Research

FTSE Russell

Preparing for China's inclusion in global benchmarks

A flexible approach to managing the transition

ftserussell.com

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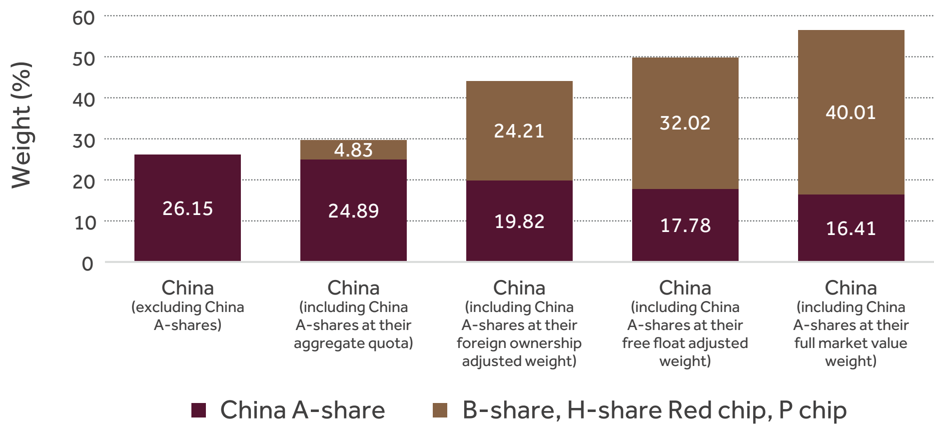
Executive summary:

- Following further increases in R/QFII allocations and improvements in the R/QFII application process, on May 26, 2015 FTSE Russell announced the start of its transition to include China A Shares in its widely followed global benchmarks, with the launch of new **FTSE China A Inclusion Indexes**.
- China is opening its market to foreign investors at a significant pace. It is increasingly likely that within two to three years China A-shares will become eligible for inclusion in FTSE's global indexes. To facilitate this growth in access, the **FTSE China A Inclusion Indexes** will give market participants a range of index choices to help them prepare for the inclusion of China A-shares in global benchmarks.
- There will be no change to the standard FTSE Global Equity Index Series. Based on FTSE's Annual Country Classification announcement, dated September 2014, China A-shares are not yet eligible for FTSE's standard global benchmarks. For inclusion further progress is required as part of FTSE's country classification process in areas such as market accessibility and quota allocation, as well as capital repatriation.
- FTSE Russell will continue to consult and engage with market participants and the Chinese authorities to monitor developments and gauge progress in these key areas. A formal review of the status and eligibility of A-shares will be held every September. The next review is due in September 2015.
- The FTSE China A Inclusion Indexes have been created to prepare market participants for the inclusion of China A-shares in FTSE's standard indexes. It will provide market participants with the following benchmark options:
    - Global benchmarks with China A-shares included and weighted by the aggregate approved quota (including QFII/RQFII)
    - Global benchmarks with China A-shares included and weighted by free float and foreign ownership-adjusted market value as if there were no quota restriction
    - Customized indexes based on an investor's own QFII/RQFII allocation
- Market participants who do not wish to have A-shares in their global benchmarks can continue to use the FTSE Global Equity Index Series.
- The index series provides a range of benchmark choices reflecting alternative ways for market participants to access the mainland China market. It has been created for clients:
    - Who would prefer to increase their China exposure over a period of time;
    - Who have no quota constraint and would prefer a higher allocation to China A-shares;
    - Who prefer having an allocation to China A-shares based on their own quota size.
- With over 14 years of experience developing China market indexes, FTSE's China benchmarks have become widely recognized by investors and ETF issuers globally as the leading measure of the China equity market and the natural choice for creating China-themed investment products.

China's expansion in the FTSE Emerging Index



Source: FTSE Russell, data as at March 31,2015

Introduction

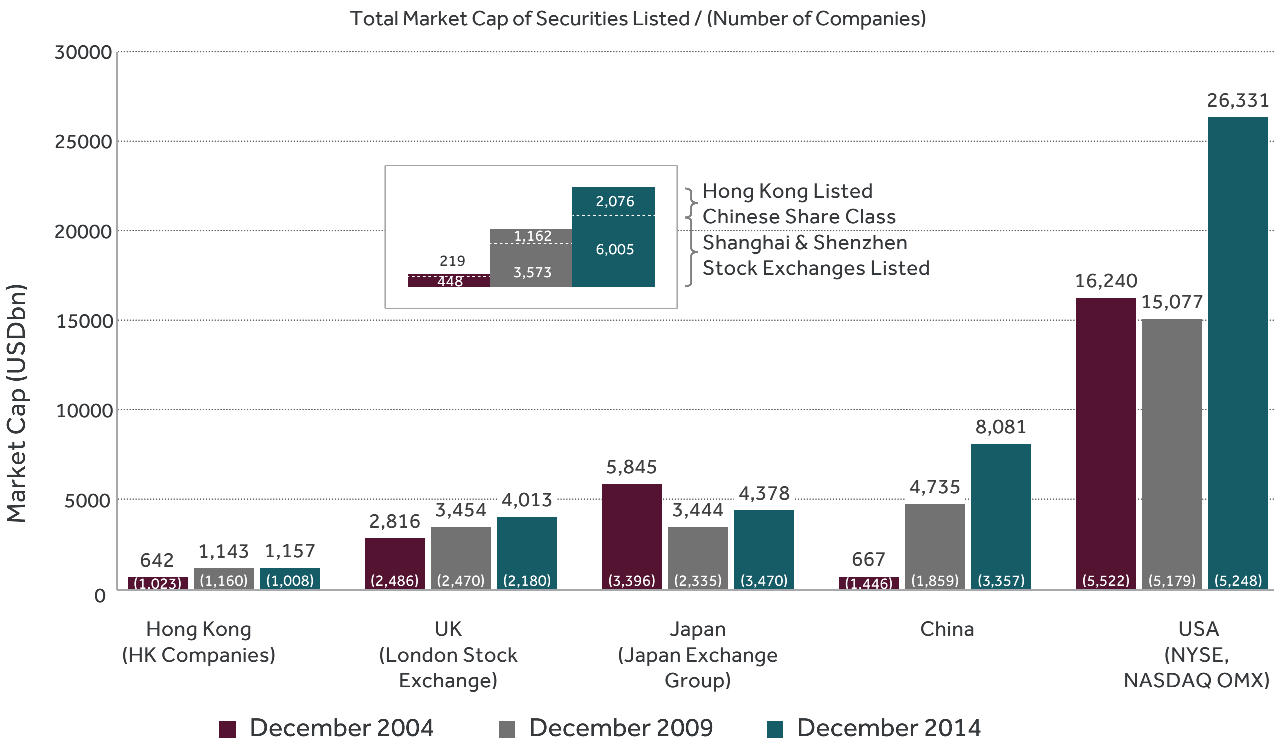
China has shown strong indications that it is willing to open its market to international investors. The approval of QFII/RQFII licenses and quota has been increasing at a tremendous pace since 2011. The launch of the Shanghai-Hong Kong Stock Connect programme last year and the recent confirmation of a stocktrading link between Shenzhen and Hong Kong by the China's State Council, has shown clear evidence that the Chinese regulators and stock exchanges are making significant efforts to improve the regulatory environment and trading mechanisms. An increasing number of investors are asking questions such as: When will China be included in global benchmarks? What can investors do to prepare for a possible inclusion? This paper aims to answer these questions and is intended for market participants as they prepare for China inclusion in FTSE's global benchmarks. Section 1 and 2 describe the development of the China A-shares market and the milestones towards its globalization. The FTSE country classification system and the assessment results on China are discussed in Section 3. Section 4 outlines FTSE Russell's solution to the China A-shares market changes. Conclusions can be found in Section 5.

