

A Proposed Mapping to Key Article 6 / 8 / 9 Distinctions - Framework based on MSCI Client Feedback

OVERVIEW AND ANALYSIS OF MSCI ESG INDEXES
BASED ON A SET OF ASSUMPTIONS DISCUSSED
WITH INVESTORS

March 2021

Introduction

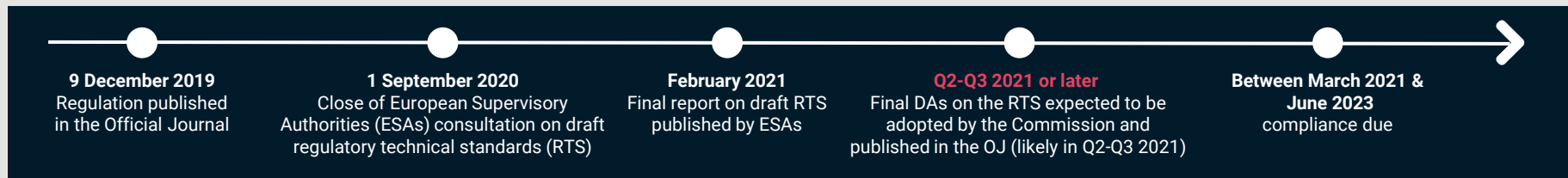
- As part of the EU Financing Sustainable Growth Action Plan, the EU Sustainable Finance Disclosure Regulation (SFDR) was established to **lay down harmonized rules for financial market participants and financial advisers on transparency** with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products.
- Apart from the disclosure requirements, **funds promoted as ESG are required to classify as being Article 8 or 9 products**, depending on whether they meet the requirements for either classification, with Article 9 taking on more restrictive criteria.
- This deck lays out **a proposed mapping to key Article 6, 8, and 9 distinctions, which includes an overview of select MSCI ESG Indexes and how they compare against a set of assumptions** based on MSCI analysis and inputs from industry participants who were involved in MSCI's client engagement initiatives. This deck has been updated to reflect the Joint ESA's Final Report on the draft Regulatory Technical Standards (RTS) regarding the disclosure requirements of the SFDR dated February 2, 2021.

Disclaimer

The information found on this deck is provided to help guide thinking around the approach for Article 6, 8 and 9 products under the EU Sustainable Finance Disclosure Regulation (SFDR). The information is provided “as is” and does not constitute legal advice or binding interpretations of the SFDR. MSCI’s proposed approach to the key SFDR distinctions are based on assumptions and client feedback as explained in this deck. Any designations of your Article 6, 8, and/or 9 products and interpretations of key SFDR distinctions/terms are the responsibility of financial market participants and should be discussed with your own legal counsel and your national competent authority as needed..

Sustainable Finance Disclosure Regulation (SFDR)

Entity Level*		Product Level*
Financial market participants** (FMPs) must disclose:	Financial advisors must disclose:	FMPs must disclose:
<p>On their websites,</p> <ul style="list-style-type: none"> Information on the integration of sustainability risks in their investment decision-making process (and if not relevant, why) When “principal adverse sustainability impacts” are being considered, statements with their due diligence policies (and if not relevant, why) (Compulsory for firms with 500+ employees) Principal adverse impacts statement (Annex I) <p>In pre-contractual disclosures (and if not relevant, why):</p> <ul style="list-style-type: none"> Manner in which sustainability risks are integrated into their investment decisions Likely impacts of sustainability risks on the returns of the financial products 	<p>On their websites, information on integration of sustainability risks (including principal adverse sustainability impacts) in their investment advice or insurance advice on their websites (and if not relevant, why)</p> <p>In pre-contractual disclosures (and if not relevant, why):</p> <ul style="list-style-type: none"> How sustainability risks are integrated into their investment or insurance advice The result of the assessment of the likely impacts of sustainability risks on the returns of the financial products 	<p>On their website, information on products pursuing sustainable objectives (Article 9 products) or promoting E&S characteristics (Article 8 products)</p> <p>In periodic reports (e.g., annual reports) information how sustainable objectives or E&S characteristics are met (Also note requirements + separate timing on principal adverse sustainability impacts)</p>



This is provided for informational purposes only and does not constitute legal advice. Timetables may change according to the EU legislative process.

