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Introduction

The MSCI Equity Indices

The objective of MSCI, with respect to its Equity Index Series, is to construct global benchmark indices that contribute to the investment process by serving as relevant and accurate performance benchmarks and effective research tools, and as the basis for various investment vehicles. As such, the MSCI Equity Indices are designed to fulfill the investment needs of a wide variety of global institutional investors. In constructing these indices, MSCI consistently applies its equity index construction and maintenance methodology across regions and developed and emerging markets. This consistency of approach makes it possible to aggregate individual country and industry indices to create meaningful regional and composite benchmark indices.

MSCI has constructed its equity indices with the same objectives in mind for more than 30 years. During that time, as the markets have evolved, MSCI's methodology has also evolved in order to ensure that the MSCI Equity Indices continue to accurately represent the opportunities available to global institutional investors. Importantly, while the methodology has evolved, the index construction objectives and guiding principles have remained paramount.

Enhanced Methodology and the MSCI Provisional Index Series

In recent years, the issue of investability has been highlighted by a number of developments, including:

- A significant rise in cross-border portfolio investments.
- The growth in passive investment management.
- A large number of IPOs and partial privatizations of large companies with restricted free float.
- An increased focus on controlling the risk of portfolios, including the portfolio’s benchmark risk.

In view of the likely continuation of these trends, there is a growing need to adjust the index weights of companies with limited free float, for which the availability of shares can be an important constraint. Including these companies in the index at a weight higher than the available free float could result in insufficient supply, which may potentially lead to distortions in price.

MSCI began to address the impact of the trends on investability of benchmarks in 1996, when it introduced its Partial Inclusion Policy and the use of Market Capitalization Factors to include certain large companies with low free float at a fraction of their full market capitalization. Further refinements and enhancements were made to this policy in 1999 and 2000.

Also in the last few years, the significant rise in domestic and cross-border mergers and acquisitions activity has led to the emergence of large global companies, especially in certain industries. This trend has resulted in increased equity market and sector concentration, making it difficult to represent the diversity of business activities in the MSCI Standard Equity Indices with a target market representation of 60%.
In light of the trends described above, and following an extensive consultation with clients and other market participants, MSCI decided to make certain enhancements to its methodology to account for (a) the investability of securities with limited free float by free float adjusting constituent weights and (b) the increasing concentration in equity markets globally by increasing the target market representation in its equity indices.

As a result, in December 2000, MSCI announced that it would adjust all of its equity indices for free float and increase the target market representation of its Standard Index Series from 60% of total market capitalization to 85% of free float-adjusted market capitalization. The combined changes will be implemented in the Standard Index Series in two separate phases. The first phase will be implemented as of the close of November 30, 2001, and the second phase will be implemented as of the close of May 31, 2002.

The phased implementation of the Enhanced Methodology in the Standard Index Series is designed to spread out the turnover in this index series and its potential market impact, and to allow ample time for investors to adapt to the changes. Another important feature of MSCI’s implementation plan is the calculation, beginning on May 31, 2001, of the MSCI Provisional Index Series based upon MSCI’s Enhanced Methodology.

The MSCI Provisional Index Series has been created to assist investors in understanding the changes that would occur if the Enhanced Methodology were immediately implemented in the MSCI Standard Index Series. The MSCI Provisional Index Series also provides increased flexibility for investors who wish to transition to the Enhanced Methodology at a time schedule that suits their needs. In addition, the MSCI Provisional Index Series is an official series and, as such, may be used as the basis for new investment mandates and for a variety of investment vehicles such as passive mutual funds, exchange traded funds and listed and over-the-counter derivative contracts.

This Methodology Book describes MSCI’s index construction objectives, guiding principles, and the Enhanced Methodology for the Provisional Index Series. In addition, Section 4 deals with specific index maintenance issues relating to the implementation of the Enhanced Methodology in the Standard Index Series. Certain specific aspects of MSCI’s Enhanced Methodology are treated in appendices at the end of the Methodology Book.
Section 1: Equity Index Construction Objectives and Guiding Principles

1.1 Purpose and Objectives

MSCI’s objective is to construct “benchmark indices” that contribute to the investment process in the following ways. First, they serve as a gauge for measuring the performance of a market. In so doing, these indices also serve as performance benchmarks in the measurement and attribution of the performance of an investment strategy. Second, they may be used as a research tool for a variety of purposes, including in the strategic asset allocation process. Performance benchmarks provide an important historical perspective on the various dimensions of investment performance of asset classes, such as returns, volatility of returns, and correlations. This historical perspective may serve as a useful guide in the determination of an appropriate strategic asset mix. Finally, benchmark indices may serve as a basis for investment vehicles designed to replicate the performance of a market or to implement and manage an investment policy. Given these uses, MSCI’s benchmark indices are designed to fulfill the investment needs of a wide variety of global institutional investors.

1.2 Guiding Principles

MSCI strives to achieve the objective of providing global benchmark equity indices by adhering to the following guiding principles in the design and implementation of its index construction and maintenance methodology.

1.2.1 Broad and Fair Market Representation

MSCI Equity Indices are constructed and managed with a view to providing broad and fair market representation. In the abstract, a total market index, representing all listed securities in a given market, would achieve this goal. In practice, however, a total market index may be difficult to use as a true performance benchmark for global investors, as it will include a very large proportion of small and/or illiquid securities, which international investors may not be able to easily reflect in their portfolios. Therefore, MSCI defines broad and fair market representation as an accurate and complete reflection in the indices of the structure and distribution of business activities across and within industries that international institutional investors can gain exposure to in a given market. MSCI strives to achieve the objective of broad and fair market representation by following a bottom-up sampling approach to index construction. This approach, which builds the indices from the industry group level up, aims to capture the structure and other characteristics of the underlying total market, but does so with securities that are truly replicable in global institutional portfolios of reasonable size. Specifically, to implement this approach, a target of 85% of free float-adjusted market representation within each industry group, within each country is used as a guideline. This guideline strikes an appropriate balance between broad and fair market representation and investability of indices.

Given the objective of representing the diversity of business activities across and within industries, MSCI’s sampling approach does not target a specific number of securities in its country indices. The number of constituents included in an index is dependent on the breadth and depth of the underlying market and on the minimum size guidelines applied in the construction of the index. However, in certain cases, an
appropriate balance needs to be attained between including a large number of securities and the additional diversification benefits that these securities bring to the index.

1.2.2 Investability and Replicability

MSCI Equity Indices are constructed and managed with a view to being fully investable from the perspective of international institutional investors. MSCI strives to achieve this objective by providing indices that are replicable. This includes representing constituents in the index at weights that can easily and cost effectively be reflected in global institutional portfolios of reasonable size. This objective is achieved by a) free float adjusting constituent weights, taking into account any Foreign Ownership Limits (FOLs) and other restrictions that hinder the implementation of the investment process for international institutional investors and b) selecting securities of reasonable size and liquidity for the indices.

1.2.3 Consistency of Approach

MSCI Equity Indices are constructed and managed with a view to providing consistency of approach across all markets around the world. This objective is achieved by applying MSCI’s index construction and management methodology, including its rules and guidelines, in a consistent fashion across all markets. The consistent application of index methodology to all markets also makes it possible to apply a “building block” approach in the construction of regional and composite indices. Under this approach, individual MSCI country indices can be aggregated to create various relevant, accurate, and comparable regional (e.g. MSCI Europe Index) and composite (e.g. MSCI EAFE Index) benchmark indices.

1.2.4 Continuity and Index Turnover

MSCI Equity Indices are managed with a view to ensuring the continuity of the indices. Continuity refers to the consistent application of index methodology over time. It also implies that the primary, but not the only, concern when considering additions and deletions is the continuity of constituents in the index being reviewed. In emphasizing continuity, MSCI wishes to provide improved predictability of and greater stability to the indices.

MSCI Equity Indices are also managed with the objective of keeping the level of index turnover relatively low, while at the same time reflecting the evolution of markets on a timely fashion. As such, costs associated with reflecting the changes in the MSCI indices in a portfolio are maintained at a reasonable level.