1. China's development and its importance to global investors

Following the implementation of market reforms in late 1970s, China has become one of the world's fastest-growing economies. Over the past few decades, it has evolved to become the largest manufacturer and the second-largest economy by GDP.

Since the establishment of the Shanghai and Shenzhen Stock Exchange in the early 1990s, the Chinese equity market has been developing at a significant pace. The first public trading commenced on December 19, 1990, with eight companies listing on the Shanghai Stock Exchange. Shortly afterwards, the Shenzhen Stock Exchange opened. There are now over 2600 companies listed on the two exchanges with a combined market capitalization that exceeds USD 6 trillion. This makes China the second largest equity market by market value. China's role in the global equity market has become increasingly important and attracted significant investor attention.

Figure 1. The growth of Chinese equities in the global landscape



Source: WFE, FTSE Russell, data as at December 31, 2014

Although the Chinese equity market represents a significant portion of the global equity investment landscape, there are still some restrictions in market accessibility for the China A-share market. As the China A-shares market gradually opens, it is important for investors to understand the potential impact that an easing of such restrictions would have on their global benchmarks.

FTSE Russell, as the leading international index provider of Chinese indexes, has been a part of this remarkable evolution since the beginning of this century. Since then it has provided Chinese domestic and international indexes to global and domestic investors. Its two flagship China indexes – the FTSE China 50 Index and FTSE China A50 Index, were designed to provide tools to investors with and without access to the domestic Chinese market. As of March 31, 2015, ETFs and funds tracking the FTSE China A50 Index and FTSE China 50 Index had assets under management of USD 14.1 billion and USD 7.8 billion, respectively.

2. Milestones towards globalization

The size of the China A-shares market is significant. However, it is only relatively recently that the idea of the possible inclusion of China A-shares into global benchmarks has started to emerge. This emergence can be attributed to three major developments in China; the expansion of the stock market, regulatory improvements and easier market accessibility for international investors. These three developments have led FTSE Russell to consider the inclusion of China A-shares into its global benchmarks.

2.1 Chinese regulatory reform

The China Securities Regulatory Committee (CSRC), established in 1992, is responsible for performing centralized supervision and regulation of the securities and futures markets on the Chinese mainland. Under the guidance of the CSRC, self-regulated organizations including the Shanghai and Shenzhen Stock Exchanges are responsible for the direct supervision over securities of listed companies trading on the exchanges' platforms.

There have been a number of regulatory reforms which are widely considered as positive steps towards opening the China A-shares market. In 2005, the CSRC proposed the elimination of non-tradable shares held by government and quasi-government authorities, which resulted in improvements in liquidity and the overall pricing mechanism of the stock market.

In the same year the CSRC tackled the issues of misappropriation of funds held on behalf of clients in securities firms and fund management companies. Completed in 2008, it introduced a requirement to use third party custodians for handling client property, and prohibited securities/fund management firms from dealing directly with client funds.

The Code of Corporate Governance for Listed Companies in China was issued by the CSRC in 2001, stating the basic principles for corporate governance of listed companies, and the protection of investors' interests and rights. In December 2013, the State Council of the People's Republic of China issued nine new suggestions to further improve the equity market and protect the legal rights of minority shareholders. The proposed enhancements include improving information disclosure, the compensation system and strengthening investor education.

In December 2013, the CSRC also provided additional guidance on the regulatory requirements of new listings. The proposed reform aims to increase the protection, rights and interests of investors. Specifically, it urges issuers to use plain language to provide accurate and complete company information, enabling investors to make informed investment decisions. Other areas of attention include promoting fair and reasonable pricing, restricting high pricing by issuers and curbing speculation in new listings. The CSRC has also recently enhanced the regulation applying to non-listed companies that gain access to market funding through the purchase of a listed firm. The so called "backdoor listing" reform will mean non-listed companies will need to meet equivalent standards to those of an IPO approval.

All these reforms and regulatory changes represent positive steps towards the opening of the China A-shares market and are considered major factors by international market participants interested in investing in the local market.

2.2 Accessibility of the China A-shares market

i) QFII/RQFII schemes

Under the current regulations in the People's Republic of China (PRC), international investors and managers from those jurisdictions are allowed to use the mainland China A-shares market via the Qualified Foreign Institutional Investor (QFII) or the Renminbi Qualified Foreign Institutional Investor (RQFII) schemes. Approval of status is required from the CSRC while investment quotas are granted by the State

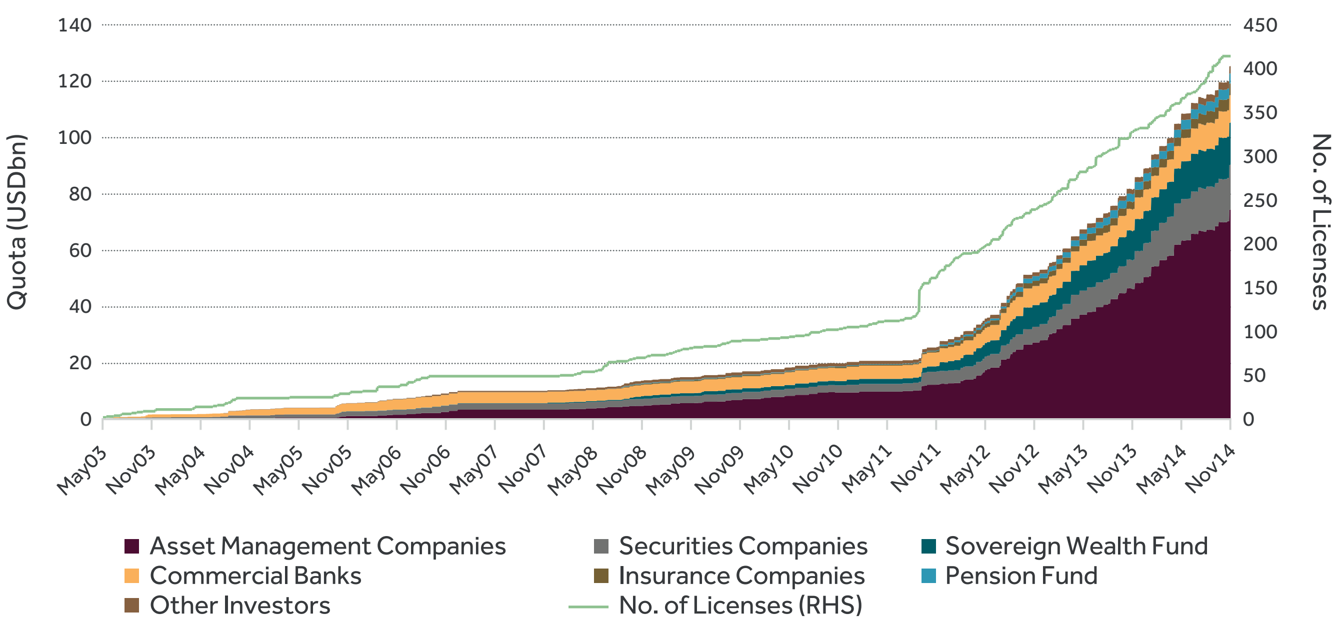
Administration of Foreign Exchange (SAFE). The QFII and RQFII schemes were launched in 2002 and 2011 respectively.