*Principles-based disclosures were due starting March 10, 2021; prescriptive disclosures (e.g. principal adverse impact statement/product templates) as well as the reference period starts January 1, 2022 with the first reporting due in June 2023

**e.g. AIFMs; investment firms providing portfolio management; institutions for occupational retirement provision; and UCITS management companies.

Rationale for the Framework

- Following the publication of the SFDR draft regulatory technical standards (RTS), MSCI conducted a series of client engagement initiatives:
 - Four workshops in August 2020 attended by 66 clients mostly based in EMEA.
 - One-on-one discussions with key ESG / ESG index clients in the second half of 2020
 - Online survey sent to 900 clients
- Key Highlights:
 - Clients expressed **strong interest for a framework** to help them classify their ESG funds
 - Clients consider **Article 8 as funds integrating ESG considerations** and being more focused on financial materiality, while **Article 9 funds are seen as more focused on sustainable economic activities/impact and/or aim to reduce carbon emissions in line with the Paris Agreement**
 - There was a **consensus on using proxies for defining good governance practices, as well as on using UNGC or norms-based exclusions** as a minimum prerequisite.
- Based on the multiple client engagement efforts, we derived a set of assumptions / proxies used to measure MSCI ESG Indexes against key distinguishing features of Article 8 and 9 products.
- We have further modified the framework to reflect the Joint ESA's Final Report on the draft RTS dated February 2, 2021.

What are Article 8 and Article 9 products as per SFDR?

Article 8

- Promotes **environmental** or **social** characteristics, or a combination



- Must have **good governance practices** (sound management structures, employee relations, staff remuneration, tax compliance)



Article 9

- Must have a **sustainable investment objective**

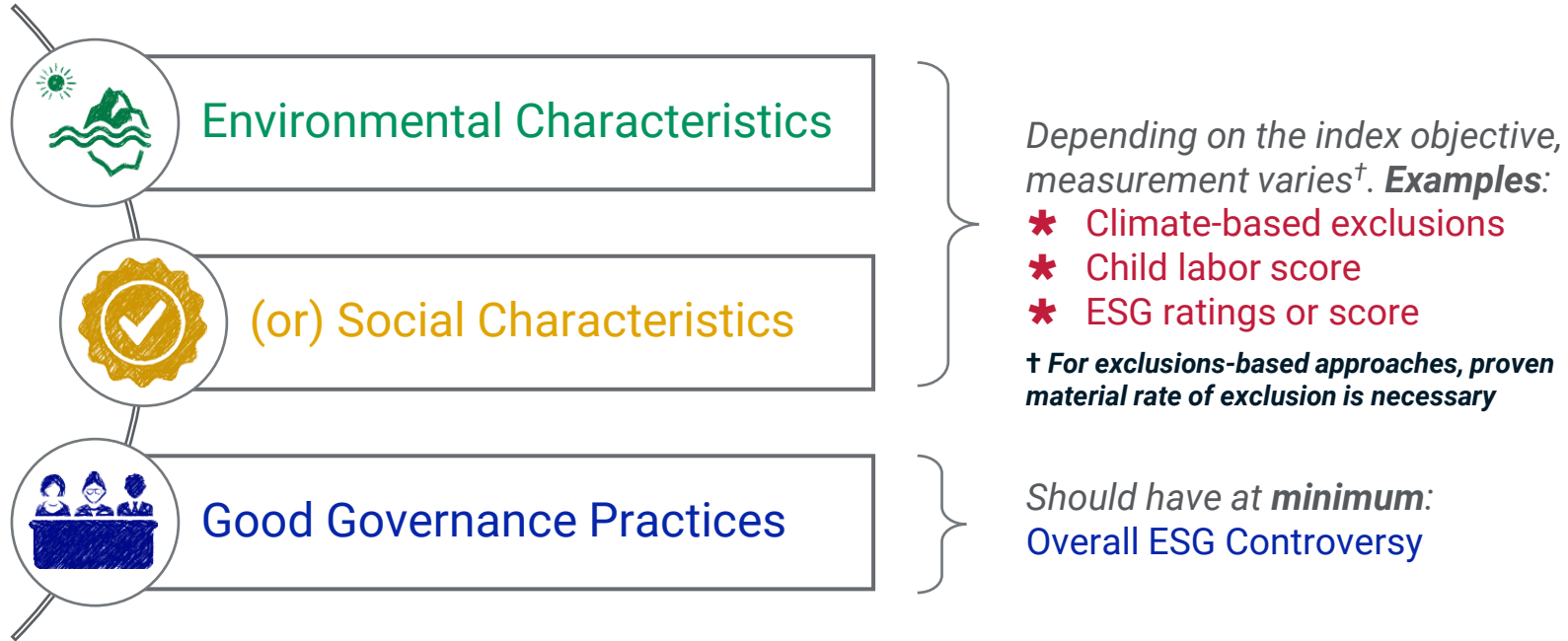
- **Economic activities that contribute to an environmental objective**
 - Key resource efficiency indicators (use of energy, renewable energy, raw materials, water and land, production of waste, GHG emissions, impact on biodiversity and circular economy)
- **(or) Economic activities that contribute to a social objective**
 - Tackle inequality or foster social cohesion
 - Social integration and labor relations
 - Investment in human capital or economically or socially disadvantaged communities
- **DNSH principle** (OECD, UNGPBHR, ILO, IBHR) AND **principal adverse impact indicators (14+)** to be taken into account
- **Follow good governance practices**, in particular with respect to sound management structures, employee relations, staff remuneration, tax compliance

