

**MSCI**

A Clear View of  
Risk and Return

# Consultation on a Proposed Enhanced MSCI Global Socially Responsible Indices Methodology

February 2012

# Executive Summary

- The MSCI Global Socially Responsible Indices(SRI) are currently based on the Global Socrates (GS) ESG ratings. MSCI intends to migrate these indices to an enhanced methodology based on a new suite of MSCI ESG Research products available on MSCI ESG Research's new platform – ESG Manager- to increase the transparency and granularity of the ESG signals while keeping the philosophy underpinning the indices unchanged. Consequently, the impact of the enhancement is likely to be relatively marginal.
- MSCI proposes to use a combination of three MSCI ESG products for the purpose of index creation – IVA ratings for overall best-in-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. The document should be read in conjunction with the consultation document on MSCI Global ESG Indices\*.
- In addition, MSCI also proposes the following changes to the existing MSCI Global SRI 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 would 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 would not be considered eligible for the Index Review.
  - Minimum Rating for a non index constituent in the MSCI Global SRI would be increased from “BBB” to “A”
  - An existing index constituent would be deleted if it falls to a ‘B’ or ‘CCC’.
- MSCI proposes to transition to the enhanced methodology along with the transition of the MSCI Global ESG Indices.
- 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 Global SRI Methodology

- Currently, the MSCI Global Socially Responsible Indices are based on Global Socrates ESG ratings.
- The rebalancing results are announced five days before the effective date through Integrated Client File (ICF) and a Global Summary Document.
- An annual index review is done in May, coinciding with the May Semi-Annual Index Review of the MSCI equity indices (herein, “Parent Indices”). The indices are also reviewed on a quarterly basis to coincide with Semi-Annual Index Review in November and Quarterly Index Review in February and August.
- Companies that are inconsistent with certain values based criteria are excluded from the MSCI Global SRI.
- All constituents of the MSCI Global ESG indices having a company level rating of “BBB” or above are eligible for inclusion in the MSCI Global SRI.
- At each annual index review, the composition of the index is reassessed in order to target 50% free float-adjusted cumulative market capitalization of each sector of the underlying MSCI Parent Index. Buffer rules are applied in the following order to minimize turnover:
  - Companies in the top 35%
  - ‘AA’ rated companies in the top 50%
  - Current index constituents in the top 65%
  - Remaining companies in the eligible universe
- At the quarterly index reviews, any existing index constituent whose rating falls to “BB” or lower is deleted from the MSCI Global SRI. Additions to the indices are only considered in those sectors where the resulting free float adjusted market capitalization coverage does not meet the 50% target with 10% buffer.

# Proposed enhancements

- MSCI ESG Research has introduced a new ESG research platform – ESG Manager. This platform provides products with two distinct ESG signals – overall ESG assessments (IVA ratings) and screening for controversial practices and business activities (Impact Monitor and ESG Screener).
- Currently the MSCI Global SRI is based on the Global Socrates ratings which bundles both ESG management performance and penalties for controversial practices and business activity into one single rating.
- MSCI proposes to unbundle the above and use three different indicators to reflect the underlying philosophy of the MSCI Global SRI:
  - IVA Ratings : for overall, best-in-class company ESG ratings.
    - Select the “Best in Class” by sector.
  - Impact Monitor: assessment of company involvement in specific ESG controversies.
    - Avoid companies engaged in very severe and severe ESG controversies.
    - All existing constituents with an Impact Monitor controversy assessment of very severe (IM flag of RED & IM Score: 0&1) will be excluded from the MSCI Global SRI. All non-index constituents will be eligible only if they are not involved in any major controversies ( IM Flag of GREEN & IM Score $\geq$ 5) .
  - ESG Screener: for identification of company involvement with the production of controversial products
    - Avoid companies with major business involvement in the production of products with high negative social or environmental impacts.
- Along with the above, the MSCI Global SRI will continue to exclude companies that are inconsistent with values based criteria such as Alcohol, Civilian Firearms, Gambling, Military Weapons, Nuclear Power, Tobacco, Adult Entertainment and Genetically Modified Organisms (GMO), as per the existing methodology.