Both schemes have gone through a series of changes since their launch and the changes in the past three years are particularly significant. From the end of December 2011 to the end of March 2015, the QFII and RQFII quota available to foreign investors increased from USD 30 billion to USD 150 billion and from RMB 20 billion (USD 3.2bn) to RMB 690 billion (USD 111.3bn), respectively.[1]

In the past 2 years, UK, Singapore, France, Germany, South Korea, Australia and Switzerland joined Hong Kong as offshore centres and are allowed to use Renminbi to invest in Chinese securities under the RQFII scheme. In addition to increasing quotas, the CSRC has relaxed the eligibility requirements criteria for the QFII and RQFII schemes. In the past year, the total number of licensed QFIIs and RQFIIs increased by 25 per cent to 414 licenses and the total quota approved increased by 46 per cent to USD 125.3 billion (QFII: USD 72.1bn and RQFII: USD 53.2bn).[2]

One would expect the relaxation of eligibility requirements for the QFII and RQFII schemes would mean more investor groups becoming eligible. Interestingly, the QFII and RQFII quota has been issued mainly to asset managers, followed by commercial banks, securities companies and sovereign wealth funds as shown in Figures 2 and 3. We expect this pattern to change as more pension funds seek to diversify their equity exposure as the Chinese market becomes more accessible to international investors.

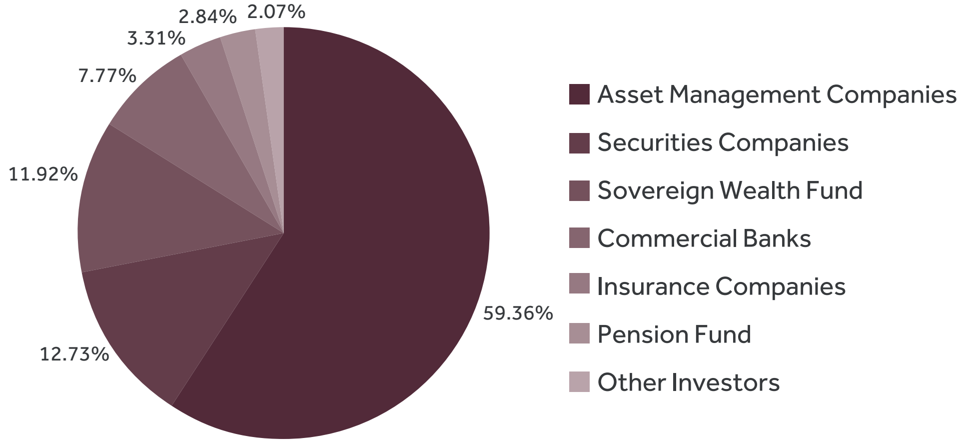
Figure 2. Historical QFII and RQFII quota by investor type



Source: FTSE Russell, CSRC and SAFE, data as at March 31, 2015

[1] Source: FTSE Russell, CSRC, SAFE, data as at March 31, 2015
[2] Source: FTSE Russell, CSRC, SAFE, data as at March 31, 2015

Figure 3. QFII and RQFII quota breakdown by investor type



Source: FTSE Russell, SAFE, data as at 31 March 2015

The relaxation of eligibility criteria has also been accompanied by an expansion in the investment scope. QFII and RQFII eligible investors can now invest in index futures and bonds traded on the inter-bank market. Other restrictions such as the foreign ownership limit for QFII and the ratio of equity/bond investment for RQFII have also been revised to allow greater flexibility. A summary of the major revisions to the two schemes are shown in Figure 4 and 5.

Figure 4. Relaxation of the QFII applicant criteria

	Before July 2012			After July 2012		
Eligible investors	**Business requirement**	**Capital/ net asset requirement**	**AUM requirement**	**Business requirement**	**Capital/ net asset requirement**	**AUM requirement**
Asset management companies, Insurance companies, and other institutional investors	5 years experience	N/A	≥ USD 5bn	2 years experience	N/A	≥USD 500m
Commercial Banks	Total assets within top 100	N/A	≥ USD 10bn	10 years experience	≥USD 300m of tier 1 capital	≥USD 5bn
Securities companies	30 years experience	≥ USD 1bn paid in capital	≥ USD 10bn	5 years experience	≥USD 500m of net assets	≥USD 5bn

Source: CSRC, SAFE

Figure 5. The milestones of the QFII and RQFII schemes

	QFII			RQFII		
	Available quota	**Eligible investor**	**Investment scope / restriction**	**Available quota**	**Eligible investor**	**Investment scope / restriction**
Dec 2002	Launched the QFII Scheme with USD 4bn quota					
Jul 2005	Increased QFII quota to USD 10bn					
Oct 2007	Tripled QFII quota to USD 30bn					
Dec 2011				Launched the RQFII Scheme with RMB20bn quota for HK		
Apr 2012	Increased QFII quota from USD 30bn to USD 80bn			Granted HK extra RMB 50bn RQFII quota to RMB 70bn		
Jul 2012		Lowered the Requirement of Eligible Investor	Permitted investment in stock index futures and fixed income products in the interbank bond market			
Dec 2012			Removed the USD 1bn quota limit for central banks and sovereign wealth funds	Increased HK RQFII quota to RMB 270bn		
Mar 2013				Allowed RQFII applications from HK financial institutions	Allowed RQFIIs to trade index futures and fixed income products Removed the 80% fixed income and 20% equity allocation restriction	

	QFII			RQFII		
	Available quota	**Eligible investor**	**Investment scope / restriction**	**Available quota**	**Eligible investor**	**Investment scope / restriction**
Jul 2013	Increased QFII quota to USD 150bn			Granted the UK and Singapore RMB 80 bn and RMB 50bn quota		
Mar 2014				Granted France RMB 80bn quota		
Jul 2014				Granted South Korea and Germany RMB 80bn quota each		
Nov 2014				Granted Australia RMB 50bn		
Jan 2015				Granted Switzerland RMB 50bn		
Mar 2015			Removed the USD 1bn quota limit for fund management firms			

Source: CRSC, SAFE

ii) Shanghai-Hong Kong Stock Connect Programme

International investors may also access the China A-shares market through the Shanghai-Hong Kong Stock Connect programme. This programme was launched on November 17, 2014. There are two components under the arrangement. The first component is the "northbound trading" that allows Hong Kong investors to trade China A-shares. The second component is the "southbound trading" that allows mainland investors to trade Hong Kong listed shares.

The initial northbound and southbound trading quota size is RMB 300 billion (USD 47.9bn) and RMB 250 billion (USD 39.9bn) respectively. The respective daily net quota limits are RMB 13 billion (USD 2.1bn) and RMB 10.5 billion (USD 1.7bn).[3] Any unused daily quota cannot be carried over to the next business day. If on a particular trading day the daily quota balance drops to zero, buy orders will

[3] Source: FTSE Russell, data as at April 30, 2015

be suspended for the remainder of the day. As of 30 April 2015, the remaining northbound aggregate quota is RMB 170.2 billion and the remaining southbound aggregate quota is RMB 165.3 billion. Both daily and aggregate quotas are applied on the aggregate market level and the concept of firm or institutional level quota ownership under the QFII/RQFII scheme does not exist under this programme.

According to a spokesman for the Hong Kong Stock Exchange, the quota size will be reviewed periodically and will be increased if necessary. "Southbound trading" requires that the value of assets under each investment account has to be more than RMB 0.5 million. The eligibility criterion is a key difference when compared with the QFII/RQFII scheme which requires an approval process. Another key difference is that accessibility to the scheme is open to both institutional and retail investors.

