MSCI'S FEEDBACK ON SUSTAINABLE FINANCE – MINIMUM STANDARDS FOR CLIMATE BENCHMARKS

MSCI

May 2020

INTRODUCTION

MSCI appreciates the opportunity to comment on the SUSTAINABLE FINANCE – MINIMUM STANDARDS FOR CLIMATE BENCHMARKS.

About MSCI

MSCI Equity Indexes

MSCI is a leading provider of investment decision support tools to institutional investors globally, including asset managers, banks, hedge funds and pension funds. MSCI products and services include indexes, ESG research and tools, and portfolio risk and performance analytics. MSCI is headquartered in New York, with research and commercial offices around the world.

MSCI has been calculating indexes for more than 45 years. The MSCI equity indexes include country and regional indexes, size indexes (large cap, small cap, and micro-cap), sector indexes, style (value/growth) indexes, strategy indexes, thematic indexes and ESG indexes.

MSCI also calculates custom indexes at the request of clients, by applying client screens and constraints to MSCI equity indexes.

MSCI equity indexes are used worldwide by:

- assets owners to help them with their mandate decisions and with reviewing their managers' performance;
- active asset managers so that they can actively manage their funds against an index and report performance;
- passive fund managers to issue passive funds and ETFs based on the indexes;
- broker dealers for providing trading execution services, creating OTC and non-OTC derivative financial products and writing research more generally;
- stock exchanges to create equity index linked futures and options contracts; and
- CCPs to calculate the risks of its positions for index linked futures and options contracts.

During 2013 and 2014, MSCI implemented the IOSCO Principles for Financial Benchmarks, was externally audited during each of 2014, 2015 and 2016 for the MSCI equity indexes and select MSCI private real estate indexes, and posted the adherence statements and audit reports on the Index Regulation page of www.msci.com. During 2017, 2018 and 2019, MSCI devoted those resources to implementing the EU benchmark regulation (“BMR”), and MSCI posted the IOSCO adherence statements on the Index Regulation page of www.msci.com.

On 5 March 2018, MSCI Limited, which is a UK subsidiary of MSCI Inc., was granted authorization by the UK FCA as a UK administrator under the BMR for the MSCI equity indexes. MSCI was the first major global equity index provider to become authorized under the BMR. On 13 June 2019, MSCI notified the FCA in relation to specific UK MSCI Private Real Estate Indexes used as regulated benchmarks under the BMR. On 16 December 2019, MSCI notified the FCA in relation to the MSCI fixed income indexes.

MSCI ESG Research

For over 40 years, MSCI ESG Research has measured and modelled Environmental, Social and Governance (ESG) risk[1]. MSCI is a leading provider of ESG ratings, indexes and analytical tools. We aim to help investors integrate ESG across their entire investment process; powering better investment decisions.

Our solutions:

*First ESG provider to assess companies based on industry financial materiality, dating back to 1999. Only dataset with live history (12+ years) demonstrating economic relevance[2]. For over 11 years, we have rated companies on their exposure to, and management of, industry-specific ESG risks. We rate nearly 14,000 issuers representing more than 680,000 securities, with 90% of equity and fixed income market value. Our research is used by over 1,400 clients globally. Clients can use ESG ratings to support fundamental and quant analyses, portfolio construction and risk management and thought leadership and engagement.

* MSCI ESG Indexes: MSCI is the world’s largest provider of ESG indexes with over 1,500 ESG equity and fixed Income Indexes leveraging MSCI ESG Research data to support ESG integration, screening and impact approaches. Several global asset owners have selected MSCI ESG Indexes, with over $180 billion allocated in recent years[3]. The indexes can also be used as the basis for exchange-traded-funds and other index-based products.

* MSCI ESG Analytics: Our ESG research, data and indexes are available within MSCI’s analytics systems. MSCI Analytics clients can explore ESG

exposures on 680,000 securities and 8 million derivatives to support security selection, portfolio construction, stress testing, and risk and performance attribution analysis.

MSCI ESG Research products and services are provided by MSCI ESG Research LLC, and are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research LLC. are also used in the construction of the MSCI ESG Indexes.

For the purposes of the ESG metrics for the ESG benchmarks disclosures, the ESG metrics are provided by MSCI ESG Research LLC. MSCI ESG Indexes are provided by MSCI Inc. and utilize information from, but are not provided by, MSCI ESG Research LLC. MSCI Limited is the benchmark administrator for the MSCI Indexes under the EU Benchmark Regulation. ESG ratings, data and analysis from MSCI ESG Research LLC. are also used in the construction of the MSCI ESG Indexes.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc.

