

CONTRIBUTORS

Sarah Aird
Trucost
sarah.aird@spglobal.com

Steven Bullock
Trucost
steven.bullock@spglobal.com

Claire Curtis
Trucost
claire.curtis@spglobal.com

Completing the Picture: Measuring Environmental Performance Across Multi-Asset Investment Strategies

KEY FINDINGS

- Environmental disclosure varies greatly. Broadly speaking, large-cap and developed markets exhibit better disclosure, but significant gaps exist (particularly in Scope 3 supply chain data) that may create blind spots for market participants if overlooked.
- The Greenhouse Gas (GHG) Protocol recommends using secondary data such as environmentally extended input-output (EEI-O) life cycle modelling to estimate emissions in the absence of primary disclosure data.
- EEI-O life cycle models come in many forms. It is important for market participants to understand whether the EEI-O life cycle model being used is globally relevant and has extensive, detailed industry coverage.
- There is no single best practice approach to filling information gaps in corporate environmental disclosure; the right approach will depend on the investment strategy and environmental risk profile, along with the question being answered by the risk assessment.
- Market participants may benefit from due diligence on their data providers to understand their knowledge, skills, and abilities in assessing and ensuring corporate environmental disclosure, as well as applying environmental modelling and estimation techniques. This may include an assessment of the extent to which their models represent best practices and rely on robust, up-to-date data sources.

INTRODUCTION

Just over a year after its inception, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) published recommendations to improve market participants' ability to assess and price climate-related risks and opportunities. Specifically, financial institutions are advised to disclose the GHG emissions associated with each fund or investment.¹

In September 2016, the world's largest asset manager told the Financial Times that governments and market participants had been slow to appreciate the problems related to global warming, but this must change. "Investors can no longer ignore climate change. Climate factors have been under-appreciated and underpriced because they have been perceived to be distant [problems]," said Ewen Cameron-Watt, a senior director at BlackRock. He also underscored that climate-aware investing is possible "without compromising on the traditional goals of maximising investor returns."²

Market participants need a complete picture of environmental risk across multi-asset investment strategies and benchmarks to manage exposure and capitalize on sustainable global imperatives. However, corporate disclosure on environmental performance remains patchy. Some regions and sectors are doing well, while others are lagging. Even where there is disclosure, it is often not standardized, not validated—or worse, not correct.³

So how can market participants obtain a complete picture of corporate environmental performance?

First, it should be acknowledged that corporate disclosure is rapidly evolving; companies are making great strides toward providing transparency on environmental performance—and corporate leaders are going a step further by integrating environmental risks and opportunities with corporate strategy in financial reporting. New ways to measure corporate environmental performance are emerging that go beyond traditional company carbon and water footprints—for example, using asset-level, energy transition, and natural capital data.

Does this mean that market participants should wait for perfect data before taking action? Investment consultant Mercer makes the case for more immediate action: "Climate change deserves special focus, given its potential impact and the narrow time frame that's left to address it."⁴ In September 2016, Mark Carney, Governor of the Bank of England, said, "Markets bring the future forward, with financial impacts often occurring immediately, even if the real impact is several years into the future. The point is that the more we invest with foresight, the less we will regret in hindsight. Financial stability risks will be minimised if the transition begins early and follows a predictable path, thereby helping the market anticipate the transition to a two-degree world."⁵

Market participants are already accustomed to applying proxies and estimated data points to supplement "real" data in their investment analysis; VAR, ex-ante tracking error, profit projections, and

¹ TCFD (2016), TCFD Recommendations Report, available at <https://www.fsb-tcf.org/publications/recommendations-report/>

² Financial Times (2016), BlackRock issues climate change warning, available at <https://www.ft.com/content/e0c12344-736d-11e6-bf48-b372cdb1043a>

³ Trucost (2015), Portfolio Carbon Data: The Quality Imperative, available at <http://www.trucost.com/published-research/174/portfolio/carbon/data>

⁴ Mercer (2015), Investing in a Time of Climate Change, available at <http://www.mercer.com/our-thinking/investing-in-a-time-of-climate-change.html>

⁵ Bank of England (2016), Resolving the climate paradox, available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech923.pdf>

demand forecasts are all estimations, with an assumed level of minimized risk. Even forecasting models for pension fund liability valuations are based on assumptions and estimations. With appropriate technical expertise, the same practices can be applied to environmental analysis.