There are restrictions on the securities which can be traded as part of the scheme. Only constituents of selected local market indexes in Shanghai and Hong Kong can be traded along with any dual listed A/H shares. At the moment, there is a notable absence of Shenzhen listed companies. The market anticipates that the Shenzhen-Hong Kong Stock Connect programme will be launched later this year as part of China's plan to open up its capital market to foreign investors.

3. Should China A-shares be included in global benchmarks?

The FTSE Country Classification process is carried out annually in September and classifies all countries contained in FTSE's global benchmarks as developed, advanced emerging, secondary emerging or frontier. The FTSE Country Classification Advisory Committee, a group of independent and experienced market practitioners, assesses each country on twenty one "Quality of Markets" criteria, and on the country's economic status as measured by GNI per capita.

On the basis of this framework, FTSE Russell presents its assessments to the FTSE Policy Group for further discussion. September's Annual Country Classification announcement is approved by FTSE's internal Governance Board taking the FTSE Country Classification Advisory Committee and Policy Group recommendations into consideration.

Countries that are subject to a potential change in their classification are included in the FTSE Watch List to ensure the transition is transparent to investors. The next review of the FTSE Watch List will take place in September 2015.

Of the nine Quality of Markets criteria that must be met for a country to be assigned secondary emerging market status, there are currently two tests which the China A-shares market currently does not meet. They are i) capital mobility and ii) settlement and clearing. Additionally, there are concerns regarding the treatment of taxation. FTSE Russell observes and assesses these areas as part of the country classification process.

Figure 6. The FTSE quality of markets criteria for the China A-shares market

Criteria	Secondary emerging	China A-share 2014
Market and regulatory environment		
Formal stock market regulatory authorities actively monitor market (e.g. SEC, FCA, SFC)	x	Pass
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	x	Not met
Custody and settlement		
Settlement – Rare incidence of failed trades	x	Pass
Custody – Sufficient competition to ensure high-quality custodian services	x	Pass
Clearing & Settlement – T+3, T+5 for Frontier	x	T+0
Dealing landscape		
Brokerage – Sufficient competition to ensure high quality broker services	x	Pass
Liquidity – Sufficient broad market liquidity to support sizable global investment	x	Pass
Transaction Costs – Implicit and explicit costs to be reasonable and competitive	x	Pass
Transparency – Market depth information / visibility and timely trade reporting process	x	Pass

Source: FTSE Russell as at September 2014

i. Capital Mobility

Capital mobility is an important criterion within the FTSE Country Classification system. Objections, restrictions and penalties resulting from the remittance of capital and income for each country are evaluated. Despite the significant progress in both the QFII and RQFII schemes, international investors are still subject to a number of restrictions. The conditions imposed by the QFII scheme remain stringent in terms of the lock-up period and repatriation cycle. The RQFII scheme grants investors a relatively higher level of capital mobility, especially for open-ended funds. However, the length of the approval process, the uncertainty regarding getting approval and the size of quota remain factors to be considered by international investors. For closed-end funds under the RQFII scheme, the capital movement is not as free as for their open-ended counterparts.

Currently, there are restrictions on the approval process, lock-up period and capital repatriation:

- The approval process can last from 20 to 60 days depending on whether it is for the QFII or RQFII scheme. Not all investor types are currently permitted.
- After successfully obtaining the QFII license from the CSRC, the investment capital has to be injected within six months of the quota being approved. Investment quota not remitted within this timeframe will be forfeited unless further approval is granted.
- Under the QFII scheme, investors are subject to a lock up period of between three months to one year measured from either the day the quota is fully fulfilled or six months after the quota is approved, whichever is earlier.

- The open-ended funds repatriation period for QFII investors is currently set at one week. The amount of net redemption cannot exceed 20 per cent of its total investment as of the end of the past year. The subsequent investment quota would generally be forfeited upon repatriation.
- Under the RQFII scheme, the capital repatriation for closed-ended funds is conducted on a monthly basis.
- There is no clear and transparent rule guiding the quota size granted.

Figure 7 summarizes the requirements on the QFII and RQFII schemes.

Figure 7. Status of the QFII and RQFII schemes

	QFII	RQFII
Eligibility	Asset management companies: ≥ 2 years of experience; AUM ≥ USD 500m Insurance companies: ≥ 2 years of experience; AUM ≥ USD 500m Securities companies: ≥ 5 years of experience; Net Assets ≥ USD 500m; AUM ≥ USD 5bn Commercial banks: ≥ 10 years of experience; Tier I Capital ≥ USD 300m; AUM ≥ USD 5bn Other institutional investors (pension, foundations, trust companies etc.): ≥ 2 years of experience; AUM ≥ USD 500m	• Hong Kong subsidiaries of: • Chinese fund management companies; • Chinese securities companies; • Chinese commercial banks; • Chinese insurance companies • Financial institutions which are **registered** in any of the regulator approved RQFII centres or the **principal place of business** is in any of the regulator approved RQFII centres
Approval Process	Up to 20 working days (Status approval) Up to 20 working days (Quota approval)	Up to 60 working days (Status approval) Up to 60 working days (Quota approval)
Investment Deadline	6 months after approval	6 months after approval
Lock up Period	Pension funds, insurance funds, charity funds, endowment funds, mutual funds, government investment and monetary authorities and open-ended china fund*: 3 months Others: 1 year	1 year (with the exception of open-ended funds who are not restricted)
Capital Repatriation	Open-ended china funds: weekly; monthly repatriation ≤ 20% of total investments as at end of previous year Others: subject to SAFE's approval; monthly repatriation ≤ 20% of total investments as at end of previous year	Open-ended funds: daily Others: monthly
Holdings	≤ 10% for single QFII holder ≤ 30% in aggregate for foreign investors	≤ 10% for single RQFII holder ≤ 30% in aggregate for foreign investors

* Open-ended china funds: public open-ended funds with ≥ 70% asset invested in china domestic market

Source: FTSE Russell, CSRC, SAFE, information as at March 31, 2015

ii. Settlement and clearing

Another concern that currently prevents the China A-shares market from obtaining the secondary emerging status is its settlement process. The China Securities Depository and Clearing Corporation was founded in 2001 and is responsible for the clearing and settlement of securities traded on Shanghai and Shenzhen stock exchanges. The current settlement cycle between the central clearing house and securities companies/direct investors is T+0 (18:00) for securities and T+1 (16:00) for cash, which is different from the conventional standard applied to other markets of T+2 or T+3. This mismatch makes pre-funding necessary and is an issue for portfolio managers when rebalancing their portfolios.

Same-day turnaround trades in the A-shares market have been prohibited by the CSRC since December 2001.

iii. Taxation concerns of the QFII/RQFII schemes

Historically, the taxation treatment of QFIIs and RQFIIs had been unclear to international investors. The rules governing taxes on capital gains derived by QFIIs or RQFIIs from the trading of onshore PRC Securities were ambiguous. Important questions related to the determination of the cost basis, tax withholding and offsetting mechanism, and double taxation treatment remained unanswered.

As a result of all these uncertainties, some QFIIs have been setting aside funds in case tax collection is applied retrospectively. There are many different practices among asset managers in the market, ranging from reserving 0% to 10% from their profits for possible future taxation.