1. Through MSCI ESG Research and its legacy companies KLD, Innovest, IRRC, and GMI Ratings
2. Origins of MSCI ESG Ratings established in 1999. Produced time series data since 2007
3. Based on publicly available information in press releases published from 2014 to date

MSCI's Feedback

Article Number / Annexure	Article Content	Criticality / Clarity	MSCI FEEDBACK
Article 5	*The draft regulation states that "at .... [the date of application of this Regulation], Scope 3 GHG emissions data for at least the energy and mining sectors referred to in Divisions 05 to 09 and 19 and 20 of Annex I to Regulation (EC) No 1893/2006"*	CRITICAL	Integration of Scope 3 data from the implementation date can be challenging for benchmark providers. The Scope 3 emission data can be quite complex to calculate and estimate, considering the multiple upstream and downstream activities that companies may be involved in. Comprehensive estimation models for Scope 3 data are still being developed and standardized by various ESG data providers. The challenges of inconsistency in reported Scope 3 data or in estimated Scope 3 data was also acknowledged in the EU's Sustainable Finance Technical Expert Group (TEG) Final Report. The TEG Final Report (Section 5.3.4) allowed for the use of Fossil Fuel reserves as a metric to capture Scope 3 data. We recommend that the Commission allows Benchmark Providers to use Fossil Fuel Reserves data up to 2 years from the implementation date.
Article 7	*The Point Number 1 in the draft regulation states that " a 7 % reduction of GHG intensity on average per annum" is required for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks. Point Number 2 in the draft regulation states that the reduction " for year 'n' shall be calculated based on the GHG intensity or absolute GHG emissions for the year n-1, in a geometric progression."*	INCREASE CLARITY	The current wording of Point Number 2 leads to interpretation of Self-Decarbonization as reduction in carbon intensity of the index over previous year and not an average reduction in trajectory of the emission intensity since the implementation date. The below example can help illustrate why the change is required. Consider a hypothetical case where,

Article Number / Annexure	Article Content	Criticality / Clarity	MSCI FEEDBACK
			WACI of benchmark in 2020 = 100 WACI of benchmark in 2021 = 50 In such a case, the target WACI for the year 2022, as we interpret Point Number 1, would come out to be 86.49 (100 * 0.93 * 0.93). However, as per Point Number 2, the Benchmark would be targeting a WACI of 46.5 (50 * 0.93). The WACI of the benchmark can go below the targeted WACI due to changes in benchmark composition or signficant changes in company levels GHG intensity dure to changes in company's fundamentals. However, if the targets are enforced on a year-on-year basis, the target set for 2022 is even more aggressive and could subsequently lead to scenarios where it is infeasible to reduce the GHG Intensity to the targeted levels. We recommend that the Commission revises the Point Number 2 of Article 8 to clarify that the reduction in WACI should be calculated relative to the "Base Year". The Average per year reduction in WACI relative to the "Base Year" will remove the inconsistency between the current text of Point Number 1 and Point Number 2 of Article 8. Our recommendation is also in line with Figure 3 of the TEG Final Report wherein the Target set in year N+4 is dependent on the "Base Year" GHG Intensity. Appendix I of the HANDBOOK OF CLIMATE TRANSITION BENCHMARKS, PARIS-ALIGNED BENCHMARK AND

Article Number / Annexure	Article Content	Criticality / Clarity	MSCI FEEDBACK
			BENCHMARKS' ESG DISCLOSURES, issued by the TEG on December 20,2019 also lays down the decarbonization targets relative to the "Base Year".
Article 7	*The draft regulation states that the "enterprise inflation adjustment factor shall be calculated by dividing the average EVIC of the benchmark constituents at the end of a calendar year by the average EVIC of the index constituents at the end of the previous calendar year.*	INCREASE CLARITY	The inflation calculation as the change in average EVIC of index constituents over two years is sensitive to addition or deletion of constituents. The below example can help illustrate the point: In June 2018, MSCI added large cap A-shares of Chinese companies into the MSCI EM (Emerging Markets) Index, which led to the increase in average EVIC of the constituents from $27 B (before inclusion of China A shares in index) to $32 B (after the inclusion of China A shares stocks). Since the EVIC inflation factor aims to neutralize the effect of change in market capitalization of companies and insulate index WACI from short term market movements, the EVIC Inflation factor should only include stocks which were present in the index in both 2017 and 2018. We recommend that the Commission expand the explanation on EVIC Inflation factor to clarify that the inflation factor calculation for a period should only take into account the EVIC of index constituents common between the start and end of the period.
Article 11	*The draft regulation states that "companies involved in any activities related to tobacco" should be*	CRITICAL	Exclusion of companies with any involvement in Tobacco (including indirect ties) may lead to large number of exclusions. As of March 2020, 227