1.2.5 Disciplined Approach: Principles, Rules, and Guidelines

MSCI Equity Indices are constructed and managed using a set of principles, rules, and guidelines. This approach makes it possible to attain certain desirable attributes of a benchmark index, such as, stability of the index, proper diversification across industries and securities and accurate representation of the distribution and structure of business activities within the overall market. These desirable features of a benchmark index would be difficult to achieve through a fully rules based, mechanical methodology for inclusion and deletion of index constituents.
There are a number of areas in index construction and maintenance where clear, simple, and objective rules can be, and are, applied by MSCI to simplify the index management process, without compromising the ability of the indices to achieve the stated index construction objectives. In other more complicated areas of index construction and maintenance, where the use of rules may be impractical or may lead to conflicts with the objectives of the indices, MSCI makes decisions based on its index guiding principles and guidelines. The basic objective of index guidelines is to ensure that judgment can be applied in a structured and consistent fashion in order to reach final decisions.

1.2.6 Transparency

MSCI Equity Indices are constructed and managed with a view to being transparent in the context of MSCI’s index construction objectives, guiding principles and methodology. These objectives, guiding principles and methodology are clearly specified and published. Additionally, as mentioned above, in some areas of index construction and maintenance, explicit index rules are applied to simplify the index management process. These rules are published by MSCI and regularly updated if changes are made. In some other areas of index construction and maintenance, MSCI uses internal index guidelines to facilitate the index decision-making process. These guidelines, by their nature, are not intended to be applied rigidly and are subject to change as underlying market conditions change. Therefore, where index guidelines are used, explanations of the framework for analysis used to develop these index guidelines are also published, so that investors and other users of MSCI products can better understand the spirit in which these guidelines are developed and applied by MSCI in the decision-making process. Finally, in order to provide transparency and predictability to the marketplace, MSCI has a policy of announcing all significant changes to its indices in advance of implementing such changes.

1.2.7 Independence and Objectivity

MSCI Equity Indices are constructed and managed with a view to providing truly independent and objective editorial and content decisions. MSCI operates completely independently of all interest groups, including its shareholders, and manages its family of equity indices based on publicly-available information. The fact that MSCI is editorially independent and objective does not preclude MSCI from considering the views and suggestions of our clients and other users of our products and services. To the contrary, MSCI believes in fully engaging all stakeholders by frequently soliciting feedback, counsel, and guidance relating to all aspects of index construction and maintenance. MSCI carefully considers and analyzes all the feedback received from various constituencies, and the final decisions are taken independently of any single interest group or stakeholder and have the sole objective of preserving or enhancing the quality of the MSCI Indices.
Section 2: Constructing the Equity Indices

To construct relevant and accurate equity indices for the global institutional investor under the Enhanced Methodology, MSCI undertakes an index construction process, which involves:

- Defining the equity universe.
- Adjusting the total market capitalization of all securities in the universe for free float available to foreign investors.
- Classifying the universe of securities under the Global Industry Classification Standard (GICS).
- Selecting securities for inclusion according to MSCI’s index construction rules and guidelines.

2.1 Defining the Equity Universe

The index construction process starts at the country level, with the identification of the universe of investment opportunities. Currently, MSCI creates equity indices for 51 country markets globally.

MSCI classifies each company and its securities in one and only one country. This allows securities to be sorted distinctly by their respective countries. In general, companies and their respective securities are classified as belonging to the country in which they are incorporated. All listed equity securities, or listed securities that exhibit characteristics of equity securities, except investment trusts, mutual funds and equity derivatives, are eligible for inclusion in the universe. Shares of non-domiciled companies generally are not eligible for inclusion in the universe.

About 99% of the world’s total equity market capitalization is included in the MSCI universe.

For further details on domicile determination, see Appendix I, titled “Country Classification of Securities”.

2.2 Adjusting the Total Market Capitalization of Securities in the Universe for Free Float

After identifying the universe of securities, MSCI calculates the free float-adjusted market capitalization of each security in that universe. The process of free float adjusting market capitalization involves:

- Defining and estimating the free float available to foreign investors for each security, using MSCI’s definition of free float.
- Assigning a free float-adjustment factor to each security.
- Calculating the free float-adjusted market capitalization of each security.

2.2.1 Defining and Estimating Free Float

MSCI defines the free float of a security as the proportion of shares outstanding that are deemed to be available for purchase in the public equity markets by international investors. In practice, limitations on free float available to international investors include:

- Strategic and other shareholdings not considered part of available free float.
- Limits on share ownership for foreigners.
MSCI’s estimation of free float is based solely on publicly available shareholder information obtained from multiple information sources. For each security, all available shareholdings are considered where public data is available, regardless of the size of the shareholding. Consultation may be conducted with analysts, other industry experts and official company contacts, particularly where disclosure standards or data quality make the estimation of free float difficult.

For further details on the MSCI free float definition, see Appendix II, titled “MSCI Free Float Definition and Estimation Guidelines”.

The estimation of free float available to international investors for securities with or without foreign ownership limits is explained below.

### 2.2.1.1 Securities Not Subject to Foreign Ownership Limits (FOLs)

For securities not subject to FOLs, the free float of a security is estimated as its total number of shares outstanding less shareholdings classified as strategic and/or non-free float. Examples of shares excluded from free float are stakes held by strategic investors such as governments, corporations, controlling shareholders and management.

<table>
<thead>
<tr>
<th>Non-free float Shareholdings (%) =</th>
<th>Number of Shares Classified as Non-Free Float divided by the Total Number of Shares</th>
</tr>
</thead>
</table>

| Free Float (%) = | 100% minus Non-Free Float Shareholdings (%) |

### 2.2.1.2 Securities Subject to Foreign Ownership Limits (FOLs)

For securities subject to FOLs, the estimated free float available to foreign investors is equal to the lesser of:

- Estimate of free float, as defined above.
- FOL adjusted for non-free float stakes held by foreigners.

<table>
<thead>
<tr>
<th>Free Float for Foreign Investors (%) =</th>
<th>Minimum of:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• 100% minus Non-Free Float Shareholdings, Including Domestic and Foreign Shareholdings</td>
</tr>
<tr>
<td></td>
<td>• FOL minus Foreign Non-Free Float Shareholdings</td>
</tr>
</tbody>
</table>
2.2.2 Assigning a Free Float-Adjustment Factor

MSCI free float adjusts the market capitalization of each security using an adjustment factor, referred to as the Foreign Inclusion Factor (FIF).

2.2.2.1 Securities with Free Float Greater Than 15%, and Not Subject to FOLs

For securities with free float greater than 15%, the FIF is equal to the estimated free float, rounded up to the closest 5%.

2.2.2.2 Securities with Free Float Less Than 15%, and Not Subject to FOLs

For securities with free float less than 15%, the FIF is equal to the estimated free float, rounded to the closest 1%.

2.2.2.3 Securities Subject to Foreign Ownership Limits (FOLs)

For securities subject to Foreign Ownership Limits (FOLs), the FIF is equal to the lesser of:

- Estimated free float available to foreign investors,
  - Rounded up to the closest 5%, if the free float is greater than 15%.
  - Rounded to the closest 1%, if the free float is less than 15%.
- FOL minus foreign non-free float holdings, rounded to the closest 1%.

2.2.2.4 Securities Affected by Other Foreign Investment Restrictions

For securities affected by other foreign investment restrictions, which hinder the efficient implementation of the investment process for foreign investors, an additional adjustment factor, referred to as the Limited Investability Factor (LIF), is applied. In these special cases, the free float adjusted for limited investability is defined as the product of the available free float for foreigners and the Limited Investability Factor.

\[
\text{Free Float Adjusted for Limited Investability} = \text{Free Float for Foreigners} \times \text{the LIF}
\]

Therefore, for securities subject to other foreign investment restrictions, the Foreign Inclusion Factor is equal to:

- The estimated free float adjusted for limited investability, rounded up to the closest 5%, if the free float adjusted for limited investability is greater than 15%.
- The estimated free float adjusted for limited investability, rounded to the closest 1%, if the free float adjusted for limited investability is less than 15%. 
2.2.3 Calculating the Free Float-Adjusted Market Capitalization

The free float-adjusted market capitalization of a security is calculated as the product of the Foreign Inclusion Factor (FIF) and the security’s total market capitalization.

Free Float-Adjusted Market Capitalization = FIF times the Security’s Total Market Capitalization

The following examples illustrate the calculation of the free float-adjusted market capitalization of securities with and without Foreign Ownership Limits (FOLs).

