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# CHINA: MARKET DEVELOPMENTS AND THE IMPACT OF MSCI CHINA A SHARES INCLUSION

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## EXECUTIVE SUMMARY

*Since 2018, MSCI has been gradually including China A shares in their indices. When MSCI implements its inclusion phase planned for November 2019, China A shares will represent an estimated 3.3% of the MSCI Emerging Markets index.*

*The China A shares market represents a deep and increasingly accessible opportunity set of stocks in China, as it includes all stocks traded on the Shanghai and Shenzhen Stock Exchanges. China A shares tend to have more government ownership, have higher allocations to "old-economy" sectors, and have been more volatile than other share classes. Investors should continue to monitor China's efforts to open the China A shares market to foreign investors, and the impact of those efforts on index providers' allocations to China A shares in global indices. Where investors have the discretion, they should consider allowing active global and emerging markets managers to include China A shares in their mandates.*

## INTRODUCTION

The emerging markets investment opportunity set continues to evolve with the growth of emerging economies and equity markets. Over the past decade, continued productivity growth and the associated expansion of domestic companies, as well as myriad other factors, have driven China's rise to prominence as a large component of the emerging markets equity opportunity set. Prior to index provider MSCI's initial decision in 2018 to include A shares in global indices, China already represented approximately 30% of the MSCI Emerging Markets Index.

The China A shares market includes Chinese companies that trade on two domestic exchanges in China, Shanghai and Shenzhen. It includes approximately 3,661 stocks representing $8.4 trillion of free float-adjusted market capitalization.[1] Even though international investors can only access a small subset of China A shares, the increasing availability of these stocks bolsters the size of the China equity opportunity set, and adds market depth for investment managers with emerging markets equity allocations. In addition to depth, China A shares' historical return correlation to other global equity markets is relatively low, providing potential diversification benefits. However, investors in China A shares must be cognizant of the prominence of state-owned enterprises, the potential evolution of the market given limited foreign investment, and other emerging market risks.

While China A shares are a deep, fairly inefficient market, and thus, a potential source of alpha for active managers, their weight in the MSCI Emerging Markets index is likely to remain relatively low in the near future. Even after MSCI's February 2019 decision to increase the index's allocation to China A shares over a seven-month period beginning in May,[2] China A shares will still represent just 3.3% of the MSCI Emerging Markets Index, and 10% of the index's allocation to Chinese stocks[3] across all investable China share classes. China A shares will also represent 0.4% of MSCI's global index, the MSCI All Country World Index ("ACWI").

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[1] Source: Shanghai Stock Exchange and Shenzhen Stock Exchange as of March 31, 2019.

[2] This inclusion phase will include three steps and can be expected to conclude in November 2019.

[3] Source: MSCI.

Full inclusion of China A shares would result in a substantial increase in the MSCI Emerging Markets Index's China allocation, to approximately 40%, with A shares alone representing 15% of the index, but is unlikely to occur in the near term, due to the need for continued reforms within the China A shares market.

In this paper, we provide a brief history of China's equity market, review China's growth as a constituent of the MSCI Emerging Markets Index, and assess the potential impact for global emerging markets equity investors in the context of MSCI's decision to include China A shares.

## THE EVOLUTION OF CHINA'S EQUITY MARKET: CHINA'S STOCK MARKET, VERSION 2.0

China's modern equity market is still in its infancy relative to the United States and other developed markets. The earliest Chinese stocks were first created in the 1860s, and by the 1920s, China had a significant securities trading market. However, the founding of the People's Republic of China in 1949 precipitated the nationalization of private companies and the disappearance of Chinese listed equities. A series of government reforms in the 1980s targeting improvements in the performance of Chinese state-owned enterprises ("SOEs") accelerated the pace of equity market development[4]. China launched the Shanghai and Shenzhen Stock Exchanges in 1990 as domestic stock exchanges in order to foster the development of a tradeable equity market where domestic investors could purchase shares of Chinese companies[5]. This development represented the inception of the China A shares market. However, China A shares were not made available to foreign investors. Additional share classes were launched in the following years. Importantly, these alternative share classes were structured to trade on a variety of international exchanges such as Hong Kong, the United States, and Singapore, and were made available to international investors. These alternative share classes, which included unique listings and dual listings of companies traded in the China A shares market, drew interest from investors outside of China and grew rapidly. The structure of China's equity market, with domestic China A shares largely held by Chinese investors, remained in place until the early 2010s. Lack of accessibility excluded the A shares market from inclusion in global emerging market indices, like the MSCI Emerging Markets Index, even as China continued to grow as a component of the overall emerging markets opportunity set.

### China A shares aside: China's ascent in the MSCI Emerging Markets Index

Over the past half century, China has risen to become one of the world's largest economies. China accounted for just 2.3% of global GDP in 1980, but is projected to represent 19.2% of global GDP in 2019.[6] China's forecasted gross domestic product of approximately $14.4 trillion in 2019 ranks second in size behind only the United States among all countries globally.[7] China's status as one of the world's largest and fastest growing economies has attracted substantial foreign investment, which has supported a steady increase in the depth of the

[4] Source: Zhiwu Chen. "Capital Freedom in China as Viewed From the Evolution of the Stock Market." Cato Journal. 2013.

