

# **MSCI KLD 400 SOCIAL INDEX METHODOLOGY**

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## **1 INTRODUCTION**

The MSCI KLD 400 Social Index is a free float-adjusted market capitalization index that aims to target U.S. companies that have positive Environmental, Social and Governance (ESG) characteristics while maintaining similar sector weights as MSCI USA. The MSCI KLD 400 Social Index consists of 400 companies selected from the MSCI USA Investable Market Index (IMI).

## 2 MSCI ESG RESEARCH FRAMEWORK

The MSCI KLD 400 Social Index uses company ratings and research provided by MSCI ESG Research Inc. In particular, this index uses the following three MSCI ESG Research products: MSCI ESG Ratings, MSCI ESG Controversies and MSCI ESG Business Involvement Screening Research.

For details on MSCI ESG Research’s full suite of ESG products, please refer to: <https://www.msci.com/esg-integration>

### 2.1 MSCI ESG RATINGS

MSCI ESG Ratings provides research, analysis and ratings of how well companies manage environmental, social and governance risks and opportunities.

MSCI ESG Ratings provides an overall company ESG rating - a seven point scale from ‘AAA’ to ‘CCC’. In addition, the product provides scores and percentiles indicating how well a company manages each key issue relative to industry peers.

For more details on MSCI ESG Ratings, please refer to: <https://www.msci.com/esg-ratings>

### 2.2 MSCI ESG CONTROVERSIES

MSCI ESG Controversies (earlier known as MSCI Impact Monitor) provides assessments of controversies concerning the negative environmental, social, and/or governance impact of company operations, products and services. The evaluation framework used in MSCI ESG Controversies is designed to be consistent with international norms represented by the UN Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and the UN Global Compact. MSCI ESG Controversies Score falls on a 0-10 scale, with “0” being the most severe controversy.

For more details on MSCI ESG Controversies Score, please refer to <https://www.msci.com/documents/10199/acbe7c8a-a4e4-49de-9cf8-5e957245b86b>

### 2.3 MSCI ESG BUSINESS INVOLVEMENT SCREENING RESEARCH

MSCI ESG Business Involvement Screening Research (BISR) aims to enable institutional investors to manage environmental, social and governance (ESG) standards and restrictions reliably and efficiently.

For more details on MSCI ESG Business Involvement Screening Research, please refer to [http://www.msci.com/resources/factsheets/MSCI\\_ESG\\_BISR.pdf](http://www.msci.com/resources/factsheets/MSCI_ESG_BISR.pdf)

### **3 CONSTRUCTING THE MSCI KLD 400 SOCIAL INDEX**

#### **3.1 APPLICABLE UNIVERSE**

The applicable universe for the MSCI KLD 400 Social Index is the MSCI USA IMI.

#### **3.2 ELIGIBILITY CRITERIA**

The MSCI KLD 400 Social Index uses company ratings and research provided by MSCI ESG Research to determine eligibility.

##### **3.2.1 VALUES-BASED EXCLUSIONS**

The MSCI KLD 400 Social Index uses MSCI ESG Business Involvement Screening Research to identify companies that are involved in the following business activities. Companies that meet the business involvement criteria are excluded from the MSCI KLD 400 Social Index. Please refer to Appendix 1 for details on these criteria.

- Alcohol
- Gambling
- Tobacco
- Nuclear Weapons
- Controversial Weapons
- Conventional Weapons
- Civilian Firearms
- Nuclear Power
- Adult Entertainment
- Genetically Modified Organisms

##### **3.2.2 MSCI ESG RATINGS ELIGIBILITY**

The MSCI KLD 400 Social Index uses MSCI ESG Ratings to identify companies that demonstrated an ability to manage their ESG risks and opportunities. Existing constituents of the MSCI KLD 400 Social Index are required to have an MSCI ESG Rating above B to remain in the index, while companies that are currently not constituents of the MSCI KLD 400 Social Index are required to have an ESG rating above BB to be considered eligible for inclusion.

**3.2.3 ESG CONTROVERSIES SCORE ELIGIBILITY**

The MSCI KLD 400 Social Index uses MSCI ESG Controversies Scores to identify those companies that are involved in very serious controversies involving the environmental, social, or governance impact of their operations and/or products and services. Existing constituents of the MSCI KLD 400 Social Index are required to have an MSCI ESG Controversies Score above 0 to remain in the index, while companies that are currently not constituents of the MSCI KLD 400 Social Index are required to have an MSCI ESG Controversies Score above 2 to be considered eligible for inclusion.

**3.3 SECTOR REPRESENTATION**

The MSCI KLD 400 Social Index is designed to maintain sector weights approximately similar to the MSCI USA Index, by targeting relative sector weights of +/- 25% with respect to the MSCI USA Index.