## Other Proposed enhancements

- The results of the Index Review of the MSCI Global SRI would be announced nine days before the effective date of the Index Review through the Integrated Client File (ICF) and a Global Summary Document (for example, August 19th for the August 2011 Index review). The move from a five day period to nine days would give clients more time to analyze and implement all the index review related changes.
- The ESG ratings used for the Index Reviews would be taken as of the last calendar day of the month preceding the Index Review, i.e., January, April, July and October. If the ratings are not available, the security will be considered ineligible for inclusion.
- IVA ratings are based on a 7 point scale, 'AAA' - 'CCC' while the Global Socrates ratings are based on a 9 point scale, 'AAA' - 'C'. Since the IVA ratings system has a different ratings' scale compared to Global Socrates ratings, a higher minimum entry rule would be applied along with a higher buffer threshold for rebalancing.
- A higher minimum entry rule would also avoid excessive movement in index constituents due to minor changes in the rating of a company. A non index constituent must achieve a 'A' rating to become eligible for inclusion in the index.
- An existing index constituent would remain in the index until it is rated 'BB' or above.

# Transition Proposal

- The transition of the MSCI Global SRI would be done along with the MSCI Global ESG Indices
- The transition analysis using the enhanced methodology based on the data as of the close of November 30 2011 shows :
  - Turnover for the proposed MSCI Global SRI would be 13.48% which is comparable to the turnover of 13.1% in May 2011 Annual Index Review.

Index	# Current	# Proforma	# Additions	# Deletions	One Way Index Turnover
MSCI Global SRI	416	442	96	70	13.48%

## Break up of One Way Index Turnover

	Weight	# of securities
<b>Change In weight</b>	<b>2.30%</b>	
<b>Additions</b>	<b>5.75%</b>	96
<b>Deletions</b>	<b>5.44%</b>	70
Not in MSCI World ESG	2.38%	28
Current IVA rating : B	0.76%	8
Sector Ranking	2.30%	34
<b>One Way Index Turnover</b>	<b>13.48%</b>	

## Historical Turnover

Index Review	Turnover
February 2011	Initial Construction
May 2011	13.1%
August 2011	0.70%
November 2011	3.06%

# Top Additions to MSCI Global SRI

Name	Country	Region	Sector	GS rating	IVA rating	IM rating	IM Score	Weight
Air Liquide	FRANCE	EU	Materials	BB	A	Green	5	0.6%
Gilead Sciences	USA	US	Health Care	A	A	Green	5	0.5%
General Mills	USA	US	Consumer Staples	AA	A	Green	5	0.4%
Centrica	UNITED KINGDOM	EU	Utilities	BBB	AA	Green	5	0.4%
Travelers Cos	USA	US	Financials	A	AAA	Green	7	0.4%
AXA	FRANCE	EU	Financials	A	A	Green	5	0.4%
Hong Kong Exch.&Clearing	HONG KONG	HK	Financials	BB	AA	Green	8	0.3%
QBE Insurance Group	AUSTRALIA	AU	Financials	BBB	AA	Green	5	0.3%
Blackrock A	USA	US	Financials	BB	A	Green	5	0.3%
Fresenius Med. Care St	GERMANY	EU	Health Care	A	AA	Green	5	0.3%
Mitsui Fudosan Co	JAPAN	JP	Financials	BBB	AA	Green	8	0.2%
Vornado Realty Trust	USA	US	Financials	BBB	AA	Green	8	0.2%
Silver Wheaton	CANADA	CA	Materials	BBB	A	Green	10	0.2%
Alexion Pharmaceuticals	USA	US	Health Care	BBB	A	Green	8	0.2%
Progressive Corp	USA	US	Financials	A	A	Green	5	0.2%
PPR	FRANCE	EU	Consumer Discretionary	BBB	AA	Green	5	0.2%
Murata Manufacturing Co	JAPAN	JP	Information Technology	A	AAA	Green	10	0.2%
Dover Corp	USA	US	Industrials	BBB	A	Green	8	0.2%
Pioneer Natural Res.	USA	US	Energy	BB	A	Green	5	0.2%
Amcor	AUSTRALIA	AU	Materials	A	A	Green	5	0.2%
Cerner Corp	USA	US	Health Care	BBB	A	Green	10	0.2%
Shoppers Drug Mart Corp	CANADA	CA	Consumer Staples	BBB	AAA	Green	5	0.2%
Tokyo Electron	JAPAN	JP	Information Technology	BBB	AAA	Green	10	0.2%
Penn West Petroleum	CANADA	CA	Energy	BBB	AA	Green	8	0.1%
Resona Holdings	JAPAN	JP	Financials	A	A	Green	10	0.1%
Coca-Cola Entrprs (New)	USA	US	Consumer Staples	AA	A	Green	7	0.1%
Smith & Nephew	UNITED KINGDOM	EU	Health Care	A	AA	Green	5	0.1%
Next	UNITED KINGDOM	EU	Consumer Discretionary	A	AAA	Green	5	0.1%
Edwards Lifesciences	USA	US	Health Care	BBB	A	Green	5	0.1%