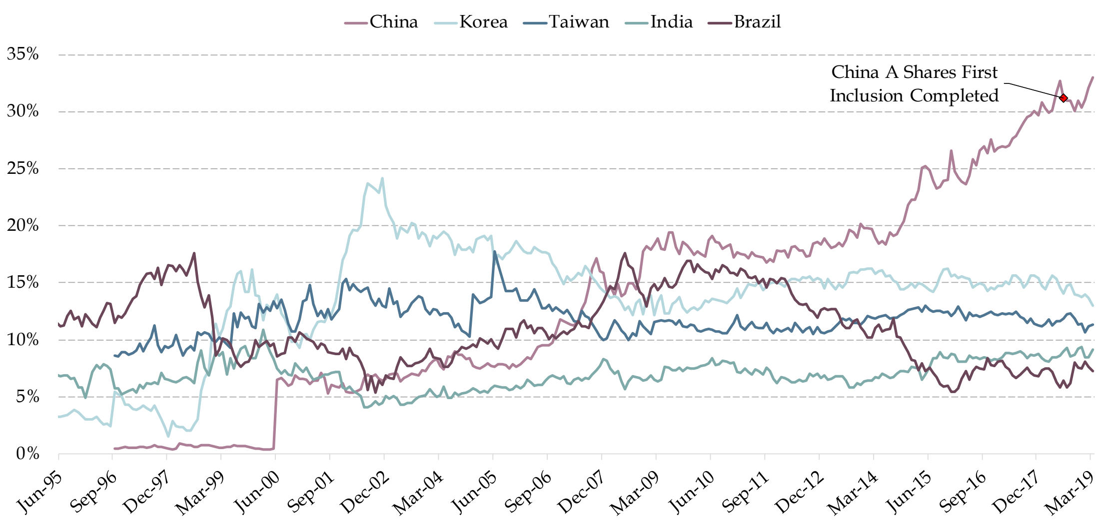
[5] Source: Franklin Allen. "China's Financial System: Opportunities and Challenges." National Bureau of Economic Research. 2012.

[6] Source: IMF.

[7] Source: World Bank.

country's capital markets. Despite the lack of access to China A shares, international investors have been able to invest in Chinese companies through stock listings of Chinese companies traded on exchanges outside of China, primarily in Hong Kong and the United States.[8] China has become the largest constituent of the emerging markets equity universe as domestic Chinese companies have grown both at home and abroad, monetizing the country's growth, infrastructure development, and an expanding and increasingly wealthy population.

**MSCI Emerging Markets Index: Top 5 Country Historical Weights**[9]
As of March 31, 2019




The steady increase of China's weight in the MSCI Emerging Markets Index, until mid-2018, included no allocation to the domestic China A shares market. In fact, China's weight in the index has not increased since the first China A shares inclusion took place in May 2018 and was completed in August 2018. It is clear that investors have been willing to invest in Chinese companies entirely through securities listed outside the Chinese market (primarily in Hong Kong and the United States) in order to access the China growth story during the past two decades.[10] China's weight in the index increased from 6% to over 30% between 2000 and 2018.[11]

Note that Taiwan (officially the Republic of China), listed as a separate market in the previous graph, is not recognized as an independent state by the People's Republic of China ("PRC"), but retains political and monetary independence from the PRC. However, the PRC is Taiwan's largest trading partner, suggesting significant integration between the two. East Asia's footprint continues to grow in global equity markets; China and Taiwan, when combined, represent approximately 44% of the MSCI Emerging Markets Index. Note that Hong Kong is

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[8] See Appendix for additional information.

[9] Source: MSCI.

[10] See appendix for additional information on Chinese share classes and listings across various global exchanges.

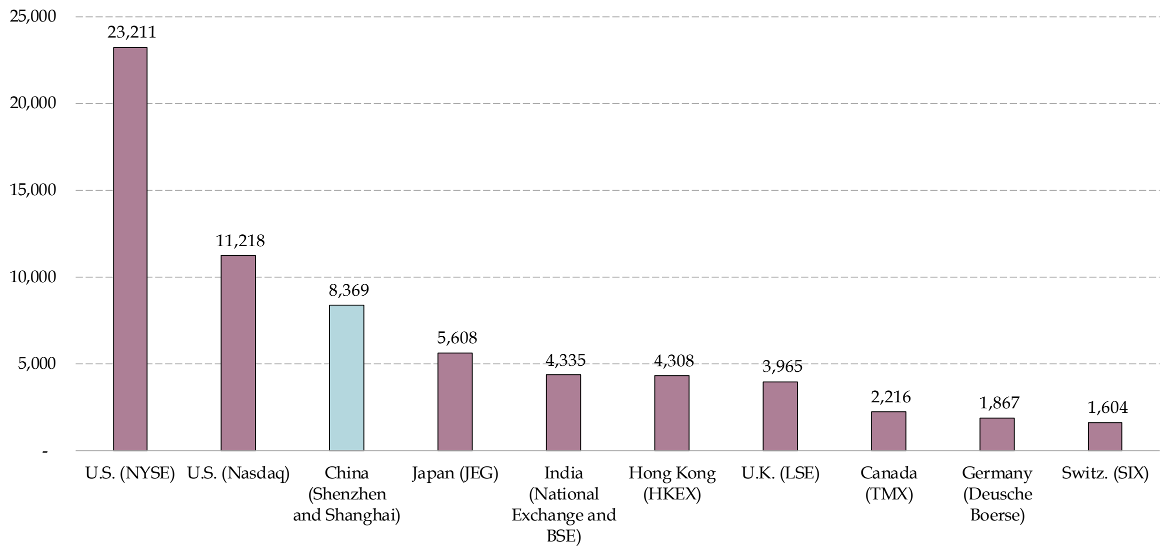
[11] Note that this definition of Chinese equities excludes companies operating/listed in Taiwan. In May 2000, MSCI included in the MSCI Emerging Markets index companies that 1) traded in Hong Kong and 2) were partially owned by the PRC, resulting in a significant increase in the index's allocation to China. China was originally added to the MSCI Emerging Markets index in 1996.

not included in these counts, as it is classified as a separate, developed market with an independent currency.