In this paper, we outline a range of approaches to “completing the picture” on corporate environmental performance across multi-asset investment strategies. Furthermore, we provide insight into which estimation techniques are best suited to enhance corporate disclosure in different investment scenarios.

LARGE LISTED EQUITY PORTFOLIO

Large institutional market participants are, in effect, “universal owners,” as they often have highly diversified long-term portfolios that are representative of global capital markets. Their portfolios are exposed to growing and widespread costs from environmental damage caused by companies.⁶

Completing the Picture

Environmental disclosure varies greatly across equity benchmarks, reflecting the trend for better disclosure in large-cap and developed markets (Exhibit 1). Disclosure gaps are most prevalent across all GHG Protocol scopes (see Author’s Note 1) in the MSCI Emerging Markets Index and least prevalent in the MSCI ACWI and [S&P 500®](#). It is likely that companies that disclose GHG data are making progress on improving their performance. The implication for equity market participants is significant; institutions with holdings in companies that do not disclose, or only partially disclose, will underestimate their exposure to carbon pricing risk if data gaps are not filled in.

Disclosure errors are also prevalent. Among the 61% of MSCI ACWI companies fully or partially disclosing Scope 1 GHG emissions data, more than 30% reported data that either needed to be corrected by Trucost analysts or could not be included in Trucost analysis.⁷

The GHG Protocol, developed by the World Resources Institute (WRI) and World Business Council on Sustainable Development (WBCSD), is the widely recognized standard for calculating GHG emissions. It recommends using secondary data, such as environmentally extended EEI-O life cycle modeling (see Author’s Note 2), for a high-level overview of emissions⁸ when assessing the impact of Scope 3 emissions, including those associated with investments.

⁶ UNEP Finance Initiative and Principles for Responsible Investment (2010): Universal Ownership, why environmental externalities matter to investors, available at <http://www.trucost.com/published-research/44/universal-ownership-why-environmental-externalities-matter-to-institutional-investors>

⁷ Trucost (2015), Portfolio Carbon Data: The Quality Imperative, available at <http://www.trucost.com/published-research/174/portfolio/carbon/data>

⁸ Greenhouse Gas Protocol, WRI and WBCSD (2011): Corporate Value Chain (Scope 3) Accounting and Reporting Standard, available at <http://www.ghgprotocol.org/standards/scope-3-standard>

Exhibit 1: Environmental Disclosure Across Investment Benchmarks

INDEX	LEVEL OF DISCLOSURE	SCOPE 1: EMISSIONS FROM OWN OPERATIONS	SCOPE 2: EMISSIONS FROM PURCHASED ELECTRICITY	SCOPE 3: BUSINESS TRAVEL BY AIR/RAIL AND UPSTREAM TRANSPORTATION/DISTRIBUTION*
MSCI Emerging Markets	Full Disclosure	206 (26%)	209 (26%)	0 (0%)
	Partial Disclosure	173 (22%)	112 (14%)	121 (15%)
	Disclosure Gap	425 (53%)	483 (60%)	683 (85%)
	Full Disclosure	980 (40%)	990 (41%)	1 (0%)
Msci ACWI	Partial Disclosure	503 (21%)	410 (17%)	623 (26%)
	Disclosure Gap	944 (39%)	1027 (42%)	1803 (74%)
	Full Disclosure	211 (43%)	209 (42%)	0 (0%)
S&P 500	Partial Disclosure	139 (28%)	131 (26%)	181 (37%)
	Disclosure Gap	145 (29%)	155 (31%)	314 (63%)

Source: Trucost. Data as of December 2016.