Article 8 Key Distinctions

POST-ENGAGEMENT INTERPRETATION OF ENVIRONMENTAL OR SOCIAL CHARACTERISTICS + GOOD GOVERNANCE PRACTICES

Article 8 Product Key Distinctions

based on client feedback



Background on MSCI ESG Indexes: environmental and social data inputs

MSCI ESG Indexes use MSCI ESG Research definitions and data sets to identify positive and negative contribution to environmental and social issues through products and services, as well as to select and/or exclude based on their contribution through operations.

SCREENING

ENVIRONMENT	SOCIAL
Thermal Coal Mining	Tobacco
O&G Extraction	Controversial Weapons
Fossil Fuel Reserves	Civilian Firearms
Thermal Coal Power	GMO
Oil & Gas Power	Adult Entertainment
Palm Oil	Gambling
Other	Other

ESG CONTROVERSIES

ENVIRONMENT PILLAR	SOCIAL PILLAR		
ENVIRONMENT	HUMAN RIGHTS AND COMMUNITY IMPACT	LABOR RIGHTS & SUPPLY CHAIN	CUSTOMERS
Biodiversity & Land Use	Impact on Local Communities	Child Labor	Product Safety & Quality
Energy & Climate Change	Human Rights Concerns	Collective Bargaining & Unions	Anticompetitive Practices
Supply Chain Management	Civil Liberties	Discrimination & Workforce Diversity	Customer Relations
Water Stress	Other	Labor Management Relations	Marketing & Advertising
Toxic Emissions & Waste		Supply Chain Labor Standards	Privacy & Data Security
Operational Waste (Non Hazardous)		Health & Safety	Other
Other		Other	

ESG RATINGS

ENVIRONMENTAL (E)		SOCIAL (S)	
Climate Change	Carbon Emissions Product Carbon Footprint Financing Environmental Impact Climate Change Vulnerability	Human Capital	Labor Management Health & Safety Human Capital Development Supply Chain Labor Standards
Natural Capital	Water Stress Biodiversity & Land Use Raw Material Sourcing	Product Liability	Product Safety & Quality Chemical Safety Financial Product Safety Privacy & Data Security Responsible Investment Ins. Health & Demographic Risk
Pollution & Waste	Toxic Emissions & Waste Packaging Material & Waste Electronic Waste	Stakeholder Opposition	Community Relations Controversial Sourcing
Environmental Opportunities	Clean Tech Green Building Renewable Energy	Social Opportunities	Access to Communications Access to Finance Access to Health Care Nutrition & Health

Examples of MSCI ESG Indexes using environmental or social data inputs

Some MSCI ESG Indexes were created with specific Environmental or Social themes, while many others take on a broader approach to incorporate combined Environmental (E) and Social (S) or ESG considerations.



