Classification of Markets in the MSCI Equity Indices | January 2008

Discussion Paper on the Classification of Markets in the MSCI Equity Indices

Twenty years ago, MSCI launched the MSCI Emerging Markets Indices as the first comprehensive and consistent investable benchmarks for this component of global equity markets. During the lifetime of the indices, the Emerging Markets' economies have grown at a rapid pace and their equity markets have become more accessible and more efficient. Emerging Markets have brought significant diversification and enhanced returns opportunities to investors even as correlations with Developed Markets have increased over time. As an asset class now representing more than 11% of the MSCI ACWI Index, Emerging Markets have become more central in asset allocation and mandate attribution decisions while the investment strategies at work in these markets are more diverse and increasingly sophisticated. It is with this background that MSCI Barra is presenting this discussion paper with the intent to engage the investment community in a dialogue about some of the criteria underpinning the classification of markets in the MSCI index series.

This paper expresses views and contains questions intended to foster a discussion with market participants. <u>It does not reflect any proposal for change to the indices</u>. Decisions, if any, affecting constituents of the MSCI Indices would be announced separately following a specific consultation based on a proposal. Implementation of any significant changes would be made after providing ample notice.

Given recent trends, MSCI Barra believes that it is now a good opportunity to have an active discussion on some classification criteria. Among these trends, the following are worth highlighting:

- Some Emerging Markets like Korea and Israel, while not fully meeting all standards that characterize Developed Markets, have achieved significant advancements in their structure and openness to international investors.

- At the same time, smaller and less accessible markets have increasingly come to the attention of investors, and MSCI Barra has launched the MSCI Frontier Market Indices, including the five GCC countries open to foreign investors, to address the needs of investors willing to consider these new investment opportunities.

- Markets like China A-shares and Saudi Arabia, while today essentially domestic markets, have also experienced considerable growth. If, in the future, these markets open themselves significantly to international investors, a meaningful broadening of the opportunity set for global investors will result.

In a classification framework spanning the spectrum of market types, from pre-Frontier, to Frontier, to Emerging and then to Developed Market, a new market accessible to international investors would logically start as a Frontier Market and evolve over time, if and when warranted, to Emerging Market status first and then to Developed Market status. In following this path, a market would need to comply with increasingly stricter standards in terms of:

- Market accessibility (openness to foreign investment, investability, and robustness and efficiency of the operational framework).
- Company and security minimum size and liquidity, as well as minimum number of companies and aggregate size of eligible securities.

- Sustainable characteristics of advanced economies and levels of geo-political risk comparable to other existing Developed Markets, for achieving Developed Market status.

While there may be a broad consensus in the investment community with respect to most classification requirements, MSCI Barra believes that the following factors and considerations may deserve further discussion:

- The requirement that a country achieve the full liberalization of its foreign exchange markets in order to be considered for Developed Market status
- The requirement that no major geo-political risk exists for a country for it to be considered for Developed Market status; and the related question of how to assess geo-political risk
- The role of capital controls, in particular of prolonged restrictions on repatriation and/or inflows, including cash reserve requirements, in determining the difference between Frontier and Emerging Markets
- The role and impact, throughout the classification framework, of increasing minimum size and liquidity eligibility requirements
- The types of restrictions imposed on foreign investors by regulators and their impact on the way the opportunity set can be reflected in the indices

These five points are discussed below

1. Liberalization of the Foreign Exchange Market

In order for a market to attain Developed Market status, MSCI Barra views the existence of a fully convertible currency, including in offshore markets, as an important requirement. This condition for seamless accessibility and fully competitive, cost effective, foreign exchange services is met by all current Developed Markets.

At this moment, only a limited number of Emerging Markets, mostly in Europe, and including Israel, have a fully convertible currency. All Emerging Market Asian currencies, including those from Korea and Taiwan, are not fully convertible. Korea has announced a plan for the liberalization of its foreign exchange market and has started to implement a series of steps in that direction. Most recently, the Korean authorities have eliminated the “real demand principle”. This principle made the purchase of local currency dependent upon proof that a securities transaction had actually taken place, causing inefficiencies and limited competition in foreign exchange services onshore. While this and other such liberalizations are very positive developments, their effects are yet to be fully assessed by market participants. For now the Korean authorities have not expressed any intention to permit the development of an offshore market for their currency.

