CONSULTATION ON FURTHER WEIGHT INCREASE OF CHINA A SHARES IN THE MSCI INDEXES

December 2018

This consultation may or may not lead to the implementation of any or all of the proposed changes in MSCI's indexes. Consultation feedback will remain confidential. MSCI may publicly disclose feedback if so requested by the provider of the feedback. In that case, the relevant feedback would be published together with the final results of the consultation.

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INTRODUCTION

- The 5% initial inclusion of China A shares was **successfully implemented** in May and August 2018 with **overwhelming positive feedback** from market participants
- MSCI is now launching this consultation on a **further weight increase of China A shares in the MSCI Indexes**
- MSCI welcomes feedback from the investment community on the proposal by **February 15, 2019** and plans to announce its decision on or before **February 28, 2019**
- This consultation **may or may not result in changes** in the MSCI Global Investable Market Indexes

CONSULTATION PROPOSALS

	Proposal	Timing
1	Increase the inclusion factor of China A Large Cap securities from 5% to 20% in two phases*	May 2019 and August 2019
2	Add ChiNext to the list of eligible stock exchange segments	May 2019
3	Add China A Mid Cap securities with a 20% inclusion factor in one phase	May 2020

*7.5 percentage points in each phase

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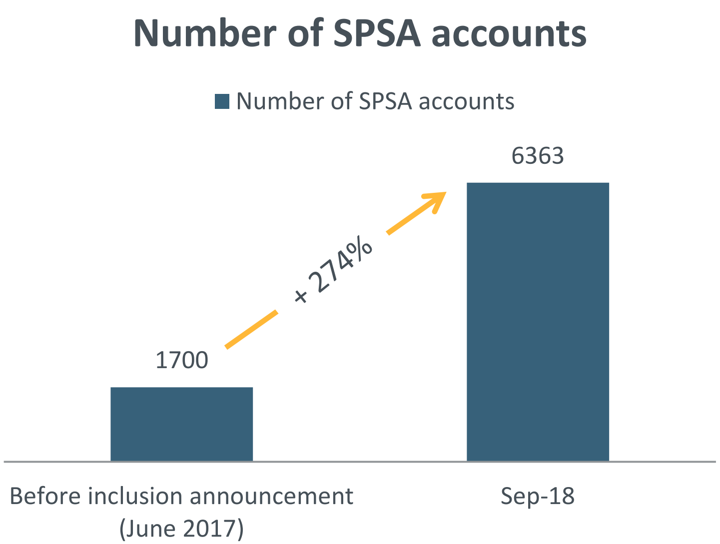
RATIONALE FOR THE PROPOSAL

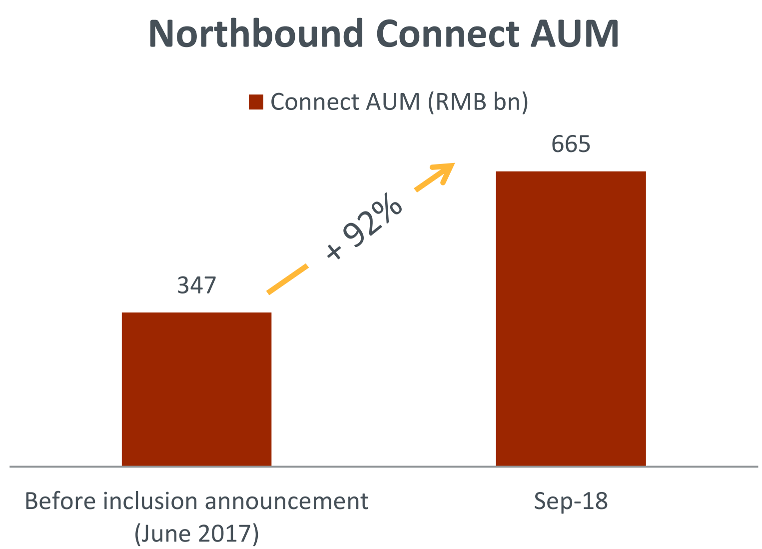
The broad participation in, and successful implementation of, the initial 5% inclusion provided strong evidence of positive market accessibility of the China A shares market via Stock Connect

Stock Connect Robustness	Stock Connect has proven to be a robust channel to access China A shares. Currently, Stock Connect daily quota and CNH liquidity are sufficient to address an inclusion factor that is a multiple of the current size
Market Accessibility Improvements	Quadrupling of the Stock Connect daily limit, visible reduction in trading suspensions and successful implementation of a closing auction mechanism on the Shanghai Stock Exchange

BROAD PARTICIPATION DURING THE INITIAL INCLUSION

Since the announcement of the MSCI China A shares inclusion, more than 4,600 new Stock Connect accounts have been opened to trade China A shares and the total Northbound Connect portfolio value grew by US$46 billion





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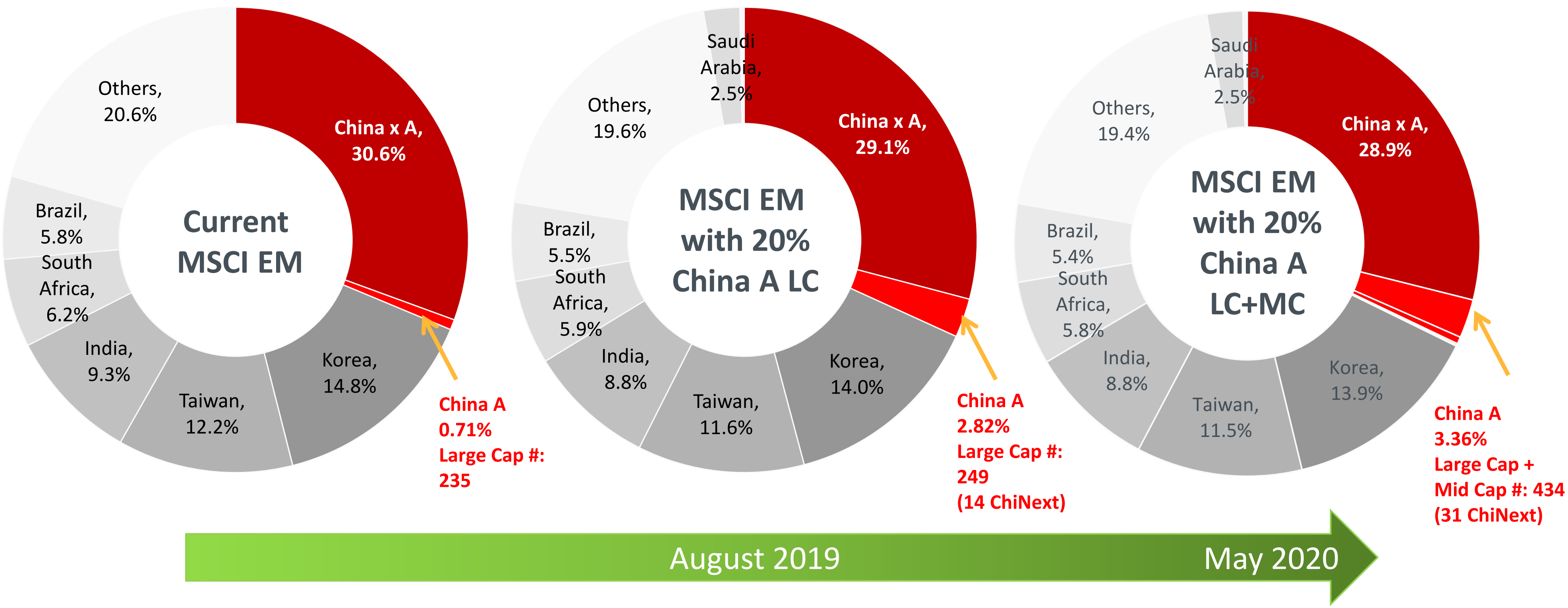
Source: MSCI, HKEX

PRO-FORMA WEIGHT IN MSCI EM INDEX

With an increase of the inclusion factor of China A Large Cap securities to 20%, the pro forma index weight of China A shares in the MSCI Emerging Market Index would be 2.8% in August 2019. The addition of China A Mid Cap securities with an inclusion factor of 20% in May 2020 would increase the pro forma weight further to 3.4%



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Data as of September 3, 2018

MARKET LIBERALIZATION CONTINUES

The pace of market opening continued to accelerate in 2018 with more than 10 opening measures year to date

Latest opening measures in the China financial sector

Nov 17
HKEX launched **RDVP** for Connect

Apr 18
PBoC **quadrupled daily quota** of Stock Connect

Apr 18
SAFE granted QDII quota of US$ 8.33 billion to 24 institutions after a three-year halt

Apr 18
SAFE widened quotas of QDLP and QDIE programs by US$ 5 billion each

Apr 18
China granted Japan Rmb 200 billion RQFII quota, third largest after HK and USA

May 18
CSRC released Administrative Measures for Foreign-Invested Securities Companies

May 18
HKEx introduced **USD/HKD collateral enhancement** service in Connect

May 18
MSCI successfully implemented the first 2.5% A shares inclusion

June 18
Shanghai issued consultation on closing auction

June 18
SAFE **removed monthly repatriation cap and principal lock up perio**d, giving QFII/RQFII the ability to access FX hedging instruments and simplifying document filing