Relative weight of a sector is computed as

$$\frac{\text{weight of the sector in MSCI KLD 400 Social Index} - \text{weight of sector in MSCI USA Index}}{\text{weight of sector in MSCI USA Index}}$$

Sectors having relative sector weight greater than upper threshold (+25%) with respect to the MSCI USA Index are considered to be overweight and sectors having relative sector weight less than lower threshold (-25%) with respect to the MSCI USA Index are considered to be underweight.

**3.4 SIZE-SEGMENT REPRESENTATION**

The MSCI KLD 400 Social Index targets a minimum count of 200 standard size-segment (Large Cap and Mid Cap) companies.

## 4 MAINTAINING THE MSCI KLD 400 SOCIAL INDEX

### 4.1 QUARTERLY INDEX REVIEWS

The composition of the MSCI KLD 400 Social Index is reviewed on a quarterly basis to coincide with the regular Index Reviews (Semi-Annual Index Reviews in May and November and Quarterly Index Reviews in February and August) of the MSCI Global Investable Market Indexes. Changes are implemented at the end of February, May, August and November. The pro forma indexes are in general announced nine business days before the effective date.

At every Quarterly Index Review, deletions and additions are made to the MSCI KLD 400 Social Index described below.

In general, MSCI uses MSCI ESG Research data (including MSCI ESG Ratings, MSCI ESG Controversies Scores and MSCI Business Involvement Screening Research) as of the end of the month preceding the Index Reviews. For some securities, such data may not be published by MSCI ESG Research by the end of the month preceding the Index Review. For such securities, MSCI will use ESG data published after the end of month, when available.

#### 4.1.1 DELETION CRITERIA

At Quarterly Index Reviews, companies are deleted from the MSCI KLD 400 Social Index for one or more of the following reasons:

- If a company is deleted from the MSCI USA IMI as a result of the Index Review, it is simultaneously removed from the MSCI KLD 400 Social Index
- Any company that fails the eligibility criteria outlined in Section 3 is deleted from the Index

### 4.2 ELIGIBILITY FOR ADDITION

At every Quarterly Index Review, after reflecting all the deletions, additions are made to the MSCI KLD 400 Social Index in order to restore the number of index constituents to 400 companies. All eligible securities of each issuer are included in the index, so the index may have more than 400 securities.

All companies of the pro forma Parent Index that pass the eligibility criteria outlined in Section 3 are eligible for inclusion in the index.

#### 4.2.1 INDEX ADDITIONS

Additions are made to the MSCI KLD 400 Social Index from the list of eligible additions based on considerations of ESG performance, sector alignment and size representation. Additions

will be made to the standard size segment as per below until the number of companies in MSCI KLD 400 Social Index is restored to 400. If the count of 400 cannot be reached, additions will be made from the small cap segment.

Standard segment:

- All companies having an MSCI ESG Rating of AAA are added
- Companies are added (in order of their industry adjusted ESG Scores) to sectors where the relative sector weights are below the lower threshold (-25%)
- Once the relative weights of all sectors are above the lower threshold or no further companies are available for addition in these sectors, companies are added sequentially based on their ESG Scores
- Companies are not added to sectors where the relative sector weight reaches the upper threshold of +25%
- A minimum of 200 standard segment companies are maintained to ensure appropriate size representation
- While adding companies to the same sector, preference is given to companies having the higher ESG Score. In case there are multiple companies with the same ESG score, the security with the highest free float-adjusted market capitalization will be added first

Small Cap segment:

- Companies are added purely based on their ESG Scores. In case of a tie, companies are added to the most underweight sector

### 4.3 ONGOING EVENT-RELATED MAINTENANCE

The MSCI Corporate Events Methodology is applied for the maintenance of the MSCI KLD 400 Social Index between Index Reviews. New additions to the MSCI USA IMI due to corporate events will not be added simultaneously to the MSCI KLD 400 Social Index, but will be considered for inclusion at the following Index Review. However, companies deleted from the MSCI USA IMI between Index Reviews are deleted at the same time from the MSCI KLD 400 Social Index.

If the number of companies in the MSCI KLD 400 Social Index falls below 400 due to corporate events, no additions will be made to restore the number of companies to 400 until the next Quarterly Index Review.

The technical details relating to the handling of specific corporate event types can be found in the MSCI Corporate Events Methodology book available on MSCI's web site at:

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



## APPENDIX 1: VALUES BASED EXCLUSION CRITERIA

The MSCI KLD 400 Social Index excludes companies that meet the following values based criteria:

