); and 3) ad-hoc board updates to reflect board movements that are reported by third-party news sources and company filings, specifically 8-Ks (Items 5.02 and 5.07) that are automatically fed to our queue for review.

21. Our largest shareholder does not hold more than 50% of the voting rights. Why is there a flag for having a controlling shareholder?

Pursuant to MSCI Governance Metrics methodology, the voting rights threshold to be considered a controlling shareholder is 30% or more. There is, however, no scoring deduction for the Controlling Shareholder key metric at either level.

ESG GOVERNANCE METRICS AND ESG RATINGS:

Please note that corporate governance data updates are made independently from our annual ESG Ratings updates. At the time of the annual ESG Ratings update, the ratings analyst team references whatever governance data is available at that time. Any subsequent changes/updates flow directly to the respective assessment(s).

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