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Consultation on a Proposed Enhanced MSCI KLD 400 Social Index Methodology

February 2012

Executive Summary

- MSCI started maintaining the MSCI KLD 400 Social Index along with the other MSCI ESG Indices post their transition in September 2010. It was then announced that MSCI would review the index methodology in the future.
- MSCI now proposes an objective and transparent methodology for the MSCI KLD 400 Social Index based on MSCI's new suite of ESG products on ESG Manager, while keeping the philosophy underpinning the index unchanged.
- MSCI proposes to use a combination of three MSCI ESG products for the purpose of index creation – IVA ratings for overall best-of-class ESG company performance, Impact Monitor scores for identifying highly controversial company practices and ESG Screener for excluding companies that fail the values based exclusion screens.
- These proposals are similar to the enhanced methodology proposal for the MSCI Global ESG Indices, on which MSCI is currently consulting with clients.*
- In addition, MSCI also proposes the following changes to the existing MSCI KLD 400 Social Index methodology, and is seeking feedback on these proposed additional enhancements.
 - Results of the Index Review to be announced nine days before the effective date (currently announced only five days before the effective date).
 - ESG ratings used for the Index Reviews will be taken as of the last calendar day of the month preceding the Index Review, i.e., January, April, July and October. Securities which do not have a rating by a given cutoff date will not be considered eligible for the Index Review.
- MSCI proposes to transition to the enhanced methodology along with the transition of the MSCI Global ESG Indices, over multiple index reviews
- Please note this consultation may or may not lead to the adoption, in whole or in part, of the proposed enhancements described herein.

* The consultation document describing these proposed enhancements in detail is available on the MSCI web site at <http://www.msci.com/products/indices/consultations/>

Current MSCI KLD 400 Social Index Methodology

- MSCI KLD 400 Social Index is a free float-adjusted market capitalization index designed to provide exposure to U.S. companies that have positive Environmental, Social and Governance (ESG) characteristics.
- The Index excludes companies with involvement in alcohol, gambling, tobacco, firearms, weapons and nuclear power.
- The Index is composed of 400 securities with high ESG performance along with the considerations of size and sector representation.
- The index is reviewed on a quarterly basis to coincide with the Semi-Annual Index Reviews in May and November and Quarterly Index Reviews in February and August.
- At each Quarterly Index Review (QIR):
 - Current index constituents are reviewed to determine if any of them should be removed due to ESG performance
 - If a constituent is removed from the MSCI USA IMI as a result of the Index Review, it is simultaneously removed from the MSCI KLD 400 Social Index
 - The deleted securities are replaced with eligible securities taking into account size and sector representation
 - The MSCI KLD 400 Social Index is restored to 400 securities at each Index Review
- The rebalancing results are announced five days before the effective date through Integrated Client File (ICF) and a Global Summary Document.

Proposal for Enhanced Methodology

The proposed methodology for the MSCI KLD 400 Index is based on the following principles, in line with the current index philosophy:

- Parent Index
 - The selection universe for the MSCI KLD 400 Social Index will be MSCI USA IMI ESG Index. The MSCI USA IMI ESG Index is designed to provide exposure to companies that have high ESG performance by targeting the top 50% companies by ESG rating within each sector
- Positive exposure to superior ESG rated companies
 - Use IVA ratings to identify companies with superior ESG performance
 - Use values based exclusion screens as in the current methodology with further refinements (as detailed in the Appendix)
 - Exclude companies having involvement in specific ESG controversies as identified by Impact Monitor
- Sector representation
 - Target relative sector weights of +/- 25% with respect to MSCI USA to align sector weights
- Size representation
 - Target a minimum count of 200 standard segment companies

Proposal for Enhanced Methodology

The composition of the MSCI KLD 400 Social Index is reviewed on a quarterly basis. The proposed deletion and addition criteria at every QIR are as follows:

- Deletion criteria at QIRs
 - Companies that are deleted from the MSCI USA IMI ESG Index (at that QIR)
 - Companies that fail the values based exclusion screens
 - Companies whose IVA rating drops to B or below
 - Companies having Impact Monitor controversy assessment of very severe (Impact Monitor score of 0 or 1)
 - Companies from overweight sectors (starting with lowest IVA rated company) until the relative sector weights are within band

- Companies eligible for addition
 - Constituents of MSCI USA IMI ESG Index
 - Companies that pass the values based exclusion screens
 - Companies with IVA rating of BBB or above
 - Companies having Impact Monitor score of 3 or above

Proposal for Enhanced Methodology

At every index review, after reflecting all the deletions, additions will be made to the MSCI KLD 400 Social Index in order to restore the number of index constituents to 400. The additions to the index will be based on ESG performance, sector alignment and size representation.

