



Index Methodology

# MSCI EM (Emerging Markets) Custom ESG Index\*

\* a custom index calculated by MSCI based on ESG criteria selected by Northern Trust

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# 1. Introduction

The MSCI EM Custom ESG Index is a custom index based on client-specified customized ESG screening criteria. The index aims to exclude companies that do not comply with UN Global Compact Principles, are involved in the production or sale of tobacco products, or are involved in the production of controversial weapons. The index also aims to exclude majority held companies with a controversial board composition. The MSCI EM Custom ESG Index is free float-adjusted market capitalization weighted.

# 2. Screening Criteria

MSCI ESG Research evaluates companies for exclusion from the MSCI EM Custom ESG Index based on three sets of ratings criteria: Compliance with UN Global Compact Principles, Tobacco, and Controversial Weapons. Institutional Shareholder Services Inc. (a third party Information Provider) then provides an additional Governance screen. These exclusion lists are provided to MSCI's Custom Index team by ISS and MSCI's ESG subsidiary (MSCI ESG Research Inc.) for use in the MSCI EM Custom ESG Index.

Please refer to [Appendix 1](#) for more details on the implementation of these criteria.

# 3. Constructing the MSCI EM Custom ESG Index

## 3.1. Underlying universe

The selection universe for the MSCI EM Custom ESG Index is the MSCI EM Index, a global equity index consisting of emerging market countries.

## 3.2. Exclusion Criteria

Companies that are involved in certain activities that violate the customized ESG screening criteria as described in Section 2 are excluded from the MSCI EM Custom ESG Index.

# 4. Maintaining the MSCI EM Custom ESG Index

## 4.1. Index Reviews

The MSCI EM Custom ESG Index is reviewed on a quarterly basis to coincide with the regular Semi-Annual and Quarterly Index Reviews of the MSCI Global Investable Market Indices. The changes are implemented as of the close of the last business day of February, May, August and November. The ESG list of companies to be excluded is produced based on MSCI ESG Research data as of the end of January, April, July and October, respectively. The Governance list of companies to be excluded from the MSCI

EM Custom ESG Index is produced annually and made effective coinciding with the MSCI February QIR as of the close of the last business day of February.

At index reviews, all companies in the underlying universe are reviewed and eligible companies are added to the MSCI EM Custom ESG Index. Existing constituents are deleted from the MSCI EM Custom ESG Index if they have been added to the exclusion list. In addition, any constituent that is deleted from the underlying index as a result of an index review is also deleted from the MSCI EM Custom ESG Index.

## 4.2. Ongoing Event-Related Maintenance

The MSCI Corporate Events Methodology is applied for the maintenance of the MSCI EM Custom ESG Index between index reviews.

Companies deleted from the underlying index between index reviews are simultaneously deleted from the MSCI EM Custom ESG Index.

Companies added to the underlying index between index reviews are simultaneously added to the MSCI EM Custom ESG Index. Their inclusion is reviewed at the following Index Review, as described in section 4.1.

The details relating to the handling of specific corporate event types can be found in the MSCI Corporate Events Methodology book available at:

<http://www.msci.com/products/indices/size/standard/methodology.html>

# Appendix 1: Screening Criteria

MSCI ESG Research creates the list of excluded securities for the MSCI EM Custom ESG Index by identifying companies within its coverage universe based on three sets of ratings criteria: Compliance with UN Global Compact Principles, Tobacco, and Controversial Weapons. Institutional Shareholder Services Inc. then provides an additional Governance screen for the MSCI EM Custom ESG Index.

## Compliance with UN Global Compact Principles

Definition: Companies that are involved in controversies classified as “very severe” in the areas of Environment, Human Rights & Community, Labor Rights & Supply Chain, or Governance will be excluded. The following areas are evaluated as part of this screen:

### Environment

Controversies related to a firm’s impact on the environment. Factors affecting this evaluation include whether a company is involved in controversies related to land use and biodiversity, toxic spills and releases, energy and climate change, water management, operational non-hazardous waste, environmental impact of products and services, and management of supply chain environmental impact.

### Human Rights & Community

Controversies related to a firm’s impact on the communities in which it does business. Factors affecting this evaluation include whether a company is involved in controversies related to support for controversial regimes, freedom of expression and censorship, and other human rights abuses and adverse impact on a community.

### Labor Rights & Supply Chain

Controversies related to a firm’s employee relations and supply chain. Factors affecting this evaluation include whether a company is involved in controversies related to labor-management relations, employee health & safety, collective bargaining & unions, discrimination and workforce diversity, and management of supply chain employee relations standards.