### Returning to China A shares: a review of the market

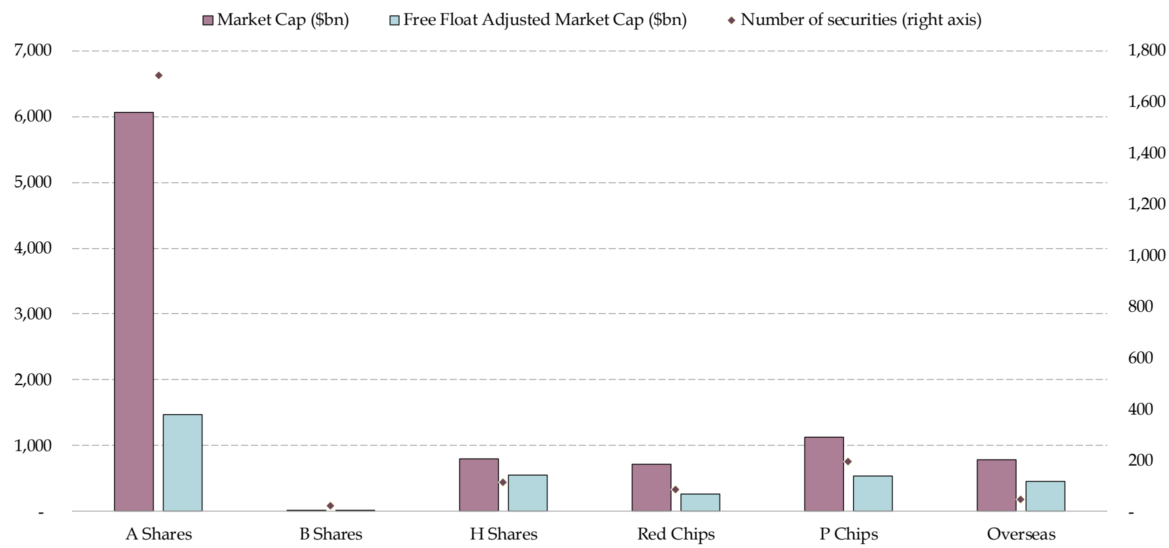
Though largely a domestic-only market until recent steps towards international inclusion, the China A shares market has grown to become one of the largest country equity markets in the world. The China A shares market includes 3,661 tradeable stocks and $8.4 trillion of total market cap.[12] Combined, the Shanghai and Shenzhen exchanges would rank as the largest non-U.S. equity exchange in the world.[13]

**World Exchange Market Capitalization**
$ billions as of March 31, 2019




[12] Source: Shanghai Stock Exchange and Shenzhen Stock Exchange as of March 31, 2019.
[13] Source: World Federation of Exchanges as of March 31, 2019.

**MSCI Index Market Cap and Number of Securities**
As of March 31, 2019[14]




Many investors view China A shares as an untapped, inefficient market with immense potential for global emerging markets investors. A glance at the total China A shares market cap, and float-adjusted market cap available to international investors as defined by MSCI, suggests that this could be the case. The China A shares market has only experienced meaningful flows from foreign investors over the past decade, and international investors still represent a small portion of the market. In addition, domestic retail investors dominate China A shares trading. This group represents 86% of traded share value, although they only account for 40% of outstanding share ownership.[15]

While China A shares present potential inefficiencies to be capitalized on by investors, the market is not without challenges. International investor access to China A shares will remain limited until Chinese authorities take additional steps to loosen what are still relatively tight restrictions on the market. The spectre of past share suspensions and the Circuit Breaker (see comments on the Circuit Breaker below), corporate governance risks, and the nature of China's political system, represent key ongoing risks for investors. Approximately 40% of China A shares by market cap are at least 20% owned by the People's Republic of China.[16] Restrictions on foreign ownership (30% limit) and existing foreign investor allocation restrictions limit the ability of international investors to enter the market. Less than one-fourth of the China A shares market, by market cap, is actually accessible to overseas investors due to state ownership, executive/employee ownership, and foreign ownership restrictions. There is a meaningful difference between the outstanding market cap and the free float- and foreign ownership limit-adjusted market cap between A shares and other share classes. Just 24% of the China A shares market is actually accessible to international investors, compared with 52% for all other China stock share classes.

[14] MSCI approximations based on investable market index methodology. Note that MSCI's count is based on their investable market methodology, and therefore does not include the entire China A shares market.
[15] Source: MSCI
[16] Source: Rhodium, National Bureau of Statistics, Ministry of Finance, WIND, Eastmoney, Bloomberg.

**Why has China A shares inclusion taken so long? Government prerogatives and MSCI's Consultation fits and starts**

The Chinese Communist Party had limited interest in liberalizing China's domestic equity markets until the 2010s. However, China's renewed focus on increasing foreign participation in the China A shares market became clear with the creation of a new foreign investment program, the RMB Qualified Foreign Institutional Investor ("RQFII") program, in 2011. This program allowed approved international institutional investors to access the China A shares market using the offshore renminbi rate (CNH) rather than the onshore rate (CNY) required for an earlier iteration of the program, QFII. The creation of the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect trading programs in 2014 and 2016, respectively, also spurred greater international interest. Unlike RQFII and QFII, the Connect programs do not require domestic regulatory investor pre-approval for international investors, and are therefore more easily accessible to international investors.

In conjunction with the introduction of the RQFII program and the relaxation of investment restrictions from 2011-2013, MSCI announced in 2013 that it would conduct a consultation (an internal review) to analyze the viability of China A shares for international investors. The goal of this review was to assess whether QFII and RQFII provided adequate liquidity, general market transparency, and regulatory assurances to international investors. MSCI concluded that investor quotas, capital mobility, capital gains tax ambiguity, and beneficial ownership uncertainty precluded inclusion after two consultations in 2014 and 2015. In the midst of this process, a rapid rally and subsequent collapse in Chinese equity markets in 2015 led to a significant domestic regulatory response.