\* GS (Global Socrates) rating is a bundling of ESG performance and highly controversial business activities represented by Impact Monitor Ratings and ESG Screener

# Top Deletions from MSCI Global SRI

Name	Country	Region	Sector	GS Rating	IVA rating	IM Rating	IM score	In Proforma MSCI	
								World ESG Index?***	Weight
MITSUBISHI UFJ FIN GRP	JAPAN	PA	Financials	AA	BB	Green	7	0	0.99%
XSTRATA	UNITED KINGDOM	EU	Materials	A	BBB	Yellow	3	1	0.59%
LOWE'S COS	USA	US	Consumer Discretionary	A	B	Green	5	1	0.57%
BAXTER INTERNATIONAL	USA	US	Health Care	A	B	Yellow	2	0	0.51%
FRANCE TELECOM	FRANCE	EU	Telecommunication Services	A	AA	Yellow	2	1	0.47%
BMW STAMM	GERMANY	EU	Consumer Discretionary	A	A	Green	5	1	0.46%
MEDCO HEALTH SOLUTIONS	USA	US	Health Care	A	B	Yellow	4	0	0.41%
JOHNSON CONTROLS	USA	US	Consumer Discretionary	AA	B	Yellow	3	1	0.36%
STATE STREET CORP	USA	US	Financials	BBB	BB	Yellow	2	1	0.36%
BB&T CORP	USA	US	Financials	A	BB	Yellow	2	1	0.33%
COMPASS GROUP	UNITED KINGDOM	EU	Consumer Discretionary	A	BBB	Yellow	3	0	0.31%
UNICREDIT ORD	ITALY	EU	Financials	AA	BB	Yellow	3	0	0.30%
ASTELLAS PHARMA	JAPAN	PA	Health Care	AA	A	Green	5	1	0.30%
ROGERS COMMUNICATIONS B	CANADA	CA	Telecommunication Services	BBB	A	Yellow	4	0	0.27%
SCHWAB (CHARLES) CORP	USA	US	Financials	A	BB	Green	5	1	0.24%
NOMURA HOLDINGS	JAPAN	PA	Financials	AA	BB	Yellow	3	0	0.23%
FIFTH THIRD BANCORP	USA	US	Financials	A	B	Green	7	0	0.21%
TELENOR	NORWAY	EU	Telecommunication Services	A	AA	Yellow	4	1	0.19%
CHIPOTLE MEXICAN GRILL	USA	US	Consumer Discretionary	A	B	Green	8	1	0.19%
DANSKE BANK	DENMARK	EU	Financials	A	B	Green	8	0	0.16%
ANTOFAGASTA	UNITED KINGDOM	EU	Materials	BBB	BBB	Green	5	0	0.14%
AVON PRODUCTS	USA	US	Consumer Staples	AA	B	Yellow	4	1	0.14%
GEBERIT	SWITZERLAND	EU	Industrials	A	BB	Green	10	1	0.14%
INT'L POWER	UNITED KINGDOM	EU	Utilities	BBB	B	Green	8	0	0.13%
DIOR (CHRISTIAN)	FRANCE	EU	Consumer Discretionary	A	BBB	Green	5	0	0.13%
MACERICH CO	USA	US	Financials	BBB	B	Green	8	0	0.12%
LINCOLN NATIONAL CORP	USA	US	Financials	BBB	BB	Green	8	1	0.12%
ADECCO	SWITZERLAND	EU	Industrials	AA	BB	Green	8	1	0.11%
SMITHS GROUP	UNITED KINGDOM	EU	Industrials	A	B	Yellow	3	0	0.10%
SOLVAY	BELGIUM	EU	Materials	A	BB	Yellow	2	0	0.10%