Example:
Calculating Free Float-Adjusted Market Capitalization:
Securities Not Subject to Foreign Ownership Limits

<table>
<thead>
<tr>
<th>Company</th>
<th>Total number of shares outstanding</th>
<th>Number of shares classified as non-free float</th>
<th>Non-free float shareholding (%)</th>
<th>Free float (%)</th>
<th>Foreign Inclusion Factor (FIF)</th>
<th>Market price ($)</th>
<th>Total market capitalization ($ mm)</th>
<th>Free float-adjusted market capitalization ($ mm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>10,000,000</td>
<td>4,300,000</td>
<td>43.0%</td>
<td>57.0%</td>
<td>0.60</td>
<td>500</td>
<td>5,000</td>
<td>3,000</td>
</tr>
<tr>
<td>B</td>
<td>10,000,000</td>
<td>8,760,000</td>
<td>87.6%</td>
<td>12.4%</td>
<td>0.12</td>
<td>500</td>
<td>5,000</td>
<td>600</td>
</tr>
</tbody>
</table>

Example:
Calculating Free Float-Adjusted Market Capitalization:
Securities Subject to Foreign Ownership Limits

<table>
<thead>
<tr>
<th>Company</th>
<th>Total number of shares outstanding</th>
<th>All shares classified as non-free float</th>
<th>Foreign Ownership Limit (%)</th>
<th>Foreign Strategic shareholding (%)</th>
<th>Foreign Ownership Limit less the foreign Strategic shareholding (%)</th>
<th>Foreign Inclusion Factor (FIF)</th>
<th>Market price ($)</th>
<th>Total market capitalization ($ mm)</th>
<th>Free float-adjusted market capitalization ($ mm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>10,000,000</td>
<td>8,760,000</td>
<td>33.3</td>
<td>10.0</td>
<td>23.3</td>
<td>0.12</td>
<td>500</td>
<td>5,000</td>
<td>600</td>
</tr>
<tr>
<td>D</td>
<td>10,000,000</td>
<td>4,000,000</td>
<td>33.3</td>
<td>10.0</td>
<td>23.3</td>
<td>0.25</td>
<td>500</td>
<td>5,000</td>
<td>1,250</td>
</tr>
<tr>
<td>E</td>
<td>10,000,000</td>
<td>4,000,000</td>
<td>33.3</td>
<td>0.0</td>
<td>33.3</td>
<td>0.33</td>
<td>500</td>
<td>5,000</td>
<td>1,650</td>
</tr>
</tbody>
</table>
2.3 Classifying Securities Under the Global Industry Classification Standard (GICS)

In addition to the free float-adjustment of market capitalization, all securities in the universe are assigned to the industry that best describes their business activities. To this end, MSCI has designed, in conjunction with Standard & Poor’s, the Global Industry Classification Standard (GICS). This comprehensive classification scheme provides a universal approach to industries worldwide and forms the basis for achieving MSCI’s objective of reflecting broad and fair industry representation in its indices.

2.3.1 Structure of the Global Industry Classification Standard (GICS)

The Global Industry Classification Standard (GICS) consists of 10 sectors, 23 industry groups, 59 industries, and 123 sub-industries. These four industry groupings are strictly hierarchical, as shown below.

The Global Industry Classification Standard (GICS)

- 10 Sectors
  - 23 Industry Groups
    - 59 Industries
      - 123 Sub-Industries

2.3.2 Industry Classification of Companies under the GICS

Under the Global Industry Classification Standard (GICS), each company is assigned uniquely to one sub-industry according to its principal business activity. Therefore, a company can only belong to one industry grouping at each of the four levels of the GICS.

Classifying securities into their respective sub-industries can be complex, especially in an evolving and dynamic environment. The guidelines used under the GICS to determine the appropriate industry classification are:

- A security is classified in a sub-industry according to the business activities that generate approximately 60% or more of the company’s revenues.
- A company engaged in two or more substantially different business activities, none of which contributes 60% or more of revenues, is classified in the sub-industry which provides the majority of both the company’s revenues and earnings.
- Where the above guidelines cannot be applied, or are considered inappropriate, further analysis is conducted, and other factors are analyzed to determine an appropriate classification.

For further details on the GICS, see Appendix III, titled “Global Industry Classification Standard (GICS)”. 
2.4 Selecting Securities for Index Inclusion

In order to ensure a broad and fair representation in the indices of the diversity of business activities in the universe, MSCI follows a “bottom-up” approach to index construction, building indices from the industry group level up. The bottom-up approach to index construction requires a thorough analysis and understanding of the characteristics of the universe. This analysis drives the individual security selection decisions, which aim to reflect the overall features of the universe in the country index.

MSCI targets an 85% free float-adjusted market representation level within each industry group, within each country. The security selection process within each industry group is based on the careful analysis of:

- Each company’s business activities and the diversification that its securities would bring to the index.
- The size (based on free float-adjusted market capitalization) and liquidity of securities. All else being equal, MSCI targets for inclusion the most sizable and liquid securities in an industry group. In addition, securities that do not meet the minimum size guidelines discussed below and/or securities with inadequate liquidity are not considered for inclusion.
- The estimated free float for the company and its individual share classes. Only securities of companies with estimated free float greater than 15% are, in general, considered for inclusion.

2.4.1 Index Constituent Eligibility Rules and Guidelines

In order to ensure the investability of MSCI Indices, the following index eligibility rules and guidelines for index inclusion are applied in the index construction process.

These rules and guidelines are applied at the security level, rather than the company level. As such, the inclusion or deletion of one share class does not imply the automatic inclusion or deletion of the other share classes of the same company.

2.4.1.1 Minimum Size Guidelines

All securities that are considered for inclusion or currently are included in the MSCI Provisional Indices must be of reasonable size, in terms of free float-adjusted market capitalization. In order to derive guidelines on eligible minimum size for inclusion and deletion for various countries and country groupings, the following factors are considered:

- The overall free float-adjusted market capitalization of the market.
- The distribution of free float-adjusted market capitalization in the country.
- The level of market concentration.
- The marginal contribution to the market of the largest security at different percentiles of the free float-adjusted market capitalization distribution.
- Other characteristics of the underlying market.

For further details on size-related eligibility criteria, see Appendix IV, titled “Minimum Size Guidelines”.

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For further details on size-related eligibility criteria, see Appendix IV, titled “Minimum Size Guidelines”.
2.4.1.2 Liquidity

All securities that are considered for inclusion or currently are included in the MSCI Indices must be characterized by adequate liquidity. However, liquidity is not the sole determinant for inclusion in the index, though it is an important consideration.

In making an assessment of adequate liquidity levels, a number of absolute and relative liquidity measures are considered. These include:

- The pattern of monthly average traded value over time.
- The pattern of monthly average traded value ratio over time. The traded value ratio is defined as the traded value divided by the free float-adjusted market capitalization of the security.
- The frequency of trading, including the number of days traded.

The analysis of the adequacy of a security’s liquidity also considers the average liquidity for the country and the industry to which the security belongs. In addition, in some cases, while assessing the liquidity of a local security, the trading volumes in ADRs or GDRs may also be considered.

2.4.1.3 Companies with Free Float Less Than 15%

Securities of companies with an overall free float of less than 15% across all share classes are generally not eligible for inclusion. Exceptions to this general rule are made only in significant cases, where not including a security of a large company would compromise the index’s ability to fully and fairly represent the characteristics of the underlying market.

For a security of a company with an overall free float of less than 15% to be eligible for inclusion, the free float-adjusted market capitalization of the security must represent at least:

- 10 basis points of the MSCI World Index or 15 basis points of the MSCI EMF Index, if included, OR
- 5% of the country index to which the security would belong, if included.

For an existing constituent to be eligible to remain in the index, the free float-adjusted market capitalization of the security must represent at least:

- 5 basis points of the MSCI World Index or 7.5 basis points of the MSCI EMF Index, OR
- 2.5% of the country index to which the security belongs.
2.4.2 Target Representation

As mentioned above, in constructing the country indices, MSCI aims to achieve a uniform level of 85% of free float-adjusted market representation within each industry group, within each country.

2.4.2.1 Target Representation at Various Industry Levels

In certain circumstances, the 85% representation target may be applied at the industry or the sub-industry level. This may happen in the case of deep and broadly diversified markets, such as the USA. It may also happen in the case of highly concentrated industry groups, which are dominated by a sub-industry. For example, in many developed markets large pharmaceutical companies dominate the Pharmaceuticals and Biotechnology industry group. In these cases, targeting the 85% market representation at the industry group level would result in these large pharmaceutical companies accounting for almost all of the targeted 85% coverage, thus leaving little room for the inclusion of the smaller, though quite significant, biotechnology firms.