Article Number / Annexure	Article Content	Criticality / Clarity	MSCI FEEDBACK
	excluded from Paris Aligned Benchmarks.		securities with an index weight of 8.11% are excluded if we use any Tobacco involvement on MSCI ACWI Index (comprising large- and mid-cap constituents in developed and emerging markets). We recommend to use a more nuanced approach that targets direct involvement using internally or externally established standards, such as the Tobacco Free Portfolios, where tobacco producers with revenue attributable is =>5% of total revenues will be flagged. In this case, production activities represent the most direct contribution to the tobacco sector.
Article 11	*The draft regulation requires the following:* *- exclusion of "companies that derive 1 % or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite"* *- exclusion of "companies that derive 10 % or more of their revenues from the exploration, extraction, distribution or refining oil fuels"* *- exclusion of "companies that derive 50 % or more of their revenues from the exploration, extraction, manufacturing or distribution of hydrocarbons, hydrogen and carbon monoxide mixtures present in gaseous state"*	CRITICAL	Typically the processes conducted between the extraction of coal and its eventual use are limited to activities such as coal washing or coal preparation, which do not significantly change the coal – instead, these changes would mostly be limited to changes in the moisture content or form of the coal. In many cases, coal washing and preparation are already conducted by the companies that mine the coal themselves, which means that revenues derived from activities like coal washing and preparation are already integrated in the overall revenues that a company derives from coal mining. We recommend that only revenue from coal mining and extraction activities are considered for exclusion through coal related activities.

Article Number / Annexure	Article Content	Criticality / Clarity	MSCI FEEDBACK
Article 11	*Section 5.9.1 of The Final Report recommends "Baseline exclusions for EU CTB and EU PAB"*	INCREASE CONSISTENCY	We see institutional investors are increasingly adopting minimum exclusions like controversial weapons from their climate strategies. In order to bring greater consistency across Climate Transition Benchmarks and Paris-aligned Benchmarks, we recommend that companies involved in Controversial Weapons be also excluded from the Climate Transition Benchmarks.
Article 14	*The draft regulation requires the following in the context of ensuring accuracy of data sources:* *1. Administrators of EU Climate Transition and of EU Paris-aligned Benchmarks shall ensure that data on Scope 1, 2 and 3 GHG emissions are accurate, in accordance with global or European standards, such as the Corporate Value Chain (Scope 3) Accounting and Reporting Standard12, the EN ISO 14064 or the EN ISO 14069.* *2. Administrators of EU Climate Transition Benchmarks and of EU Paris-aligned Benchmarks shall ensure the consistency, comparability and quality of GHG emissions data.*	CRITICAL	• Article 14 creates an unreasonable standard for benchmark administrators to meet, including because of the fact that the data will be based on data provided from other sources and those sources will not provide such guarantees. For example MSCI ESG Research is a data provider like any other to a benchmark administrator and is an independent entity (distinct from a benchmark administrator). A benchmark administrator does not control the contents of raw data quality beyond performing certain standard quality assurance checks. • To allow the benchmarks to be used more easily by global investors, we recommend that ▪ The name of the index should not need to include "EU Climate Transition" or "EU Paris-aligned" in the index name and instead the methodology can reference that the index is aligned to standards, and/or

Article Number / Annexure	Article Content	Criticality / Clarity	MSCI FEEDBACK
			▪ "EU" can be dropped from the nomenclature "EU Climate Transition" or "EU Paris-aligned" in the index name and the methodology can reference that the index is aligned to standards.

Contact us

clientservice@msci.com

AMERICAS

Americas	1 888 588 4567 *
Atlanta	+ 1 404 551 3212
Boston	+ 1 617 532 0920
Chicago	+ 1 312 675 0545
Monterrey	+ 52 81 1253 4020
New York	+ 1 212 804 3901
San Francisco	+ 1 415 836 8800
São Paulo	+ 55 11 3706 1360
Toronto	+ 1 416 628 1007

EUROPE, MIDDLE EAST & AFRICA

Cape Town	+ 27 21 673 0100
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 *

ASIA PACIFIC

China North	10800 852 1032 *
China South	10800 152 1032 *
Hong Kong	+ 852 2844 9333
Mumbai	+ 91 22 6784 9160
Seoul	00798 8521 3392 *
Singapore	800 852 3749 *
Sydney	+ 61 2 9033 9333
Taipei	008 0112 7513 *
Thailand	0018 0015 6207 7181 *
Tokyo	+ 81 3 5290 1555

* = toll free

ABOUT MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 45 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

To learn more, please visit www.msci.com.

The process for submitting a formal index complaint can be found on the index regulation page of MSCI's website at: https://www.msci.com/index-regulation.

Notice and disclaimer