\* GS (Global Socrates) rating is a bundling of ESG performance and highly controversial business activities represented by Impact Monitor Ratings and ESG Screener

\*\* Pro forma MSCI World ESG Index is based on the enhanced methodology for the MSCI Global ESG indices



# Discussion Points

- Is it helpful to advance the announcement of rebalancing results from five days to nine days?
- Is the application of the following enhancements to the existing MSCI Global Socially Responsible Indices Methodology appropriate?
  - ESG ratings used for the Index Reviews would be taken as of the last calendar day of the month preceding the Index Review
  - Only 'A' and above rated non index constituents eligible for inclusion
  - Only 'BB' and above rated current index constituents eligible for inclusion
- Is the application of a higher Impact Monitor controversy assessment for non index constituents appropriate?
- Would it be appropriate to create the MSCI Global SRI by targeting 25% free float market capitalization of each GICS sector of the underlying MSCI regional Index (Parent : MSCI World) ?
  - Current : Target 50% of free float market capitalization of each GICS sector of the underlying MSCI regional ESG Index (Parent Index : MSCI World ESG)

# Appendix

# MSCI Global SRI: Construction from MSCI World

- Parent : MSCI World
- Coverage : Target 25% free float adjusted market capitalization of each GICS sector of the underlying MSCI regional Index.

Index	# Current	# Proforma	# Additions	# Deletions	One Way Index Turnover
MSCI Global SRI	416	432	95	79	15.52%

# IVA Rating System

- IVA ratings represent an assessment of how well companies manage their exposure to environmental, social and governance risks and opportunities.
- The IVA ratings model assigns the majority of the scoring weight to the key ESG issues of an industry.
- IVA ratings are based on a 7 point scale, AAA-CCC. The ratings are based on the scores of the top and the lowest scoring companies in any given industry.
- IVA ratings are designed to complement conventional analysis of company financial performance. IVA ratings highlight how certain key ESG issues might have a material impact on a firm's business model.

# ESG Impact Monitor Overview

- Allows investors to analyze a company's significant social and environmental impacts and its ability to manage those impacts
- Captures ESG controversies and violations involving publicly traded companies
- Based on five categories of ESG Research
  - Environment, Customers, Human Rights & Community, Labor Rights & Supply Chain, Governance
- Three categories: Red (0-1), Yellow (2-4) and Green (5-10).
- Current constituents with an Impact monitor controversy assessment of very severe (IM flag of RED & IM Score: 0&1) will be excluded from the MSCI Global SRI. All non-index constituents will be eligible only if a company is not involved in any major controversies ( IM Flag of GREEN & IM Score $\geq$ 5).