Low Carbon Leaders
Low Carbon Target

Carbon and Potential Emissions

Climate Change
Climate Transition Benchmark

Low Carbon Transition



Women's Leadership
Japan Empowering Women

Gender Diversity

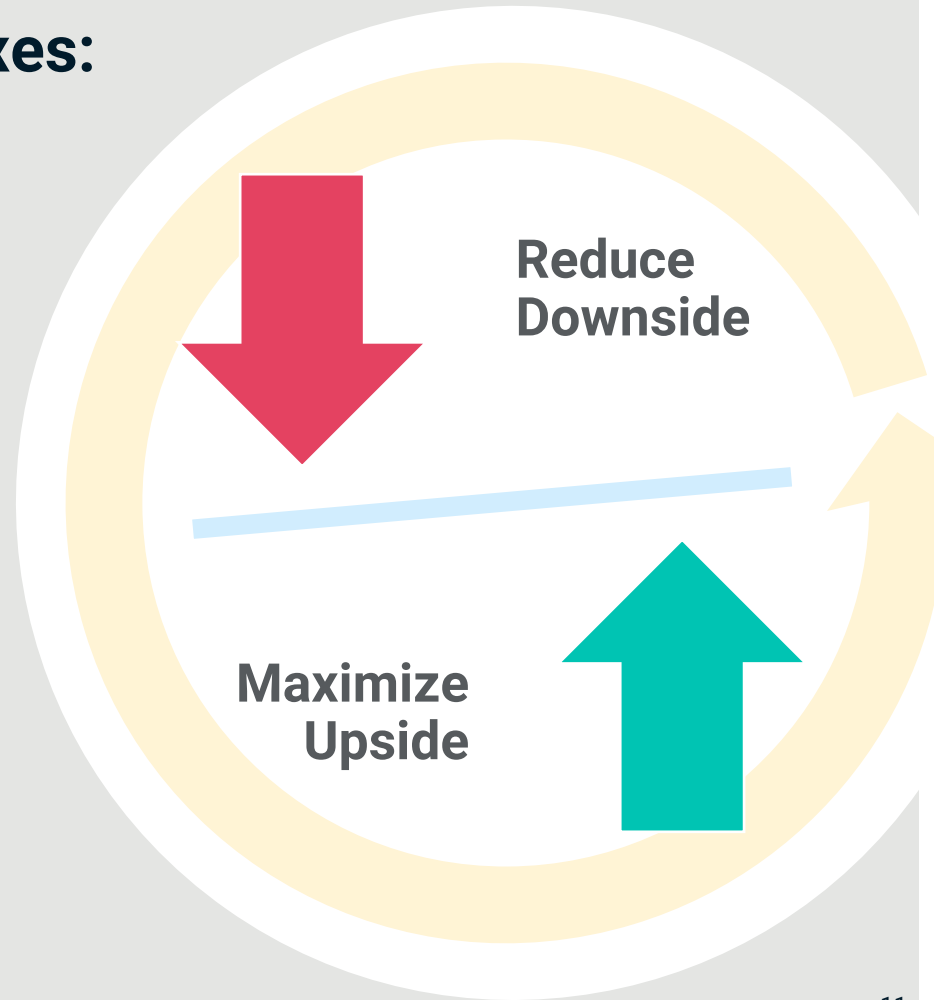


SRI
ESG Leaders
ESG Focus
ESG Universal
ESG Screened

ESG Ratings

Background on MSCI ESG Indexes: addressing governance risks

- MSCI ESG Indexes, unless focused on specific themes, generally address both the downside (e.g., headline risks) and upside (e.g., ESG best-in-class) to provide a holistic ESG approach.
 - Reduction of downside risks is done by excluding worst offenders based on **MSCI ESG Controversies**, or securities assessed as having Red Flags (Very Severe / Score of 0); as well as based on **MSCI ESG Ratings**, or securities rated CCCs.
 - Maximizing upside is done by selecting top 25% or 50% by sector using **MSCI ESG Ratings** data, or by tilting weights in favor of better ESG performers in terms of their industry-specific ESG risks.



Good Governance Practices Proxy

based on client feedback

Key areas of good governance practices

- Sound management structures
- Employee relations
- Staff remuneration
- Tax compliance

ESG CONTROVERSIES

SOCIAL PILLAR			GOVERNANCE
HUMAN RIGHTS AND COMMUNITY IMPACT	LABOR RIGHTS & SUPPLY CHAIN	CUSTOMERS	GOVERNANCE
Impact on Local Communities	Child Labor	Product Safety & Quality	Bribery & Fraud
Human Rights Concerns	Collective Bargaining & Unions	Anticompetitive Practices	Controversial Investments
Civil Liberties	Discrimination & Workforce Diversity	Customer Relations	Governance Structures
Other	Labor Management Relations	Marketing & Advertising	Other
	Supply Chain Labor Standards	Privacy & Data Security	
	Health & Safety	Other	
	Other		

