

CONSULTATION ON CHINA A-SHARES INDEX INCLUSION ROADMAP

Updated Post 2015 MSCI Market Classification Review

April 2016

BACKGROUND

- In June 2015, MSCI announced that China A-shares will remain on the 2016 review list for potential inclusion into Emerging Markets.
- While the overall market accessibility of A shares had improved significantly over the years, the 2015 consultation feedback identified three **critical** accessibility issues:
 - *Quota allocation process*
 - *Capital mobility restrictions*
 - *Beneficial ownership of investments*
- International institutional investors continue to be concerned by the liquidity and replication risk that may result from potential renewed voluntary suspensions in trading on the local stock exchanges of mainland Chinese companies.
- MSCI has also been discussing for some time with local Chinese stock exchanges the existence of anti-competitive clauses restricting the launch of financial products by any financial institution on any stock exchange internationally if these products are linked to indexes that include China A-Shares.

KEY HIGHLIGHTS OF 2016 PROPOSAL

MSCI is maintaining the proposal for a 5% partial inclusion of China A-shares into the MSCI Emerging Markets Index effective in June 2017 in one single phase.

The 5% partial inclusion approximates 1.1% weight of China A shares in the MSCI Emerging Markets Index.

- MSCI has been working closely with the Chinese regulators to seek resolutions on the remaining market accessibility issues. Since June 2015, MSCI continues to observe positive market opening measures being announced and implemented :
 1. *Linking QFII quota allocation to investment fund size*
 2. *Relaxation of capital mobility restrictions under the QFII scheme*
 3. *Simplification of the QFII application and quota granting process*
 4. *Expansion of RQFII program from 12 cities to 16 cities*
- In addition, the planned CCASS enhancements of Shanghai-Hong Kong Connect to support same day stock and money (RMB) settlement finality and the potential launch of the Shenzhen-Hong Kong Stock Connect are expected to further improve the overall accessibility of China A-shares for international institutional investors.

QUOTA AND CAPITAL MOBILITY

- MSCI views the recent QFII policy changes announced by SAFE largely resolve, at least on paper, the critical accessibility issues on quota and capital mobility

	Remaining concerns to be addressed since 2015 Annual Review	Newly implemented accessibility enhancement policies
Quota Allocation Process (QFII/RQFII)	<ul style="list-style-type: none"> • Ability to access quota commensurate with the size of assets under management 	<ul style="list-style-type: none"> ✓ Base quota is now linked to AUM ranging from US\$20mn to US\$5bn. ✓ Quota exceeding US\$5bn subject to SAFE approval
	<ul style="list-style-type: none"> • Ability to secure additional quota with certainty should the need arise 	<ul style="list-style-type: none"> ✓ No requirement for quota top-up unless it exceeds US\$5bn ✓ Quota exceeding US\$5bn subject to SAFE approval
	<ul style="list-style-type: none"> • A more streamlined, transparent and predictable quota allocation process 	<ul style="list-style-type: none"> ✓ Base quota automatically obtained based on AUM through filing with SAFE
Capital Mobility Restrictions (QFII/RQFII/Stock Connect)	<ul style="list-style-type: none"> • Extension of daily liquidity for all investment vehicles, including open-ended funds, ETFs and separate accounts 	<ul style="list-style-type: none"> ✓ Remittance period for QFIIs is removed ✓ Repatriation for QFIIs shortened to daily ✓ Separated Accounts no longer treated as closed-end fund and enjoy daily repatriation
	<ul style="list-style-type: none"> • Removal of capital lock-up and repatriation restrictions on QFII/RQFII 	<ul style="list-style-type: none"> ✓ Lock up period shortened from 1 year to 3 months ❖ Monthly repatriation of 20% of NAV remain unchanged
	<ul style="list-style-type: none"> • Elimination of potential trading uncertainty due to daily limit on the Stock Connect 	<ul style="list-style-type: none"> ❖ Pending clarification