### Governance

Controversies related to a firm’s governance practices. Factors affecting this evaluation include whether a company is involved in controversies related to bribery, fraud and governance structures.

## Tobacco

Definition: Companies that derive any revenue from the production of tobacco, or 5% or more revenue from the distribution of, supply of key products for, or retail of tobacco, as further defined below, will be excluded.

### Tobacco Producers

Companies that manufacture tobacco products, such as cigars, blunts, cigarettes, beedis, kreteks, smokeless tobacco, snuff, snus, and chewing tobacco. This also includes companies that grow or process raw tobacco leaves.

**Tobacco Distributors**

Companies that derive 5% or more of total annual revenues from the independent wholesale of tobacco products to retailers and other distributors.

**Tobacco Retailers**

Companies that derive 5% or more of total annual revenues from the retail of tobacco products.

**Tobacco Suppliers**

Companies that derive 5% or more of total annual revenues from the manufacture and supply of key products necessary for the production of tobacco products, such as tobacco flavoring, cigarette filters (acetate tow), tobacco roll paper, cigarette manufacturing machines, and tobacco packaging - specifically cigarette cartons, films, and aluminum foil.

## Controversial Weapons

Definition: Companies that manufacture cluster bombs, landmines, nuclear weapons, depleted uranium weapons, biological/chemical weapons, or their related components, as further defined below, will be excluded.

**Cluster Bomb Manufacturers**

Companies that manufacture cluster munitions whole systems or components.

**Landmine Manufacturers**

Companies that manufacture landmines whole systems or components.

**Nuclear Weapons Systems Manufacturers**

Companies that manufacture nuclear weapons, including nuclear warheads, intercontinental ballistic missiles, and ballistic missile submarines, which are capable of the delivery of nuclear warheads.

**Nuclear Weapons Components Manufacturers**

Companies that manufacture critical components for nuclear weapons or nuclear weapons delivery systems.

**Biological/Chemical Weapons Systems Manufacturers**

Companies that manufacture biological or chemical weapons, which are defined as weapons that use pathogens such as viruses, bacteria, and disease-causing biological agents, toxins, or chemical substances that have toxic properties that kill, injure, or incapacitate.

**Biological/Chemical Weapons Components Manufacturers**

Companies that manufacture critical components for chemical or biological weapons systems.

**Depleted Uranium Weapons Manufacturers**

Companies involved in the production of depleted uranium (DU) weapons, ammunition, and armor. Depleted uranium is a by-product of the uranium-enrichment process used to make nuclear weapons and nuclear-reactor fuel.

**Governance – Controversial Board Composition**

Definition: Institutional Shareholder Services Inc. will create the list of excluded securities by identifying companies within its coverage universe that meet all of the following criteria:

**Majority held companies**

Emerging markets can be largely characterized by concentrated ownership structures and low institutional ownership with varying levels of government control and family ownership. These large shareholders often occupy key positions within the company while watching over the succession planning thereby creating the potential to self-dealing and to frustrate minority shareholder rights. Companies will be screened on individual shareholders whereby companies with individual holdings of at least 50% of the voting rights will be excluded from the index.

**Independence**

From a minority shareholder perspective independent board members are at the forefront to constructively challenge board decision making, avoid executive entrenchment as well as misalignment of its remuneration and company performance. A sufficient proportion of independent directors on the board can contribute to mitigating such risks. Companies will be screened on independence levels whereby companies with less than one third of independence on the board will be excluded.

**Key committees**

Key committees at the board level dealing with nomination (succession planning), audit (financial planning and reporting) and remuneration (incentive planning) are a further step into specialization of board responsibilities, primarily in those areas where executives are more likely to have a conflicting interest. Companies having a combination of these three committees will contribute in offsetting risks of self dealing. Companies will be screened on a combination of the three key committees whereby companies which do not have a combination of such committees will be excluded.

**Audit and remuneration committee**

Audit and remuneration committees are instrumental in the monitoring and compensating of executive management as well as in the ensuring of the integrity of the company's financial reporting and accounting systems. The set up of such committees is recommended by most international codes of corporate governance. Committees will be screened on a combination of audit and remuneration committees, whereby companies which do not have a combination of both committees will be excluded.

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<sup>1</sup> As of September 30, 2013, as reported on January 31, 2014 by eVestment, Lipper and Bloomberg

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