July 18
China opened A shares to eligible foreign individual investors

July 18
Ministry of Commerce to consult on reducing the lock up period on listed company investments by foreign strategic investors from 3 years to 1 year

August 18
SSE implemented **closing auction** similar to SZSE on August 20, 2018

Aug 18
MSCI successfully implemented the second 2.5% A shares inclusion

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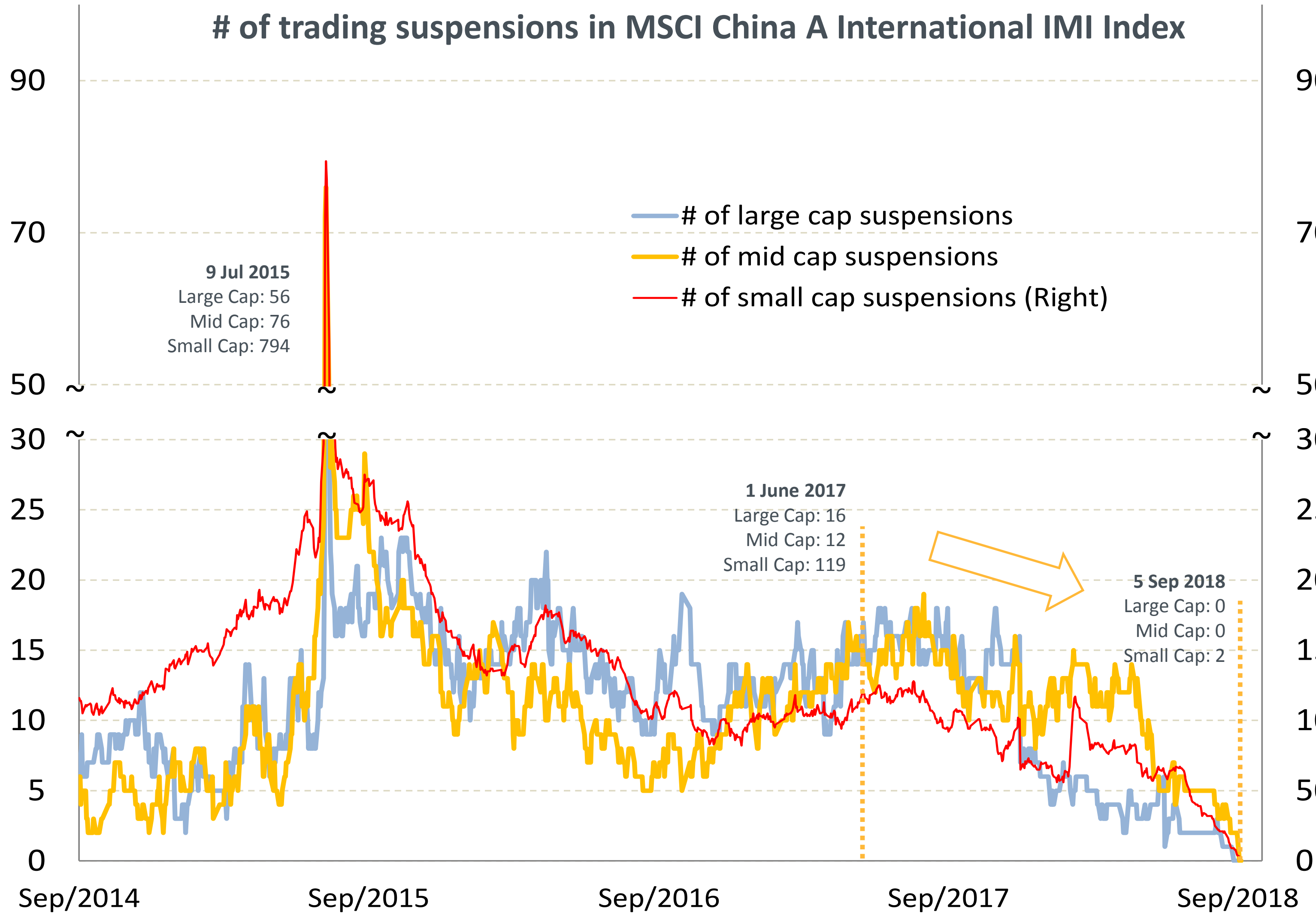
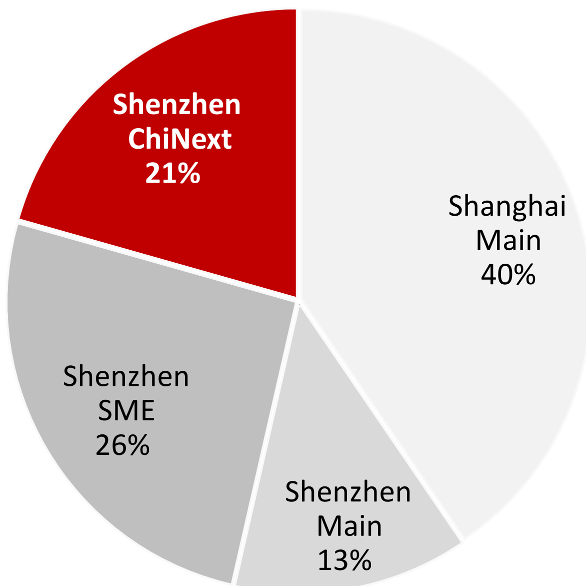
VISIBLE IMPROVEMENT IN TRADING SUSPENSIONS



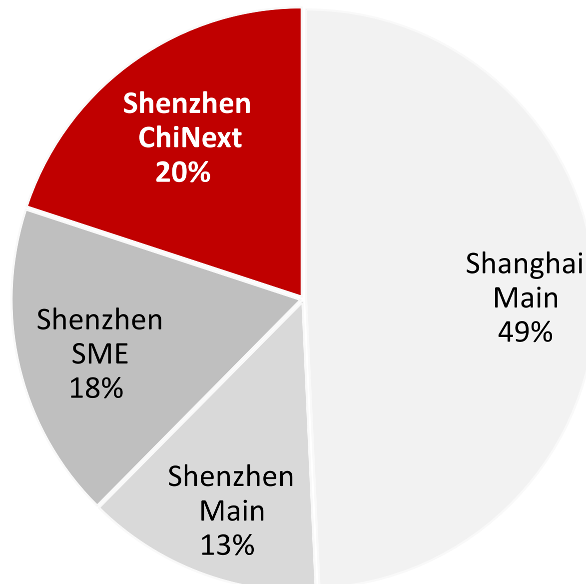
CHINEXT REPRESENTS 20% OF THE CHINA A SHARES INVESTMENT OPPORTUNITY SET

- The ChiNext board represents around one-fifth of the total China A shares opportunity set in terms of number of stocks and free float adjusted market capitalization. It has a larger free float adjusted market capitalization than the Shenzhen main and SME boards
- ChiNext securities are currently accessible through the expansion of Stock Connect. There are currently **194** ChiNext stocks eligible to be traded via Stock Connect

Distribution of A shares: # of stocks



Distribution of A shares: free float market capitalization



Data as of September 3, 2018; Based on all listed China A shares in Shanghai and Shenzhen Stock Exchanges

COMPARISON OF LISTING REQUIREMENTS

- Listing requirements of ChiNext board are not materially lower than the main board/SME board
- Most tech companies made their debut in ChiNext, which is positioned as China's "Nasdaq"

<table>
<tr><th rowspan="2">Items</th><th rowspan="2">Main Board & SME Board</th><th colspan="2">ChiNext Market</th></tr>
<tr><th>Criteria I</th><th>Criteria II</th></tr>
<tr><td>Net Profit</td><td>Positive net profit in the last 3 consecutive years and the aggregate value is no less than RMB 30 million</td><td>Positive net profit in the past 2 consecutive years, and accumulated profit no less than RMB 10 million</td><td>Positive net profit in last one year</td></tr>
<tr><td>Revenue/
Cash Flow</td><td>Accumulated revenue in past 3 years no less than RMB 300 million, or accumulative net operating cash flow no less than RMB 50 million.</td><td colspan="2">No less than RMB 50 million in revenue during the past year and >30% revenue growth during the past two years</td></tr>
<tr><td>Net Assets</td><td>Tangible asset ratio > 80%</td><td colspan="2">No less than RMB 20 million at the end of the most recent reporting period with no uncovered losses</td></tr>
<tr><td>Share Capital</td><td>Total stock capital before issuance is no less than RMB 30 million</td><td colspan="2">A total share capital of no less than RMB 30 million after the IPO</td></tr>
<tr><td>Others</td><td colspan="3">Shall not be subject to any of (6) circumstances which adversely affect its ongoing profitability</td></tr>
</table>

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Source: Shenzhen Stock Exchange

KEY DISCUSSION QUESTIONS

- Is 20% inclusion factor for both Large and Mid Cap securities appropriate for the next phase of A shares inclusion?
  - Are you anticipating any accessibility constraints that could make the proposed weight increase challenging?
- The proposed implementation of the increase in inclusion factor to 20% for China A Large Cap securities would coincide with the reclassification of the MSCI Saudi Arabia and MSCI Argentina Indexes to Emerging Markets.
  - Is the management of potential turnover an important consideration?
- Is the differentiated treatment between China A Large and Mid Cap securities appropriate?
  - How much time would you require to be ready to cover the additional 168 China A Mid Cap securities?
- Do you agree with the addition of ChiNext to the list of eligible stock exchange segments for China?
  - Are you already invested in ChiNext securities?