*The most commonly reported GHG Protocol Scope 3 categories

Author’s Note 1: GHG Protocol Scopes

The GHG Protocol differentiates between direct and indirect emissions using a classification system across three scopes.

- Scope 1 includes direct emissions from sources that a company owns or controls. This includes direct emissions from fuel combustion and industrial processes.
- Scope 2 covers indirect emissions relating solely to the generation of purchased electricity that is consumed by the owned or controlled equipment or operations of the company.
- Scope 3 covers all other indirect emissions both upstream (supply chain) and downstream (in-use) of a company’s operations.

Author’s Note 2: What Is EEI-O Life Cycle Modelling?

A traditional input-output (I-O) model is a standard business tool used by economists worldwide, including the U.S. Bureau of Economic Analysis and European Economic and Social Committee, to measure the interdependencies of sectors in an economy. EEI-O life cycle modeling extends the traditional I-O model by applying sector-level environmental emission factors. In its most basic form, the framework quantifies the economic transactions between industries that both produce goods (outputs) and consume goods from other industries (inputs) in the process of producing each industry’s own output. In other words, for a single unit of revenue in a given sector, an I-O model quantifies the amount of expenditure required in other sectors across its entire supply chain—from raw material sourcing to company operations. When a traditional I-O model is extended to include environmental information, the framework can be used to estimate resource use, land use, pollutants, and other environmental issues for each sector contained within the underlying model.

Consider the example of the automobile manufacturing sector. In order to produce a single automobile, inputs will be required from other sectors, including energy, steel production, and tire manufacturing. In addition, the energy, steel production, and tire manufacturing sectors each require their own inputs, and

so on, throughout the supply chain. A traditional I-O model is able to estimate the economic transactions that are required to produce a single automobile across the supply chain. When these economic transactions are extended to include sector-level environmental information, it is also possible to estimate the environmental impacts and dependencies associated with the production of the same automobile throughout the supply chain.

Trucost's Approach

Trucost's Environmental Register is the most comprehensive source of corporate environmental performance data, with up to 10 years of time-series data for almost 700 environmental indicators and natural capital costs. The data is derived in two ways.

1) Researching, standardizing, and validating corporate environmental performance data

Trucost researches, standardizes, and validates environmental performance data for the world's largest publicly listed companies, representing 93% of global markets by market cap. Trucost analysts verify, enhance, and incorporate all types of company-disclosed environmental impact data, from carbon emissions to energy use and production, to make the best use of primary data and minimize disclosure gaps. Trucost further applies a revenue-scaling approach in specific circumstances—for example, when a company disclosed information in a previous year but provides no current disclosure, and its business activities have remained consistent.

Beyond its detailed research process to gather and check company-disclosed data, Trucost makes an additional investment in its quality assurance process, engaging with each company annually to verify its research and collect the latest non-disclosed information.

2) Enhancing corporate disclosure

To complete disclosure gaps across diversified equity portfolios from company operations and their supply chains (including all raw materials), Trucost supplements its research with world-class proprietary EEI-O life cycle modeling. Key to Trucost's approach are best-in-class data sources, underpinned by robust quality control procedures and a detailed assessment of company business activities. This approach is particularly important for sectors where carbon impacts are high but disclosure is low and company activities are varied. For example, fewer than 50% of companies in the "Packaged Foods & Meats" GICS⁹ Sub-Industry classification⁹ disclose Scope 1 or 2 emissions data. Among the 126 companies within this classification, Trucost identified 38 business activities ranging from "Snack Food Manufacturing" to "Clothing and Clothing Accessories Stores," each with a distinct GHG emissions profile. If a financial institution used a simple high-level sector average, there would be no inter-sector differentiation between companies, and estimated GHG emissions would be wide of the mark. A detailed analysis based on the specific mix of business activities is more accurate because it takes into account the different emission factors for each type of activity, rather than using an average of all 38 different activities.

