IQ INSIGHTS

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MSCI Gives 'A' Shares Green Light

For the fourth consecutive year, MSCI launched a consultation on the proposal to add the 'A' share class of equities to its main suite of indices. After passing on previous proposals three times from 2014–2016, this year, in accordance with its 2017 market classification review, MSCI made the official announcement shortly after the U.S. stock market close on Tuesday June 20th, that the 'A' share class will indeed be added to the MSCI Emerging Markets Standard Index in 2018. For several months, MSCI canvassed a broad group of institutional investors for their feedback and ultimately concluded that, given improved access to the 'A' shares via the Hong Kong Connect Programs, inclusion was warranted.

Background

Many investors attain "Chinese" equity exposure through Hong Kong and US listed stocks ('N' shares), as FTSE, S&P, and MSCI Indices include 'H' shares and Red Chips (both traded on Hong Kong exchange), US traded lines such as Alibaba and Baidu, and to a lesser extent mainland traded 'B' shares, in their standard global equity indices. However, these aforementioned stocks represent just a subset of the total Chinese market capitalization available. For example, the inclusion of the 'A' share class at full float adjusted market cap would increase the allocation to China within the MSCI EM Index from its current weight of approximately 29% to 45%. However, exposure to 'A' shares, has historically been relatively difficult to obtain for foreign investors. As a result, global equity index providers have maintained stand-alone 'A' share China indices for investors who have been able to access that share class.

There are currently three ways foreign investors can access the 'A' share market:

a. **The QFII (Qualified Foreign Institutional Investor) Scheme** This program was established in 2002, and involves (a) applying for an individual license with China Securities Regulatory Commission (CSRC) and then (b) obtaining a quota from State Administration of Foreign Exchange (SAFE).

b. **The RQFII (Renminbi Qualified Foreign Institutional Investor) Scheme** This program launched in 2011 and was initially available to financial institutions that were registered in Hong Kong (although it has been expanded to several other locations, such as London, Singapore, Paris and fairly recently the U.S., to name just a few). An individual license and quota is also required as part of the RQFII Program.

c. **The Hong Kong Stock Connect Programs** The Shanghai-Hong Kong Stock Connect Program was launched in November of 2014, and the Shenzhen Connect Program was launched in November 2016. The Programs allow for "Northbound" trading from Hong Kong of China 'A' shares, as well as "Southbound" trading from mainland China of Hong Kong listed shares. No individual license or investor quota is required to partake in the Connect Programs.

Access Point Nuances

Previous MSCI proposals for inclusion of 'A' shares focused on access through QFII and RQFII Schemes. However, with the launch of the Shenzhen Connect Program in November in 2016, and subsequent increased access to 'A' share market that ensued, MSCI shifted focus of its 2017 Market Classification proposal to the add 'A' share access via the Connect Programs. Each channel of access to the 'A' share market has its own nuances, as described below and summarized in Figure 1:

a. **QFII Program** There is a 3 month lock-up period and there is also a maximum monthly repatriation limit (20% of AUM) per month. The latter aspect was one of the issues resulting in postponing the inclusion of 'A' shares in previous consultations.

b. **RQFII Program** There is a 3 month lock-up period on closed end funds, but no maximum monthly repatriation limit with this scheme. Each location has a maximum quota allotted, and the first location launched, Hong Kong, recently had the maximum quota increased from 270 Billion to 500 Billion RMB (~$75 Billion), as the initial quota had been fully allocated.

c. **Hong Kong Connect Programs** There is no lock-up period and while there is no individual quota or license required to participate in the Connect Programs, there is a daily aggregate quota shared across all participants. The daily quota limits the net purchases on a given trading day, for each location, to a maximum of 13 Billion RMB (~$2 Billion).

Figure 1: Access Point Comparison

	QFII	RQFII	HK CONNECT
Initial Launch Date	2002	2011	2014/2016
Repatriation Limit	Yes	No	No
Individual License Required	Yes	Yes	No
Individual Quota Required	Yes	Yes	No
Aggregate Daily Quota	No	No	Yes

Previous Consultations

Aside from the 20% monthly limitation on repatriations via the QFII Scheme, other factors that played a role on MSCI passing on promotion of the 'A' share class in previous consultations included local exchanges' pre-approval restrictions on launching financial products and trading suspension policies.