\* As of close of November 30 2011

# ESG Impact Monitor

## List of companies with IM Rating as RED

Name	Country Name	Sector	IVA rating	In Current ESG Index	IM Rating
EXXON MOBIL CORP	USA	Energy	BB	0	Red
CHEVRON CORP	USA	Energy	BB	0	Red
NESTLE	SWITZERLAND	Consumer Staples	A	0	Red
PFIZER	USA	Health Care	B	0	Red
BP	UNITED KINGDOM	Energy	BB	0	Red
TOTAL	FRANCE	Energy	BBB	0	Red
WAL-MART STORES	USA	Consumer Staples	BBB	0	Red
RIO TINTO PLC	UNITED KINGDOM	Materials	A	0	Red
BAYER	GERMANY	Health Care	BBB	0	Red
ANGLO AMERICAN (GB)	UNITED KINGDOM	Materials	AA	0	Red
BARRICK GOLD CORP	CANADA	Materials	BBB	0	Red
GOLDMAN SACHS GROUP	USA	Financials	A	0	Red
ABB LTD	SWITZERLAND	Industrials	AA	0	Red
DAIMLER	GERMANY	Consumer Discretionary	CCC	0	Red
MONSANTO CO	USA	Materials	CCC	0	Red
FREEPORT MCMORAN C & G B	USA	Materials	BB	0	Red
HALLIBURTON CO	USA	Energy	CCC	0	Red
NEWS CORP A	USA	Consumer Discretionary	CCC	0	Red
RIO TINTO LTD	AUSTRALIA	Materials	0	0	Red
BAE SYSTEMS	UNITED KINGDOM	Industrials	CCC	0	Red
NEWS CORP B	USA	Consumer Discretionary	CCC	0	Red
TYSON FOODS A	USA	Consumer Staples	CCC	0	Red
ALPHA NAT RESOURCES	USA	Energy	B	0	Red
TOKYO ELECTRIC POWER CO	JAPAN	Utilities	CCC	0	Red
ALCATEL LUCENT	FRANCE	Information Technology	AAA	0	Red
KBR	USA	Industrials	CCC	0	Red
OLYMPUS CORP	JAPAN	Health Care	CCC	0	Red
VEDANTA RESOURCES	UNITED KINGDOM	Materials	CCC	0	Red
FOXCONN INTERNATIONAL	HONG KONG	Information Technology	BB	0	Red

\* As of close of November 30 2011

# ESG Screener - Controversial Business Involvement

- Identifies all global publicly traded companies involved in activities such as production of alcohol or tobacco products, or those that violates religious screening mandates such as Catholic values and Islamic values.
- Allows investors to divest from companies that violate legislative mandates that prohibit investment in companies that manufacture controversial weapons or operate in companies such as Sudan and Iran.
- Companies with involvement in certain controversial business activities above a certain thresholds will be excluded from the MSCI Global SRI

# ESG Screener - Controversial Business Involvement thresholds

- Alcohol: “Producers” that earn 50% of more of total revenues or USD \$1 billion in revenue from alcohol
- Tobacco: “Producers” that earn 50% of more of total revenues or USD \$1 billion in revenue from tobacco products
- Gambling: “Operations” & “Support” companies that earn 50% of more of total revenues or USD \$1 billion in revenue from gambling-related activities
- Weapons: All companies involved in “Conventional Weapons Systems” and “Conventional Weapons Components” that earn at least 50% of revenue or USD \$3 billion from weapons-related products
- Weapons: Companies that earn less than 50% of revenue from Conventional Weapons, but that earn 50% of more of total revenue from weapons-related products and services.
- Weapons: All companies involved in “Nuclear Weapons Systems”, “Nuclear Weapons Components”, “Chemical and Biological Weapons Systems”, and “Chemical and Biological Weapons Components” regardless of amount of revenue
- Weapons: All companies classified as a “Cluster Bomb Manufacturer”, “Landmine Manufacturer” or “Depleted Uranium Manufacturer” regardless of amount of revenue
- Civilian Firearms: “Producers” that earn 50% or more of revenue or USD \$ 1 billion in revenue from civilian firearms
- Sudan : All companies on the Sudan Targeted Divestment List
- Burma: All companies classified as “Military Tie”, “Pay for Mineral/Energy Rights”, “Involvement in Natural Gas/Petroleum Sector”, “Involvement in Mineral Extraction”, or “Involvement in Power Production Activities” with an exception of companies with minor involvement in power production activities or companies involved through their parent company’s activities.
- Nuclear Power: All companies classified as “Design Nuclear Reactors” , “Uranium Mining” or “Fuel Enrichment ”and all companies with 3000 MW or more of installed nuclear capacity. Also, companies with at least 15% of owned capacity from renewable sources are an exception.



