COMPLETE GUIDE TO CHINESE SHARE CLASSES & CHINA ETF INVESTING

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INTRODUCTION

The financial media has an infatuation with fund closures: Recent headlines, such as "ETF INDUSTRY HIT WITH RASH OF FUND CLOSINGS" and "Record Number of ETF Closures This Year" highlight how popular a topic it is. Fund closures can cause advisors and investors a number of headaches, including but not limited to the need to recognize capital gains; find a new vehicle for exposure; and rectify tracking problems. However, one thing investors don't need to worry about is losing all of their money. When an issuer shuts down a fund, it sells all its positions and distributes the proceeds to shareholders. As an investor, you get paid out at NAV. Still, it's a hassle: No advisor wants to tell a client that the fund he chose was so unpopular that it closed. Moreover, there are tax, cost and tracking considerations to worry about.

Investing in China is tricky. There are now more than 20 China-focused ETFs to choose from, ranging from size and style funds to sector-specific funds. As if sifting through expense ratios, liquidity and holdings isn't enough, China investors have another big, fundamental factor to consider: Chinese share classes.

Foreign investment in China is still restricted: A U.S. investor cannot simply open a brokerage account and trade locally listed Chinese shares. As a result, there are multiple shares classes of Chinese companies floating around on various exchanges, allowing investors different ways to access this complex market.

Depending on the underlying index that an ETF tracks, some funds are eligible to hold only a certain type of shares. This matters because the different share classes an ETF is eligible, or ineligible, to hold can significantly impact the fund's performance, and ultimately determine the type of Chinese companies in the portfolio.

Chinese share classes, especially as they relate to ETFs, are often misunderstood—or worse, ignored altogether. We at IndexUniverse think investors deserve better, so we prepared this document to provide insight and guidance on the topic to help investors make an informed decision on choosing the right China ETF.

SHARE-CLASS DESCRIPTIONS

For the most part, local investors in China buy what are known as "A-shares." These are the shares of companies traded on the domestic Shanghai and Shenzhen stock markets, quoted in renminbi. Except for a select few qualified foreign institutional investors (QFIIs)—and via some unusual products —most investors cannot readily buy A-shares.

Due to this restriction, most ETFs currently access the Chinese market through shares of Chinese companies listed in Hong Kong, the U.S. or a special "B" share class traded in Shanghai or Shenzhen. These "investable" shares consist of H-shares, red chips, P-chips, B-shares and N-shares.

Let's look at each of these shares below, because grasping their differences is crucial.

- **A-shares:** Chinese companies incorporated on the mainland and traded in Shanghai or Shenzhen, quoted in RMB.
- **B-shares:** Chinese companies incorporated on the mainland and traded in Shanghai and quoted in USD or traded in Shenzhen and quoted in HKD (open to foreign ownership).
- **H-shares:** Chinese companies incorporated on the mainland and traded in Hong Kong.
- **Red chips:** State-owned Chinese companies incorporated outside the mainland (mostly in Hong Kong) and traded in Hong Kong.

- **P-chips:** Nonstate-owned Chinese companies incorporated outside the mainland, most often in certain foreign jurisdictions (Cayman Islands, Bermuda, etc.) and traded in Hong Kong.
- **N-shares:** Chinese companies incorporated outside the mainland, most often in certain foreign jurisdictions, and U.S.-listed on the NYSE or Nasdaq (ADRs of H-shares and red chips are also sometimes referred to as N-shares).

SHARE CLASSES AND ETF BREAKDOWN

It may come as a surprise that some of the most popular China ETFs are not eligible to hold all investable shares. For example, the $6.1 billion iShares FTSE China 25 Index Fund (NYSEArca: FXI), which holds 25 of the largest and most liquid Hong Kong-listed Chinese shares, is only eligible to hold H-shares and red chips.

This means China's largest Internet company, Tencent Holdings, is excluded because it's classified as a P-chip, even though Tencent has a market capitalization of $64 billion, which would put it within the 25 largest H.K.-listed Chinese companies.

The key to knowing which share class a fund is eligible to hold lies in knowing which index the fund tracks. FTSE, a leading index provider in the space, to date has considered P-chips to be Hong Kong companies, and has listed them in developed market Hong Kong indexes instead of their China index series.

Therefore, ETFs that track FTSE's China indexes, such as FXI, are only eligible to hold H-shares and red chips, which limit their scope, as the indexers' classification methodology determines where that company sits in their global breakdown.

The iShares FTSE (HK Listed) Index Fund (NYSEArca: FCHI), a "total market" version of FXI with over 120 holdings, is in a similar boat. So again, it misses out on important P-chip names like Tencent Holdings, Belle International, Want Want China, Gome Electronics and Geely Automobile.