Example:

The USA Pharmaceuticals and Biotechnology Industry Group

In the USA, the number of securities at the sub-industry level demonstrates the depth of the Pharmaceuticals and Biotechnology Industry Group. For example, there are 198 securities in the Biotechnology sub-industry. Many of these listed securities are relatively large and liquid, and hence potential candidates for index inclusion.

If MSCI were to select securities for index inclusion focusing solely on the largest free float-adjusted market capitalizations at the Pharmaceuticals and Biotechnology industry group level, this would lead to securities in the Pharmaceuticals sub-industry dominating the industry group. In this case, selecting securities for index inclusion by targeting an 85% market representation in each of the Pharmaceuticals and Biotechnology sub-industry levels allows for the inclusion of relatively large and liquid securities from both sub-industries. This results in an index which better represents the full breadth of business activities in this industry group without sacrificing investability.

2.4.2.2 Over- and Under-Representation

The distribution of free float-adjusted market capitalization and the level of concentration within industries and industry groups also affect the level of market representation that can reasonably be realized in a country index. This may result in an industry group representation level that may exceed or remain below the 85% target representation guideline. These differences in the structure of industries account for the differences in target market representation of industries and industry groups that are actually achieved in the indices.
Example:

Over-Representation

Suppose two securities, Cell Co and Mobile Corp, dominate the Wireless Telecommunications Services industry in a country, accounting for 70.0% and 23.0% of the free float-adjusted market capitalization of the industry, respectively.

Including only the larger Cell Co in the index would yield an industry representation of 70%, which is 15% below the desired target representation of 85%. Including Mobile Corp in the index, in addition to Cell Co, would result in the industry representation increasing to 93%, which is 8% above the 85% targeted guideline. In this case, all other things being equal, it would be more appropriate to include both companies in the index, as the resulting industry group representation would be closer to the 85% target level.

Example:

Under-Representation

Suppose the Energy industry group in a given country consists of four companies, Drilling Corp, Exploration Corp, National Oil Company, and Marketing Co, accounting for 35%, 20%, 40%, and 5% of the free float-adjusted market capitalization of the industry group, respectively.

Drilling Corp and Exploration Corp are both exclusively engaged in the exploration and production of oil and gas products. National Oil Company and Marketing Co, on the other hand, are exclusively engaged in the refining and marketing of oil and gas products.

In this case, including Drilling Corp and National Oil Company would provide a better diversification of business activities in the index. The inclusion of both companies would result in an industry group representation of 75%. In addition to these two companies, it would be more appropriate to include Marketing Co in the index, rather than Exploration Corp, as the resulting industry group representation of 80% would be closer to the 85% target than the industry group representation of 95% that would result from the inclusion of Exploration Corp. Therefore, in this example, all other things being equal, Exploration Corp would not be added to the index and the industry group representation would remain at 80%.

This example also highlights the fact that in certain industry groups the application of the 85% industry group representation target could lead to a large company, such as Exploration Corp, not being added to the index, while a smaller company, such as Marketing Co, might be included in the index.
2.4.2.3 Security Size and Target Market Representation

In certain cases, the free float-adjusted market capitalization representation that is achieved in the index for a given industry group may remain below the targeted 85% level because only a few securities in the industry are of a size that is considered reasonable for inclusion in the country index.

For further details on minimum size guidelines, see Section 2.4.1.1 and Appendix IV, titled “Minimum Size Guidelines”.

Example:

Security Size and Industry Representation

Suppose that an industry group consists of 25 securities. The five largest securities in this industry group have a free float-adjusted market capitalization of over $US 1,000 million each. These five securities account for 75% of the free float-adjusted market capitalization of the industry group. The remaining securities have a free float-adjusted market capitalization of less than $US 300 million each. For this country the appropriate size for inclusion in the country index is estimated at $US 400 million, in free float-adjusted terms.

In this example, the five largest securities in the industry group are included in the index, while the remaining securities are not considered for inclusion due to small size. As a result, only a 75% industry representation is achieved in the index for this industry group.

2.4.2.4 Number of Constituents and Industry Representation

MSCI does not target a specific number of securities for inclusion in its indices. However, there may be instances where an appropriate balance needs to be attained between including a large number of securities and the additional diversification benefits that these securities bring to the country index.

Example:

The USA Biotechnology Sub-Industry

As mentioned above, in the case of the USA, there are 198 securities in the Biotechnology sub-industry. Many of these listed securities are of a similar size, which is considered reasonable for the country. These companies are hence potential candidates for index inclusion.

If the 85% industry representation target were strictly followed, it would result in the inclusion of approximately 50 securities. This number is considered too large, in the context of the relative size of these securities, their marginal contribution to the country index and the additional diversification benefits they bring to the index. Therefore, including a much smaller number of securities is considered appropriate, even though it results in a sub-industry representation which remains below the target level of 85%.
2.4.2.5 Industry Representation: A Summary

In constructing its equity indices under the Enhanced Methodology, MSCI aims to target a free float-adjusted market representation of 85% within each industry group, within each country. However, because of differences in the structure of industries, this industry representation target may not be exactly and uniformly achieved in the indices across all industry groups. The differences in the structure of industries, and other considerations, may lead to over- or under-representation in certain industries. In these instances, the indices are constructed with a view to minimizing the divergence between the industry group representation achieved in the index and the 85% representation guideline.

Since the over- and under-representation of industries is unlikely to be exactly off-setting, the average industry group representation achieved in a given country is also likely to be different from the 85% level.

MSCI’s bottom-up approach to index construction, which builds the equity indices from the industry group level up, coupled with the 85% industry group representation guideline, may at times lead to a large company in an industry group not being included in the index, while a smaller company from the same or a different industry group might be added. Also, since the MSCI Indices are built from a country perspective, a large company in an industry group in one country may not be included in that country’s index, while a smaller company in the same industry group in another country might be added to that country’s index.
Section 3: Maintaining the Indices

Under the Enhanced Methodology, the MSCI Equity Indices are maintained with the objective of reflecting, on a timely basis, the evolution of the underlying equity markets. In maintaining the indices, emphasis is also placed on their continuity and on minimizing turnover in the indices.

MSCI classifies index maintenance in two broad categories:

- Index rebalancing.
- Market driven changes and corporate events.

3.1 Index Rebalancing

The index rebalancing process is designed to ensure that the indices continue to be an accurate reflection of an evolving marketplace. The evolution may be due, for example, to a change in the composition or structure of an industry or other developments, including regular updates in shareholder information used in the estimation of free float. During the examination of a country index at a quarterly index rebalancing, the free float-adjusted market capitalization and representation of each industry group in the index is measured against the underlying market. A complete or partial index rebalancing, which will result in additions and deletions, for a country may be necessary if one or more industry groups have become significantly over- or under-represented.

3.1.1 Index Rebalancing Additions

During an index rebalancing, securities may be added to a country index for a variety of reasons, including availability of new opportunities for inclusion due to privatizations, new issues, and restructurings, changes in industry classification, increases in free float, and removal or relaxation of Foreign Ownership Limits (FOLs). Potential additions are analyzed not only with respect to their industry group, but also with respect to their industry or sub-industry group, in order to represent a wide range of economic and business activities. All additions are considered in the context of MSCI’s Enhanced Methodology, including the index eligibility rules and guidelines.

3.1.2 Index Rebalancing Deletions

During an index rebalancing, securities may be deleted from a country index for a variety of reasons, including significant decreases in free float-adjusted market capitalization, significant deterioration in liquidity, changes in industry classification, decreases in free float, more restrictive Foreign Ownership Limits (FOLs), and availability of a better industry representative. In assessing deletions, it is important to emphasize that indices must represent the full-investment cycle, including bull as well as bear markets. Out-of-favor industries and their securities may exhibit declining prices, declining market capitalizations, and/or declining liquidity, and yet not be deleted because they continue to be good representatives of their industry group.
3.1.3 Index Rebalancing Changes in Foreign Inclusion Factors (FIFs)

Changes in free float estimates and a corresponding change in the FIFs resulting from regular updates of shareholder information will typically be aggregated and recognized in the indices at the time of the quarterly index rebalancing.