On October 31, 2014, the Ministry of Finance (MOF), China Securities Regulatory Commission and the State Administration of Taxation (SAT) announced that QFIIs and RQFIIs are temporarily exempt from Corporate Income Tax (CIT) on China-sourced capital gains derived from transfer of shares and other equity investment assets on or after November 17, 2014. On the same day, it was announced that capital gains derived prior to November 17, 2014 shall be subject to Chinese CIT. QFII and RQFII quota holders must file tax documents or apply for an exemption before July 31, 2015. As part of this process quota holders are required to prepare dividend tax certificates which can only be obtained from companies directly, thus increasing the administrative burden of managing the fund.

iv. Implementation issue of the Shanghai-Hong Kong Stock Connect programme

The Shanghai-Hong Kong Stock Connect programme is a breakthrough development compared with other quota schemes China has adopted so far.[4] It does not require an approval process and is open to both institutional and retail investors. The quota limit is applied on a market aggregate level and not on an individual basis. The Scheme was launched on November 17, 2014 and the trading volume had reached the northbound trading quota limit of its first trading day. Despite the improved market access, market participants still have concerns on a number of issues regarding universe coverage, quota limit, ownership structure, pre-trade stock delivery and enforcement of regulations. For example, investors

[4] Source: http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/chinaconnect.htm

are allowed to trade only a subset of securities on the Shanghai Stock Exchange under the scheme. Securities on the Shenzhen Stock Exchange – which contribute a significant weighting in FTSE's China indexes – are not covered. In terms of continuity in market access, the Stock Connect Programme does not include any details as of today about when and how the quota will be re-granted in case the current quota is used up. It creates a certain level of uncertainty as to whether market access is provided on a continuous and regular basis.

Some of these concerns have been addressed and the remaining are still waiting to be alleviated going forward. In March 2015, the CSRC indicated at the National People's Congress that the details of the Shenzhen-Hong Kong Stock Connect will be released during the first half of 2015 and implemented in the second half of 2015. The HKEx launched the Enhanced Pre-trade checking model in March 2015 to address the requirement of transferring shares to brokers before market open. CSRC has released the official document "The Clarification on Beneficial Ownership under SH-HK Stock Connect" in May 2015. FTSE Russell will closely monitor any further developments of the schemes and study the implications as part of the country classification process.

Based on the country classification meeting in September 2014, China A-shares currently are not included in FTSE's standard global benchmarks. However, FTSE Russell acknowledges at the current pace of change it is increasingly likely that in the next three years China A-shares will become eligible for inclusion in FTSE's global indexes. Accordingly FTSE Russell will continue to engage with the Chinese authorities and closely follow market developments, including regulatory standards, capital mobility and market trading mechanisms.

Considering the uniqueness and pace of the current changes to the China A-shares market environment, FTSE Russell believes that the sensible path for China is to provide benchmark choices for clients, which will be described in the next section.

4. FTSE Russell's solution to the China A-shares inclusion

Although there is still significant restriction in market accessibility for the China A-share market, the domestic market is opening up to international investors at a significant pace. The granting of R/QFII quotas is gathering pace and the application process for R/QFII quota has been simplified. The size of approved aggregate R/QFII quota increased from USD 3.8 billion in March 2005 to USD 125.3 billion in March 2015. The total number of licensed QFIIs and RQFIIs increased by 25 percent to 414 licenses in the past year. In fact, an increasing number of international financial institutions have been granted a sizeable amount of R/QFII quota in the recent two years. Figure 8 shows the top R/QFII quota holders as at the end of April 2015. Market participants would like to make use of the improved market access to the China A-shares market; however they still lacked an appropriate and flexible benchmark which would allow them to achieve this aim.

Figure 8. Top QFII / RQFII quota holders

QFII		RQFII	
Company	Quota (USDbn)	Company	Quota (RMB converted to USDbn)
Norges Bank	2.5	CSOP Asset Management Limited	7.43
Hong Kong Monetary Authority	2.5	E Fund Management (Hong Kong) Co., Limited	4.39
Government of Singapore Investment Corporation Pte Ltd	1.5	China Asset Management (Hong Kong) Limited	3.51
Temasek Fullerton Alpha Pte Ltd	1.5	Harvest Global Investments Limited	2.38
Abu Dhabi Investment Authority	1.5	Haitong International Securities Group Limited	1.73
Bank Negara Malaysia	1.5	Vanguard Investment Australia Ltd	1.61
Kuwait Investment Authority	1.5	Bosera Asset Management (International) Co., Limited	1.55
Monetary Authority of Macao	1.5	Shinhan BNP Paribas Asset Management Co., Ltd.	1.29
Fidelity Investments Management (Hong Kong) Limited	1.2	Taikang Asset Management (Hong Kong) Company Limited	1.19
	0.02		0.03

Total QFII Quota = USD 73.6bn; Total RQFII Quota = RMB 363.7bn (or USD 58.6bn)

Source: FTSE Russell, SAFE, data as at April 30, 2015

In order to provide a solution for these market participants, FTSE Russell has launched the FTSE China A Inclusion Indexes which aims to fulfill the following three criteria:

- It needs to cater for the different ways of accessing China A-shares by different segments of investors;
- It needs to reflect the dynamically changing environment in the China market; and
- It needs to be transparent and easy for users to understand.

There are two important components in the FTSE China A Inclusion Indexes: the construction of the China country component and the dynamic weighting to be allocated to China A shares.

4.1 China Country Component

The first step in FTSE Russell's proposed solution is to create the China country component. This has the following features:

- It is constructed based on the FTSE Global Equity Index Series methodology;
- China is reviewed as a single entity (A share + H share + Red chips + B share + P chips);
- The China A-shares selected as part of the review process will eventually become the constituents of FTSE GEIS when China is classified as secondary emerging;

- Index constituent weightings are the same regardless of the allocation to China A-shares in FTSE GEIS.

Figure 10 shows the characteristics of the China country component within the FTSE China Inclusion Indexes. The FTSE China Index consists of large and mid-cap companies and the FTSE China A All Cap Index consists of large, mid and small companies. Similar to the FTSE Global Equity Index Series the FTSE China All Cap Index aims to capture 98 percent of the eligible universe.

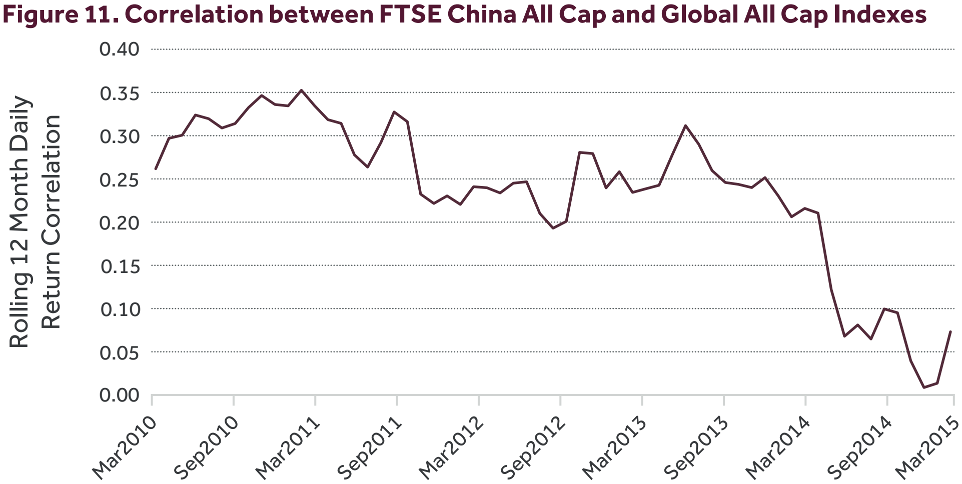
Figure 10. Characteristics of the FTSE China Indexes

	FTSE China index		FTSE China all cap index	
ICB industry	No. of constituents	Index wgt (%)	No. of Constituents	Index wgt (%)
Oil & Gas	10	2.82	21	2.46
Basic Materials	99	10.33	259	11.97
Industrials	158	22.85	396	24.39
Consumer Goods	86	12.26	241	13.55
Health Care	53	5.75	101	5.89
Consumer Services	42	5.11	106	5.49
Telecommunications	1	0.51	4	0.48
Utilities	28	4.00	52	3.73
Financials	74	31.97	137	26.12
Technology	32	4.41	94	5.91
Totals	**583**	**100**	**1411**	**100**

Source: FTSE Russell, data as at March 31, 2015

Including China A-share market in the global portfolio can potentially bring diversification benefits. Figure 11 shows the historical rolling 12 month daily return correlation between the FTSE China All Cap Index and the FTSE Global All Cap Index. It shows that the correlation between the China index and the global index is less than 40% in the last five years.