⁹ S&P Dow Jones Indices and MSCI (2015), GICS The Global Industry Classification Standard, available at: https://www.spcapitaliq.com/documents/products/GICS_Mapbook_v2.pdf

EEI-O life cycle modeling further provides critical insight into potential pass-through costs from resource constraints and “polluter pays” regulations along corporate supply chains, which are not picked up by high-level sector average estimations.

EEI-O life cycle models come in many forms. Some cover only small regions, while others are globally oriented. Some represent a few industry sectors, while others cover many more. It is important for market participants to understand whether the EEI-O life cycle model being used to estimate disclosure data is globally relevant and has extensive, detailed industry coverage.

Author’s Note 3: Not All Models Are Equal: What Sets Trucost’s EEI-O Life Cycle Model Apart?

There are a wide range of EEI-O life cycle models available to market participants wishing to complete the picture on corporate environmental performance. Many are freely available, but this can lead to a trade-off on data quality. What sets Trucost’s model apart?

- **Quality of Data Sources**

Trucost applies best-in-class scientific literature, including industry “top-down” data from the World Bank and U.S. Environmental Protection Agency, sector specific “bottom-up” data from organizations like the United Nations Food and Agriculture Organization, and peer-reviewed life cycle assessment [LCA] studies by university researchers) to calculate the environmental impacts of different business activities. Trucost analysts also apply company-disclosed data when possible—for example, when it is high quality and relates to select, specific business activities, rather than a mix of company business activities.

- **Granularity of Business Activity Analysis**

Many publicly available EEI-O life cycle models are based on a single-country economy, and they may cover only a small proportion of business activities relevant to that country. Trucost’s global model is derived from the U.S. economy, due to its broad economic scope. To further ensure the model is representative of globally dispersed company operations and supply chains, Trucost applies global environmental factors and expands its economic scope to cover almost 500 discrete business activities. In particular, Trucost splits up high-impact sectors, such as utilities and agriculture, to ensure that the most environmentally significant business activities are accounted for and modeled. This means that we can create estimated environmental impacts specific to cattle farming and different grain farming industries, as well as industry verticals, such as wholesale of these products, which have different impact profiles, but can often be part of one company’s business mix. A single sector estimation for such a company in the “agriculture” sector would produce much more simplified and potentially inaccurate estimates of the company’s environmental impacts.

- **Regularity of Updates**

A frequent criticism of publicly available EEI-O life cycle models is that they are out of date. Every year, Trucost updates its environmental impact data and engages with companies to incorporate the latest disclosed and non-disclosed environmental performance information.

- **Scope of Environmental Indicators**

Some models only estimate GHG emissions, but Trucost calculates the environmental performance of companies against almost 700 environmental indicators, from GHG and other pollution emissions, to water dependency and land use impacts, across company operations and supply chains back to raw material dependency—and it has done so for over 10 years.