3.1.4 Index Rebalancing Frequency And Timing

Index rebalancing for each MSCI Country Index generally takes place every 12 to 18 months. Individual country index rebalancing for MSCI Country Indices usually occurs on only four dates throughout the year: as of the close of the last business day of February, May, August and November. MSCI Index additions and deletions due to quarterly index rebalancings are announced at least two weeks in advance.

3.2 Event-Related Constituent Changes

Event-driven changes to the indices are the result of new issues, mergers, acquisitions, bankruptcies, other similar corporate events, as well as changes in free float and Foreign Ownership Limits. These changes are reflected in the indices outside of a quarterly index rebalancing, and as such, are announced and implemented as they occur.

Event-related constituent changes are classified in three broad categories:

- Early Inclusion of Non-Constituents.
- Early Deletion of Constituents.
- Mergers and Acquisitions.

3.2.1 Early Inclusion of Non-Constituents

In general, newly listed equity securities available to foreign investors would be considered for inclusion in the MSCI Indices, according to MSCI’s Enhanced Methodology index rules and guidelines, at the time of the quarterly index rebalancing for the country. However, for new issues that are significant in size and meet all the MSCI inclusion criteria, an early inclusion, outside of the quarterly index rebalancing, may be considered.

Securities may also be considered for early inclusion in other significant cases, resulting from removal or relaxation of Foreign Ownership Limits (FOLs), a large additional offering of an already listed security, consolidation or restructuring in the industry giving rise to a large new company, and a company spun-off from a non-constituent company.

In order to qualify for early inclusion, a security must represent:

- At least 1% of the country index, if included in the USA, Japan, the UK, Canada, France, Germany, Italy, Netherlands and Switzerland indices.
- At least 2.5% of the country index, if included in for any other country index.
Securities spun-off from existing constituents are not subject to the guidelines for early inclusion specified above and, therefore, may be included immediately as long as they meet all the index constituent inclusion criteria.

3.2.2 Early Deletion of Constituents

In the case of suspension for bankruptcy or near bankruptcy, the suspended company is deleted, outside of a regular quarterly index rebalancing, at the lowest price (unit or fraction of the currency) at which a security could have traded in a given market.

In cases where the suspension is due to a major restructuring, which results in a company being ineligible (at least for a significant period of time) for normal listing and trading on the stock exchange, the MSCI policy is to remove the company from the index when there is little likelihood the company will return to normal trading. In this case, if an official price quote cannot be obtained, an unofficial price estimate may be used as the constituent’s exit price.

Securities may also be considered for early deletion in other significant cases, such as decreases in free float and Foreign Ownership Limits (FOLs).

3.2.3 Mergers and Acquisitions and Other Events

MSCI monitors all cases of mergers and acquisitions, or capital restructurings, which affect a company within the MSCI universe. Generally, a corporate event will be reflected in the index on the effective date of the transaction. However, in certain cases, another date that more appropriately reflects the terms of the transaction in the index may be chosen, for example, where the new company does not start trading until after the effective date of the transaction.

3.2.3.1 Acquisition of a Constituent Company

When a constituent company is acquired, its securities are removed from the index. If the constituent company is acquired by another constituent company, the securities of the acquiring company will remain in the index. If the constituent company is acquired by a non-constituent company, the constituent company’s securities may be replaced by the securities of the acquiring company.

3.2.3.2 Acquisition by a Constituent Company of a Non-Constituent Company

When a constituent company acquires a non-constituent company, the securities of the acquiring company may remain in the index or may be removed from the index, if, for example, these securities are no longer representative of the industry as a result of the acquisition.

3.2.3.3 Foreign Inclusion Factor (FIF) of the Resulting Entity

When two companies merge, or a company acquires another company, the free float of the resulting entity is estimated on a pro forma basis, and the corresponding FIF is applied simultaneously with the event.
3.2.3.4 Changes in Foreign Inclusion Factors (FIFs) Due to Other Events

Changes in Foreign Ownership Limits (FOLs) for constituent securities may lead to changes in the FIFs for these securities. These changes will be implemented as soon as possible.

Changes in free float due to market events may also lead to changes in FIFs. These changes, when significant, may be implemented outside an index rebalancing.

3.2.4 Announcement Policy for Event-Related Changes and IPOs

3.2.4.1 Event-Related Changes

The following event-related changes are publicly announced prior to their implementation:

1. Free float market capitalization changes of $US 5 billion or more.
2. Free float market capitalization changes that are equal to at least 1% of the constituent's underlying country index.
3. Additions and deletions of constituents.

All event-related changes that meet the criteria described above are publicly announced, whenever possible, at least ten business days prior to these changes becoming effective in their respective country index.

Changes in Foreign Ownership Limits (FOLs) and early deletions of a constituent due to bankruptcy are publicly announced at least one business day prior to the implementation of the change in their respective country index.

3.2.4.2 IPOs

Early inclusions of large IPOs in the Provisional Index Series are publicly announced no earlier than shortly before the first day of trading and no later than before the opening of the third day of trading in the market where the company has its primary listing.
Section 4: Transitioning the Standard Equity Index Series to the Enhanced Methodology

As previously announced, the MSCI Enhanced Methodology will be implemented in the Standard Index Series in two phases. These two phases will be implemented in two Special Rebalancings of the MSCI Standard Index Series as of the close of November 30, 2001 and as of the close of May 31, 2002, respectively. By the end of the second phase, constituent weights in the MSCI Standard Index Series and the MSCI Provisional Index Series will have fully converged. In the interim, in order to minimize the divergence between the Standard and the Provisional Index series, the following general principles will be applied in the maintenance of the Standard Index Series.

4.1 General Maintenance Principles

4.1.1 Coordination of Changes between the MSCI Standard and Provisional Index Series

During the transition period, MSCI will closely coordinate changes between the Standard and the Provisional Indices. Changes in the Standard Index Series will be handled in a manner that facilitates their convergence to the Provisional Index Series. In particular, this will be achieved by implementing changes affecting constituents that are common to the Standard and the Provisional Index Series simultaneously in the two index series. This general principle will be applied to the regular quarterly index rebalancings as well as to corporate events.

4.1.2 Additions

All additions to the MSCI Standard Index Series, resulting from IPOs and partial and regular quarterly index rebalancings will be included at their final Foreign Inclusion Factors (FIFs) determined in accordance with the Enhanced Methodology. Additions resulting from corporate events, including spin-offs from existing constituents, will be treated according to the Market Capitalization Grandfathering rule discussed below.

4.1.3 Mergers, Acquisitions and Other Corporate Events

The market capitalization weight of constituents resulting from mergers, acquisitions and similar corporate events within a MSCI Country Index will be determined as the higher of a) their free float-adjusted market capitalization and b) the market capitalization of the initial constituents included in the MSCI Country Index prior to the event, after deducting cash exiting the index as a result of the event.

This principle is referred to as the "Market Capitalization Grandfathering Rule". It will be implemented through the use of Market Capitalization Factors (rounded to the closest 5% for securities with free float above 15% and to the closest 1% for securities with free float below 15%). It will be applied to all corporate events except rights issues and similar participatory corporate actions, which will be handled according to their specific subscription terms.
The Market Capitalization Grandfathering Rule will generally apply only to the market capitalization of constituents within the country index in which the resulting company will be included. However, very large cross-border mergers which involve index constituents in more than one country will be analyzed on a case-by-case basis and their detailed treatment will be announced with sufficient notice.

**Examples:**

**Application of the Market Capitalization Grandfathering Rule**

A company – with an initial market capitalization of 1250, a Market Capitalization Factor (MCF) of 1 and a free float of 50% - issues new shares for the acquisition of a non-index company with a market capitalization of 400 and a free float of 75%. The actual free float of the acquiring company after the event will be \([(1250 \times 50\%) + (400 \times 75\%)] / 1650 = 56\%\). Note that the free float-adjusted market capitalization of 925 post event is smaller than the currently included market capitalization of 1250 (1250 x 100%). Applying the Market Capitalization Grandfathering Rule, the new MCF is derived from the following calculation: 1250 / (1250 + 400) = 76\%, which is then rounded to 75\%. Due to rounding, this leads to a slight decrease in the included market capitalization from 1250 to 1237.5 (1650 x 75\%).