**Last Ten Years: China A Shares Equity Market Performance (April 2009 = 100)**[17]
As of March 31, 2019


[17] MSCI China A Shares Onshore Index.

Chinese authorities suspended trading of over 1,470 companies, representing nearly half of the China A shares market, during the 2015 crash.[18] In addition, volatility in early 2016 triggered China's Circuit Breaker, a mechanism authorities used to halt markets after significant selloffs. The Circuit Breaker was triggered in January 2016 in Shanghai and Shenzhen, due to a significant market decline, only a few days after it had been formalized and came into effect.[19]

**MSCI Inclusion and Next Steps**

In MSCI's third Consultation in 2016, the index provider referenced stock suspensions as a key sticking point in their decision to delay adding China A shares. The Chinese Securities Regulatory Commission and other Chinese government institutions subsequently implemented stock suspension rules to reduce their use in local markets, and suspended the use of the Circuit Breaker entirely. These actions and clarification of several other outstanding issues (dividend taxes, beneficial ownership, quotas) were enough to convince MSCI to decide to add China A shares to emerging markets and global indices after their fourth Consultation in 2017. MSCI added 222 large cap China A shares in two stages from May to August 2018 to reach an inclusion factor of 5%,[20] resulting in a China A shares index weight of approximately 0.7%, which is where the MSCI Emerging Markets' China A shares allocation is at present. China A shares were also included in global indices (those that include emerging markets) resulting in an allocation to A shares of just under 0.1% in the MSCI ACWI Index. It is important to note here that, after the introduction of Connect, MSCI elected to base inclusion exclusively on the Connect program, and not QFII/RQFII.

Subsequent to this initial inclusion step, upon the fifth Consultation, MSCI announced in February 2019 that it intends to increase the weight of large cap China A shares, and add mid caps, using a 3-step inclusion process between May 2019 and November 2019, to a 20% inclusion factor. MSCI cited an increase in Connect flows, a continued tapering of stock suspensions, an increase in Connect quotas, and further stock suspension guidelines. The second inclusion is expected to result in a total of 253 large cap and 168 mid cap China A shares, on a pro forma basis, in standard indices. This second inclusion phase will result in China A shares comprising 3.3% of the MSCI Emerging Markets Index, and 0.4% of the MSCI All Country World Index ("ACWI"), a market cap weighted benchmark including global developed and emerging markets.

[18] Source: Financial Times. "Question & Answer: China's share trading suspensions" 2015.

[19] Source: Shenzhen Stock Exchange. "Circuit Breaker Mechanism in China." 2016.

[20] Source: MSCI. The inclusion factor adjusts MSCI's target weight to large cap China A shares based on the 30% max foreign ownership limit imposed on Chinese stocks and a measure of existing free float available to overseas investors ("foreign room"). A 5% inclusion factor results in 5% * 30% or 1.5% of total market cap being included in the index.

**MSCI Emerging Markets Country Weights With China A Shares Inclusion**
As of January 22, 2019[21]

| | Allocations Pre-Inclusion | Allocation After 2018 Inclusion | 2019 Inclusion Step 3 | Theoretical Full Inclusion |
|---|---|---|---|---|
| China ex A | 30.4 | 30.2 | 28.6 | 24.9 |
| China A | 0.0 | 0.7 | 3.3 | 14.8 |
| Korea | 13.6 | 13.5 | 12.7 | 11.3 |
| Taiwan | 11.1 | 11.0 | 10.4 | 9.1 |
| India | 8.9 | 8.8 | 8.3 | 7.3 |
| Brazil | 7.9 | 7.8 | 7.4 | 6.6 |
| Other | 28.1 | 27.9 | 29.3 | 26.0 |

While China A shares inclusion has drawn a significant amount of attention from financial market participants, A shares remain a modest component of the MSCI Emerging Markets Index. As of March 2019, their weight in the index remains below 1.0%. Even after Step 3 of the inclusion that MSCI recently announced, China A shares will represent only 3.3% of the index and 10% of the index's allocation to Chinese stocks. Chinese equities, excluding China A shares, will comprise approximately 28.6% of the index. Still, it is worth exploring the implications of the addition of China A shares to the characteristics of the MSCI Emerging Markets Index. The following chart provides a general overview of the structure of four key indices. All four indices reflect MSCI's "standard" investable universe, which includes large and mid cap stocks.