Figure 11. Correlation between FTSE China All Cap and Global All Cap Indexes



Source: FTSE Russell, data as at March 31, 2015

4.2 The allocation decision

The second step in FTSE Russell's proposed solution is to decide how large China A-shares weighting should be in the global benchmarks. To answer this important allocation question, FTSE Russell has devised a framework that takes the unique environment of the China A-shares market into consideration. There are two significant factors which make the allocation decision a challenging task. Firstly, market access differs across investors and secondly, the China A-shares market is evolving at a significant pace.

FTSE Russell's China A Inclusion Indexes provide three options and offers clients the flexibility to choose when to include China A shares in their Emerging Markets or Global Equity Markets benchmarks. The three options are:

1. allocation based on aggregate quota;
2. allocation based on no quota restriction; and
3. a customized allocation.

i. China A-shares allocation based on aggregate QFII/RQFII approved quota

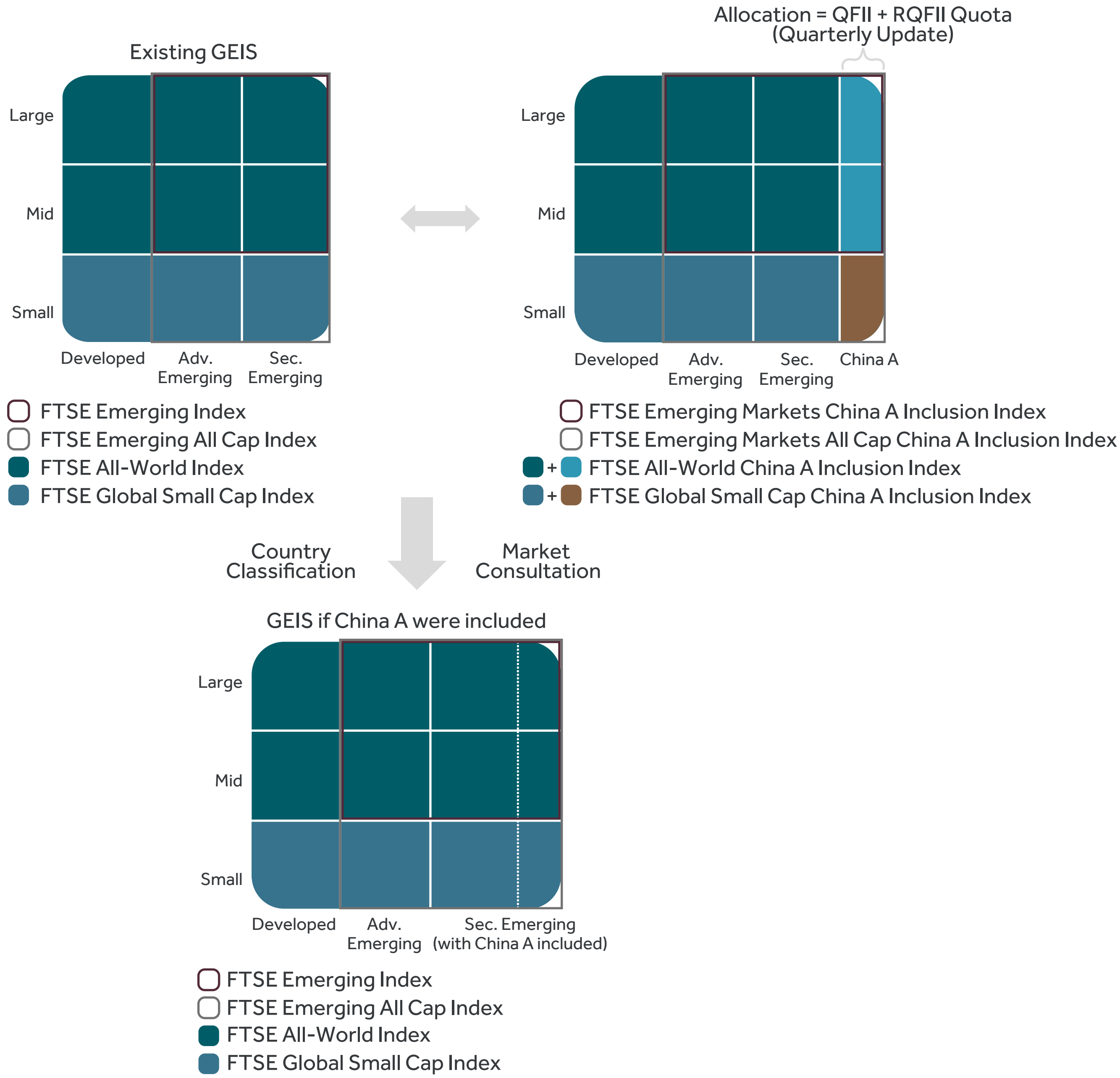
The allocation of China A-shares to FTSE's global benchmarks will reflect the accessibility available to international investors. It is currently set equal to the aggregate QFII and RQFII quota approved for international investors. The allocation is adjusted proportional to the changes in the approved quota. There is a built-in mechanism ensuring that the allocation of China A-shares is in line with the accessibility available to international investors. Another major benefit of this solution is that it allows market participants to anticipate the China A-shares allocation based on the approved quota information. This approach covers not only the currently available quota schemes (i.e. QFII and RQFII), but also those from any other existing and future schemes that increase market access, such as the Shanghai-Hong Kong Stock Connect programme, when they are deemed suitable.

The quota adjusted series will be suitable for clients:

- Who would prefer not to have China A-shares included at their full market weight;
- Who would like to increase their China exposure over a period of time; and
- Who require a transparent and systematic approach to their China A-shares allocation.

An illustration of this solution is shown in Figure 12.

Figure 12. China A-shares allocation based on available aggregate QFII/RQFII quota



Based on this allocation methodology, the China A constituents would have a weight of 4.83 per cent in the FTSE Emerging Markets China A Inclusion Index, which corresponds to a weight of 0.46 per cent in the FTSE All-World China A Inclusion Index. When the same analysis is applied to the FTSE All Cap Indexes, the weight of China A constituents would increase to 5.64 per cent and 0.53 per cent respectively. Breakdowns by country for these indexes are shown in Figure 13.