# Proposed screens for Business Involvement vs. Values based Exclusion Criteria for MSCI Global Socially Responsible Index

Screens	Proposed screens for Business Involvement	Values based Exclusion Criteria for MSCI Global Socially Responsible Index
Alcohol	<ul style="list-style-type: none"> <li>Producers that earn 50% or more or USD 1 Bn revenue</li> </ul>	<ul style="list-style-type: none"> <li>Producers that earn 5% or more revenue</li> </ul>
Gambling	<ul style="list-style-type: none"> <li>Operations &amp; Support that earn 50% or more or USD 1 Bn revenue</li> </ul>	<ul style="list-style-type: none"> <li>Operations &amp; Support that earn 5% or more revenue</li> </ul>
Tobacco	<ul style="list-style-type: none"> <li>All companies that earn 50% or more or USD 1 Bn</li> </ul>	<ul style="list-style-type: none"> <li>All producers and distributors.</li> <li>Retailers and suppliers with more than 15% revenue</li> </ul>
Adult Entertainment	No Screen	<ul style="list-style-type: none"> <li>Producers that 5% or more revenue</li> </ul>
Nuclear Power	<ul style="list-style-type: none"> <li>All companies classified as nuclear "Utility" or involved in Uranium mining or designing nuclear reactors</li> <li>5% or more revenue from nuclear related activities</li> </ul>	<ul style="list-style-type: none"> <li>All companies classified as nuclear "Utility" or involved in Uranium mining or designing nuclear reactors</li> <li>5% or more revenue from nuclear related activities</li> </ul>
Military Weapons	<ul style="list-style-type: none"> <li>All companies classified as "Nuclear Weapons System", "Nuclear Weapons Components", "Chemical &amp; Biological Weapons System", Chemical and Biological Weapons components", "Cluster Bomb Manufacturer" or "Landmine manufacturer"</li> <li>50% or more or USD 1 Bn revenue from Military Weapons</li> </ul>	<ul style="list-style-type: none"> <li>All companies classified as "Nuclear Weapons System", "Nuclear Weapons Components", "Chemical &amp; Biological Weapons System", Chemical and Biological Weapons components", "Cluster Bomb Manufacturer" or "Landmine manufacturer"</li> <li>5% or more revenue from Military Weapons</li> </ul>
Burma, Sudan	<ul style="list-style-type: none"> <li>Classified as Military Ties, pay for mineral/energy right, involvement in Natural gas/Petroleum sector or mineral extraction or power production activities</li> <li>Companies on Sudan Targeted divestment list</li> </ul>	No Screen
Civilian Firearms	<ul style="list-style-type: none"> <li>Producers that earn 50% or more or USD 1 Bn revenue</li> </ul>	<ul style="list-style-type: none"> <li>All companies classified as Producers</li> <li>Retailers that earn 15% or more</li> </ul>
Genetically Modified Organisms	No Screen	<ul style="list-style-type: none"> <li>Companies that derive any revenue from activities such as genetically modified plants</li> </ul>

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## Americas

Americas	1.888.588.4567 (toll free)
Atlanta	+1.404.551.3212
Boston	+1.617.532.0920
Chicago	+1.312.706.4999
Monterrey	+52.81.1253.4020
Montreal	+1.514.847.7506
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Frankfurt	+49.69.133.859.00
Geneva	+41.22.817.9777
London	+44.20.7618.2222
Milan	+39.02.5849.0415
Paris	0800.91.59.17 (toll free)

## Asia Pacific

China North	10800.852.1032 (toll free)
China South	10800.152.1032 (toll free)
Hong Kong	+852.2844.9333
Seoul	+798.8521.3392 (toll free)
Singapore	800.852.3749 (toll free)
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Tokyo	+81.3.5226.8222

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