**MSCI Emerging Markets and China Index Characteristics**
As of March 31, 2019[22]

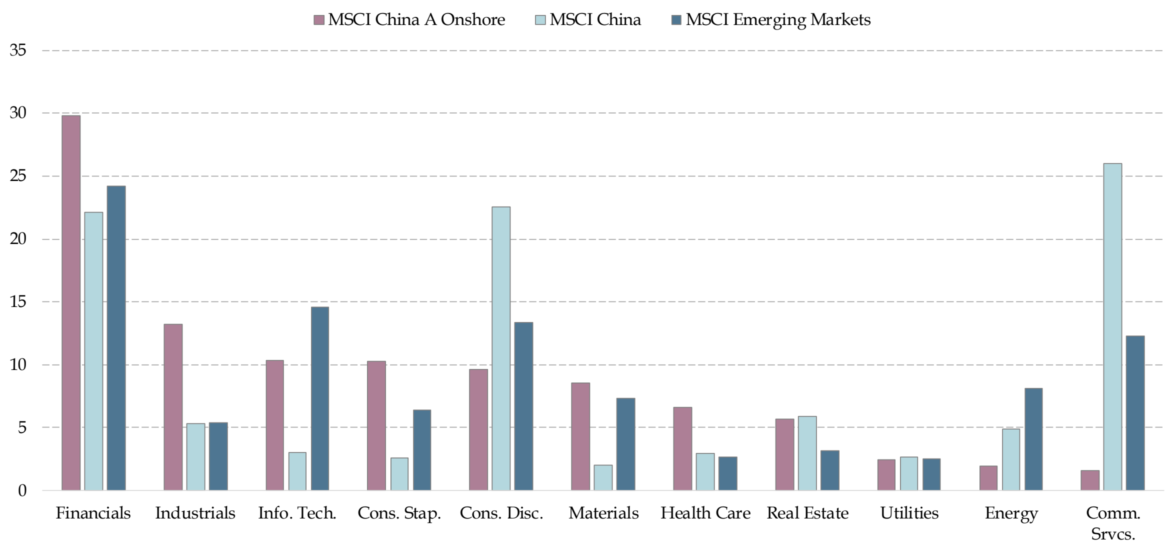
| | MSCI China A Onshore | MSCI China A International | MSCI China A Inclusion | MSCI China | MSCI Emerging Markets |
|---|---|---|---|---|---|
| Description of Investment Universe | Large and mid cap representation across all China securities listed on the Shanghai and Shenzhen exchanges, **not adjusted for foreign float** | Large and mid cap representation across all China securities listed on the Shanghai and Shenzhen exchanges, **adjusted for foreign float** | China A shares securities **currently included** in the MSCI Emerging Markets Index | **All China securities** included in the MSCI Emerging Markets Index | |
| Number of Constituents | 541 | 408 | 238 | 469 | 1136 |
| Total Market Cap ($ bn) | 1755.8 | 1065.3 | 887.8 | 1749.7 | 5301.7 |
| Dividend Yield | 1.9 | 2.0 | 2.2 | 2.1 | 2.7 |
| Price/Earnings | 15.1 | 14.7 | 13.9 | 13.7 | 13.1 |
| Fwd. Price/Earnings | 12.2 | 12.2 | 11.7 | 11.7 | 11.8 |
| Price/Book | 1.9 | 1.9 | 1.8 | 1.8 | 1.6 |
| Index Turnover | 11.1 | 10.1 | 9.8 | 12.7 | 6.9 |
| Top 10 Weight | 23.1 | 20.5 | 24.6 | 50.9 | 24.4 |

As evidenced by their market cap and constituent count, significant headroom exists for the allocation to Chinese equities to increase relative to the total opportunity set of China A shares available to international investors. The MSCI Emerging Markets Index currently includes only 238 China A shares.

[21] Per MSCI announcement of second inclusion phase in February 2019.
[22] Source: MSCI.

A key consideration for investors is the potential impact of China A shares on portfolio characteristics within investors' China allocation and the implications for emerging markets equity exposure at large. China A shares are slightly more expensive on price/earnings and price/book valuation relative to the comparison indices, but the characteristics are broadly similar. One point of differentiation for China A shares is the reduced concentration of the opportunity set; while the MSCI China index's top ten stocks represent more than 50% of the index, concentration in the top ten falls below 25% in the China A shares market, offering improved diversification.

**MSCI Emerging Markets and China Index Sector Allocations**
As of March 31, 2019[23]




By sector, the MSCI China A Onshore Index is overweight Industrials, Financials, and Consumer Staples, and underweight Consumer Discretionary and Communication Services, relative to the MSCI China Index and the MSCI Emerging Markets Index. Differences in sector characteristics reflect a more diverse opportunity set, and the greater number of state owned enterprises (SOEs) within the domestic Chinese stock market. SOEs represent approximately 65% of the China A shares companies currently included in the MSCI Emerging Markets Index; these companies account for 78% of market capitalization of A shares in the index.[24] Many of these companies, especially those in the industrials and materials sectors (as well as select financials such as industrial development banks), are production-oriented and reliant upon Chinese government stimulus for growth. This represents both an opportunity and a risk; investors in the newly available China A shares market must be cognizant of the risks to old-economy SOEs as China continues to emphasize a transition to a consumer-oriented, service-based economy through coordinated policy initiatives.[25]

[23] Source: MSCI.

[24] Source: Asia Society, Rhodium Group. "Missing Link: Corporate Governance in China's State Sector". 2018. Prior to MSCI 2019 inclusion steps.

[25] Source: Nick Lardy. "China: Toward a Consumption-Driven Growth path." Peterson Institute. 2016.

Reviewing performance over the longest common period available, the MSCI China A Onshore Index underperformed both the MSCI China Index and the MSCI Emerging Markets index, with higher volatility, resulting in a much lower Sharpe Ratio. China A shares have also been more volatile than most other key emerging market countries, indicating that incremental additions of China A shares to the MSCI Emerging Markets Index could lead to an increase in volatility for investors[26]. However, a redeeming quality of the onshore China A shares market is that market's low level of correlation to the MSCI Emerging Markets Index, implying potential risk mitigating diversification benefits. As the China A shares market is made more accessible to international investors, this low correlation of returns could migrate higher over time.

**Historical Risk and Returns[27]**
January 2001 to March 2019

| | MSCI China A Onshore | MSCI China | MSCI Emerging Markets |
|---|---|---|---|
| Return (%) | 5.8 | 10.1 | 9.1 |
| Standard Deviation (%) | 32.2 | 29.6 | 24.1 |
| Sharpe Ratio | 0.14 | 0.29 | 0.32 |
| Correlation to MSCI EM Index | 0.42 | 0.83 | 1.00 |
| Downside Deviation (%) | 10.5 | 10.8 | 10.3 |
| Best 3-Month Return (%) | 63.6 | 49.9 | 56.2 |
| Worst 3-Month Return (%) | -41.3 | -43.5 | -44.9 |
| Max Drawdown (%) | -53.7 | -42.7 | -41.1 |

As evidenced by total returns and volatility, investors in China A shares have experienced significant cyclicality in performance. While upside participation has been high in bull markets, it has been matched by substantial short-term drawdowns that have impacted long-term returns adversely. As noted previously, China A shares market trading is dominated by a high volume of retail trading activity, which could increase the likelihood of continued rapid market rallies and subsequent declines. High exposure to cyclical stocks in the industrial, financial, and materials sectors has also been a headwind for the onshore market relative to the MSCI China Index, which includes more communication services and information technology companies listed in other markets that have performed well over the past decade.