REMAINING ACCESSIBILITY ISSUES TO BE ADDRESSED

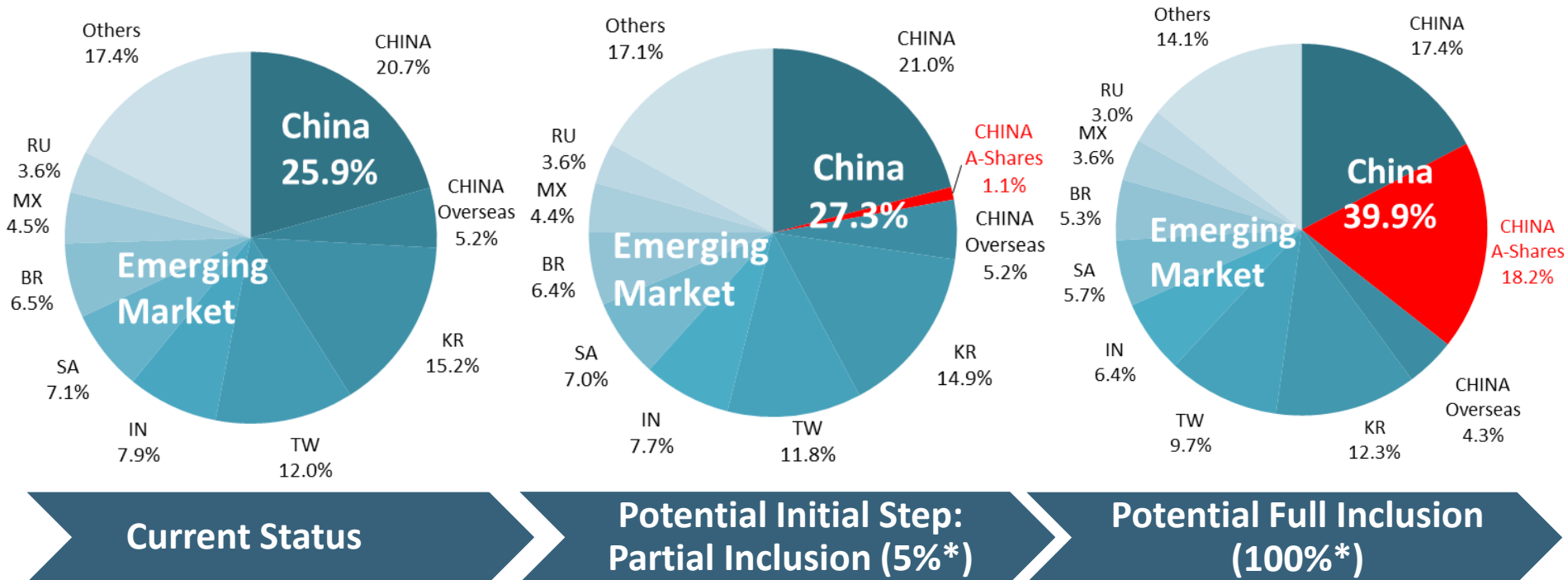
- The beneficial ownership issue on separate accounts, the widespread voluntary suspension practices and the anti-competitive measures imposed by the local Chinese stock exchanges which limit the fund vehicles available to international investors are the only remaining critical issues that need to be adequately addressed to alleviate investors concern.

	Outstanding Issues	Current Status
Beneficial Ownership	<ul style="list-style-type: none"> Current QFII/RQFII framework does not provide a clear recognition on the ultimate beneficial ownership of assets under separate accounts. 	<ul style="list-style-type: none"> ✓ Client names can be now included in QFII/RQFII separated accounts ❖ Pending further clarification update from the CSRC
Widespread voluntary suspension	<ul style="list-style-type: none"> Widespread voluntary suspension practices prevented normal market trading activities and caused liquidity and replication concern. 	<ul style="list-style-type: none"> ✓ SSE plans to limit suspensions to no longer than three months ❖ Pending further regulatory measures on limiting voluntary suspension practices
Anti-competitive clauses	<ul style="list-style-type: none"> Existence of a provision that all financial products (including Exchange Traded Funds) linked to an index containing China A Shares need to be pre-approved by the local Chinese stock exchanges even if listed internationally is unique among emerging markets. 	<ul style="list-style-type: none"> ❖ Pending resolution by the local Chinese stock exchanges