ESG RATINGS

Corporate Governance	Board Pay Ownership Accounting
Corporate Behavior	Business Ethics Anti-competitive Practices Corruption & Instability Financial System Instability Tax Transparency
Human Capital	Labor Management Health & Safety Human Capital Development Supply Chain Labor Standards

Not covered by UNGC screen

Depending on industries' material risks, Labor Management or HCD may not be incorporated

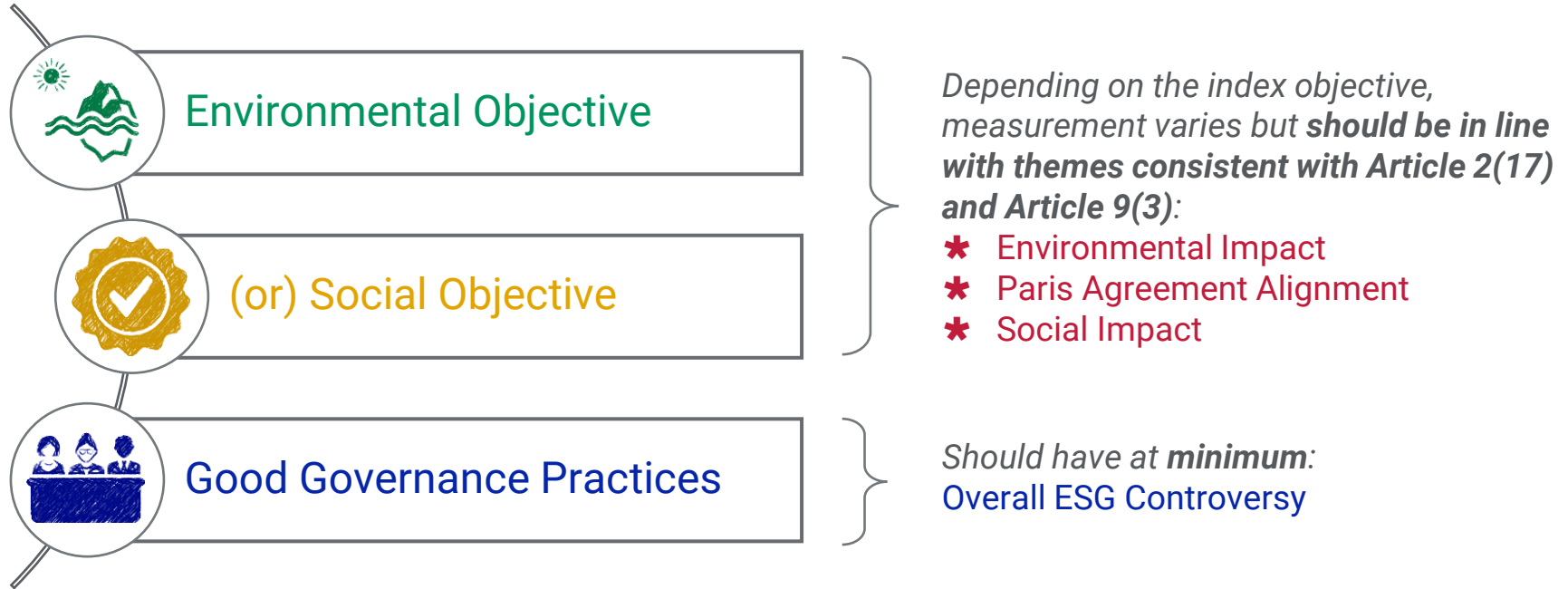


Article 9 Key Distinctions

POST-ENGAGEMENT INTERPRETATION OF SUSTAINABLE INVESTMENT
OBJECTIVE

Article 9 Product Key Distinctions

based on client feedback



Interpreting Sustainable Investment Objective based on client feedback

Article 2(17): 'sustainable investment' means an investment in **an economic activity that contributes to an environmental objective**, as measured, for example, by *key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy*, or an investment in **an economic activity that contributes to a social objective**, in particular an *investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities*, **provided that such investments do not significantly harm any of those objectives** and that the investee companies **follow good governance practices**, in particular with respect to *sound management structures, employee relations, remuneration of staff and tax compliance*;

Since the definition is currently not linked to the EU Taxonomy, a potential approach is to use metrics to indicatively provide economic activities that contribute to an environmental or social objective that capture conceptually similar key resource indicators or social themes