Some investors may see MSCI Barra’s Developed Market requirement for a fully liberalized foreign exchange market as excessive. MSCI Barra would like to engage investors to discuss the importance and the extent of this requirement. Including a country without a fully liberalized foreign exchange market in Developed Markets would result in a de-facto lowering of the standard for Developed Markets. Is that desirable? Is that a problem?

2. Major Geo-Political Risk

There is a general consensus that the existence of major political risks is a characteristic of Emerging Markets. One type of political risk is geo-political risk. Geo-political risk is linked to the existence of threats to the sovereignty of a country and to the integrity of its institutions, its people and their assets.

MSCI Barra has heretofore refrained from considering countries with high geo-political risk for inclusion in its Developed Markets Indices. Three of the more advanced Emerging Markets are characterized by important geo-political risks: South Korea, due to the North Korean threat, Taiwan due to China's claims and Israel due to the Palestinian issue. While over time investors have expressed concerns about those risks in the context of Developed Markets, more recently some investors have conveyed the opinion that the Korean risk is now more acceptable.

With respect to this factor also, there are investors who believe that these considerations should play no role in MSCI Barra's Market Classification, and there are those who have a very different assessment of these risks. MSCI Barra would like investors to put forward arguments in this debate. Including a country in Developed Markets with a high level of geo-political risk would result in a de-facto lowering of the standard for Developed Markets. Is that desirable? Is that a problem?

3. Restrictions on Funds Repatriation and/or Inflows

Historically, various forms of capital controls have existed in several Emerging Markets at some point in time, often as temporary restrictions in response to a particular financial crisis. However, some markets have had prolonged periods of inaccessibility. With the creation of a Frontier Markets category, there is a case for setting a higher standard for Emerging Markets and classifying those countries with systemic poor accessibility as Frontier Markets. Should this, in particular, apply to Argentina and Colombia, both of which, for protracted periods, have maintained restrictions and penalties to discourage inflows and outflows into/from their equity markets? Would there also be a case to consider reclassifying markets that have a history of using temporary restrictions, like Thailand, to Frontier Markets?

If a distinction needs to be made, how long should temporary accessibility restrictions last before considering a change in status from Emerging Market to Frontier Market? Can there be an explicit timeframe that holds for any phase in a market cycle?

4. Increasing Size and Liquidity Requirements

The MSCI Global Investable Markets Indices (GIMI) methodology has introduced different eligibility criteria related to size and liquidity, to account for the fact that investors have different expectations for market categories with very different characteristics. There are higher requirements for Developed Markets than for Emerging Markets, and Frontier Markets have even lower requirements. These differences are particularly important for the Standard Indices (Large + Mid Cap companies) which intend to represent, in a cost-efficient way, the core holdings of investors.

At this point in time there are several Frontier Markets where the constituents of the MSCI Standard Index would pass the minimum size and investability requirements for Emerging Markets, namely, the United Arab Emirates, Kuwait and Qatar. Provided that their operational frameworks become robust and efficient, it is reasonable to expect that these markets should transition to the Emerging Markets Index.

By contrast, most securities in Jordan fail the minimum size and investability requirements for Emerging Markets. For continuity purposes, the GIMI methodology ensures that a country index currently classified as an Emerging Market would have a minimum of three constituents in the Standard Index, even if one or more of the three securities do not fulfill minimum size and investability requirements. Would it be appropriate to modify the GIMI methodology, such that if a Standard Index for a market did not have at least three constituents that met the minimum requirement in a twelve-month period, the market should no longer qualify for Emerging Market status? In such a scenario, Jordan would be considered for reclassification to the Frontier Markets, where the lower requirements would result in a more balanced index.

There could also be a case for imposing aggregate materiality thresholds at the country level, for the Standard Index. Several emerging markets are small and, as a consequence, are overlooked by many emerging markets investors. Should markets such as Pakistan or Morocco be more appropriately classified in Frontier Markets based on materiality thresholds?