PROPOSAL FOR 5% INITIAL INCLUSION REMAINS INTACT

- MSCI is maintaining its proposal to include China A-shares in the MSCI China Index in steps starting with a partial Inclusion Factor of 5%
 - The inclusion in the MSCI China Index would be reflected in its corresponding composite indexes, including the MSCI Emerging Markets Index, simultaneously
 - The pro forma MSCI China Index would be constructed based on one integrated China equity universe comprising A-shares, B-shares, H-shares, Red-chips, P-chips and Overseas listed China companies
 - A 5% Inclusion Factor would be applied to the FIF-adjusted market capitalization of China A-shares in the pro forma MSCI China Index
 - The free float-adjusted market capitalization of China A-shares would be evaluated based on the Foreign Inclusion Factor (FIF) subject to a 30% Foreign Ownership Limit (FOL)
 - The implementation of this proposal would coincide with the May 2017 Semi-Annual Index Review
 - Any subsequent increase in the Inclusion Factor of China A-shares in the MSCI Emerging Markets would be subject to positive market liberalization developments and public consultation with market participants
- Please note that this proposal may or may not lead to any changes to the MSCI Indexes

POSSIBLE INDEX INCLUSION ROADMAP OF CHINA A-SHARES



- Inclusion of overseas listed Chinese companies such as Baidu and Alibaba in November 2015 SAIR

- Further improvements in quota allocation mechanism and size of overall quota
- Further relaxation on capital mobility and other market accessibility constraints

- Abolishment of the quota system
- Full liberalization of capital mobility restrictions
- Alignment of International accessibility standards

Data as of March 30, 2016

* The percentage number refers to the Inclusion Factor applied to the free float-adjusted market capitalization of China A share constituents in the pro forma MSCI China Index. China A-share securities are subject to a foreign ownership limit of 30%

Overseas listed Chinese companies were included in Nov 2015

TRANSITION ANALYSIS

- If the partial inclusion proposal is accepted, the number of constituents in the MSCI China Index would increase from 155 to 609 with a majority of new constituents coming from A shares. ¹
- The estimated one way index turnover will be 7.2%, comparable to the first-phase transition of overseas listed China ADRs in November 2015.

	Current Standard		Pro forma (IF* = 5%)			# Securities	
	Weight	# Sec	Weight	# Sec	1 way Turnover	Add	Del
MSCI China A	100%	804	100%	421	27.69%	-	383
Large Cap	67.8%	302	84.4%	271		5	36
Mid Cap	32.2%	502	15.6%	150		25	377
MSCI China A IMI	100%	1969	100%	1910	20.28%	145	204
Large Cap	51.9%	302	54.8%	271		5	36
Mid Cap	24.7%	502	10.2%	150		25	377
Small Cap	23.4%	1165	35.0%	1489		329	5
MSCI China	100%	155	100%	609	7.19%	454	-
A Shares	0.0%	0	4.0%	421	4.03%	421	0
B Shares	0.3%	2	0.5%	4	0.15%	2	0
H Shares	40.8%	74	38.6%	83	0.70%	9	0
Red Chip	19.6%	31	18.8%	37	0.59%	6	0
P Chip	19.1%	34	19.0%	47	1.32%	13	0
Overseas#	20.1%	14	19.1%	17	0.41%	3	0
MSCI EM		835	100%	1289	1.97%	454	-
A Shares	-	-	1.1%	421	1.13%	421	-
MSCI EM (include LC only)		835	100%	1139	1.79%	304	-
A Shares (include LC only)	-	-	0.8%	271	0.95%	271	-