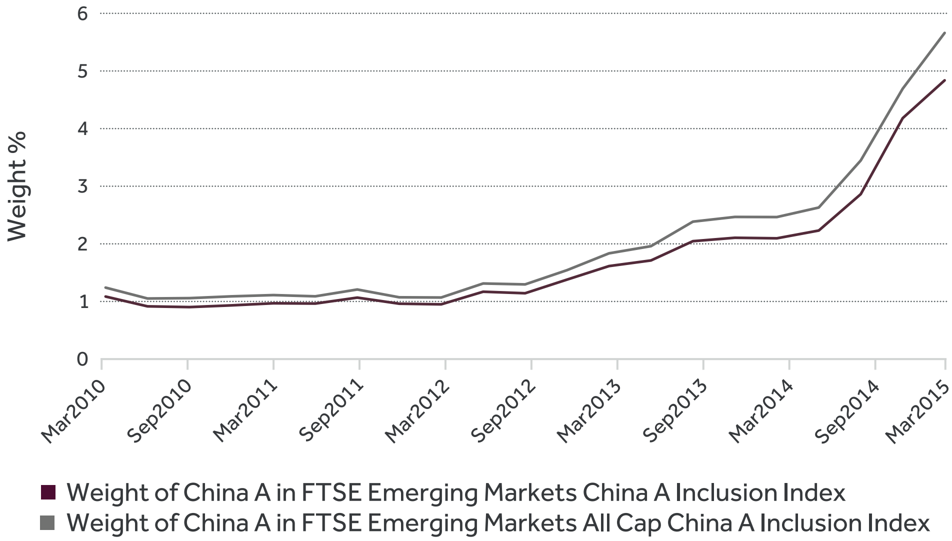
Figure 13. Country breakdown of FTSE Emerging and All-World and related All Cap China A Inclusion Indexes

Country	FTSE Emerging Index (%)	FTSE Emerging Markets China A Inclusion Index (%)	FTSE Emerging All Cap Index (%)	FTSE Emerging Markets All Cap China A Inclusion Index (%)
China (A)	–	4.83	–	5.64
China	26.15	24.89	24.97	23.56
Taiwan	14.49	13.79	16.65	15.71
Brazil	8.48	8.07	8.09	7.64
South Africa	9.63	9.17	8.86	8.36
India	12.16	11.57	12.32	11.63
Russia	4.19	3.99	3.79	3.58
Mexico	5.30	5.04	5.05	4.77
Others	19.60	18.65	20.26	19.12
Country	**FTSE All-World Index (%)**	**FTSE All-World China a Inclusion Index (%)**	**FTSE Global All Cap Index (%)**	**FTSE Global All Cap China a Inclusion Index (%)**
China (A)	–	0.46	–	0.53
China	2.38	2.36	2.23	2.22
USA	50.76	50.53	51.71	51.44
Japan	8.42	8.38	8.15	8.11
UK	7.01	6.98	6.91	6.88
France	3.21	3.20	2.96	2.95
Germany	3.22	3.21	3.05	3.03
Switzerland	3.21	3.19	2.96	2.95
Others	21.79	21.69	22.02	21.90

Source: FTSE Russell, data as at March 31, 2015

Figure 14 illustrates the trend of growth for the China A-share weighting within the global benchmark. The weighting of the China A-shares in both indexes was still relatively small five years ago. However, the rapid growth of approved R/QFII quota and the increase in the market size in recent years has led to a significant increase in the allocation. The weighting of China A-shares in the FTSE Emerging Market China A Inclusion index increased from 1% in 2010 to 4.8% in 2015.

Figure 14. Historical weight of China A-Shares in the FTSE Emerging Markets China A Inclusion Indexes



ii. China A-shares allocation based on no quota restrictions

Although the QFII and RQFII schemes can potentially impose quota size restrictions on investors, not all investors are subject to such constraints. There might also be some market participants who wish to see the potential size of China reflected in global benchmarks in the absence of quota restrictions. A suitable benchmark solution for this group of market participants should not therefore be affected by any quota restriction.

As part of FTSE Russell's solution, a non-quota version of the index series has also been developed. The China A-shares allocation will be calculated by adjusting for free float and foreign ownership restrictions under this option.

The non-quota adjusted series will be suitable for clients:

- Who have no quota constraint;
- Who prefer a higher exposure to the Chinese A-shares market;
- Who would like to see what the expected size of the China A-shares market would be in global indexes.

Figure 15 illustrates the effect of adding the FTSE China A indexes with no quota adjustment to the existing FTSE Global Equity Index Series. When there are no restrictions on including China A-shares into FTSE's Global indexes, the weight of China A-shares constituents in the FTSE Emerging and FTSE All-World Indexes would increase to 24.21 percent and 2.82 percent, respectively. When the FTSE All Cap Indexes are considered, the China A-share constituent weightings are even higher at 27.26 and 3.26 percent. The country breakdowns for these indexes are provided in Figure 16.

Figure 15. China A-shares Allocation Based on No Quota Restrictions

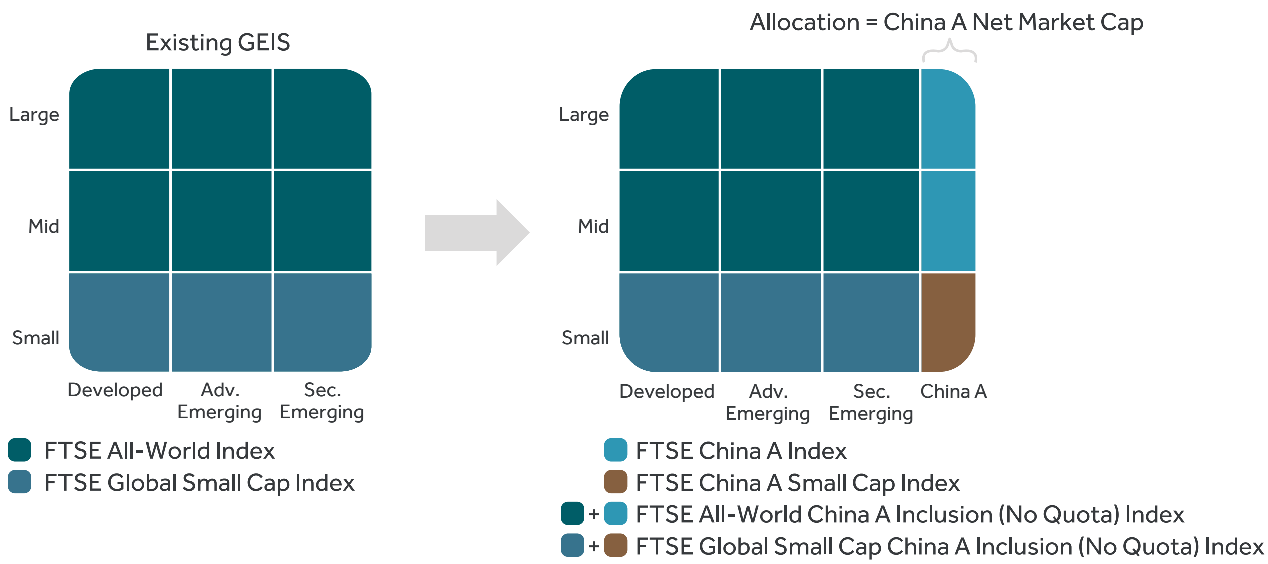


Figure 16. Country breakdown of FTSE Emerging and All-World non-R/QFII Indexes

Country	FTSE Emerging Index (%)	FTSE Emerging Markets China A Inclusion (no Quota) Index (%)	FTSE Emerging All Cap Index (%)	FTSE Emerging Markets All Cap China A Inclusion (no Quota) Index (%)
China (A)	–	24.21	–	27.36
China	26.15	19.82	24.97	18.14
Taiwan	14.49	10.98	16.65	12.10
Brazil	8.48	6.43	8.09	5.88
South Africa	9.63	7.30	8.86	6.44
India	12.16	9.21	12.32	8.95
Russia	4.19	3.18	3.79	2.75
Mexico	5.30	4.02	5.05	3.67
Others	19.60	14.85	20.26	14.72