- **Quality Control**

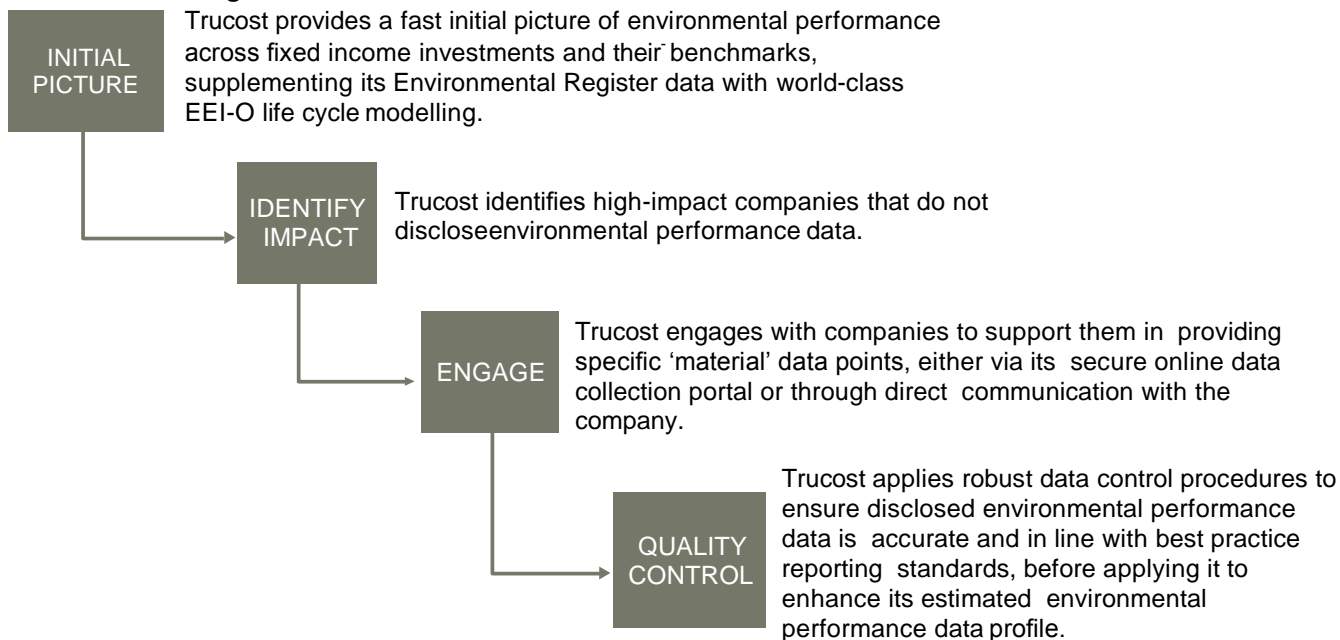
Trucost applies robust data control procedures, from sector specialist analyst data checks to automated outlier identifications, as well as an annual company engagement program.

FIXED INCOME PORTFOLIO

Fixed income market participants typically invest in a mix of public and privately owned companies through their issued debt. Since environmental performance disclosure tends to be more prevalent among public companies, fixed income market participants may have more blind spots and unanticipated exposure to environmental risk in their portfolios.

As with an equity portfolio approach, Trucost supplements its extensive corporate environmental performance data (Environmental Register) with world-class proprietary EEI-O life cycle modeling to provide a complete picture of environmental performance across corporate fixed income portfolios and benchmarks. In this way, Trucost is able to identify high-impact investments, including within the high-yield space, where disclosure on environmental performance is unavailable. Trucost then engages with high-impact, non-disclosing companies to support them in providing environmental performance data to enhance estimated data “where it most matters” (see Exhibit 2).

Exhibit 2: Refining Estimated Data “Where it Most Matters”



Source: Trucost. Chart is provided for illustrative purposes.

REAL ASSETS, PROJECT FINANCE, AND GREEN BONDS

Investors in real assets, project finance, and green bonds may benefit from an asset-specific, “bottom-up” approach to assessing the environmental performance for due diligence or capital allocation—for example, in the case of a highly concentrated or thematic portfolio where an assessment of the specific environmental risks or benefits of the investment is important. Or, in cases where the market participant has greater access to detailed asset-specific information, Trucost analysts may be able to employ a more granular methodology. This is often the case for real assets, such as forests, infrastructure, and real estate, as well as green bonds, which may have overall carbon reduction impacts that the market participant wishes to capture. It could also apply to project finance and commercial lending, where market participants may have the opportunity to ask more detailed due-diligence questions about the company or asset prior to investment.

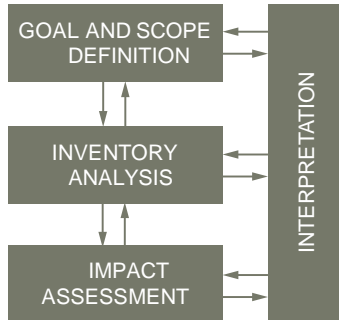
There are many different methodologies that can be applied in such circumstances, depending on the specific asset, the research question, and the data available. Trucost analysts are expert environmental economists with substantial experience in identifying appropriate methodologies and best-in-class LCA models (using data from peer-reviewed scientific literature) in order to provide detailed and asset-specific estimates of the natural capital impacts of an asset. In addition, we create custom tools that enable market participants to apply environmental data alongside their financial data or build it into their own scorecards and decision-support tools.