Data as of March 30, 2016

1. The pro forma index constituents are based on the MSCI China A International Index.

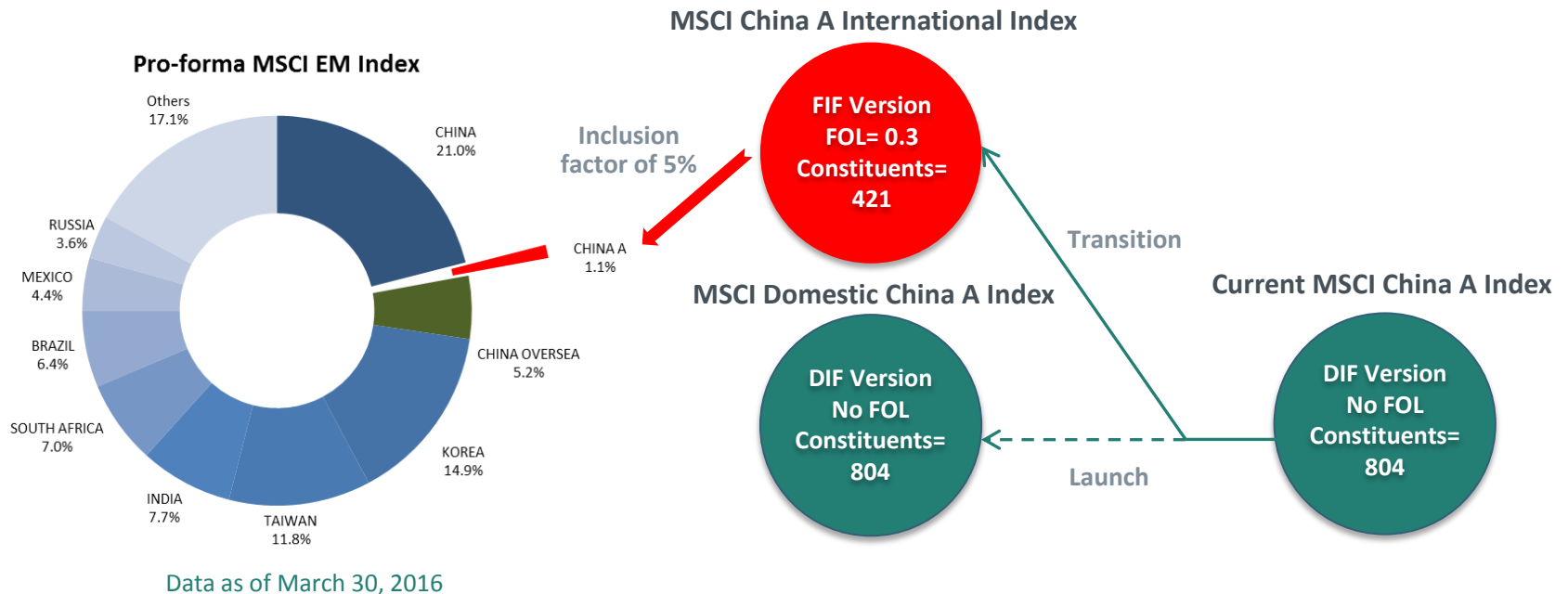
KEY DISCUSSION POINTS

1. What have been your experience with regards to the recent QFII policy relaxations with regards to quota and capital mobility?
2. Do you now see the policies align to a satisfactory resolution for China A-shares to be included in the MSCI Emerging Markets Index?
3. Given the QFII quota is now linked to the asset size of investors and potentially sufficient to cater for a larger allocation, does a 5% initial inclusion still represent a reasonable proposal ?
4. Would you agree with the proposed one-phase transition plan and implementation timeline?