5. **Dealing with investment restrictions and constraints in markets that are opening up**

Today, two important markets remain largely closed to foreign investors: Saudi Arabia and China A. However, some investors are in a position to get exposure to these markets. A number of qualified institutional investors (QFII) are accessing the China A market through their approved investment quota. Other investors are getting exposure to A shares indirectly through Participatory Notes or other synthetic securities. In Saudi Arabia, foreign investors are able to get exposure to the domestic market through dedicated mutual funds.

The gradual opening of these markets has started, and some evolutionary paths could be envisioned.

Historically countries have followed several paths to open up their markets to global investors. The most common ways are a) defining Foreign Ownerships Limits (FOLs) at the security level which would be progressively increased, b) introducing separate share classes reserved to foreign investors, often with reduced voting power and c) establishing quota systems set at each investor level and also at the aggregate level for all foreign investors.

FOLs and separate share classes aim to limit the ability of foreign investors to exercise some degree of control on domestic companies. The objective of quota systems is to closely control and limit the foreign capital flows into and from the country. Many countries have used these measures individually or in combination.

The different paths to opening a market to foreign investors have different consequences in terms of speed and ease of reflection in a global index.

Foreign ownership limits are currently taken into account in the free-float available to foreign investors, which is used to calculate the weight of a security in the index. This very simple treatment works as long as the maximum ownership limit is not reached by foreign investors. After that point, this simple treatment may not reflect the illiquidity experienced by prospective international investors and the security should logically be deleted from the index unless there are mechanisms in place for foreigners to trade amongst themselves at a different price.

Separate share classes that foreign investors can buy with no limit are technically the easiest to reflect in an index. But they are disliked by investors because their greatly reduced voting rights are seen as poor governance and mistreatment of minority investors.

Finally restrictions implemented through quota systems are the most problematic to reflect in a global equity index. These systems create important differences in the treatment between investors as authorities exercise discretion on the decision to grant a quota to each applicant, on the timing of the grant and on the size of the quota. In addition, once a quota is approved, the corresponding amounts generally need to be fully remitted within certain timeframes failing which the unused quota is cancelled. Given the imperative for an index to act in fairness to all investors, the recognition of the markets that choose this route can only take place with significant delays and at reduced weights, through the use of Limited Investability Factors (LIFs), as was the case with Taiwan in the MSCI Emerging Markets Indices from September 1996 to May 2005.

Today, the QFII and quota process for accessing the China A market is still too restrictive to consider a partial inclusion of China A Shares in the MSCI Emerging Markets Index. However, with the creation of the MSCI Frontier Markets Indices, would there be a case for considering a partial inclusion of China A and Saudi Arabia shares into the Frontier Market Index? And if this is premature today, what would need to happen in the accessibility to these markets for some representation in the Frontier Markets to be considered?

MSCI Barra will proactively seek views from investors over the next few months and welcomes feedback from all market participants on the topics raised and views expressed in this discussion paper. Market participants are invited to contact MSCI Barra client service to provide feedback. MSCI Barra intends to share its conclusions from the discussions with the investment community by June 2008.

Please note that this is a discussion document, not a proposal for changes. Other considerations, in addition to those highlighted in this document may significantly impact the assessment of markets. Decisions, if any, affecting constituents of the MSCI Indices would be announced separately and would follow a specific consultation based on a publicly available proposal. Significant index changes, if any, following the specific consultation would be implemented with ample lead-time.

APPENDIX: MARKET CLASSIFICATION FRAMEWORK

Criteria	Frontier	Emerging	Developed
A Market Accesibility			
A.1 Openness to foreign ownership	**At least some**	**Significant**	**Very high**
A.2 Restrictions to Inflow / Outflow of Funds	**May exist**	**Minimal**	**None**
A.3 Efficiency of operational framework	**Modest**	**Good and tested**	**Very High**
A.4 Full convertibility of currency	**No requirement**	**No requirement**	**Yes**
B Size and Liquidity Requirements fo Standard Index			
B.1 Company size (full) *	**USD 521 mm**	**USD 1042 mm**	**USD 2048 mm**
B.2 Security size (float) *	**USD 77 mm**	**USD 521 mm**	**USD 1042 mm**
B.3 Security liquidity **	**2.5% ATVR**	**15% ATVR**	**20% ATVR**
B.4 Minimum nb of companies meeting criteria	**2**	**3**	**5**
C Economic Developemnt			
C.1 High Income Country	**No requirement**	**No requirement**	**Yes**
C.2 Sustainability of Development	**No requirement**	**No requirement**	**Yes**
D Other			
D.1 Absence of Major Geo-Political Risk	**No requirement**	**No requirement**	**Yes**