Standard segment:

- Add all companies having IVA rating of AAA, irrespective of sector weight
- Add companies (in order of their IVA scores) to sectors where the relative sector weights are below the lower threshold (-25%). The sector weights will be recalculated after every addition
- Once relative sector weights of all sectors are above the lower threshold or no further companies are available for addition in these sectors, companies will be added sequentially based on their IVA scores. The sector weights will be recalculated after every addition
- No companies will be added to a sector if it reaches the upper threshold of +25%
- A minimum count of 200 securities will be maintained to ensure appropriate size representation
- While adding companies to the same sector, preference will be given to companies having higher IVA score. In case there are multiple companies with the same IVA score, one with higher free float-adjusted market capitalization will be added first

Small Cap segment:

- Add companies based on their IVA score. In case of a tie, add to the most underweight sector

Transition Proposal

- MSCI proposes to transition to the enhanced methodology, along with the transition of the MSCI Global ESG Indices, over multiple index reviews (i.e. in two phases)
 - Standard Segment
 - In the first phase, all existing constituents currently rated “B” or below will be deleted from the index, starting with the most overweight sectors*, over multiple index reviews
 - This will result in a total of 35 deletions with a weight of 8.7% in the current index**
 - In the second phase, all constituents that are not part of the pro forma MSCI USA IMI ESG Index will be deleted from the index, starting with the most overweight sectors, over multiple index reviews
 - This will result in a total of 22 deletions with a weight of 12.6% in the current index***
 - Small cap segment
 - Will follow a transition plan along similar lines as the standard segment
- At each index review, other deletions and additions will be made to the index in line with the proposed methodology, to restore the number of securities to 400

* As long as the rating remains “B” or below at the time of the deletion

** Based on data as of close of November 30, 2011

*** These deletions are based on the pro forma MSCI USA IMI ESG Index constructed using the enhanced methodology

Proposed Top Deletions*

Security Name	Sector	GS Rating	IVA Rating	Impact Monitor	Impact Monitor Score	Current weight
Microsoft Corp	Information Technology	BBB	A	Yellow	2	3.8%
Qualcomm	Information Technology	BBB	A	Yellow	3	1.8%
Disney (Walt)	Consumer Discretionary	BB	BB	Yellow	2	1.2%
Home Depot	Consumer Discretionary	BB	B	Yellow	2	1.1%
Amgen	Health Care	A	B	Yellow	3	1.0%
Cvs/caremark	Consumer Staples	BBB	BB	Yellow	2	1.0%
Costco Wholesale Corp	Consumer Staples	BBB	A	Yellow	2	0.7%
eBay	Information Technology	BBB	BBB	Yellow	2	0.7%
Baxter International	Health Care	A	B	Yellow	2	0.6%
Lowe's Cos	Consumer Discretionary	A	B	Green	5	0.6%
Walgreen Co	Consumer Staples	BB	B	Yellow	2	0.6%
Biogen Idec	Health Care	A	BB	Yellow	4	0.5%
Automatic Data Process	Information Technology	BBB	BBB	Green	10	0.5%
Corning	Information Technology	A	A	Green	5	0.5%
Johnson Controls	Consumer Discretionary	AA	B	Yellow	3	0.4%
Illinois Tool Works	Industrials	BB	B	Yellow	4	0.4%
McKesson Corp	Health Care	A	B	Yellow	2	0.4%
Thermo Fisher Scientific	Health Care	BBB	BB	Green	5	0.4%
Intuitive Surgical	Health Care	BBB	B	Green	10	0.3%
Netapp	Information Technology	BBB	B	Green	5	0.3%