[26] As measured by trailing period standard deviation for Brazil, China (non-A shares and A shares, separately), India, Korea, South Africa, and Taiwan from January 2001 to March 2019. Among these countries, only Brazil's volatility was higher than China A shares over the common period. Source: MSCI.

[27] Source: MSCI. Reported financials for China A shares companies are based on Chinese Accounting Standards (CAS), which may differ from widely accepted International Financial Reporting Standards (IFRS) and U.S. GAAP reporting standards. While CAS is converging with IFRS, this could still result in variation in reported results and valuation statistics relative to other emerging markets.

**Cumulative Index Returns**[28]

January 2001 to March 2019

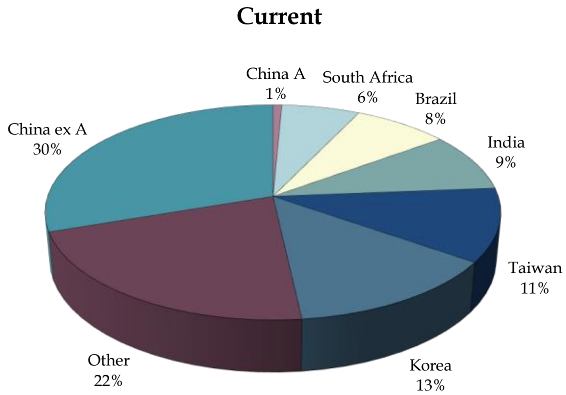

### Potential for future increases in the MSCI Emerging Markets Index allocation to China A shares and implications

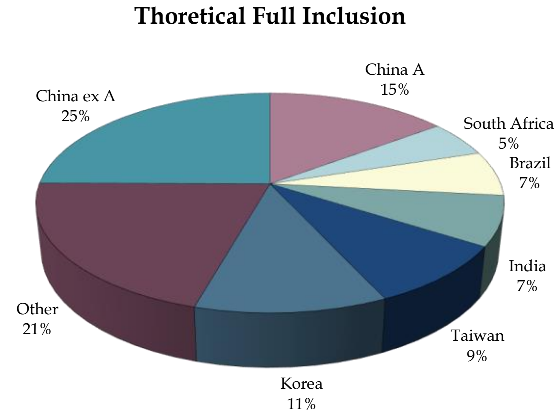
The trajectory of market liberalization in China is positive for international equity investors seeking to access the market. China continues to increase QFII/RQFII quotas and has expanded the Shanghai and Shenzhen Connect programs since they were launched. MSCI's initial inclusion and subsequent planned increase in their inclusion factor to 20% are indicative of China's push to increase foreign investment inflows into Chinese companies.

Eventually, a broader swath of the China A shares market will be included in standard indices, though the timing of continued inclusion is subject to significant acceleration or deceleration and remains uncertain. If full inclusion is eventually achieved, implying a 100% inclusion factor from MSCI, China A shares could represent 15% of the MSCI Emerging Markets Index, assuming no material changes to other index constituents. This would bring the MSCI Emerging Markets Index allocation to China to approximately 40%. The combined allocation to China and Taiwan would represent slightly less than half of the index.

[28] Source: MSCI.

**MSCI Emerging Markets Index Weights**
**As of January 2019**[29]




However, meaningful hurdles continue to exist. MSCI has highlighted restrictions on derivatives trading, settlement cycles, trading holiday inconsistencies, and the lack of an Omnibus mechanism as critical issues[30] that China must address before an additional increase in China A shares will be considered. We believe that a continued cap on Connect flows, significant volatility resulting from high retail volume, continued foreign ownership limits, and general Chinese regulatory activities represent additional, material risks.[31]

Until these hurdles are overcome, China A shares will remain a relatively small component of the MSCI Emerging Markets Index. However, investors in emerging markets should remain cognizant of China's growing importance as a component of global emerging markets, and global markets broadly. Given that President Xi Jinping and the Chinese Communist Party have stated that they are working to open their domestic financial markets to create incentives for foreign participation, the likely path for China A shares is towards an increased weight. New modifications to the existing market structure aimed at addressing concerns stated by international investors and index providers are announced almost every month.

[29] Source: MSCI as of January 22, 2019. Subject to change based on market performance, country constituent changes, and inclusion timing.
[30] Source: MSCI. "Further Weight Increase of China A Shares in MSCI Indexes." 2019.
[31] A full list of MSCI's highlighted risk factors and Meketa Investment Group's supplementary risk factors can be found in an appendix.

## CONCLUSION

The China A shares market represents a deep and increasingly accessible opportunity set of stocks in China. The market has relatively low correlations to other global equity markets, offering the potential for improved diversification and risk-adjusted returns, despite the higher volatility of the China A shares market. Investors in China A shares must be cognizant of the proliferation of leverage-heavy, old economy Chinese state-owned enterprises, which face significant corporate governance risks and could suffer as China focuses on shifting to a consumption-led growth model. However, the inherent risks of SOEs, the sheer size of the market, and perceived inefficiency in China A shares due to the lack of international investment result in opportunities for active managers to add value. As a result, investors should continue to monitor China's efforts to open the China A shares market to foreign investors, and the impact of those efforts on index providers' allocations to China A shares in global indices.