- **Alcohol**
  - All companies classified as a “Producer” that earn either 5% or more revenue or more than \$500 million in revenue from alcohol-related products.
- **Gambling**
  - All companies classified as involved in “Operations” and “Support” that earn 5% or more in revenue, or more than \$500 million in revenue, from gambling-related products
- **Tobacco**
  - All companies classified as “Producer”
  - All companies classified as “Distributor”, “Retailer”, and “Supplier” that earn 15% or more in revenue from tobacco-related products
- **Nuclear Weapons**
  - All companies classified as involved in manufacturing of “Nuclear Weapons”, or “Nuclear Weapons Components”
- **Controversial Weapons**
  - All companies with any tie to Controversial Weapons (cluster munitions, landmines, depleted uranium weapons, biological/chemical weapons, blinding lasers, non-detectable fragments and incendiary weapons), as defined by the methodology of the MSCI Ex-Controversial Weapons Indexes available at <https://www.msci.com/index-methodology>
- **Conventional Weapons**
  - All companies that earn 5% or more revenues or more than \$500 million in revenue from manufacturing of Conventional Weapons and Conventional Weapons Components, and Weapons Support Systems and Services
- **Civilian Firearms**
  - All companies classified as “Producer”
  - All companies classified as a “Retailer” that earn 5% or more in revenue, or more than \$20 million in revenue, from civilian firearms-related products

- **Nuclear Power**
  - All companies classified as a nuclear “Utility”
  - All companies involved in Uranium Mining
  - All companies involved in designing nuclear reactors
  - All companies involved in enrichment of fuel for nuclear reactors
  - All companies classified as a “Supplier” to the nuclear power industry that earn 15% or more in revenue from nuclear-power related products
  - All companies with 6000 MW or more of installed capacity attributed to nuclear sources or with 50% or more of installed capacity attributed to nuclear sources
- **Adult Entertainment**
  - All companies classified as a “Producer” that earn more than 5% in revenue, or more than \$500 million in revenue, from this adult entertainment materials
- **Genetically Modified Organisms (GMO)**
  - All companies that derive any revenue from activities like genetically modifying plants, such as seeds and crops, and other organisms intended for agricultural use or human consumption
  - Companies that are only involved in GMO Research & Development activities are not excluded

## APPENDIX 2: METHODOLOGY TRANSITION

Effective at the May 2016 Index Review, the MSCI KLD 400 Social Index transitioned to the methodology described in the methodology book, following enhancements to the MSCI ESG Controversies (previously the MSCI Impact Monitor). The details of the changes are as given below.

The changes to MSCI ESG Controversies included adjusting the scoring model to align the scores with individual controversy case levels, including the introduction of an Orange flag, and the removal of specific controversial business involvement (CBI) criteria from the model to refocus the ESG Controversies scores on event-driven controversies.

MSCI implemented the following changes to the MSCI KLD 400 Social Index methodology effective June 1, 2016 to maintain consistency with the existing index construction objectives:

1 - As per the old MSCI ESG Impact Monitor methodology, securities which had an Impact Monitor score of 0 and 1 had a Red controversy flag. Under the new methodology, only securities with an ESG controversies score of 0 have a Red controversy flag. For indexes where constituents were ineligible to be included in the index if their Impact Monitor score was 0 or 1 (current Red controversy flag), the exclusion criteria was changed to ESG Controversies score = 0 in order to continue to only exclude securities with Red controversy flag in the MSCI KLD 400 Social Index .

2 - MSCI Impact Monitor earlier incorporated exclusion rules based on controversial business involvement criteria related to alcohol, tobacco, gambling, nuclear power, conventional weapons and controversial weapons. The values based exclusion criteria that were already a part of the MSCI KLD 400 Social Index were more stringent than most of these rules. As a result, only the 'Nuclear Power' screen was updated to reflect the additional rules that were earlier incorporated in the MSCI Impact Monitor. The details of the exclusion rules are mentioned in Appendix 1.

**The following sections have been modified since May 2012:**

2 ESG Research Framework

- Updated

3.1 Selection Universe

- Updated the selection universe

3.2 Eligibility Criteria

- Replaced old section 3.2 titled ‘Values Based Exclusion Criteria’

4.1 Quarterly Index Reviews

- Updated sub-sections titled ‘Index Additions’ and ‘Deletion Criteria’

Appendix 1: Value Based Exclusion Criteria

- Updated values based exclusion criteria for ‘Military Weapons’ and ‘Civilian Firearms’ categories

Appendix 2: Transition to the enhanced MSCI KLD 400 Social Index Methodology

- Section Deleted

**The following sections have been modified since November 2014:**

Section 3.2.3: ESG Controversies Score Eligibility

- Updated the MSCI ESG Controversies Score eligibility requirements

Appendix 1: Values Based Exclusion Criteria

- Updated the screening criteria for companies involved in ‘Nuclear Power’

Appendix 2: Methodology Transition

**The following sections have been modified since May 2016:**

Section 1: Introduction

- Updates to the description

Section 4.1: Quarterly Index Reviews

- Clarification on use of ESG data for securities whose data would be available after the end of the month preceding Index Review

**The following sections have been modified since September 2017:**

Appendix 1: Values Based Exclusion Criteria

- Updated the controversial business screening criteria pertaining to Controversial Weapons

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