REVIEW OF EXISTING ACCESSIBILITY CONSTRAINTS

The China A shares market has achieved significant progress in market opening. However, MSCI believes further progress could be made with respect to its market accessibility standards and is seeking feedback from international institutional investors as to what further improvements could facilitate the implementation of the proposal

1. **Trading suspensions**: while there has been visible improvement lately, trading suspensions in the China A shares market remain unique when compared to other emerging markets. As a reminder, MSCI does not include and will remove stocks in prolonged suspension from the index
2. **Alignment of international settlement cycle**: China currently operates on a T+0/1 settlement cycle. Despite the availability of market solutions on T+1/2 DVP/RDVP through Stock Connect, the short settlement cycle onshore continues to pose operational challenges to global investors, especially for those based outside Asian time zones
3. **Access to hedging and derivatives vehicles**: Exchange restrictions placed on China A shares index licensing of certain listed futures and options as well as certain leveraged and inverse leveraged investment instruments, whether onshore or offshore, continue to hamper investors' ability to manage risk and gain exposure beyond the cash market
4. **Access to CNY for stock settlement**: The current pool of CNH liquidity remains sufficient to address an inclusion multiple the size of 5%. However, direct access to CNY for stock settlement could represent a more efficient FX option for international investors and financial intermediaries

REVIEW OF EXISTING ACCESSIBILITY CONSTRAINTS (CON'T)

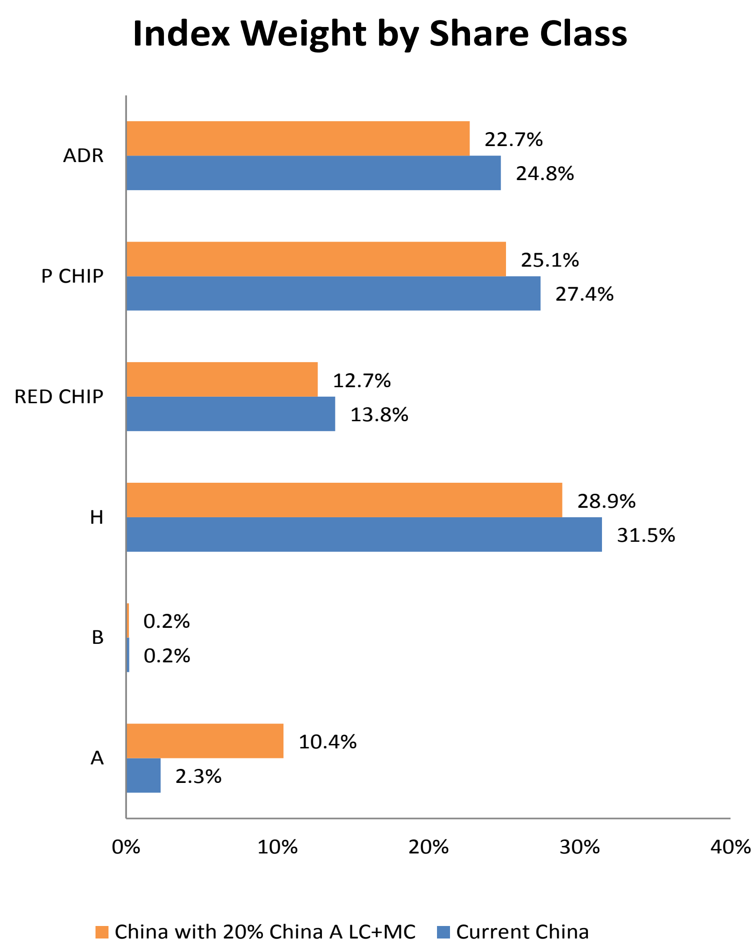
5. **Trading Holidays**: As Mainland China and Hong Kong observe different holiday schedules, Stock Connect is not open to international investors when Hong Kong is on holiday
6. **Access to IPOs and ETFs:** IPOs and ETFs remain outside the scope of Stock Connect
7. **Stock Lending and Borrowing:** While short selling is technically allowed, there is no functioning stock lending and borrowing market. This hampers investors' ability to implement their investment views
8. **Stability of the Stock Connect universe**: Given that the eligibility universe of Northbound Connect is tied to non-MSCI indexes, there is a dependency and forced turnover issue in the maintenance of MSCI Indexes
9. **Omnibus in Stock Connect**: Given the implementation of the Broker-to-Client Assigned Number (BCAN) in Stock Connect, a functioning omnibus structure may need to be developed to allow for efficient transactions and achieving best execution