## APPENDIX: TIMELINE OF MARKET CHANGES AND MSCI INDEX DECISIONS

**2002-2013**

- (2002) QFII Launched
- (2013) RQFII Launched
- (2013) RQFII eligibility list expanded
- (2013) MSCI Puts China A-Shares on 2014 Market Classification Review List

**2014**

- MSCI conducts 1st Consultation. MSCI does not add China A-Shares due to QFII/RQFII quota, capital mobility, capital gains tax uncertainty.
- China launches Shanghai Connect.

**2015**

- MSCI conducts 2nd Consultation. No addition. MSCI notes beneficial ownership uncertainty.
- Chinese equity market volatility culminates in policy response from Chinese authorities and stock suspensions.

**2016**

- Circuit Breaker.
- MSCI conducts 3rd Consultation. No addition. MSCI notes large increase in stock suspensions, Circuit Breaker, QFII quota.
- CSRC clarifies beneficial ownership, notes legal enforcement.

**2017**

- MSCI conducts 4th Consultation. MSCI announces intention to include China A-Shares in global indices in 2018.
- China looses pre-approval requirements preventing creating of index-linked vehicles.

**2018**

- MSCI adds China A-Shares between May and August 2018 at 5% inclusion factor.
- China increases Connect quota, adds stock suspension rules.
- President Xi Jinping directly addresses equity market, noting that China planned to "steadily widen the opening up" of capital markets.

**2019**

- (February) MSCI conducts 5th Consultation. Announces plan to increase China A-Shares inclusion factor to 20%.

## APPENDIX: CHINA SHARE CLASSES

The table below represents all share classes of Chinese companies listed on various exchanges. H shares are denominated in Hong Kong dollars and trade on the Hong Kong Stock Exchange[32]. China B shares, which were accessible only to international investors until 2001, drew considerably less interest than China H shares due to their initial listing on local Chinese exchanges, where investors were more inclined to trust the longer-standing Hong Kong Stock Exchange. Today they remain a small component of the China listed equity market. Red Chips, also listed in Hong Kong, were initially developed as a tool to reform State-Owned Enterprises in China to increase competitiveness and improve corporate governance. P-Chips refer to Chinese companies listed in Hong Kong that are incorporated in the Cayman Islands, Bermuda, and the British Virgin Islands. Overseas listings include N-Shares (Listed on the NYSE) and S-Chips (listed in Singapore). Overseas listed shares, particularly those listed on the New York Stock Exchange, sometimes represent an investment in an offshore company that indirectly controls a domestic Chinese business. This listing structure, called a variable interested entity or "VIE" structure, allows overseas shareholders to invest in Chinese companies that have restrictions on foreign investor participation, such as internet services. The legal enforceability of shareholder rights in these securities is uncertain.[33]

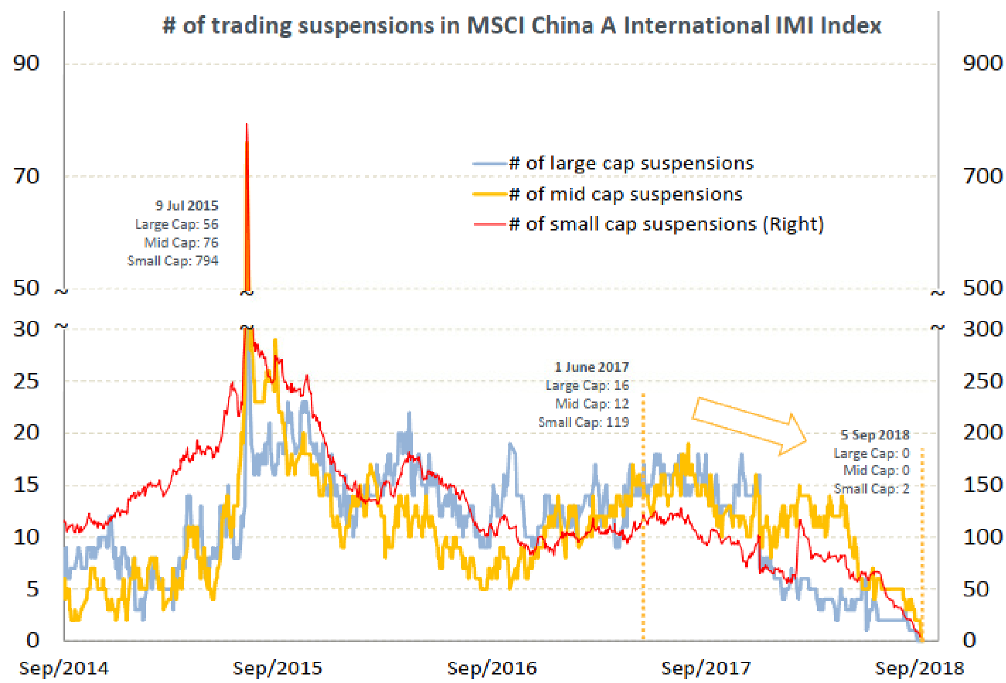
**China Share Class Decomposition[34]**

| | A Shares | B Shares | H Shares | Red Chips | P Chips | Overseas |
|---|---|---|---|---|---|---|
| Incorporation | China | China | China | Outside China | Outside China | Outside China |
| Types of Stocks | Any | Any | Any | State-Owned | Non-State-Owned | Any |
| First Traded | 1990 | 1992 | 1993 | 1972 | 2000 | 1992 |
| Stock Exchange | Shanghai, Shenzhen | Shanghai, Shenzhen | Hong Kong | Hong Kong | Hong Kong | United States, Singapore |
| Currency | RMB (domestic) | USD, HKD | HKD | HKD | HKD | USA, SGD |
| Available to Chinese Investors | Yes | Yes | QDII/Stock Connect | QDII/Stock Connect | QDII/Stock Connect | QDII/ Stock Connect |
| Available to International Investors | Through QFII/RQFII/ Stock Connect | Yes | Yes | Yes | Yes | Yes |
| MSCI Investable Market Cap ($ bn) | 1464.3 | 7.1 | 555.4 | 258.5 | 532.9 | 455.5 |
| Number of Securities | 1705 | 22 | 115 | 84 | 196 | 46 |

The MSCI Emerging Markets Index currently includes significant allocations to H shares, Red Chips, P Chips, and Overseas shares, in addition to the increasing allocation to China A shares.