In a different case, if the same company acquires a non-index company with a market capitalization of 800 and a free float of 100\%, the free float-adjusted market capitalization of 1425 \([(1250 \times 50\%) + (800 \times 100\%)]\) is greater than the current included market capitalization of 1250. Accordingly, the resulting MCF would be 70\% (or 1425 / 2050).

**4.2 November 30, 2001 Special Rebalancing**

**4.2.1 Constituents Included in Both the Standard and the Provisional Indices**

At the time of the November 30, 2001 Special Rebalancing, the market capitalization of all securities in the Standard Indices that are also constituents of the Provisional Indices will be adjusted by an Interim Foreign Inclusion Factor (FIF). The Interim FIF applied to a security will equal the simple average of the current Market Capitalization Factor (MCF) of the security in the Standard Index and its Final FIF in the Provisional Index:

- Rounded-up to the closest 5\%, if the average is greater than 15\%.
- Rounded to the closest 1\%, if the average is less than 15\%.

**4.2.2 Additions to the Standard Indices**

At the November 30, 2001 Special Rebalancing, the market capitalization of all then current constituents of the Provisional Indices, not then included in the Standard Index will be added to the Standard Index with an Interim FIF. The Interim FIF applied to such a security will be equal to half of the Final FIF of that security in the Provisional Indices:

- Rounded-up to the closest 5\%, if half of the Final FIF is greater than 15\%.
- Rounded to the closest 1\%, if half of the Final FIF is less than 15\%.
4.2.3 Deletions from the Standard Indices
At the November 30, 2001 Special Rebalancing, all current Standard Index constituents that are not included in the Provisional Indices will be fully deleted from the Standard Indices as of the close of November 30, 2001.

4.2.4 Dis-assimilation of Share Classes
Under the Enhanced Methodology, the different share classes of an issuer will no longer be assimilated, as they currently are under the existing methodology. As a result, in the case of a security for which different share classes are currently assimilated, the number of shares in the Provisional Indices will be lower than in the Standard Indices. In these cases, the number of shares outstanding in the Standard Indices will not be changed until May 2002 and an Interim FIF will be calculated and applied in November 2001. This Interim FIF will be derived such that the market capitalization for a given constituent will be approximately equal to the simple average of the market capitalization of that constituent in the Standard Indices prior to the changes and the market capitalization in the Provisional Indices:
- Rounded up to the closest 5%, if the average is greater than 15%.
- Rounded to the closest 1%, if the average is less than 15%.

4.3 May 31, 2002 Special Rebalancing
At the time of the May 31, 2002 Special Rebalancing, the market capitalization of all securities in the Standard Indices, including those for which share classes are currently assimilated, will be calculated using the number of shares outstanding in the Provisional Indices on May 31, 2002. At that time, the market capitalization of all securities in the Standard Indices will be adjusted by their final Foreign Inclusion Factors (FIFs).
Appendices
Appendix I: Country Classification of Securities

This appendix outlines the guidelines MSCI uses to determine the country classification of equity securities.

Each of the securities followed in the MSCI universe is classified in one and only one country. In general, all companies’ equity securities are classified in the country in which they are incorporated. This has the advantage of being fairly simple and objective in the vast majority of cases, but in a few circumstances it may prove to be insufficient.

For example, if the securities of the company do not trade in its country of incorporation1 or if the country is not part of the MSCI country universe, then the country of incorporation cannot be used as the determining criterion. These and other factors may create the need to classify a company’s equity securities in a different country.

In such circumstances, MSCI determines the appropriate country of classification using a set of considerations, the most important of which are:

- The company’s main equity trading markets and its shareholder base.
- The geographical distribution of its operations (in terms of assets and production).
- The location of its headquarters.
- The country in which investors consider the company to be most appropriately classified.

Change of Incorporation

In the event that a company already classified in a country by MSCI subsequently re-incorporates abroad it generally will remain within the country in which it was initially classified. However, it may be re-classified into its new country of incorporation if the change is also accompanied by a fundamental restructuring of the company’s business.

When MSCI changes a company’s country classification, the company’s equity securities will not automatically be included in the index of its new country even if it was a constituent of its original country’s index. These securities would have to meet all constituent selection criteria in the new country.

Review and Maintenance

To allow for corporate transformations and changes in investor perceptions, MSCI periodically reviews the country classification of companies not classified into their country of incorporation.

1 For example, several companies are domiciled but not listed in the Netherlands.
Inclusion in the Country Universe

For index construction purposes, companies whose equity securities trade in their country of classification generally become part of that country's universe\(^2\). It is from that pool of available securities that index constituents are selected and industry representation is determined.

\(^2\) Special treatment is applied where there are a significant number of large companies trading exclusively outside of their country, such as in the cases of Israel and China.
Appendix II: Free Float Definition and Estimation Guidelines

MSCI defines the free float of a security as the proportion of shares outstanding that is deemed to be available for purchase in the public equity markets by international investors. In practice, limitations on the investment opportunities available to international institutional investors include:

- **Strategic and other non-free float shareholdings**: Stakes held by private or public shareholders whose investment objectives or other characteristics suggest that those holdings are not likely to be available in the market. In practice, disclosure requirements generally do not permit a clear determination of these investment objectives. Therefore, MSCI classifies shareholdings as free float or non-free float based on a categorization of investor types.

- **Limits on share ownership for foreigners**: Limits on the proportion of a security’s share capital that is authorized for purchase by non-domestic investors. Where they exist, these foreign share-ownership limits are set by law, government regulations, or company by-laws.

- **Other foreign investment restrictions**: Investment restrictions, other than those described above, which materially limit the ability of international investors to freely invest in a particular equity market, sector or security. There is typically no simple way to account for these limitations in a benchmark, as these restrictions tend to be more subtle and complex, and may affect different market participants in different ways.

### Classification of Shareholder Types

MSCI primarily classifies shareholdings as free float or non-free float based on a categorization of investor types.

<table>
<thead>
<tr>
<th>NON-FREE FLOAT</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Governments</td>
<td>Shareholdings owned by governments and affiliated entities are generally classified as non-free float.</td>
</tr>
<tr>
<td>Companies</td>
<td>Shares owned by companies, including treasury shares owned by the company itself.</td>
</tr>
<tr>
<td>Banks</td>
<td>Shareholdings by banks are considered as strategic, excluding shareholdings held in trust on behalf of third parties that are deemed to be non-strategic.</td>
</tr>
<tr>
<td>Principal officers and Board Members</td>
<td>Shares owned by the company’s principal officers or members of the Board of Directors, including shares owned by individuals or families that are related to or closely affiliated with the company’s principal officers, members of the Board of Directors, or founding members deemed to be insiders.</td>
</tr>
</tbody>
</table>
FREE-FLOAT

<table>
<thead>
<tr>
<th>Category</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>Shares owned by individuals, excluding shares owned by individuals or families that are related to or closely affiliated with the company’s principal officers or members of the Board of Directors or founding members deemed to be insiders, and, also excluding those shareholdings held by individuals, the significant size of which suggests that they are strategic in nature.</td>
</tr>
<tr>
<td>Investment funds, mutual funds and unit trusts</td>
<td>Shares owned in investment funds, mutual funds and unit trusts, including shares owned in passively managed funds.</td>
</tr>
<tr>
<td>Pension funds</td>
<td>Shares owned in employee pension funds, excluding shares of the employing company, its subsidiaries or affiliates.</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>In principle, all stakes held by insurance companies are part of free float. For exceptions to this general principle, please refer to the additional discussion on insurance companies presented below.</td>
</tr>
<tr>
<td>Social security funds</td>
<td>Shares owned in social security funds, unless the fund’s management is deemed to exert influence over the management of the company.</td>
</tr>
</tbody>
</table>

In the event that the above categories should not appropriately capture the nature of a specific shareholding, its classification as free float or non-free float will be determined based on a more extensive analysis.

Special Cases

The following guidelines will be applied in analyzing the special cases set forth below:

- **Nominees or trustees:** Shareholdings registered in the name of a nominee or trustee are classified as strategic or non-strategic based on an analysis of who the ultimate beneficial owner of the shares is, according to the shareholder types described above.

- **Government agencies and government-related investment funds:** Shareholdings of government agencies and government-related investment funds are classified based on an analysis of the objective of the investment and the extent of government involvement in managing the companies.