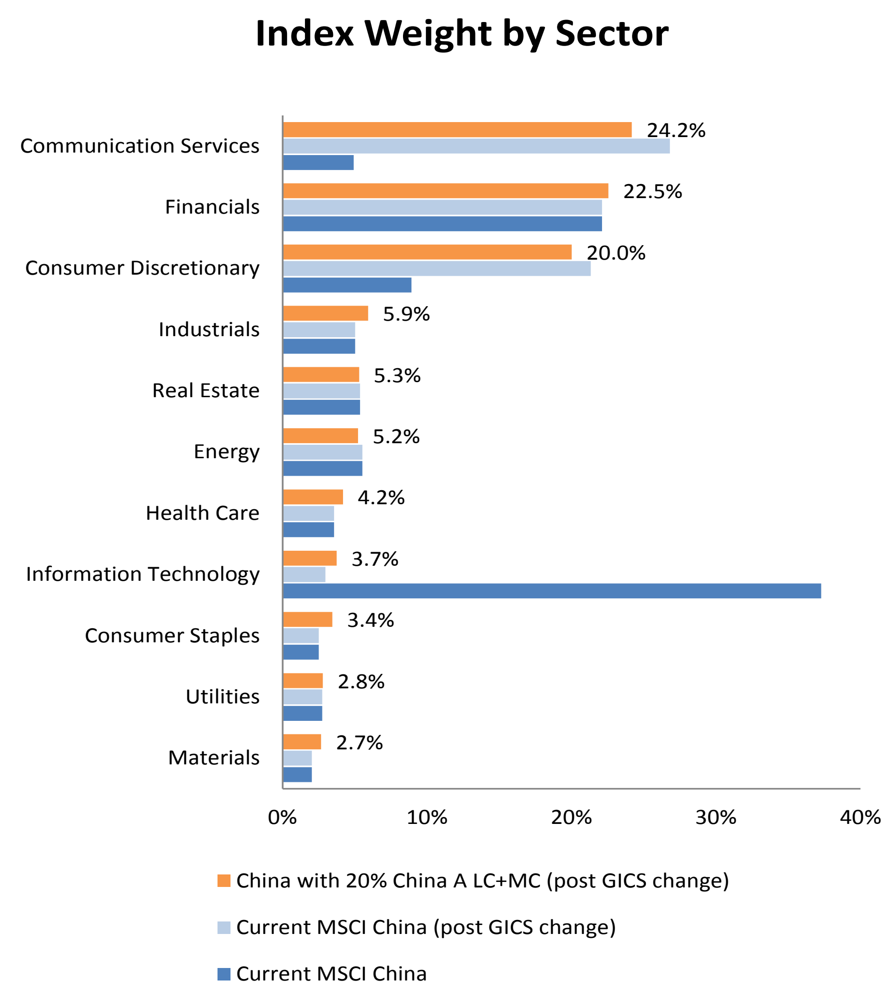
APPENDIX

INDEX WEIGHT BY SECTOR AND SHARE CLASS

HYPOTHETICAL FULL INCLUSION SCENARIO

INDEX WEIGHT COMPARISON BY SHARE CLASS AND SECTOR

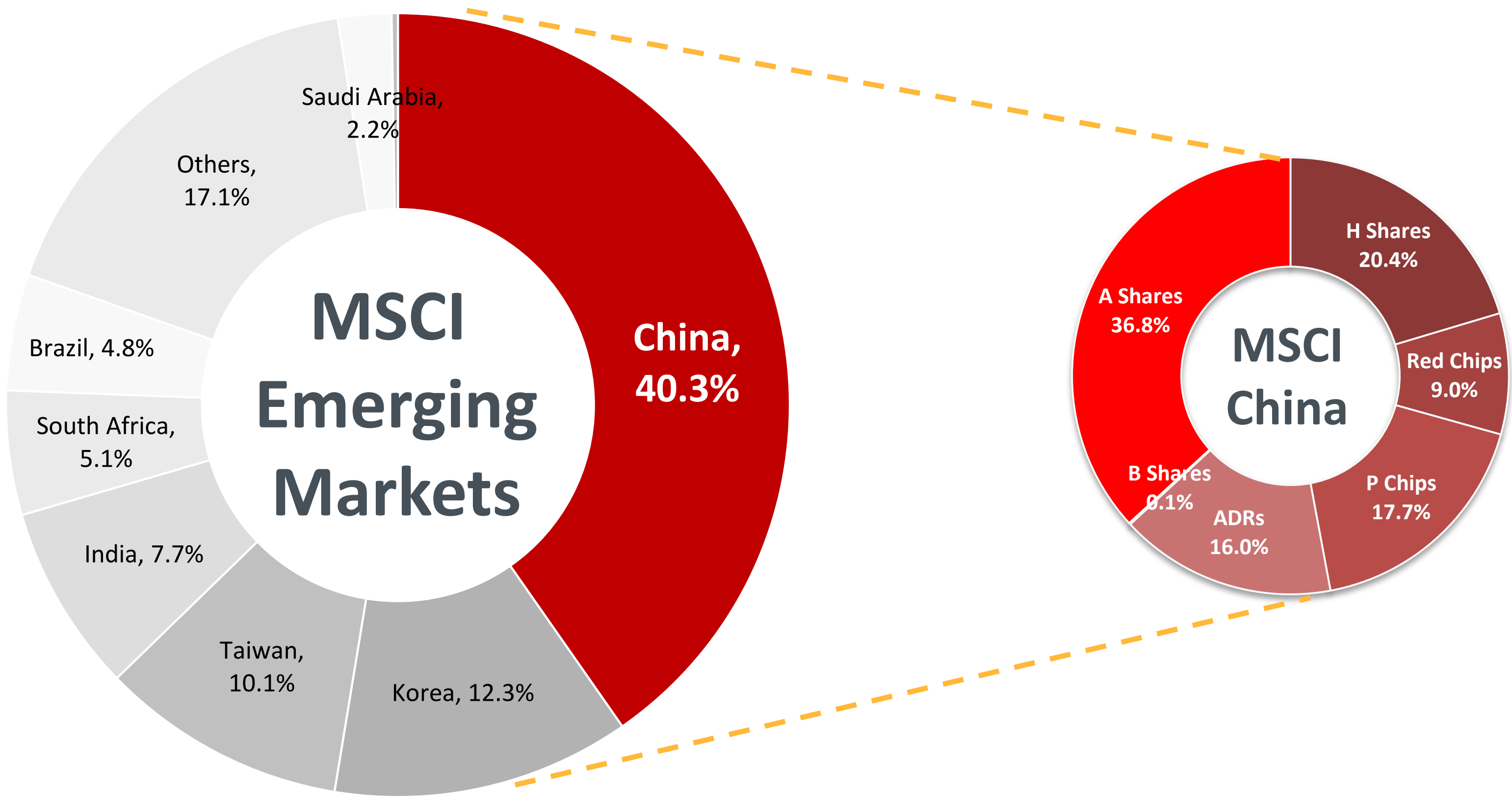




Data as of September 3, 2018. GICS changes effective September 28, 2018

A HYPOTHETICAL FULL INCLUSION SCENARIO

MSCI China (including A shares) could have a weight of 40% in MSCI Emerging Markets Index



Data as of September 3, 2018, assuming Stock Connect eligible Large and Mid Cap A shares are fully included in the MSCI Emerging Markets Index

APPENDIX

Turnover Analysis

INCLUSION TIMING OF A SHARES WITH SAUDI ARABIA

- While each market classification decision is independent, unsynchronized timing in the inclusion of the MSCI Saudi Arabia and Argentina Indexes and further inclusion of China A large cap shares could create additional market volatilities for a longer period of time
  - Synchronized rebalancing could save turnover by US$ 3.3 billion on a pro forma basis

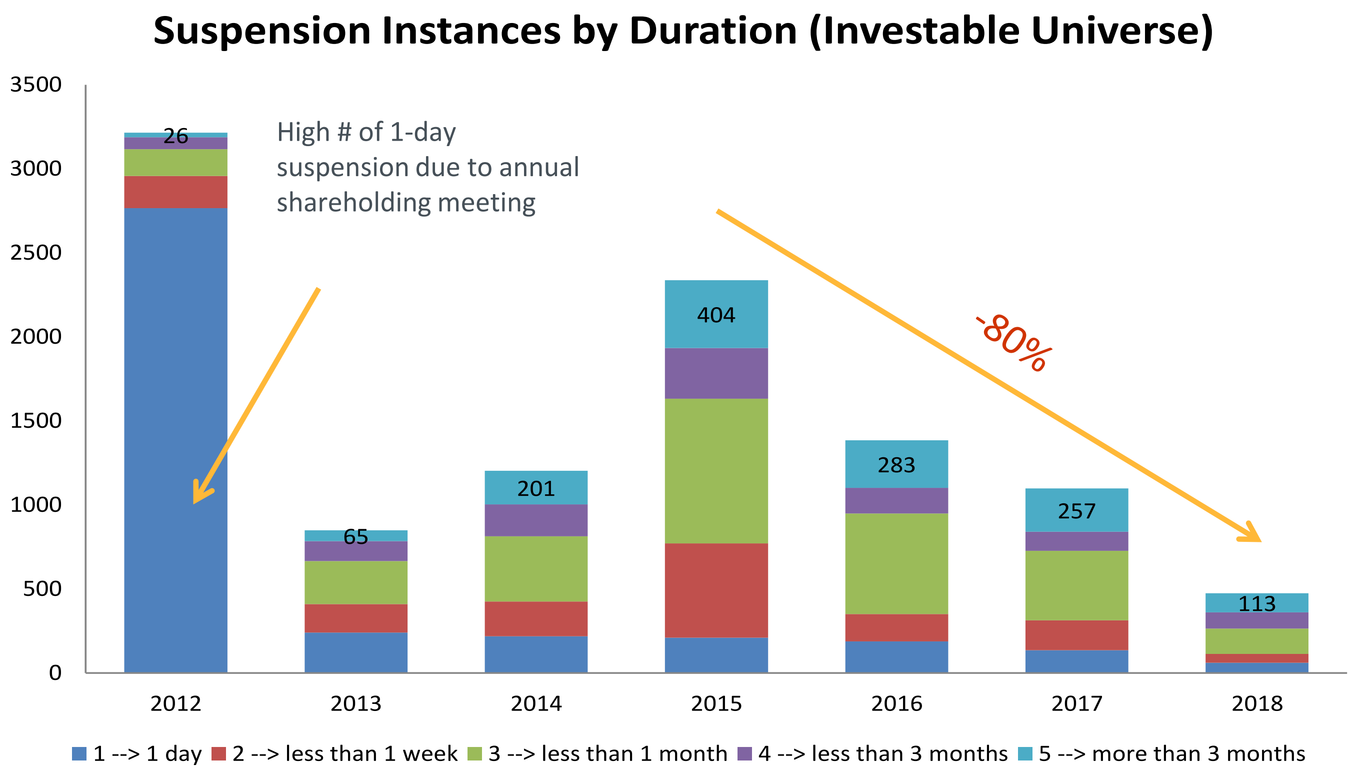
		May 2019 - August 2019	May 2020 - August 2020	Total EM Portfolio Turnover Post Inclusion
Unsynchronized rebalancing	+ Saudi Arabia (May/Aug 2019) + Argentina (May 2019) + China A (May/Aug 2020)	Saudi Arabia & Argentina: +$68bn China A shares: -0.4bn Rest of EM: -$67.6bn	Saudi Arabia & Argentina: -$1.2bn China A shares: +60.9bn Rest of EM: -$59.7bn	5.0%
Synchronized rebalancing	+ Saudi Arabia (May/Aug 2019) + Argentina (May 2019) + China A (May/Aug 2019)	Saudi Arabia & Argentina: +$66.8bn China A shares: +$60.5bn Rest of EM: -$127.3bn	n/a	4.9%

Index weights are based on data as of 3 September 2018. Portfolio flows are estimated based on assets benchmarked to MSCI indexes as of Dec 31, 2017, as reported on March 31, 2018 by eVestment, Morningstar and Bloomberg. The USD 3.3 billion turnover compares total capital movements impacted by the synchronized vs. unsynchronized rebalancing.

APPENDIX

AN UPDATE ON TRADING SUSPENSIONS

VISIBLE REDUCTION IN TRADING SUSPENSIONS SINCE 2015



- Compared to 2015, overall suspension instances have declined by 80% in 2018
- Reduction in trading suspensions is observed across different durations
- Most suspension instances in China rarely last for only one day
- There remain many cases of suspensions exceeding 3 months in duration

MAIN REASONS FOR IMPROVEMENTS IN SUSPENSION

Recent improvements in trading suspensions can be attributed to tighter enforcement of suspension policies announced in 2016

Reasons for improved trading suspension performance

1. **Improved quality of suspension disclosures** – listed companies are now required to disclose restructuring details related to the underlying assets, counterparties, transaction methods and content of restructuring agreements. Exchanges strive to strictly control information disclosure consistency to curb "arbitrary suspension announcements"