The result is a robust assessment of environmental liabilities and benefits, from carbon and other pollution emissions to water and land use, across the entire project lifecycle, compared to a “business as usual” baseline and tailored to the asset and data available (see Exhibit 3).

Author's Note 4: What Is an LCA?

The United Nations Environment Programme defines LCA as a tool for the systematic evaluation of the environmental aspects of a product or service system through all stages of its life cycle. LCA provides an adequate instrument for environmental decision support.

Exhibit 3: The Phases of LCA



Source: United Nations Environment Programme (UNEP). Chart is provided for illustrative purposes.

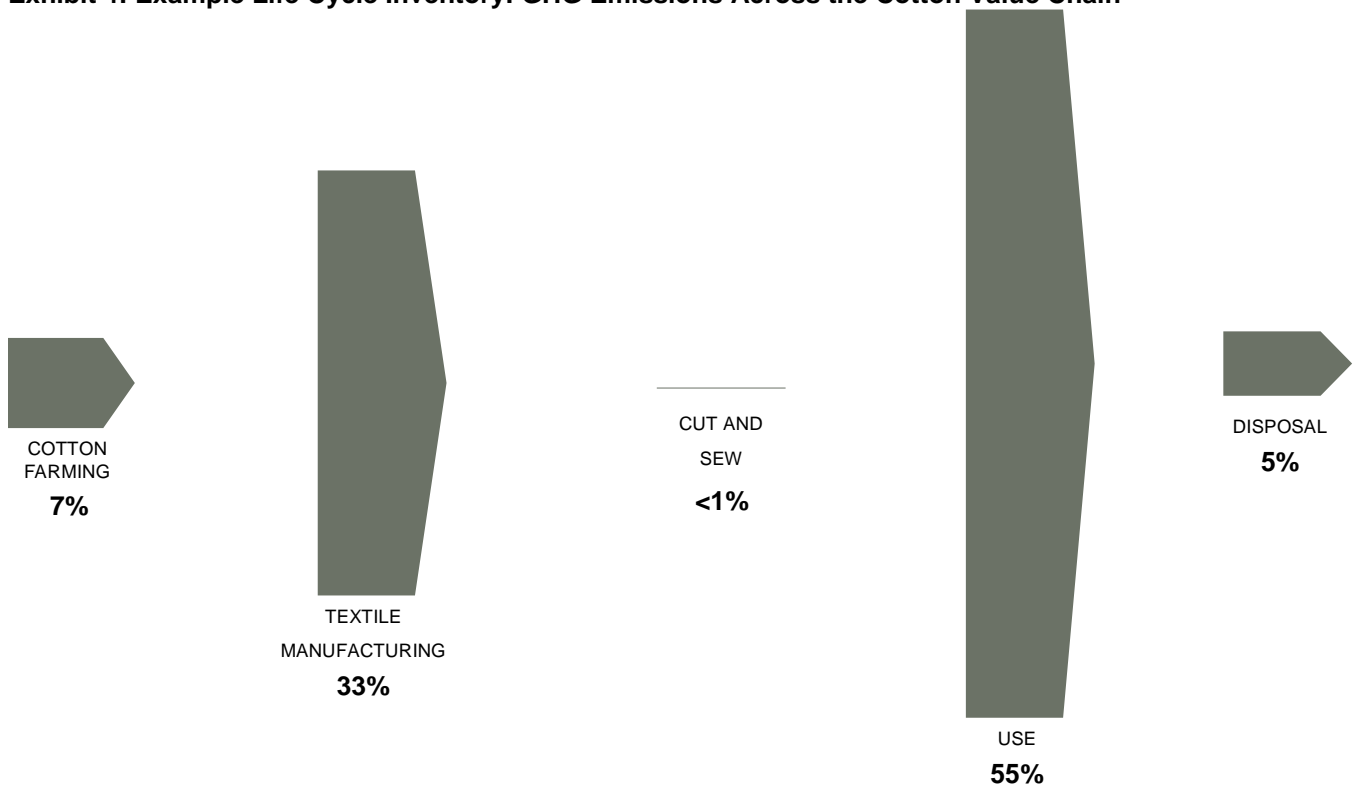
The phases of the LCA are as follows.

