

# **MSCI World Small Cap Custom ESG Low Carbon Index**

**May 2019**

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## **1 Introduction**

MSCI Indexes are constructed and maintained in accordance with the MSCI Global Investable Market Indexes Methodology and calculated as per the MSCI Index Calculation Methodology. This methodology book provides a description of the rules and guidelines followed by MSCI for the construction and maintenance of the MSCI World Small Cap Custom ESG Low Carbon Index (the “Index”). The MSCI World Small Cap Custom ESG Low Carbon Index aims to represent the performance of a strategy that is designed to increase the Index’s exposure to positive environmental, social and governance (ESG) factors as well as exhibit lower carbon exposure than MSCI World Small Cap Index (the “Parent Index”) by applying exclusions based on various ESG criteria.

## **2 ESG Research Framework**

MSCI ESG Research provides in-depth research, ratings and analysis of the environmental, social and governance-related business practices of thousands of companies worldwide. It consists of an integrated suite of tools and products to efficiently manage research, analysis and compliance tasks across the spectrum of ESG factors.

The MSCI World Small Cap Custom ESG Low Carbon Index uses research provided by MSCI ESG Research. In particular, this index uses the following three MSCI ESG Research products: MSCI ESG Controversies Score, MSCI ESG Business Involvement Screening Research and MSCI ESG CarbonMetrics Data.

For details on MSCI ESG Research’s full suite of ESG products, please refer to: [http://www.msci.com/products/esg/about\\_msci\\_esg\\_research.html](http://www.msci.com/products/esg/about_msci_esg_research.html)

### **2.1 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-9cf85e957245b86b>

### **2.2 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)

### **2.3 MSCI ESG CARBONMETRICS DATA**

MSCI ESG Research collects annual company-specific direct (Scope 1) and indirect (Scope 2) greenhouse gas (GHG) emissions data from company public documents and/or the Carbon Disclosure Project. If a company does not report GHG emissions, then MSCI ESG Research estimates Scope 1 and Scope 2 GHG emissions. Further, to normalize for size, MSCI ESG Research divides the sum of Scope 1 and Scope 2 GHG emissions by the issuer market capitalization to calculate emission intensity.

For companies which do not report emission data and where MSCI ESG Research has not estimated the greenhouse gas emissions yet, the methodology uses the average emissions per dollar of issuer market capitalization for the companies in the same industry group, multiplied by the market capitalization of the company as the estimated emission for the company.

MSCI ESG Research collects fossil fuel reserves data where relevant for companies which have reserves, typically in the Oil & Gas, Coal Mining and Electric Utilities industries (details in MSCI ESG CarbonMetrics methodology). The data is updated on an annual basis and based on information disclosed by companies. Sources include company publications, other public records and third-party data providers. For newly added companies where data is not available yet, the methodology uses zero fossil fuel reserves.

### 3 Constructing the MSCI World Small Cap ESG Low Carbon Index

The MSCI World Small Cap Custom ESG Low Carbon Index is constructed by applying the following steps to the Parent Index.

- ESG Screening
- Carbon Screening
- Governance Issue Screening
- Weighting

#### 3.1 ESG SCREENED UNIVERSE

The eligible universe comprises all constituents of the Parent Index that meet the below mentioned screening criteria:

##### 3.1.1 MINIMUM MSCI ESG CONTROVERSIES STANDARDS

Constituents must not be flagged by MSCI ESG Controversies based on any of the below mentioned ESG criteria:

1. **Environment Controversies:** Companies that are involved in very severe environment controversies (“Red Flag”).
2. **Governance Controversies:** Companies that are involved in very severe governance controversies (“Red Flag”).
3. **Human Rights Controversies:** Companies that are involved in very severe human rights controversies (“Red Flag”).
4. **Labor Rights Controversies:** Companies that are involved in very severe labor rights controversies (“Red Flag”).

##### 3.1.2 BUSINESS INVOLVEMENT SCREEN

Companies that are involved in the following businesses and meet the business involvement exclusion criteria as detailed in Appendix 1 are excluded from the index:

- Civilian Firearms
- Controversial Weapons
- Conventional Weapons
- Nuclear Weapons
- Tobacco

### **3.2 CARBON SCREENED UNIVERSE**

Securities from the ESG Screened Universe (from section 3.1) that are not excluded as per the below carbon emission exclusion criteria are included in the Carbon Screened Universe

#### **3.2.1 CARBON EMISSION EXCLUSIONS**

1. Exclude securities with any ownership of fossil fuel reserves.
2. Absolute Emission Exclusions are applied using the following steps:
  - a. Compute cumulative absolute emission (Scope 1 + Scope 2 emission) of the securities in the ESG Screened Universe.
  - b. Sort the securities in descending order of absolute emission.
  - c. Exclude securities with the highest absolute emission until the cumulative absolute emission of the remaining securities is less than 50% of the total cumulative absolute emission computed previously.
3. Emission Intensity Exclusions are applied using the following steps:
  - a. Compute Total Carbon Emission Intensity of the securities in the eligible universe by dividing Total Scope 1+2 Emissions by Total Sales
  - b. Compute the exclusion threshold as 50% of the Total Carbon Emission Intensity computed earlier.
  - c. Calculate Carbon Emission Intensity of each security as the ratio of absolute emission to total sales of the security and sort the securities in the descending order of Carbon Emission Intensity.
  - d. Exclude the securities with the highest Carbon Emission Intensity until the Total Carbon Emission Intensity of the remaining securities falls below the threshold set.
  - e. Exception – Add back securities with the GICS® sub-industry Renewable Electricity (GICS code: 55105020).