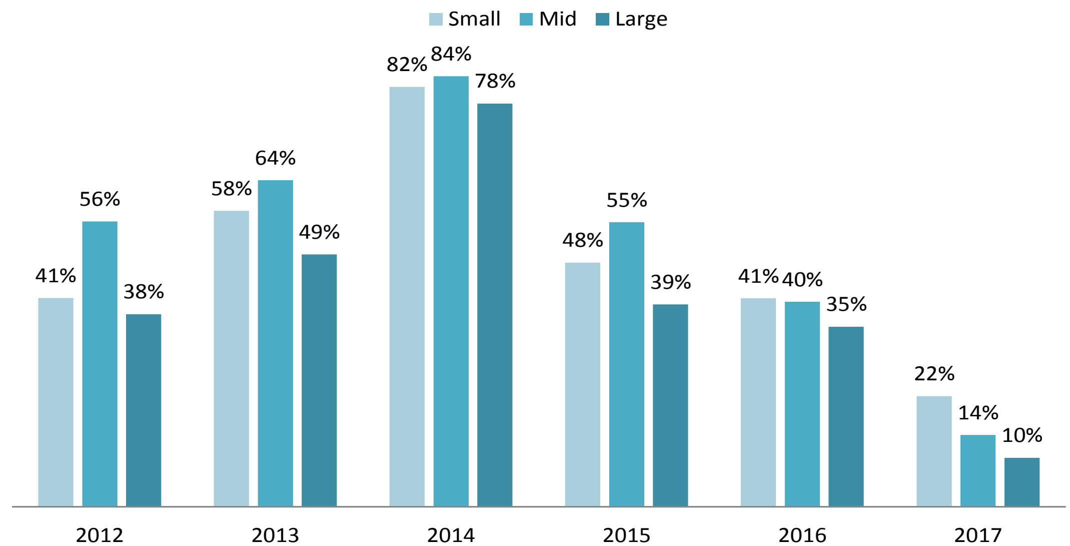
2. **Narrowed scope for trading suspension** – non-public offerings, transfer of control rights and external investments are examples that do not justify long term trading suspension. Exchanges have been guiding listed companies to reduce reliance on trading suspension when planning major corporate actions

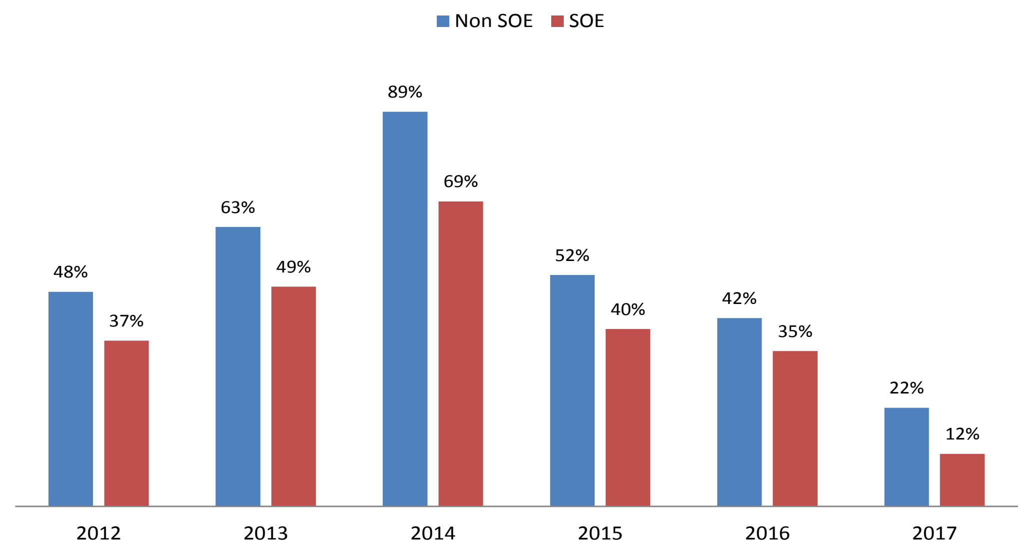
3. **Enhanced role of phased information disclosure –** to reduce unnecessary suspension, exchanges urge listed companies to speed up audit work and follow the approval procedures thereby shortening the duration of trading suspension

PROBABILITY OF REPEATED SUSPENSION

- By analyzing the trend of trading suspensions in two consecutive years, we derive the historical trend of repeated suspensions as a proxy for measuring probability of repeated suspension
- The probability of a large cap A shares to be suspended repeatedly has dropped to 10% in 2017 from 78% in 2014
- The probability of a large cap SOE A shares to be suspended repeatedly has dropped to 12% in 2017 from 69% in 2014
- The probability of non-SOE going into repeated suspension is higher

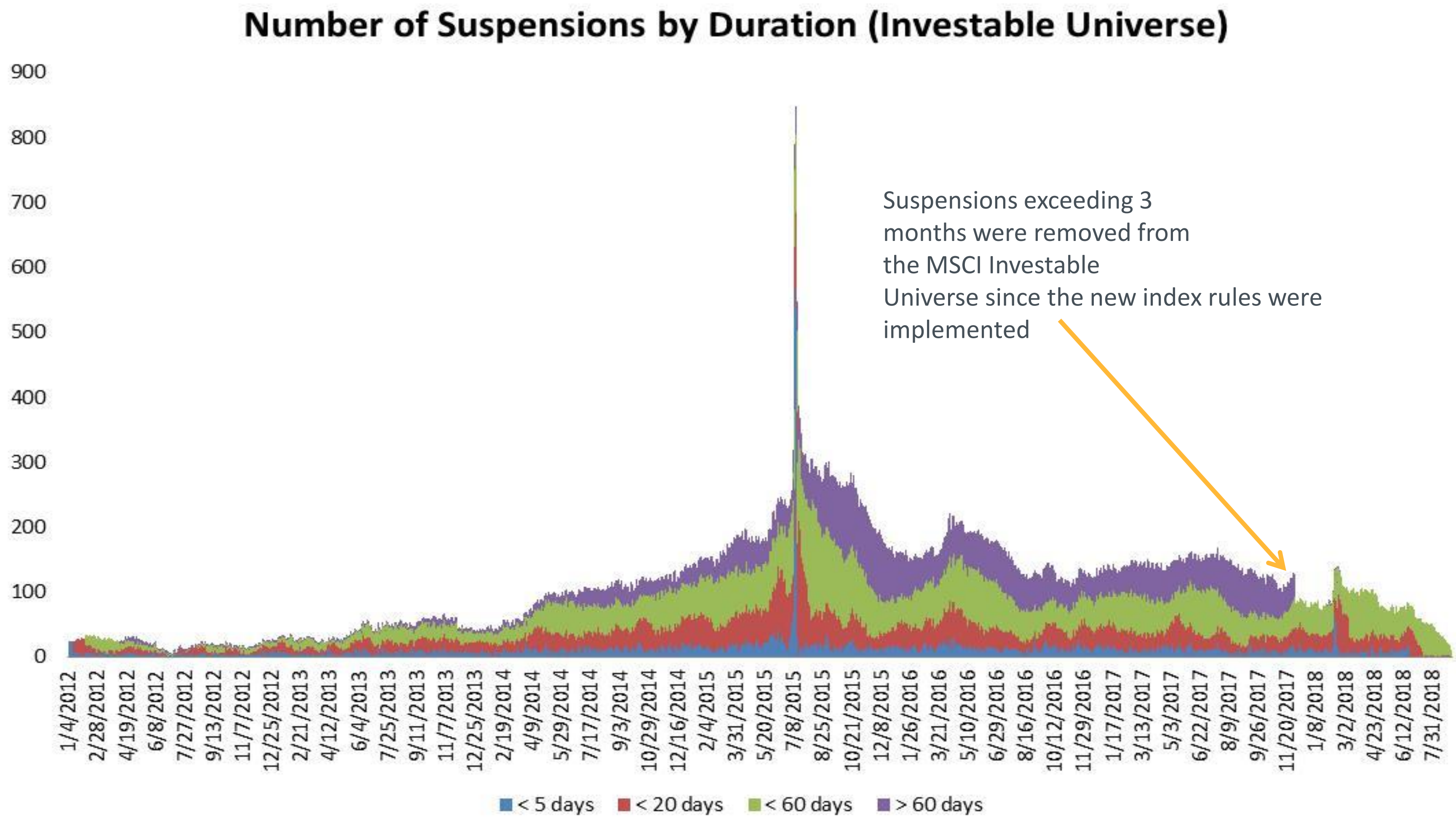
Probablity of current suspensions also suspended in the following year