Country	FTSE All-World Index (%)	FTSE All-World China A Inclusion (no Quota) Index (%)	FTSE Global All Cap Index (%)	FTSE Global All Cap China A Inclusion (no Quota) Index (%)
China (A)	–	2.82	–	3.26
China	2.38	2.31	2.23	2.16
USA	50.76	49.33	51.71	50.03
Japan	8.42	8.18	8.15	7.89
UK	7.01	6.81	6.91	6.69
France	3.21	3.12	2.96	2.87
Germany	3.22	3.13	3.05	2.95
Switzerland	3.21	3.12	2.96	2.87
Others	21.79	21.18	22.02	21.30

Source: FTSE Russell, data as at March 31, 2015

iii. Customized China A-shares allocation

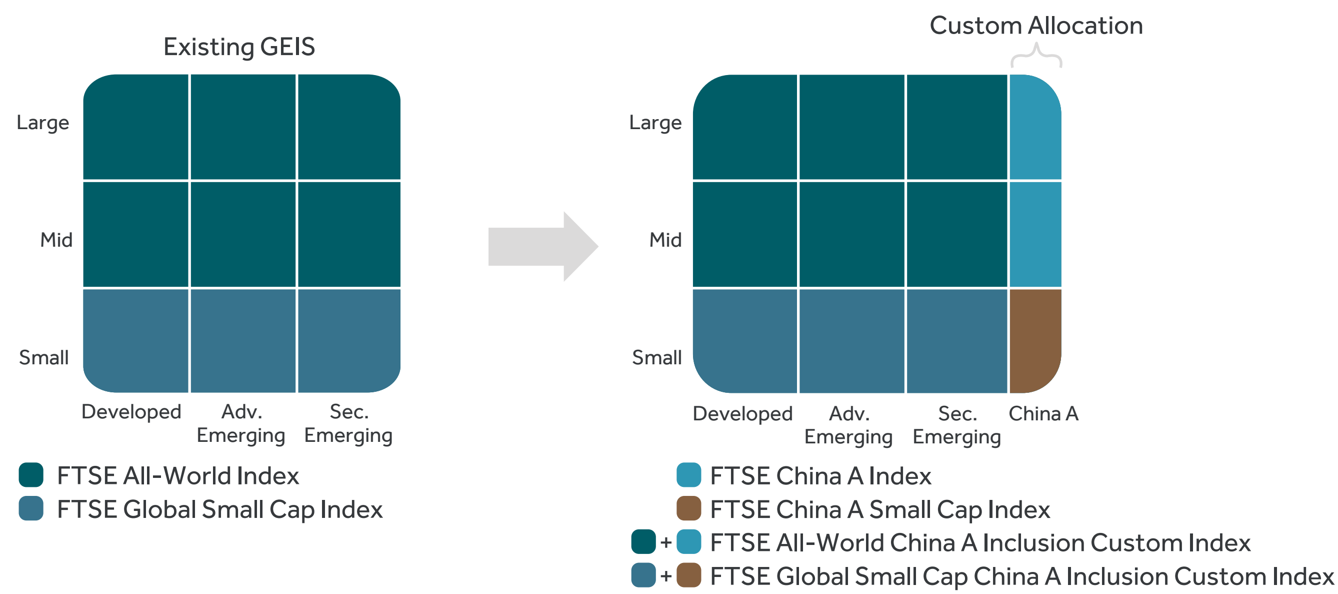
One appealing feature of FTSE's China A-shares solution is that it also provides an option to customize the index to suit individual users' preferences. Since the amount of QFII/RQFII quota and the fund size may vary substantially across different market participants, a custom index is a potential solution that tailors the different needs. The custom option allows index users to choose their own allocation of China A-shares in a regional/global benchmark, based on a quota size or investment view. Furthermore, the custom option can also incorporate a built-in mechanism to adjust the size of the allocation to take account of increased quotas over time.

The customized index solution will be suitable for clients:

- Who prefer having an China A-shares allocation based on a particular quota size;
- Who prefer seeing the weight of China A-shares increasing as quotas increases;
- Who prefer choosing an allocation based on specific investment views.

This solution is illustrated in Figure 17.

Figure 17. Customized China A-shares allocation



5. Conclusion

The market for China A-shares has experienced several key changes in the past twenty years. These changes include regulatory reforms to the Securities Law, to non-tradable shares, the launch of the QFII/RQFII schemes and recently the Shanghai-Hong Kong Stock Connect programme. Until three years ago, many investors had not considered the idea of including China in global benchmarks. With over 2,600 companies listed since 1991 and a market capitalization of approximately USD 6 trillion it is understandable why investors are paying more attention to the changes going on in China.

Recently China has shown strong indications that it is willing to open its market to international investors. The approval of QFII/RQFII licenses and quota has been increasing at a tremendous pace since 2011. The Shenzhen-Hong Kong Stock Connect is widely expected to be launched in second half of 2015. There is clear evidence that the Chinese regulators and stock exchanges are putting in significant efforts to improve the regulatory environment and trading mechanisms. More and more investors are beginning to ask the China question: when will China be included in global benchmarks?

In order to determine if a country should be included in its global benchmarks, FTSE applies an objective and consistent approach to the categorization of countries via the FTSE Country Classification System. At the most recent review carried out in September 2014, there were three criteria that the China A-shares market did not fulfil and as a result China A was retained on the watch-list for potential secondary emerging status.

FTSE Russell accepts that at the current pace of change it is increasingly likely that within the next two to three years China A-shares will become eligible for inclusion in FTSE's global indexes. This will depend on improvements in areas such as market accessibility and quota allocation, capital repatriation and changes in clearing and settlement. FTSE Russell will continue to consult and engage with the Chinese authorities and market participants to monitor developments and gauge progress in these key areas.

In the interim more and more investors are gaining access to the China market via the existing quota system. The FTSE China A Inclusion Indexes have been developed as a standard set of indexes to provide market participants with benchmark options to transition their portfolios. The index users will be offered the options to choose their China A-shares allocation based on differing quotas or views on the market. Index users can adopt either 1) Global benchmarks with China A-shares included and weighted by the aggregate approved quota, 2) Global benchmarks with China A-shares included and weighted by free float and foreign ownership-adjusted market value as if no quota restriction existed or 3) Customized indexes based on an investors own QFII/RQFII allocation. For those market participants who do not wish to have A-shares in their global benchmarks they can continue to use the FTSE Global Equity Index Series. FTSE Russell will continue to monitor clients' needs and work closely with them as China continues to open its market to international investors.

For more information about our indexes, please visit ftserussell.com.

About FTSE Russell

FTSE Russell is a leading global provider of benchmarking, analytics and data solutions for investors, giving them a precise view of the market relevant to their investment process. A comprehensive range of reliable and accurate indexes provides investors worldwide with the tools they require to measure and benchmark markets across asset classes, styles or strategies.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create ETFs, structured products and index-based derivatives.

FTSE Russell is focused on applying the highest industry standards in index design and governance, employing transparent rules-based methodology informed by independent committees of leading market participants. FTSE Russell fully embraces the IOSCO Principles and its Statement of Compliance has received independent assurance. Index innovation is driven by client needs and customer partnerships, allowing FTSE Russell to continually enhance the breadth, depth and reach of its offering.

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