1. **Goal and Scope Definition:** The products or services to be assessed are defined, a functional basis for comparison is chosen, and the required level of detail is defined.
2. **Inventory Analysis of Extractions and Emission:** The energy and raw materials used and emissions of the atmosphere, water, and land, are quantified for each process, then combined in the process flow chart and related to the functional basis.
3. **Impact Assessment:** The effects of the resource use and emissions generated are grouped and quantified into a limited number of impact categories, which may then be weighted for importance.
4. **Interpretation:** The results are reported in the most informative way possible, and the need and opportunities to reduce the impact of the product(s) or service(s) on the environment are systematically evaluated.¹⁰

There are two types of LCA models: EEI-O life cycle models and process attributional models. Trucost analysts apply both approaches depending on the specific application and type of estimation required.

¹⁰ United Nations Environment Programme (2016) Life Cycle Assessment, available at <http://staging.unep.org/resourceefficiency/Consumption/StandardsandLabels/MeasuringSustainability/LifeCycleAssessment/tabid/101348/Default.aspx>

Exhibit 4: Example Life Cycle Inventory: GHG Emissions Across the Cotton Value Chain



Source: Trucost. Data as of December 2016. Chart is provided for illustrative purposes.

KEY CONSIDERATIONS FOR MARKET PARTICIPANTS

Consideration 1: What is the best approach to completing data gaps for an investment strategy?

There is no single best practice approach to completing the picture on corporate environmental performance. The right approach will depend on the particular investment strategy and environmental risk profile, along with the question the market participant wants the risk assessment to answer. High-quality, detailed EEI-O life cycle modeling is well suited to completing data gaps across broad market investments, because it provides “fit-for-purpose” data to screen risks across an array of environmental indicators, encompassing the entire company operation back to raw material extraction. Alternatively, when a market participant wants to scrutinize similar assets, targeted company engagement is recommended to collect primary data for specific material impacts and identify regional impacts such as water scarcity that might otherwise be concealed. EEI-O life cycle modeling is also a powerful tool for identifying high-impact companies where engagement on environmental performance disclosure is required. For investments in real assets, a “bottom-up” approach, combining best-in-class LCA studies and peer-reviewed scientific data with primary data collected on specific “material” data points via company engagement is recommended. When applying sector-based, revenue-scaling methods, market participants should be confident that an appropriate baseline is being derived, in terms of both sample size and commonality of business activities.

Consideration 2: What quality procedures are being applied when data gaps are completed?

While market participants are accustomed to using estimates in investment analysis, they need to be confident that assumed levels of risk are minimized. Appropriateness and robustness of data sources,

as well as best-in-class quality control procedures should be ensured. This may require a variety of safeguards, including documented procedures to ensure that analysts apply techniques in a consistent way, peer-reviewed documentation of research sources and assumptions, documented data hierarchy outlining data preferences, logic regarding the application of different disclosure gap filling techniques, and company engagement to validate research and assumptions.

Consideration 3: What expertise is needed?

Market participants need to be confident that their data providers have expertise in applying the full range of data estimation approaches to ensure that the most appropriate technique is applied to the specific investment scenario.

CONCLUSION

There are many different approaches to completing the picture on corporate environmental performance; what is critical is matching the right approach to the investment strategy and risk analysis. Knowledge of which approach to use and the trade-offs of each comes from employing expert staff, as well as long-time experience in applying environmental data to a wide range of asset classes and investment themes.

Market participants may benefit from conducting due diligence on their data providers to understand their knowledge, skills, and abilities in assessing and ensuring corporate environmental disclosure, as well as applying environmental modeling and estimation techniques, including the extent to which their models represent best practice and rely on robust, up-to-date data sources.

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