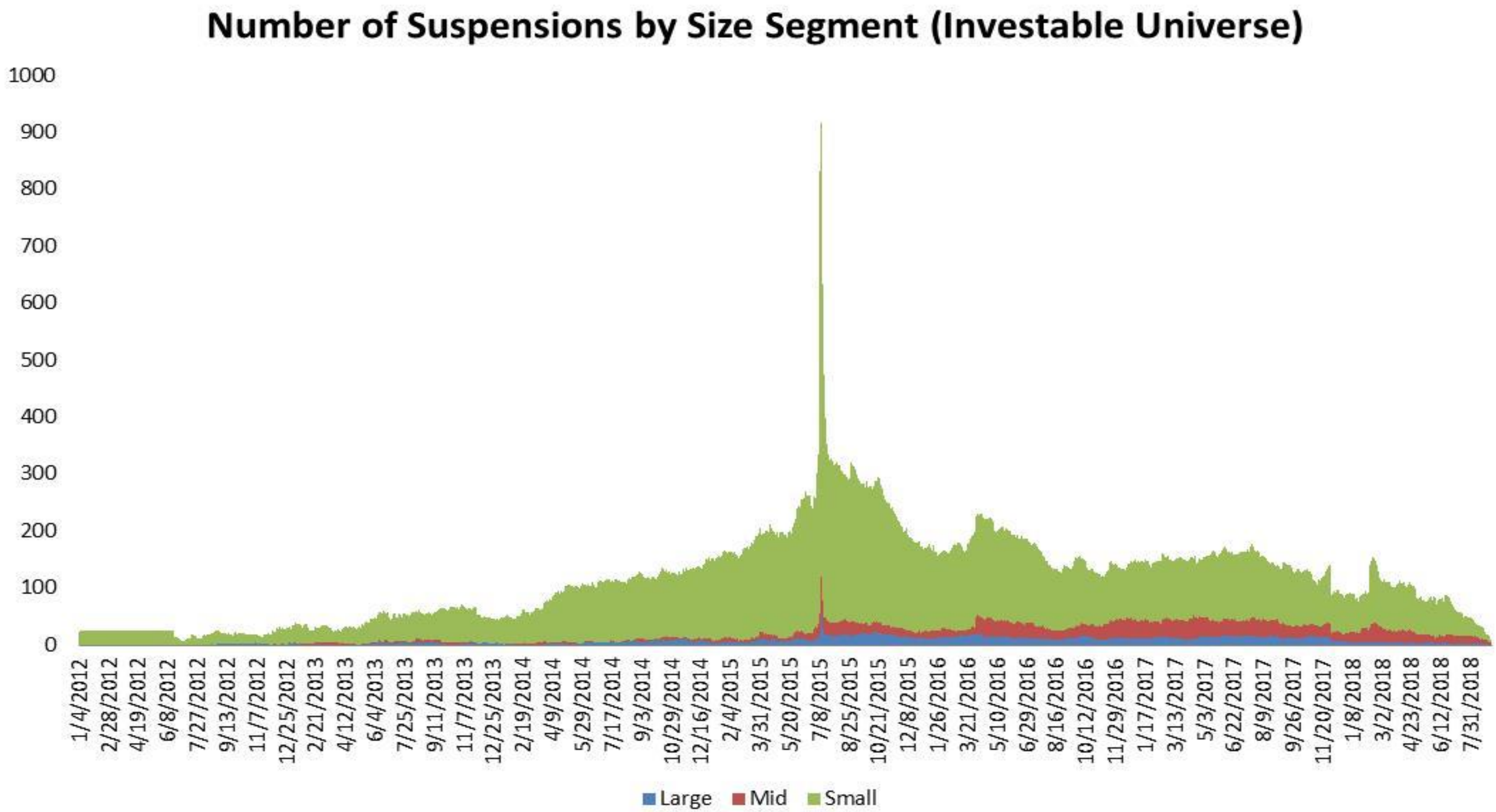
Data include all companies suspended at any point in time but exclude 1 day suspensions

TRADING SUSPENSIONS BY VARIOUS DURATION HORIZONS HAVE ALL COME DOWN



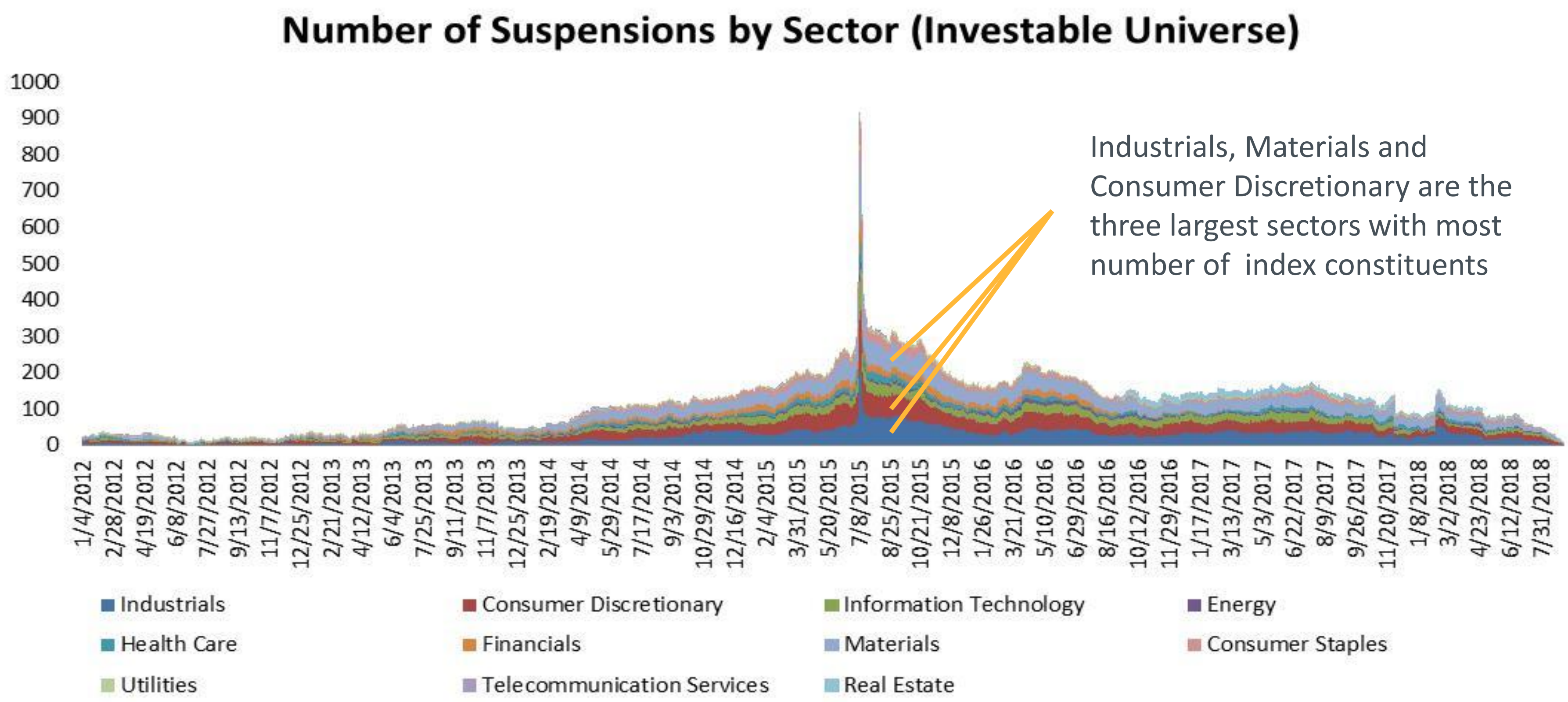
Data include all companies suspended at any point in time but exclude 1 day suspensions

SUSPENSION BY SIZE-SEGMENT



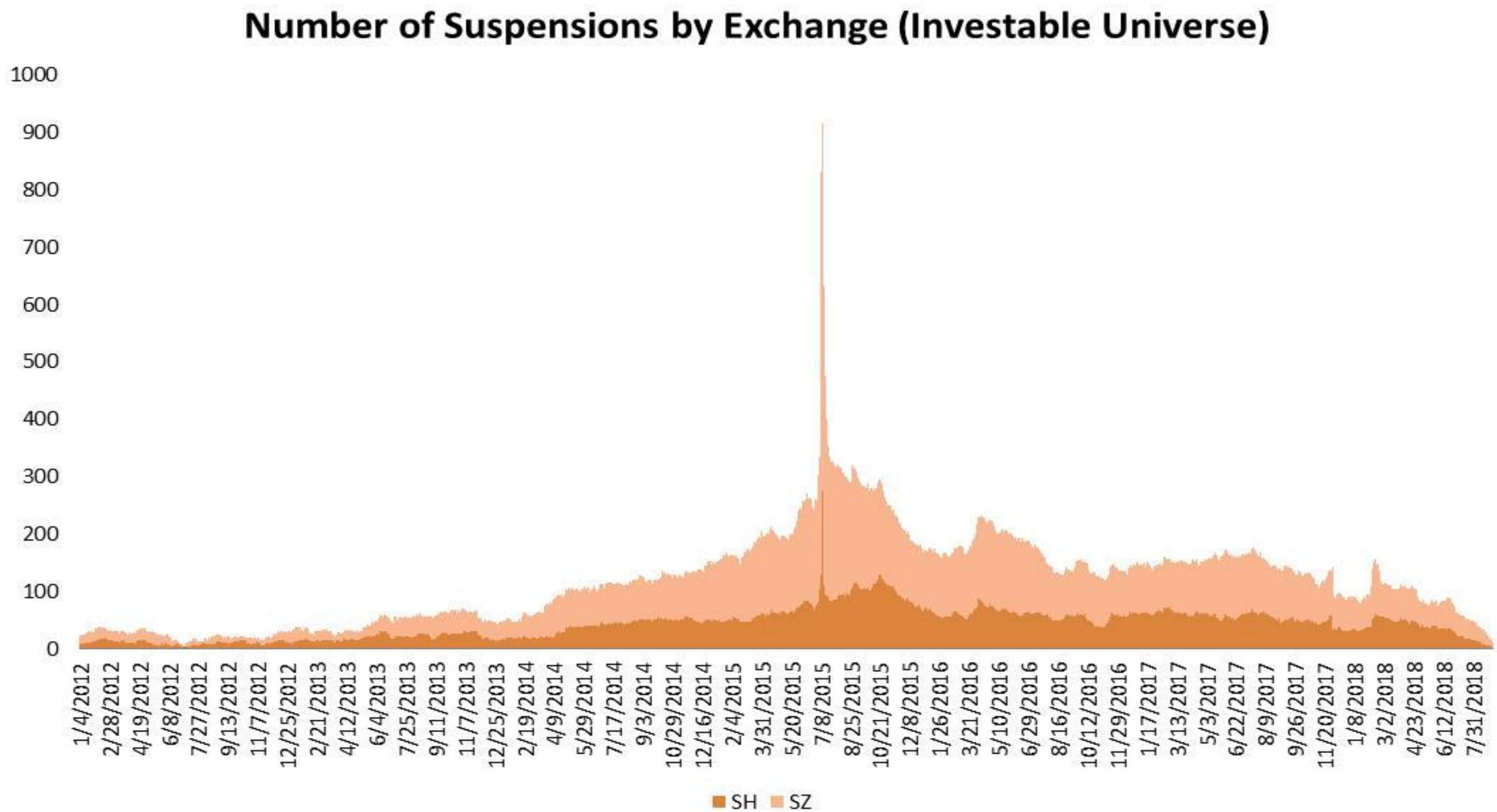
Data include all companies suspended at any point in time but exclude 1 day suspension