* Includes deletions from both phases, as described in the transition proposal

Proposed Top Additions*

Security Name	Sector	IVA Rating	Impact Monitor	Impact Monitor Score	Proforma weight
Viacom B (New)	Consumer Discretionary	BBB	Yellow	4	0.52%
Centurylink	Telecommunication Services	BBB	Green	5	0.51%
Cognizant Tech Solutions	Information Technology	BBB	Green	5	0.46%
Time Warner Cable	Consumer Discretionary	A	Yellow	4	0.43%
Equity Residential	Financials	BBB	Green	5	0.37%
Marsh & McLennan Cos	Financials	BBB	Yellow	4	0.36%
Hcp	Financials	BBB	Green	10	0.34%
Intuit	Information Technology	A	Green	8	0.34%
Motorola Solutions	Information Technology	AA	Yellow	3	0.31%
Paccar	Industrials	BBB	Green	5	0.29%
Macy's	Consumer Discretionary	BBB	Yellow	3	0.29%
Kroger Co	Consumer Staples	A	Yellow	3	0.28%
Avalonbay Communities	Financials	BBB	Green	5	0.26%
Int'l Paper Co	Materials	BBB	Yellow	3	0.26%
O'reilly Automotive	Consumer Discretionary	BBB	Green	5	0.23%
Cliffs Natural Resources	Materials	BBB	Green	5	0.23%
Dover Corp	Industrials	A	Green	8	0.23%
Conagra Foods	Consumer Staples	A	Yellow	4	0.23%
Fluor Corp	Industrials	AA	Yellow	3	0.21%
Bunge	Consumer Staples	A	Yellow	3	0.20%

* Includes additions from both phases, as described in the transition proposal

Discussion Points

- Is it helpful to move the announcement of rebalancing results from five days to nine days?
- Is the selection of MSCI USA IMI ESG as the selection universe appropriate?
- Are the IVA rating thresholds for the deletions (B or below) and additions (BBB or above) appropriate?
- Is the application of a higher Impact Monitor controversy assessment of very severe or severe for non index constituents appropriate?
- Are the thresholds for relative sector weights (+/- 25%) appropriate?
- Is the floor on the number of standard segment companies (200) adequate?
- What would be the appropriate timeline for the transition?
- Is the deletion of existing constituents that are “B” rated, or are not part of the MSCI USA IMI ESG Index appropriate?

Appendix

Proposed Enhanced Values based exclusion screens

	Current	Proposed
<u>Adult Entertainment</u>		<ul style="list-style-type: none"> All companies classified as “Producer” that earn 5% or more of revenue from adult entertainment activities All “Producers” that earn USD \$500 million in revenue from adult entertainment activities
<u>Alcohol</u>	<ul style="list-style-type: none"> Producers: any involvement 	<ul style="list-style-type: none"> All companies classified as “Producers” that earn 5% or more of total revenues from alcohol-related activities All “Producers” that earn USD \$500 million in revenue from alcohol
<u>Civilian Firearms</u>	<ul style="list-style-type: none"> Producers: any involvement 	<ul style="list-style-type: none"> All companies classified as “Producers” that earn 5% or more of total revenue from firearms All “Producers” that earn USD \$500 million in revenue from firearms All companies classified as “Retailers” that earn 15% or more of revenues from civilian firearms
<u>Gambling</u>	<ul style="list-style-type: none"> Owner/operators of gambling facilities Suppliers of key products: >50% or major player 	<ul style="list-style-type: none"> All companies classified as “Operations” or “Support” that earn 5% or more of revenues from gambling-related activities All “Operations” and “Support” companies that earn USD \$500 million in revenue from gambling
<u>Nuclear Power</u>	<ul style="list-style-type: none"> Owner/operator: any level Design nuclear reactors Uranium Mining 	<ul style="list-style-type: none"> All companies classified as “Utility”, “Uranium Mining”, “Nuclear Reactor Construction/Design” or “Fuel Enrichment” All companies classified as “Essential Supplier” that earn 15% or more of revenues from nuclear-related activities
<u>Tobacco</u>	<ul style="list-style-type: none"> Producers: any involvement 	<ul style="list-style-type: none"> All companies classified as “Producer” All companies classified as “Distributor”, “Retailer”, or “Supplier” that earn 15% or more of revenues from tobacco products
<u>Weapons</u>	<ul style="list-style-type: none"> Controversial Weapons (NBC): any involvement Conventional Weapons and key component parts: 2% or \$50 million 	<ul style="list-style-type: none"> All companies classified as “Nuclear Weapons Systems”, “Nuclear Weapons Components”, “Chemical/Biological Weapons Systems”, “Chemical/Biological Weapons Components”, “Depleted Uranium Manufacturer”, “Cluster Bomb Manufacturer”, or “Landmine Manufacturer” All companies that earn 5% or more of revenue from weapons-related products or services All companies that earn USD \$500 million in revenue from weapons-related products or services

MSCI KLD 400 Social Index – Historical Turnover

MSCI KLD 400 Social Index

Index Review	# Additions	# Deletions	Turnover
Nov 2011	6	3	1.4%
Aug 2011	9	4	1.2%
May 2011	14	8	3.6%
Feb 2011	1	0	0.5%
Nov 2010	8	7	3.7%
Aug 2010	2	2	2.1%

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