Pre-Approval Requirement for Financial Products
A point of concern voiced by investors in previous consultations was the pre-approval process related to financial products linked to indices that contain 'A' shares. This pre-approval would not only apply to new products, but also to existing products. This naturally could be an issue for example, an exchange traded product benchmarked to an index that was about to include China 'A' shares — particularly, if it were an existing product, and was denied approval to include 'A' shares. Through dialogue with regulators, MSCI gained comfort that the initial phase of inclusion of the 'A' shares will not meet resistance, as it applies to financial products linked to the MSCI Indices.

Stock Suspensions Previous criticism of the 'A' share market as it related to proposals for inclusion also centered on the number of stock suspensions that occurred during the summer of 2015 — a period in which global markets were under tremendous pressure. Approximately 1,400 or roughly 50% of the total stocks trading on the Shenzhen and Shanghai exchanges were suspended at one point during this period. While the number of suspensions has come down significantly since 2015, the number and percentage of 'A' share stock suspensions are still highest of any market in the world. As a result, MSCI is proposing limiting the 'A' shares eligible for inclusion to exclude those that have been suspended more than 50 days within the previous 12 months and those suspended at the time of semi-annual and quarterly reviews.

Stock Connect Models

As the two Connect Programs uniquely allow for access to Chinese 'A' shares, not directly through mainland China, but rather via the Hong Kong Stock Exchange (HKEX), operationally there had to be a way to facilitate the trading, settlement and safekeeping of these stocks. With this in mind, currently there are 2 different stock models to choose from under the Hong-Kong Connect Programs: a) the TPC Model and b) The SPSA Model.

TPC Model The TPC (Third Part Clearing) Model was the first of the two models to be established. Only one broker can be appointed and used for this model. This model acts like an omnibus structure, without requiring an investor ID. Due to this structure, concerns over transparency of ownership arose, spurring the need for the second model.

SPCA Model The SPCA (Special Segregated Account) Model. This model supports the use of multiple brokers. This model also is an individual account model, which requires an investor ID for each fund. As such, this model allows for improved clarity over the TPC Model with regards to beneficial ownership.

Further Connect Considerations

Currently, the standard settlement cycle on 'A' share equites is T+0 and standard settlement also does not represent a true Delivery vs. Payment ('DVP'), whereby cash and securities movement for a trade happens simultaneously. Standard T+0 settlement on equity purchases essentially requires pre-funding cash into the account prior to execution, however, depending on the broker(s) used, extended settlements of T+1 and T+2 can be negotiated. Also, if the subcustodian and executing broker used are the same entity, a synthetic DVP can be achieved. Recently, however, HKEX announced a plan to roll out Real-Time Delivery versus Payment (RDVP) for the SPSA Model, with a target date of Nov 2017. With this new development, counterparty settlement risk should be reduced as the stocks and cash will move at the same time.

Index Implementation

MSCI is expected to initially add 'A' share stocks to the Index using a 5% inclusion factor, divided into two installments, with the first half effective May of 2018 and the 2nd half effective August 2018, from the perspective of access via the Hong Kong Connect Programs. For a mandate benchmarked to the MSCI EM Index, the weight allocated to the 'A' shares as of August 2018, is expected to represent approximately 0.75% in aggregate, spread across over 200 large cap stocks. The expected 'A' share weight decreases, naturally, the broader the index under consideration is (see Figure 2). There is no set timeline for any additional weight increases of the 'A' shares within the MSCI ACWI Universe after August 2018. Additionally, MSCI is reserving the right to add the stocks in one tranche in May 2018 if the aggregate daily Connect quotas are either a) significantly increased from the current 13 Billion Renminbi limit or b) abolished altogether.

Figure 2: Expected China 'A' share weight by Index

Index	Approximate 'A' share weight (%), effective close of 8/31/2018
MSCI Emerging Market (EM) Index	0.75
MSCI All Country World (ACWI) Index ex-US	0.18
MSCI All Country World (ACWI) Index	0.09

Sources: MSCI, Ignites, CSRC, SAFE, State Street, HSBC.

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