Controversies* to represent DNSH

Proxy used to capture conceptually similar good governance practices

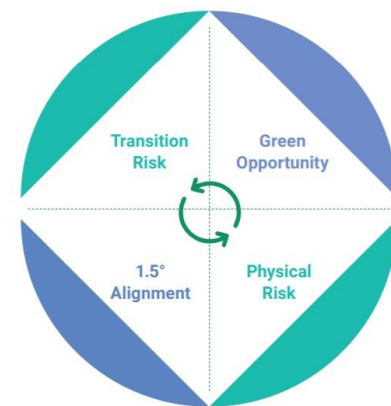
Interpreting Sustainable Investment Objective based on client feedback

Article 9(3): Where a financial product has a **reduction in carbon emissions as its objective**, the information to be disclosed pursuant to Article 6(1) and (3) **shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.**

By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council (20) is available, the information referred to in Article 6 shall include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

Although sustainable investment objective specifies “key economic activities”, it also specifies that Paris-aligned carbon emissions reduction as one of the objectives that would meet Article 9 requirements.

Proof of concept:
MSCI
Climate
Paris
Aligned



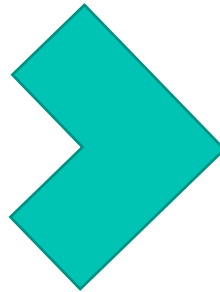
Minimum tracking error relative to parent and low turnover

Sustainable Investment: Environmental Objective Proxy

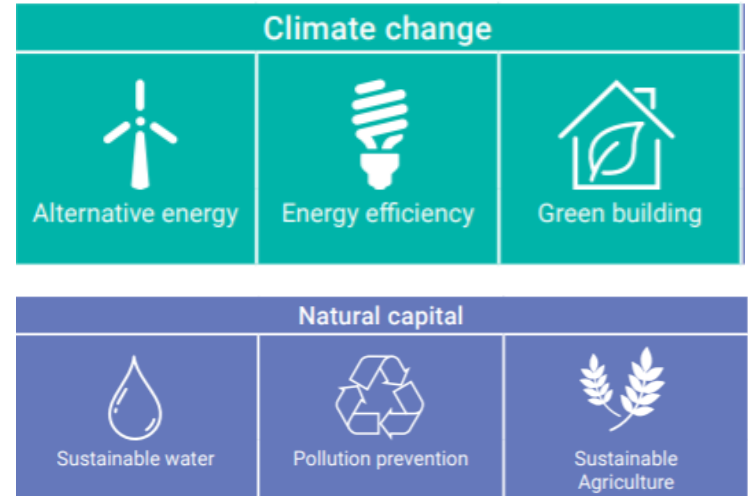
based on client feedback

Economic activities as measured by key resource efficiency indicators

- Use of energy
- Renewable energy
- Raw materials
- Water and land
- Production of waste
- GHG Emissions
- Impact on biodiversity and circular economy



SUSTAINABLE IMPACT METRICS



Examples of indexes that aim to meet similar environmental objectives:

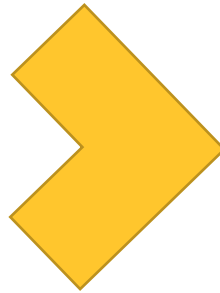
ACWI Sustainable Impact, Global Environment, Climate Paris Aligned

Sustainable Investment: Social Objective Proxy

based on client feedback

Economic activities that contribute to key social themes

- Tackle inequality or foster social cohesion
- Social integration and labor relations
- Investment in human capital or economically or socially disadvantaged communities



SUSTAINABLE IMPACT METRICS



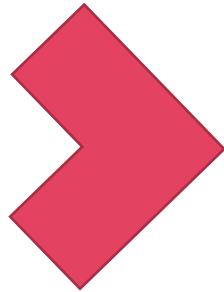
Examples of indexes that aim to meet similar social objectives:

ACWI Sustainable Impact

Sustainable Investment: Do No Significant Harm Proxy

based on client feedback

- While the SFDR references Do No Significant Harm Principle, there is no definition yet. To arrive at a proxy, **we follow MSCI ESG Research's EU Taxonomy Screening Guide, which uses Red and Orange Flags for Environment Controversies.**
- Similarly, because Sustainable Investment includes social objectives, **we follow the same principle but use Red and Orange Flags for Social Controversies if the methodology refers to a social theme or issue.**



EXCERPT FROM THE EU TAXONOMY SCREENING GUIDE:

Very Severe (Red Flag) and Severe structural (Orange Flag) environmental controversies based on the MSCI ESG Controversy Methodology present a clear indication of companies' violation of standards and norms with significant adverse impact on the environment.