** Minimum in use for the November 2007 Semi-Annual Index Reviews*
*** ATVR - Annualized Traded Value Ratio*

Contact Information

clientservice@mscibarra.com

Americas

Americas	1.888.588.4567 (toll free)
Atlanta	+ 1.404.949.4529
Boston	+ 1.617.856.8716
Chicago	+ 1.312.706.4999
Montreal	+ 1.514.847.7506
New York	+ 1.212.762.5790
San Francisco	+ 1.415.576.2323
Sao Paulo	+ 55.11.3048.6080
Toronto	+ 1.416.943.8390

Europe, Middle East & Africa

Amsterdam	+ 31.20.462.1382
Cape Town	+ 27.21.683.3245
Frankfurt	+ 49.69.2166.5325
Geneva	+ 41.22.817.9800
London	+ 44.20.7618.2222
Madrid	+ 34.91.700.7275
Milan	+ 39.027.633.5429
Paris	0800.91.59.17 (toll free)
Zurich	+ 41.1.220.9300

Asia Pacific

China Netcom	10800.852.1032 (toll free)
China Telecom	10800.152.1032 (toll free)
Hong Kong	+ 852.2848.7333
Singapore	+ 65.6834.6777
Sydney	+ 61.2.9033.9333
Tokyo	+ 813.5424.5470

www.mscibarra.com

Notice and Disclaimer

- This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. (which is registered to do business in New York under the name NY MSCI), Barra, Inc. ("Barra"), or their affiliates (including without limitation Financial Engineering Associates, Inc.) (alone or with one or more of them, "MSCI Barra"), or their direct or indirect suppliers or any third party involved in the making or compiling of the Information (collectively, the "MSCI Barra Parties"), as applicable, and is provided for informational purposes only. The Information may not be reproduced or redisseminated in whole or in part without prior written permission from MSCI or Barra, as applicable.

- The Information may not be used to verify or correct other data, to create indices, risk models or analytics, or in connection with issuing, offering, sponsoring, managing or marketing any securities, portfolios, financial products or other investment vehicles based on, linked to, tracking or otherwise derived from any MSCI or Barra product or data.

- **Historical data and analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction.**

- **None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), or a promotion or recommendation of, any security, financial product or other investment vehicle or any trading strategy, and none of the MSCI Barra Parties endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies. None of the Information, MSCI Barra indices, models or other products or services is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.**

- The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information.

- NONE OF THE MSCI BARRA PARTIES MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY LAW, MSCI AND BARRA, EACH ON THEIR BEHALF AND ON THE BEHALF OF EACH MSCI BARRA PARTY, HEREBY EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

- **Without limiting any of the foregoing and to the maximum extent permitted by law, in no event shall any of the MSCI Barra Parties have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited.**

- Any use of or access to products, services or information of MSCI or Barra or their subsidiaries requires a license from MSCI or Barra, or their subsidiaries, as applicable. MSCI, Barra, MSCI Barra, EAFE, Aegis, Cosmos, BarraOne, and all other MSCI and Barra product names are the trademarks, registered trademarks, or service marks of MSCI, Barra or their affiliates, in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor's. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and Standard & Poor's.

- The governing law applicable to these provisions is the substantive law of the State of New York without regard to its conflict or choice of law principles.

About MSCI Barra

MSCI Barra is a leading provider of investment decision support tools to investment institutions worldwide. MSCI Barra products include indices and portfolio analytics for use in managing equity, fixed income and multi-asset class portfolios.

The company's flagship products are the MSCI International Equity Indices, which are estimated to have over USD 3 trillion benchmarked to them, and the Barra risk models and portfolio analytics, which cover 56 equity and 46 fixed income markets. MSCI Barra is headquartered in New York, with research and commercial offices around the world. Morgan Stanley, a global financial services firm, is the majority shareholder of MSCI Barra.