SUSPENSION BY SECTOR



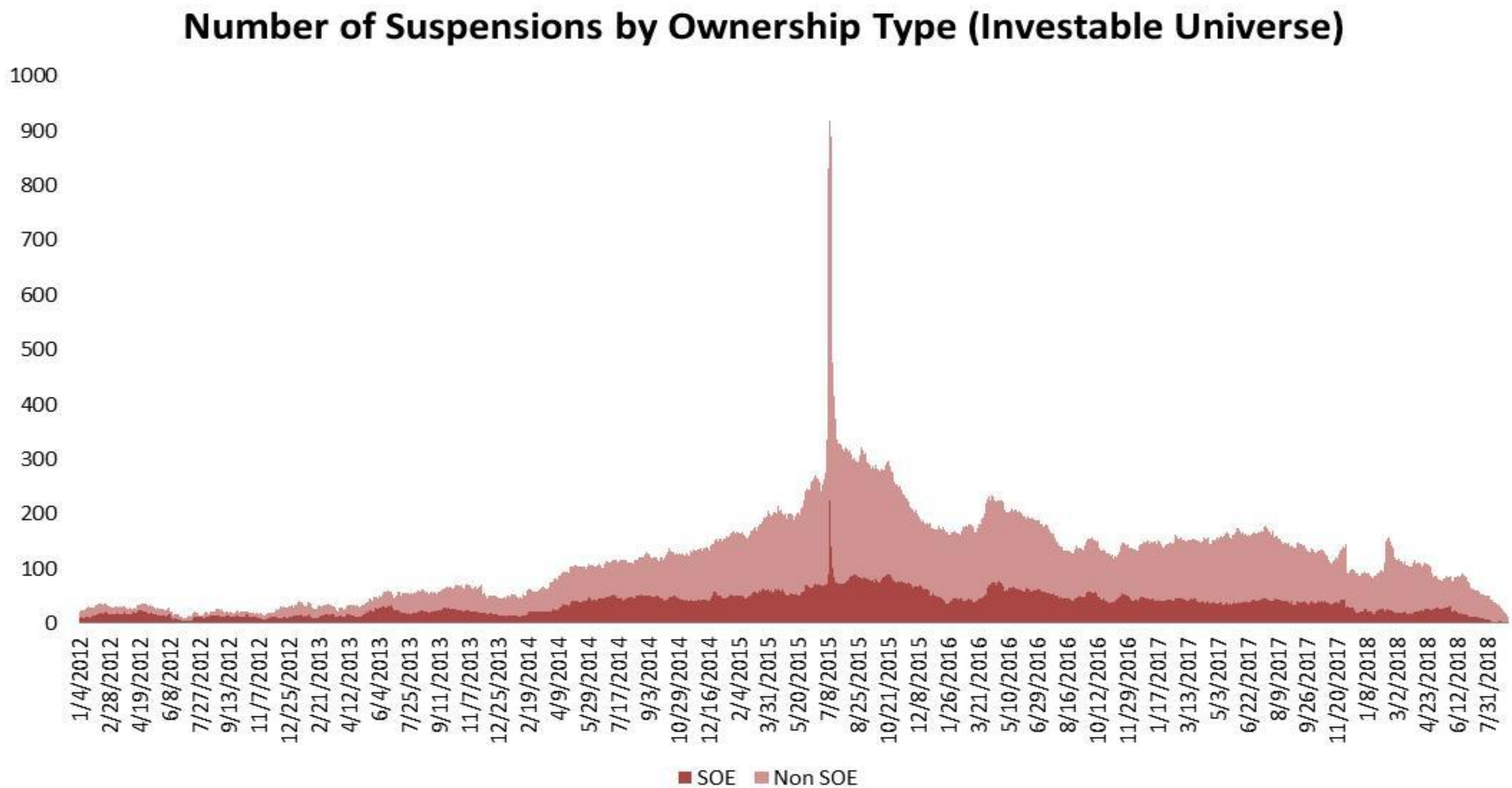
Data include all companies suspended at any point in time but exclude 1 day suspension

SUSPENSION BY STOCK EXCHANGE



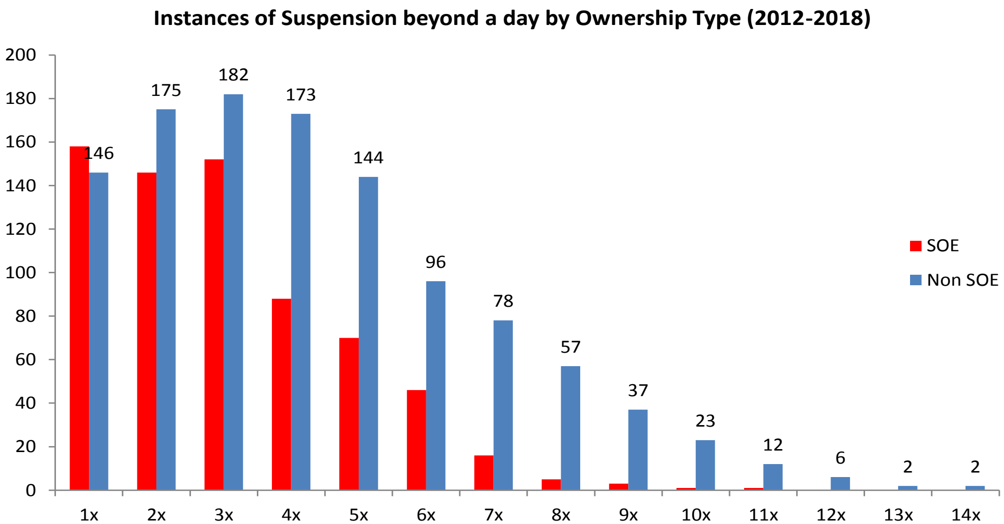
Data include all companies suspended at any point in time but exclude 1 day suspension

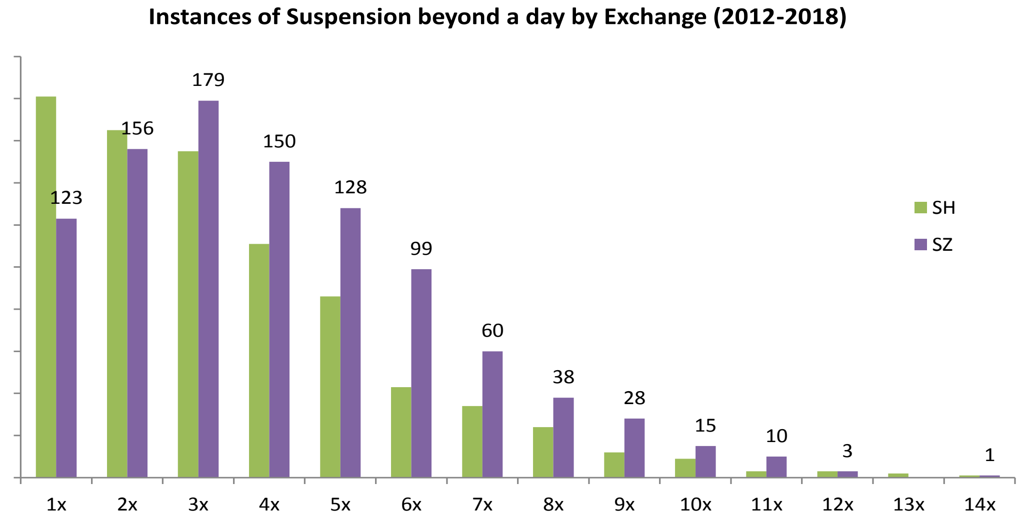
SUSPENSION BY OWNERSHIP TYPE

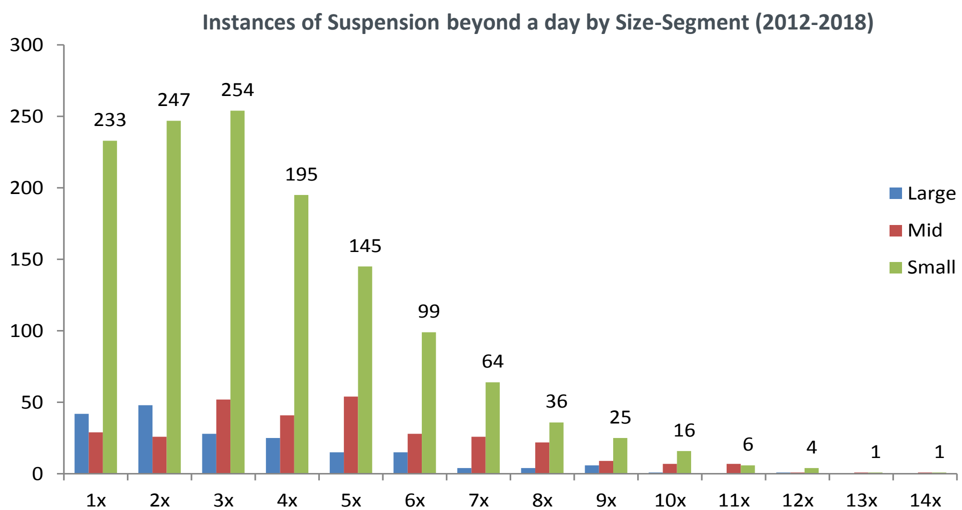


Data include all companies suspended at any point in time but exclude 1 day suspension