[32] Source: FTSE Russell. "Guide to Chinese Share Classes" 2018.
[33] Source: Paul Gillis. "Variable Interest Entities in China." GMT Research. 2012.
[34] Source: MSCI, FTSE Russell.

## APPENDIX: MSCI CHART ON CHINA A SHARES SUSPENSIONS[35]




[35] Source: MSCI. "China A Shares Inclusion and Investment Strategies." 2019. The MSCI China A International IMI represents the all cap China A shares opportunity set accessible to international investors through Stock Connect.

## APPENDIX: LIBERALIZATION EFFORTS IN CHINA A SHARES MARKET

China's first effort to make A shares available to foreign investors came in 2002 with the introduction of the Qualified Foreign Institutional Investor ("QFII") scheme. The RQFII program, at inception in 2011, largely mirrored the original QFII program, but with one key modification. Investors in RQFII would be able to invest in domestic Chinese markets using offshore renminbi (CNH). However, hurdles continue to limit foreign investors' interest in the QFII and RQFII programs. The RQFII program was initially restricted to Chinese financial institutions with subsidiaries in Hong Kong, though participation was subsequently expanded to include a larger number of countries, including the United States, in 2013. QFII investors were also subject to a 20%/month repatriation limit, and both schemes were subject to an initial 3-month lock-up on invested capital[36]. These restrictions were removed in July 2018.[37] More recently, in January 2019, the CSRC announced a plan to combine the QFII and RQFII programs to unify their regulations and shorten the review process for foreign investors.

China also introduced the Connect program to allow foreign investors to gain access to China A shares starting in 2014. Connect does not require investor pre-approval. However, the scope of the Connect programs is still limited to large index constituents. In addition, differences in trading hours between the Shanghai, Shenzhen, and Hong Kong stock exchanges result in a shorter trading day and a higher frequency of market closure days, as both markets must be open during any Northbound Connect transaction. Purchases through the Northbound Connect channel (purchases of China A shares by foreign investors) are subject to a fixed inbound quota of $8.3 billion per day in aggregate for each of the two exchanges, Shanghai and Shenzhen.[38] Finally, trade settlement operates with a lag; stock sales execute at T+0 but cash settlement by authorized Hong Kong Stock Exchange Participants occurs at T+1, increasing counterparty risk. The following table provides a list of foreign investor access channels.

[36] Source: BNY Mellon. "Decoding the Full Potential of RQFII." 2018. MSCI. "Are You Ready for China A Shares?" 2017.

[37] Source: China State Administration for Foreign Exchange. "Provisions on the Administration of Foreign Exchanges in Domestic Securities Investments by QFII." People's Bank of China. "Circular of the PBOC and the SAFE on Issues Concerning the Administration of Domestic Securities Investment by RQFII." 2018.

[38] This quota was increased from $1.9 billion per day in May 2018 per Reuters. "China to sharply boost daily stock connect quotas from May 1." Reuters. April 11, 2018.

## China A Shares Current Access Channels for International Investors[39]

| | | | Stock Connect | |
|---|---|---|---|---|
| | **QFII** | **RQFII** | **Shanghai-Hong Kong Connect** | **Shenzhen-Hong Kong Connect** |
| Inception | 2002 | 2011 | 2014 | 2016 |
| Investable Market | All securities, funds, primary activities, derivatives | All securities, funds, primary activities, derivatives | SSE 180 and SSE 380 indexes, A share with dual H share listing, secondary and rights issues | SZSE Component and Small/Mid Cap Innovation Index with >$880mm mkt. cap. A share with dual H share, secondary and right issues |
| Investor Pre-Approval Required | Yes | Yes | No | No, but ChiNext restricted to institutional investors |
| Investment Quota | Quota linked to AUM, SAFE Approval | Quota Linked to AUM | No, only aggregate market quota | No, only aggregate market quota |
| Capital Mobility Restriction | NA | NA | NA | NA |
| Currency | CNY (domestic) | CNH (offshore) | CNH | CNH |

39 Source: MSCI.

## APPENDIX: CONTINUED RISKS FOR INVESTORS IN CHINA A SHARES

**MSCI has highlighted the following risks as hurdles to any decision to increase the allocation to China A shares in emerging markets and broader global indices.**

1) Limited access to hedging and derivatives
2) Settlement cycle: securities settlement at T+0 and cash settlement at T+1
3) Trading holiday differences between China and Stock Connect in Hong Kong
4) Lack of Omnibus trading mechanism in Stock Connect

In addition, we have the following supplementary concerns:

1) Continued cap on Northbound Connect (international investor) flows. While the quota was increased in May 2018 to $8.3 billion, representing a quadrupling of the previous quota, a quota continues to exist.
2) A high degree of retail volume, along with other factors, has resulted in considerable volatility in the China A shares market.
3) Corporate governance is largely unaddressed by companies in the China A shares market, increasing risks to minority shareholders.
4) Continued government interference in company/industry/sector activities and exposure to a centrally planned economic system.
5) Potential for systematic, adverse government actions such as stock suspensions and a reinstitution of the Circuit Breaker.
6) Continuation of foreign ownership limits and preventions on overseas ownership of certain types of companies.
7) Nature and lack of clarification on temporary exemption of China Connect securities from standard People's Republic of China income taxes.

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