- * *Every controversy is examined based on the nature of impact (minimal to very serious harm), scale of impact (low to extremely widespread), extenuating and exacerbating circumstances, and structural or idiosyncratic nature of the case.*
- * *The overall assessment is represented in a form of a score (0 representing involvement in Very Severe cases, 10 indicating no involvement in controversies) and a corresponding flag (Red, Orange, yellow, and Green).*

MSCI ESG Indexes vis-à-vis the Principal Adverse Sustainability Impact (PASI)

Adverse Sustainability Indicator
GHG emissions
Carbon footprint
GHG intensity
Exposure to companies active in the fossil fuel sector
Share of non-renewable energy consumption and production
Energy consumption intensity per high impact climate sector
Activities negatively affecting biodiversity-sensitive areas
Emissions to water
Hazardous waste ratio
Violations of UNGC principles and OECD Guidelines for Multinational Enterprises
Lack of processes and compliance mechanisms to monitor compliance with UNGC principles and OECD Guidelines for Multinational Enterprises
Unadjusted gender pay gap
Board gender diversity
Exposure to controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons)

Most MSCI ESG indexes already incorporate one or more PASI metrics, albeit with nuances in metric definitions and/or calculations. They are incorporated either comprehensively or partially, and either as a direct input or indirectly through the ESG Ratings framework. However, given that there is no further guidance in ESA's Final Report on the draft RTS, MSCI cannot determine the extent of incorporation needed or calculate any minimum threshold for reduction or improvement, from which to form the basis of potential methodological changes.

To illustrate how frequently used ESG factors or screens provided by MSCI ESG Research and applied as described in MSCI ESG index methodologies may align to facets of PASI metrics, an indicative mapping is available to clients through the [MSCI Client Support site](#).

Good Governance Practices Proxy

based on client feedback

Key areas of good governance practices

- Sound management structures
- Employee relations
- Staff remuneration
- Tax compliance

ESG CONTROVERSIES			
SOCIAL PILLAR			GOVERNANCE
HUMAN RIGHTS AND COMMUNITY IMPACT	LABOR RIGHTS & SUPPLY CHAIN	CUSTOMERS	GOVERNANCE
Impact on Local Communities	Child Labor	Product Safety & Quality	Bribery & Fraud
Human Rights Concerns	Collective Bargaining & Unions	Anticompetitive Practices	Controversial Investments
Civil Liberties	Discrimination & Workforce Diversity	Customer Relations	Governance Structures
Other	Labor Management Relations	Marketing & Advertising	Other
	Supply Chain Labor Standards	Privacy & Data Security	
	Health & Safety	Other	
	Other		

Not covered by UNGC screen

ESG RATINGS

Corporate Governance	Board Pay Ownership Accounting
Corporate Behavior	Business Ethics Anti-competitive Practices Corruption & Instability Financial System Instability Tax Transparency
Human Capital	Labor Management Health & Safety Human Capital Development Supply Chain Labor Standards

Depending on industries' material risks, Labor Management or HCD may not be incorporated



Mapping MSCI ESG Indexes to the Article 6, 8, and 9 key distinctions

COMPARING MSCI ESG INDEXES AGAINST THE IDENTIFIED SET OF
INDICATIVE MEASUREMENT PARAMETERS

Details on approach to comparing MSCI ESG Indexes

based on client feedback explained in previous sections

E, S AND G CONSIDERATIONS IN METHODOLOGY

Index	Environment Data Inputs	Social Data Inputs	Governance Data Inputs
SRI ESG Leaders ESG Focus	<ul style="list-style-type: none"> Climate exclusions Controversy exclusion Ratings exclusion & selection 	<ul style="list-style-type: none"> Values-based exclusions Controversy exclusion Ratings exclusion & selection 	<ul style="list-style-type: none"> Controversy exclusion Ratings exclusion & selection

The ESG inputs to the methodologies are listed under their respective columns as per MSCI ESG Research classification of what constitutes as E, S, and G, while distinguishing between exclusion or selection.

Does it take into consideration Art. 6/8/9 key distinctions?