### **3.3 GOVERNANCE ISSUE SCREENED UNIVERSE**

Companies that are identified under the following governance key issues are excluded from the Carbon Screened universe (from Section 3.2).

- Qualified Auditor Opinion
- Controlling Shareholder Concerns

Please refer to Appendix 2 for the details on the governance screens.

### **3.4 WEIGHTING**

The remaining securities are reweighted to add up to a weight of 100% in the proportion of their free float market capitalization weight in the Parent Index.



## **4 Maintaining the MSCI World Small Cap Custom ESG Low Carbon Index**

### **4.1 SEMI-ANNUAL INDEX REVIEWS**

The MSCI World Small Cap Custom ESG Low Carbon Index is reviewed on a semi-annual basis, coinciding with the May and November Semi-Annual Index Reviews of the Parent Index.

In general, MSCI uses MSCI ESG Research data (including MSCI ESG Ratings, MSCI ESG Controversies Scores, MSCI ESG CarbonMetrics Data and MSCI Business Involvement Screening Research) as of the end of the month preceding the Index Reviews for the rebalancing of the Index. 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, for the rebalancing of the Index.

The pro forma Index is typically announced nine business days before the effective date.

At each Semi-annual Index Review, the MSCI World Small Cap Custom ESG Low Carbon Index is rebalanced as described in Section 3.

### **4.2 ONGOING EVENT-RELATED CHANGES**

The general treatment of corporate events in the MSCI World Small Cap Custom ESG Low Carbon Index aims to minimize turnover outside of Index Reviews. The methodology aims to appropriately represent an investor's participation in an event based on relevant deal terms and pre-event weighting of the index constituents that are involved.

Additionally, if the frequency of Index Reviews in the Parent Index is greater than the frequency of Index Reviews in the MSCI World Small Cap Custom ESG Low Carbon Index, the changes made to the Parent Index during intermediate Index Reviews will be neutralized in the MSCI World Small Cap Custom ESG Low Carbon Index.

The following section briefly describes the treatment of common corporate events within the MSCI World Small Cap Custom ESG Low Carbon Index.

No new securities will be added (except where noted below) to the Index between Index Reviews. Parent Index deletions will be reflected simultaneously.

**EVENT TYPE**

**EVENT DETAILS**

**New additions to the Parent Index**

A new security added to the parent index (such as IPO and other early inclusions) will not be added to the index.

**Spin-Offs**

All securities created as a result of the spin-off of an existing Index constituent will be added to the Index at the time of event implementation. Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

**Merger/Acquisition**

For Mergers and Acquisitions, the acquirer's post event weight will account for the proportionate amount of shares involved in deal consideration, while cash proceeds will be invested across the Index.

If an existing Index constituent is acquired by a non-Index constituent, the existing constituent will be deleted from the Index and the acquiring non-constituent will not be added to the Index.

**Changes in Security Characteristics**

A security will be removed as an Index constituent if there are changes in characteristics (country, sector, size segment, etc.) Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

Further detail and illustration regarding specific treatment of corporate events relevant to this Index can be found in the MSCI Corporate Events Methodology.

The MSCI Corporate Events methodology book is available at: <https://www.msci.com/index-methodology>

## Appendix 1: Business Involvement Screening Criteria

- **Controversial Weapons**

- All companies with any tie to Controversial Weapons (cluster munitions, landmines, depleted uranium weapons, biological/chemical weapons, blinding lasers, nondetectable fragments and incendiary weapons), as defined by the methodology of the MSCI Global Ex-Controversial Weapons Indexes available at <https://www.msci.com/index-methodology>.

- **Conventional Weapons**

- All companies deriving 5% or more aggregate revenue from weapons systems, components, and support systems and services.

- **Civilian Firearms**

- All companies deriving 5% or more revenue from the manufacture and retail of civilian firearms and ammunition.

- **Nuclear Weapons**

- All companies that manufacture key nuclear weapons component.
- All companies that manufacture nuclear weapons, including nuclear warheads, intercontinental ballistic missiles, and ballistic missile submarines, which are capable of the delivery of nuclear warheads.

- **Tobacco**

- All companies classified as a "Producer".
- All companies deriving 5% or more revenue from the distribution of tobacco products.
- All companies deriving 5% or more revenue from the retail sales of tobacco products.
- All companies deriving 5% or more revenue from supplying products essential to the tobacco industry.

## Appendix 2: Governance Key Issues

- **Qualified Auditor Opinion**

- All companies where the auditor expressed a qualified opinion or questioned the company's ability to remain a going concern as per the most recently reported period.

- **Controlling Shareholder Concerns**

- All companies where the ownership structure or governance arrangements indicate special concerns for minority public shareholders.
  - The companies can be flagged by a number of factors or combination of factors, including where:
    - any of the following Key Metrics (KM) are also flagged:
      - No Independent Directors
      - Leadership Concerns
      - Undersized Board
      - Cross Shareholdings
      - Poison Pill
    - or any of the following apply:
      - The issuer has issued Golden Shares
      - The issuer is controlled via a stock pyramid
      - The issuer incorporated as a Partnership Limited by Shares
      - The largest shareholder holds more than 75% of the total voting rights.

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