APPENDIX

FOR EXISTING MSCI CHINA A INDEX CLIENTS

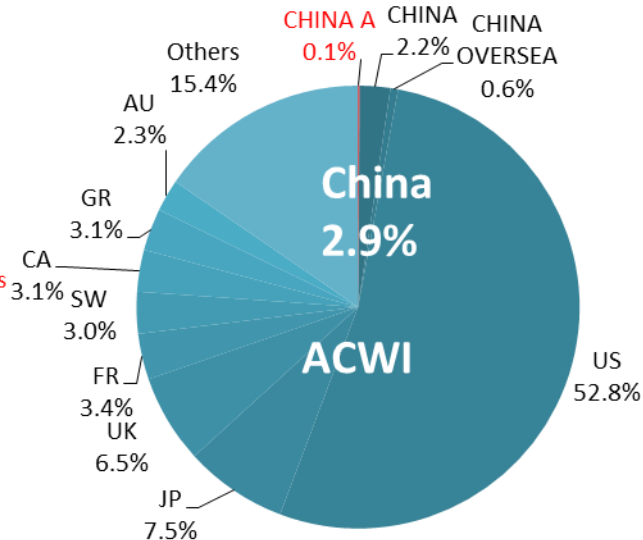
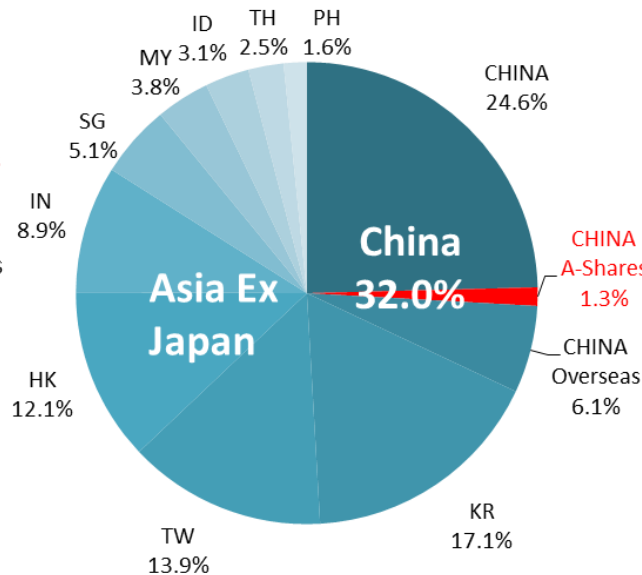
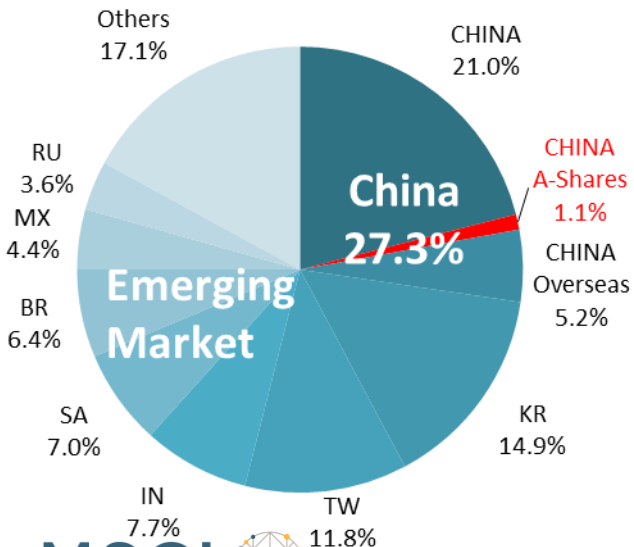
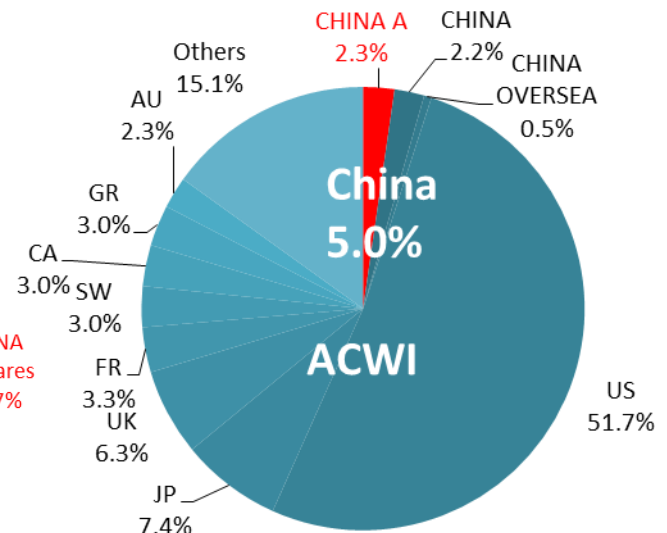
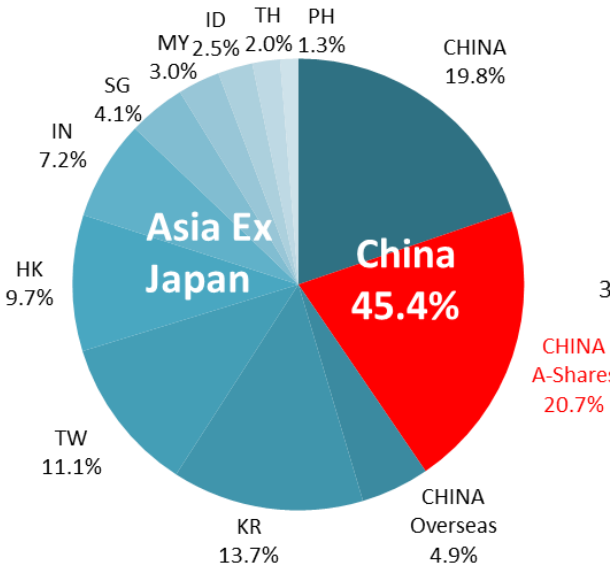
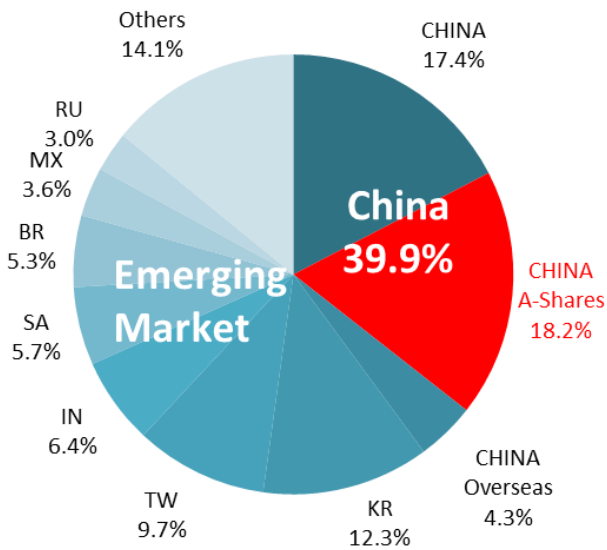
- Existing clients who benchmarked to the MSCI China A Index can consider transitioning to the MSCI China A International Index. The index is available since 2015.
- In addition, MSCI proposes to maintain the MSCI China A Index as a **domestic index** for clients who wish to gain a deeper and broader access to the China A-share opportunity set
 - Question: Does it make sense to disconnect the minimum size threshold with the MSCI Global Investable Market Indexes?*