- **Insurance companies:** Shareholdings by insurance companies are considered as non-free float, when analysis shows that these holdings are unlikely to be made available as free float in the market. This analysis typically looks at the nature of the insurance business in each country, a company's business practices with its group-related or other companies, and the regulatory environment in the country, including fiscal incentives. These factors, individually or combined,
could restrict the insurance company’s shareholdings from being made freely available in the stock market. Therefore, the treatment of stakes held by insurance companies may differ from country to country. For example, in the case of Japan, insurance companies’ holdings in other companies belonging to the same “keiretsu” group, which are held to reinforce business relationships, are treated as non-free float. Similarly, because of the structure of equity ownership and the importance of financial alliances, insurance companies’ stakes in other companies are typically treated as strategic in some European countries such as France, Germany and Italy.

- **ADRs and GDRs:** Shares that are deposited to back the issuance of ADRs and GDRs are classified as non-strategic, unless it is established that a specific stake held in ADRs or GDRs is strategic in nature.

- **Shares with "loyalty" incentives:** In a public offering, special incentives are sometimes provided to retail investors and are subject to a minimum holding period. These shares will not be considered as part of the free float during the minimum holding period if the incentives are deemed to be material. In general, a conditional share bonus in a ratio of 1 to 5 (or an equivalent price discount of \(1/6\)), or more, will be considered as material.

**Other Foreign Ownership Restrictions**

In the case where other foreign investment restrictions exist, which materially limit the ability of international investors to freely invest in an equity market or in a security, a Limited Investability Factor may be applied to ensure that the investability objectives of the MSCI Indices can be achieved. There is typically no simple way to account for these types of investability limitations in a benchmark as they tend to be subtle and complex, and may affect different market participants in different ways. Such restrictions may involve a complex process of investor validation, qualification, restrictions on funds transfer, investment quota restrictions, other applications of foreign ownership limitations and various complex administrative requirements. Therefore, where deemed necessary, a Limited Investability Factor will be determined and applied based on an extensive case-by-case analysis. The application of this Limited Investability Factor permits a more accurate comparison of constituent markets and securities that have more complex and subtle restrictions on the investment process to markets and securities where investment limitations can be appropriately reflected in their standard Foreign Inclusion Factors.
Appendix III: Global Industry Classification Standard (GICS)

Introduction

The Global Industry Classification Standard (GICS) was developed by MSCI in collaboration with Standard & Poor's (S&P) to provide an efficient, detailed and flexible investment tool. It is designed to respond to the global financial community’s need for a global, accurate, complete and widely accepted approach to defining industries and classifying securities by industry. Its universal approach to industry classification aims to improve transparency and efficiency in the investment process.

Key Features of GICS

The key features of GICS are that it is:

- Universal: the classification applies to companies globally.
- Accurate: the structure precisely reflects the state of the industries in the equity investment universe.
- Flexible: the classification consists of four levels of analysis, ranging from the most general to the most specialized sub-industry.
- Evolutionary: annual reviews are conducted to ensure that the classification remains fully representative of the universe.

To provide the level of precision critical in the investment process, GICS is designed with four levels of classifications:

The Global Industry Classification Standard (GICS)

10 Sectors

23 Industry Groups

59 Industries

123 Sub-Industries

GICS has 10 sector classifications:

- Energy
- Materials
- Industrials
- Consumer Discretionary
- Consumer Staples
- Health Care
- Financials
Philosophy and Objectives of GICS

The way in which securities are classified into asset classes forms the basis of many important investment decisions. The relative merits of each security are judged primarily within these asset classes, and investment decisions are taken within this framework.

Approaches to Industry Classification Schemes

While grouping securities by country and regions is relatively straightforward, classifications by industries are more difficult. There are many approaches to developing industry classification schemes. Some of them are discussed below.

At one extreme, is a purely statistical approach, which is solely financial market-based and backward looking, using past returns. Aggregations are formed around correlation, and this often yields unintuitive groupings that are dissimilar across countries and regions. Another approach attempts to define a priori financial market-oriented groups or themes, such as cyclical, interest rate sensitive, etc. The difficulty, however, lies in finding widely accepted and relatively stable definitions for these themes.

Two other approaches begin with an economic perspective on companies. The first focuses on a production orientation while the other adopts a market or demand orientation in the analysis of companies. The production-oriented approach was effective in the past in its analysis of the microstructure of industries from the standpoint of producers. For instance, it segregated goods and services on the premise that it was a different set of companies that provided each to consumers. As the structure of the global economy evolved, the limitation of this approach became increasingly obvious. The ever-increasing share of discretionary income brought about by economic development, the emergence of the service era, and the availability and accessibility of information with the advent of new communication technology has moved the emphasis from producers to consumers.

GICS: Market Demand-Oriented

The Global Industry Classification Standard (GICS) is designed to be market demand-oriented in its analysis and classification of companies. For example, drawing the line between goods and services is becoming increasingly arbitrary as they are now commonly sold together. Thus, this distinction between goods and services is replaced by adopting the more market-oriented sectors of “Consumer Discretionary” and “Consumer Staples”, which group goods and services sub-industries. In addition, the creation of large stand-alone sectors such as Health Care, Information Technology and Telecommunication Services accurately represents industries that provide significant value to the consumer in today’s global, integrated economy. This further contributes to a more uniform distribution of weights among the 10 sectors.
GICS Company Classification

The Global Industry Classification Standard (GICS) is used to assign each company to a sub-industry according to its principal business activity. Since the GICS is strictly hierarchical, a company can only belong to one grouping at each of the four levels.

An Illustration of the GICS - Information Technology Sector:

Classification by Revenue

In order to provide an accurate, complete and long term view of the global investment universe, a company’s revenues often provide a more stable and precise reflection of its activities than earnings. Furthermore, industrial and geographical breakdowns of revenues are more commonly available than earnings broken down the same way for most companies. Nevertheless, company valuations are more closely related to earnings than revenues. Therefore, earnings remain an important secondary consideration in a company’s industry classification.

General Guidelines for Classification

The primary source of information used to classify securities are a company’s annual reports and accounts. Other sources include brokers’ reports and other published research literature. As a general rule, a company is classified in the sub-industry whose definition most closely describes the business activities that generate at least 60% of the company’s revenues.
Example: Nokia (FI)

<table>
<thead>
<tr>
<th>1998 Results</th>
<th>Telecommunications</th>
<th>Mobile Phones</th>
<th>Other Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>33%</td>
<td>61%</td>
<td>6%</td>
</tr>
<tr>
<td>Earnings</td>
<td>38%</td>
<td>62%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Classified as:

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>INDUSTRY GROUP</th>
<th>INDUSTRY</th>
<th>SUB-INDUSTRY</th>
<th>Sector</th>
<th>Industry Group</th>
<th>Industry</th>
<th>Sub-Industry</th>
<th>Sector</th>
<th>Industry Group</th>
<th>Industry</th>
<th>Sub-Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
<td>45</td>
<td>4520</td>
<td>452010</td>
<td>45201020</td>
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<td></td>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Information Technology</td>
<td>Technology Hardware &amp; Equipment</td>
<td>Communications Equipment</td>
<td>Telecommunication Equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

However, a company engaged in two or more substantially different business activities, none of which contribute 60% or more of revenues, is classified in the sub-industry which provides the majority of both the company’s revenues and earnings. When no sub-industry provides the majority of both the company’s revenues and earnings, the classification will be determined based on further MSCI research and analysis. In addition, a company significantly diversified across three or more sectors, none of which contributes the majority of revenues or earnings, is classified either in the Industrial Conglomerates sub-industry (Industrial Sector) or in the Multi-Sector Holdings sub-industry (Financials Sector).

Example: General Electric (US)

<table>
<thead>
<tr>
<th>1998 Results</th>
<th>Materials</th>
<th>Industrials</th>
<th>Discretionary</th>
<th>Financials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>6%</td>
<td>34%</td>
<td>10%</td>
<td>50%</td>
</tr>
<tr>
<td>Earnings</td>
<td>12%</td>
<td>45%</td>
<td>16%</td>
<td>27%</td>
</tr>
</tbody>
</table>

Classified as:

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>INDUSTRY GROUP</th>
<th>INDUSTRY</th>
<th>SUB-INDUSTRY</th>
<th>Sector</th>
<th>Industry Group</th>
<th>Industry</th>
<th>Sub-Industry</th>
<th>Sector</th>
<th>Industry Group</th>
<th>Industry</th>
<th>Sub-Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20</td>
<td>2010</td>
<td>201050</td>
<td>20105010</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Industrials</td>
<td>Capital Goods</td>
<td>Industrial Conglomerates</td>
<td>Industrial Conglomerates</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the case of a new issue, the classification will be determined based primarily on the description of the company’s activities and pro forma results as given in the prospectus.