SUSPENSION BY INSTANCES







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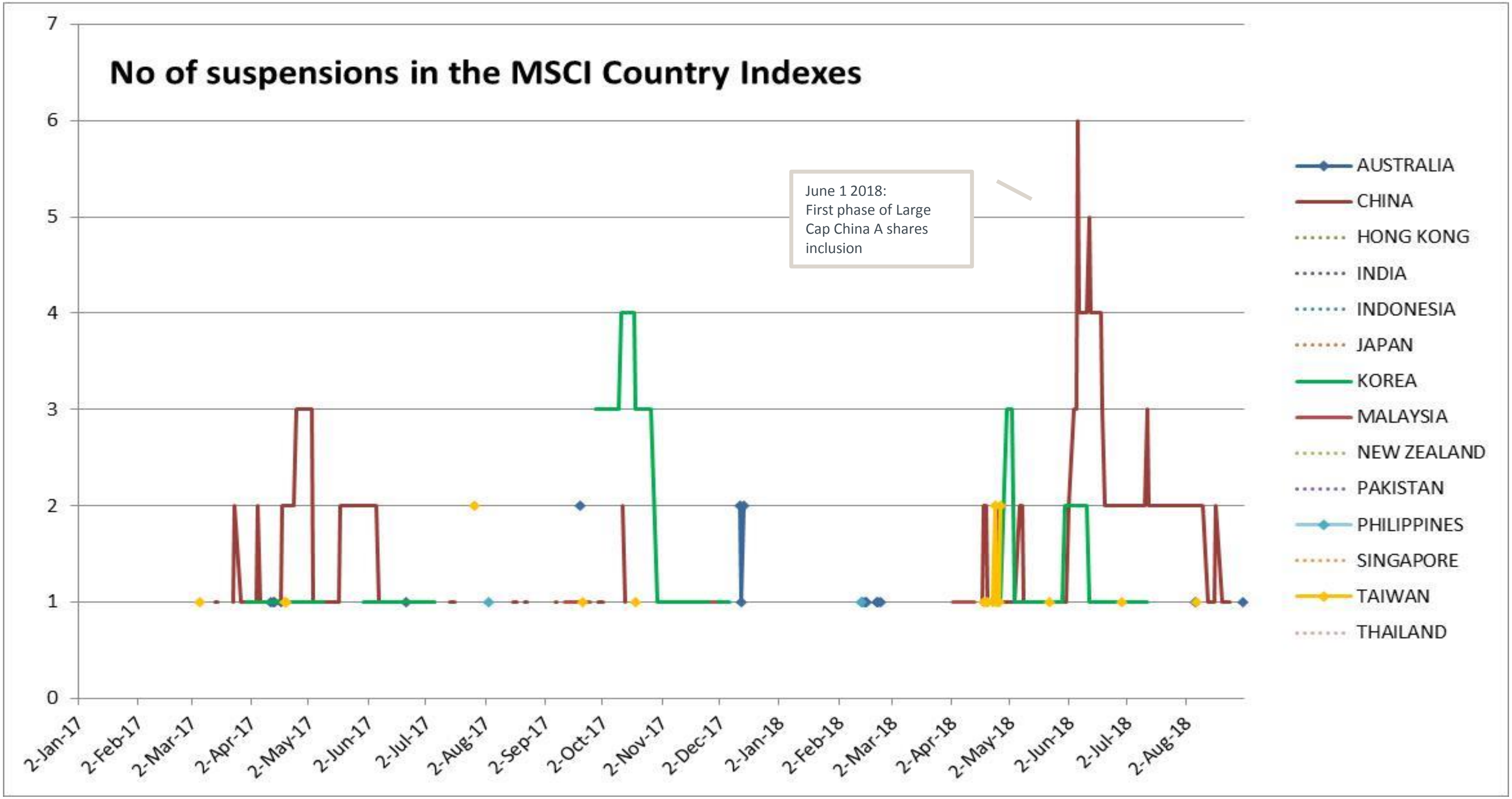
REGIONAL COMPARISON – STANDARD INDEX



less frequent suspensions   not shown on chart (less than 10 count over the period)

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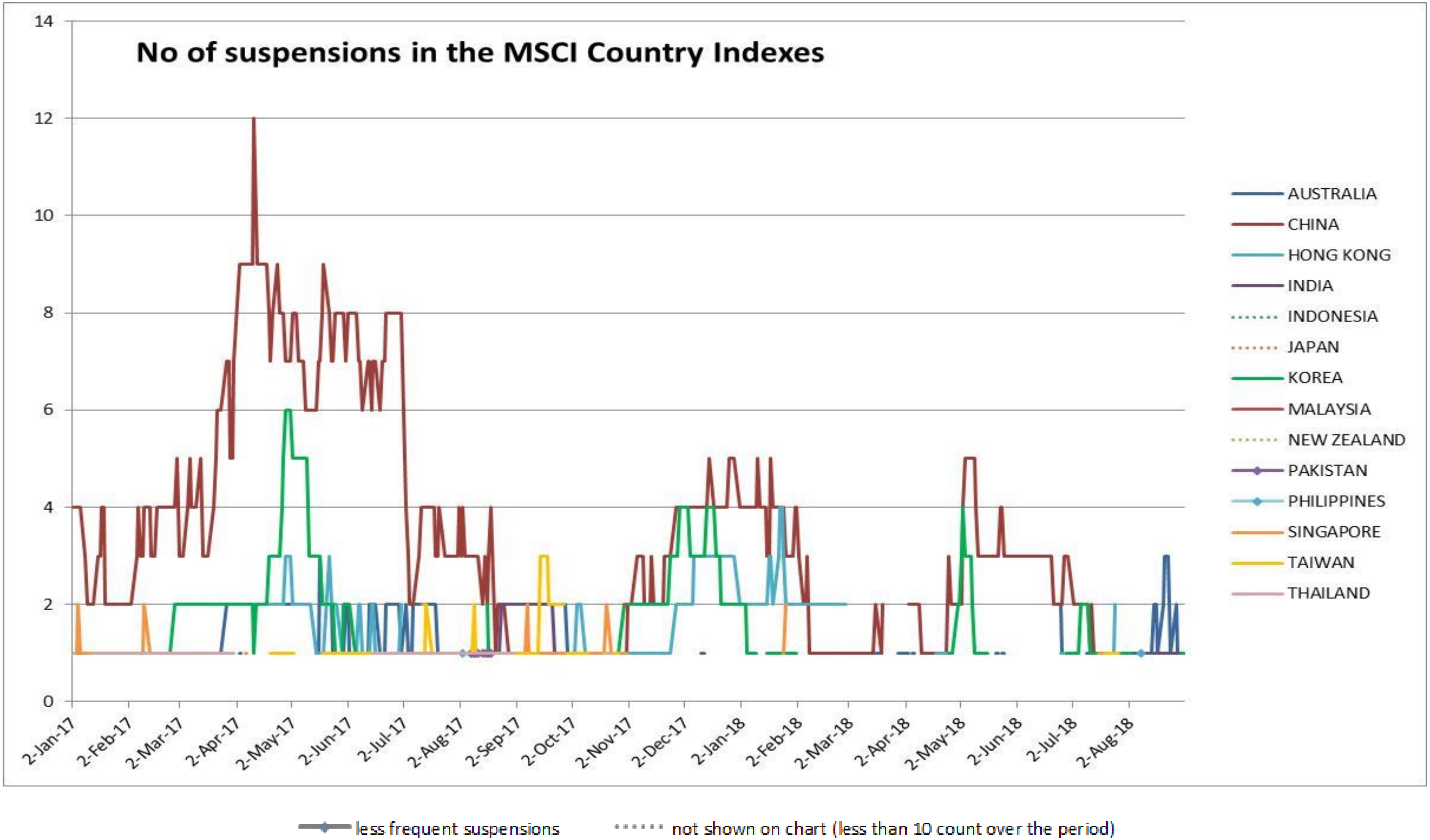
Data shows the number of suspended securities in the respective MSCI Country Index as of each day from January 2017 to August 2018

REGIONAL COMPARISON – SMALL CAP INDEX



MSCI

Data shows the number of suspended securities in the respective MSCI Country Index as of each day from January 2017 to August 2018

ABOUT MSCI

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

MSCI serves 99 of the top 100 largest money managers, according to the most recent P&I ranking.

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