KEY ACCESS CHANNELS TO CHINA A-SHARES

	RQFII		QFII		Stock Connect
Eligible Investors	Institutional investors based in selected eligible locations Individual Quota: None		Institutional investors that meet certain operation and AUM requirements Base quota ranging from US\$20 million to US\$ 5 billion		All investors
Application Process	Need license (CSRC) and quota (SAFE) The process can range from weeks to months		<ul style="list-style-type: none"> Applications for base quota will be filed with SAFE via onshore custodians Applications for quota exceeding US\$5 billion will be required to apply to SAFE directly for approval 		N.A.
Capital Mobility	<u>Open-Ended Funds:</u> -Repatriation: Daily -Lock-up: None -Remit Period: None -Others: Quota required to be used within 1 year upon approval	<u>Others:</u> -Repatriation: Monthly -Lock-up: 1 year -Remit Period: 6 months	<u>Open-Ended Funds:</u> -Repatriation: Daily -Lock-up: 3 months -Remit Period: N.A. -Others: Monthly repatriation cannot exceed 20% of NAV of previous year	<u>Others:</u> -Repatriation: Daily -Lock-up: 1 year -Remit Period: 6 months -Others: Monthly repatriation cannot exceed 20% of NAV of previous year	No restriction
Equity Coverage Universe	All securities listed on Shanghai and Shenzhen Stock Exchanges				570+ stocks listed on Shanghai Stock Exchange

POSSIBLE INDEX INCLUSION ROADMAP



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Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research.

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