Article 6 Key Distinctions	Article 8 Key Distinctions	Article 9 Key Distinctions
<input checked="" type="checkbox"/> E/S Safeguards	<input checked="" type="checkbox"/> E/S Characteristics <input type="checkbox"/> DNSH <input checked="" type="checkbox"/> Good Governance	<input type="checkbox"/> Sustainable Objective <input type="checkbox"/> DNSH <input checked="" type="checkbox"/> PASI <input checked="" type="checkbox"/> Good Governance

Indicates whether the methodology inputs appear to be consistent with key distinctions of Article 6/8/9 based on assumptions/ proxies. DNSH is crossed off for methodologies that do not incorporate inputs that are associated with “making sustainable investments”, while PASI is not incorporated in the analysis.

Note: For the descriptions of key concepts referenced, please refer to Slide 25.

Comparing MSCI ESG indexes using the framework

based on client feedback explained in previous sections

E, S AND G CONSIDERATIONS IN METHODOLOGY

Index	Environment Data Inputs	Social Data Inputs	Governance Data Inputs
SRI ESG Leaders ESG Focus	<ul style="list-style-type: none"> Climate exclusions Controversy exclusion Ratings exclusion & selection 	<ul style="list-style-type: none"> Values exclusions Controversy exclusion Ratings exclusion & selection 	<ul style="list-style-type: none"> Controversy exclusion Ratings exclusion & selection
Climate Paris Aligned	<ul style="list-style-type: none"> Climate exclusions & selection Carbon reduction Controversy exclusion Self-Decarbonization Clean tech overweight 1.5°C Alignment 	<ul style="list-style-type: none"> Values exclusions Controversy exclusion 	<ul style="list-style-type: none"> Controversy exclusion
Ex-Controversial Weapons	n/a	<ul style="list-style-type: none"> Values exclusion (Controversial Weapons) 	n/a

Does it take into consideration Art. 6/8/9 key distinctions?

Article 6 Key Distinctions	Article 8 Key Distinctions	Article 9 Key Distinctions
<input checked="" type="checkbox"/> E/S Safeguards	<input checked="" type="checkbox"/> E/S Characteristics <input type="checkbox"/> DNSH <input checked="" type="checkbox"/> Good Governance	<input type="checkbox"/> Sustainable Objective <input type="checkbox"/> DNSH <input checked="" type="checkbox"/> PASI <input checked="" type="checkbox"/> Good Governance
<input checked="" type="checkbox"/> E/S Safeguards	<input checked="" type="checkbox"/> E/S Characteristics <input checked="" type="checkbox"/> DNSH <input checked="" type="checkbox"/> Good Governance	<input checked="" type="checkbox"/> Sustainable Objective <input checked="" type="checkbox"/> DNSH <input checked="" type="checkbox"/> PASI <input checked="" type="checkbox"/> Good Governance
<input checked="" type="checkbox"/> E/S Safeguards	<input type="checkbox"/> E/S Characteristics <input type="checkbox"/> DNSH <input type="checkbox"/> Good Governance	<input type="checkbox"/> Sustainable Objective <input type="checkbox"/> DNSH <input checked="" type="checkbox"/> PASI <input type="checkbox"/> Good Governance

❖ At present, Principal Adverse Impact Indicators (PASI) are not taken into consideration in the analysis given lack of clearer guidance

DNSH only applies if an Article 8 product is making sustainable investments, while it applies for all Article 9 products

For the descriptions of key concepts referenced, please refer to Slide 25.

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Key concepts based on ESA's Final Report on the draft RTS

- **Environmental or social safeguards:** “As regards investments that do not qualify as sustainable or as contributing to the environmental or social characteristics promoted by the financial product, financial market participants may decide to apply some baseline environmental or social safeguards such as those referred to in Regulation (EU) 2020/852.” (Final Report on the draft RTS, page 16)
- **Environmental or social characteristics** (applies to Article 8 / “light green” products): “Financial products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (environmental or social characteristics) cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions.” (Final Report on the draft RTS, page 15)
- **Sustainable investment objective** (applies to Article 9 / “dark green” products): Financial products that follow Article 2(17) definition of sustainable investment of the EU SFDR
- **Good governance practices:** As per the Final Report on the draft RTS, the definition for good governance should follow Article 2(17) of the EU SFDR – “in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance”
- **DNSH:** “DNSH reporting must also show whether the investments are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.” (Final Report on the draft RTS, page 9)

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