Review of Sub-Industry Classification

A company’s sub-industry classification will be reviewed either when a significant corporate restructuring occurs or when the new annual report is made available. In any case, in order to provide a stable sub-industry classification, when reviewing a company’s classification, changes will be minimized in the sub-industry classification to the extent possible by disregarding temporary fluctuations in the results of a company’s different activities.

In the event that the above guidelines should not appropriately capture a particular company’s business activity, its classification will be determined based on a more extensive analysis.
Appendix IV: Minimum Size Guidelines

Objective

The objective of MSCI is to provide global benchmark equity indices that can serve as relevant and accurate performance benchmarks, effective research tools, and as the basis for a wide variety of investment vehicles. MSCI strives to achieve this objective by following some guiding principles in the design and implementation of its index construction and maintenance methodology. One such guiding principle is to construct and manage the MSCI Equity Indices such that they can easily and cost-effectively be replicated in global institutional portfolios of reasonable size. The easy and cost-effective replicability of indices requires that constituents in MSCI Indices be represented at their free float-adjusted, investable weight and that existing constituents or new securities that are considered for inclusion be of reasonable size and liquidity. The move toward free float-adjustment and a broader and deeper industry group representation target of 85% of the free float-adjusted market capitalization further requires that a closer consideration be given to the size of existing or potential new constituents. In many industries and countries, in the absence of an eligible minimum size requirement for inclusion, achieving this broader and deeper level of target market representation could well result in the inclusion of many small securities, which global institutional investors may find difficult to reflect in their portfolios in a cost-effective fashion.

Size Distribution and Structure of Markets

The determination of minimum size for inclusion is complicated by the fact that the free float-adjusted market capitalization or size distributions vary considerably across markets around the world. These variations are caused by differences in the structure of underlying markets. For example, in the case of the USA, a free float-adjusted market capitalization of $US 1 billion would correspond to the size of the largest security within the 94th percentile of the distribution of free float-adjusted market capitalization. This security’s contribution to US market capitalization would amount to 0.7 basis points. In the case of Japan, a $US 1 billion free float-adjusted market capitalization would correspond to the size of the largest security within the 85th percentile of the distribution of free float-adjusted market capitalization and its contribution to the market would amount to 4.2 basis points. This simple example illustrates that an minimum size threshold of $US 1 billion would be too low in the case of the USA, as it would result in the inclusion of hundreds of securities with a negligible marginal contribution to the country index. On the other hand, this minimum size threshold would be too high in the case of Japan, as an 85% target market representation could only be achieved by including all securities with a free float-adjusted market capitalization of up to $US 1 billion, irrespective of their industry group affiliation. The table below provides the characteristics of a security of $US 1 billion free float-adjusted market capitalization in some large developed markets. This table further highlights the variation of size patterns across countries.
Characteristics of a Security of $US 1 Billion Free Float-Adjusted Market Cap (Data as of November 2000)

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Size</th>
<th>Percentile of Total Market</th>
<th>Contribution to Total Market</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Free float-adjusted ($US bn)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>14,960</td>
<td>94</td>
<td>0.7</td>
</tr>
<tr>
<td>Japan</td>
<td>2,390</td>
<td>85</td>
<td>4.2</td>
</tr>
<tr>
<td>UK</td>
<td>2,360</td>
<td>92</td>
<td>4.2</td>
</tr>
<tr>
<td>France</td>
<td>810</td>
<td>94</td>
<td>12.4</td>
</tr>
<tr>
<td>Canada</td>
<td>670</td>
<td>84</td>
<td>14.9</td>
</tr>
<tr>
<td>Germany</td>
<td>660</td>
<td>89</td>
<td>15.2</td>
</tr>
<tr>
<td>Switzerland</td>
<td>610</td>
<td>93</td>
<td>16.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>460</td>
<td>95</td>
<td>21.8</td>
</tr>
<tr>
<td>Italy</td>
<td>360</td>
<td>89</td>
<td>28.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>270</td>
<td>82</td>
<td>36.9</td>
</tr>
</tbody>
</table>

Notes:
1 Percentile of free float-adjusted market capitalization in descending order to which the $US 1 billion security belongs.
2 Contribution of a $US 1 billion security to the total market.

Framework for Determining Minimum Size Guideline

The above example highlights the fact that, given the differences in the structure of underlying markets, a simple rule that defines the minimum size for inclusion for all markets around the world cannot be designed to simplify the index construction process. A rigid rule would also introduce unnecessary turnover, potentially leading to benchmark instability. Therefore, a careful assessment of what constitutes minimum size for inclusion needs to be made on a country by country basis and/or on the basis of certain country groupings, based on overall market size or other criteria. In order to develop guidelines for minimum size for inclusion for various countries and/or country groupings, MSCI has designed a framework for analyzing this issue. This framework requires a careful analysis and interpretation of different factors, such as:

- The overall free float-adjusted market capitalization of the market.
- The distribution of free float-adjusted market capitalization in the country.
- The level of market concentration.
- The marginal contribution of securities, belonging to different percentiles of the free float-adjusted market capitalization distribution, to the country index.
- Other relevant characteristics of the underlying market at the time of decision.
Minimum Size Guidelines for Inclusion

Based on the framework described above, the following minimum size thresholds for inclusion were considered appropriate for the different countries and country groupings shown below. These thresholds, based on market data as of April 2001, were applied in the construction of the MSCI Provisional Index Series.

<table>
<thead>
<tr>
<th>DEVELOPED MARKETS</th>
<th>Stand Alone</th>
<th>Large</th>
<th>Medium/Small</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min. size guidelines</td>
<td>Min. size guidelines</td>
<td>Min. size guidelines</td>
<td></td>
</tr>
<tr>
<td>$US mm</td>
<td>$US 800 - 1000 mm</td>
<td>$US 325 - 400 mm</td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>3,000</td>
<td>Canada</td>
<td>Australia</td>
</tr>
<tr>
<td>UK</td>
<td>1,200</td>
<td>France</td>
<td>Austria</td>
</tr>
<tr>
<td>Japan</td>
<td>600</td>
<td>Germany</td>
<td>Belgium</td>
</tr>
<tr>
<td>Singapore</td>
<td>150</td>
<td>Italy</td>
<td>Denmark</td>
</tr>
<tr>
<td>New Zealand</td>
<td>150</td>
<td>Netherlands</td>
<td>Finland</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Greece</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>EMERGING MARKETS</th>
<th>Large</th>
<th>Medium</th>
<th>Small</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min. size guidelines</td>
<td>Min. size guidelines</td>
<td>Min. size guidelines</td>
<td></td>
</tr>
<tr>
<td>$US 200 - 250 mm</td>
<td>$US 100 - 125 mm</td>
<td>$US 50 - 75 mm</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>China</td>
<td>Argentina</td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>India</td>
<td>Chile</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>Israel</td>
<td>Columbia</td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>Malaysia</td>
<td>Czech Rep.</td>
<td></td>
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<tr>
<td>Taiwan</td>
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<td>Egypt</td>
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<td>Hungary</td>
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<td>Indonesia</td>
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<td>Jordan</td>
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<td></td>
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<td>Morocco</td>
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<td></td>
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<td>Russia</td>
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<td></td>
<td></td>
<td>Sri Lanka</td>
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<td></td>
<td></td>
<td>Thailand</td>
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<td></td>
<td></td>
<td>Turkey</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>Venezuela</td>
<td></td>
</tr>
</tbody>
</table>

Users of MSCI Indices should view the minimum size thresholds for securities in various countries and country groupings presented above with caution. In general, index guidelines are subject to review as underlying market conditions change and are less rigid than index rules. In particular, the minimum size thresholds are somewhat time-dependent. MSCI has a policy of periodically reviewing the minimum size thresholds, at the time of its regularly scheduled quarterly index rebalancings.

Minimum Size Guidelines for Deletions

As a matter of policy, the minimum size guideline for deletions is set at 60% of the eligible minimum size threshold for inclusions. Deletions due to small size are carried out primarily at the time of the quarterly index rebalancings for the country indices being reviewed.