It's worth noting that on June 18, 2012, FTSE announced that it will reclassify P-chips from Hong Kong to China in their FTSE Global Equity Series, effective March 2013. Then on Sept. 26, 2012, it extended that reclassification announcement to its FTSE China 25 Index. This means that P-chips, such as Tencent, should be eligible for inclusion into FXI once this reclassification takes effect in March 2013.

MSCI's scope is slightly wider than FTSE because its indexes are eligible to hold P-chips. Still, MSCI does not include N-shares in its indexes. According to MSCI's methodology, a security's country classification is determined by the location of its incorporation and primary listing.

Many N-shares are incorporated in tax havens like the Cayman Islands or Bermuda, and have their primary listings in the U.S. (N-shares and the regulatory and legal risks associated with them are discussed in detail below).

Therefore, ETFs like the iShares MSCI China Index Fund (NYSEArca: MCHI) provide exposure to mega-cap P-chips like Tencent Holdings, but exclude many significant N-share technology names like Baidu, Sina and NetEase. This example also shows that significant sector biases result from the share-class issue.

Investors looking to get a broad mix of all investable Chinese shares have options, such as the SPDR S&P China ETF (NYSEArca: GXC). The $875 million GXC holds all investable shares, providing the most comprehensive exposure to the Chinese market currently available to U.S. investors.

Other cap-weighted options that provide comprehensive share-class exposure include the Guggenheim China All-Cap ETF (NYSEArca: YAO) and the Guggenheim China Small Cap ETF (NYSEArca: HAO). Global X's suite of China sector ETFs also pulls its holdings from a universe of all investable shares.

A-shares aren't entirely inaccessible to ETF investors. Those looking to dive into the A-share market have one option: the Market Vectors China ETF (NYSEArca: PEK), which enters into swap agreements with QFIIs, in order to track the CSI 300 Index. But investors in PEK need to weigh some factors.

First, because it utilizes a swap agreement, the fund comes with counterparty risk. PEK currently has one swap counterparty, Credit Suisse. This means if Credit Suisse fails as a company, or fails to deliver on its end of the deal, the shareholders could be affected.

PEK's counterparty also gains access to A-shares as a QFII, and QFIIs have quotas (currently $1 billion per institution). So when demand is especially strong for A-shares, swaps get more expensive—which can cause the fund to trade at premiums to its net asset value.

From its inception in late 2010 until August 2011, PEK often traded at premiums north of 10 percent. As China eventually increased its QFII quotas and demand for A-shares decreased with the slowdown in Chinese growth, premiums have since fallen.

It's worth noting that in July 2012, Van Eck Associates was granted QFII status for $100 million, meaning it will likely be the first U.S.-based ETF provider to have a physically backed China A-share fund.

When this change is implemented, it should alleviate the premium issue significantly until that $100 million quota is reached. Investors should stay tuned for further developments from Van Eck.

N-SHARES AND THE VARIABLE INTEREST ENTITY STRUCTURE

The PowerShares Golden Dragon China Portfolio (NYSEArca: PGJ) is an interesting case because it's only eligible to hold U.S.-listed Chinese shares, or N-shares.

PGJ's holdings consists of a mixture of ADRs of H-shares and red chips that trade in Hong Kong, and N-shares of companies that have their primary listing in the U.S., and use a variable interest entity structure (VIE).

This VIE structure is worth discussing in more depth, since there's been quite a bit of scrutiny in recent years surrounding the regulation and legality of VIEs.

Certain sectors in China are restricted from foreign direct investment. Therefore, companies operating in restricted sectors like Internet, media and education set up holding companies overseas, usually in tax havens like the Cayman Islands or Bermuda, and float shares of the holding company in overseas markets (such as the NYSE or Nasdaq).

The investors have ownership in a wholly foreign-owned entity in China, which enters into contractual agreements with the VIEs to share in the profits. The VIEs, which maintain the business licenses, are often owned by a select few executives—sometimes just the founder.

The Chinese government has not actually addressed the legality of this structure, and so far, has simply turned a blind eye to it. Furthermore, the details surrounding the control of the operating companies and regulation of the VIE structure are questionable.[1-3]

Sina Corp was the first company to list in the U.S. using this structure, in 2000. Over the next decade, hundreds of other Chinese companies listed using VIEs, and continue to do so today. Still, recent events have tested investor confidence in this structure.

For example, the recent SEC probe into New Oriental Education & Technology Group's (NYSE: EDU) accounting practices brought the future viability of VIEs into question again.

The day the probe was announced, EDU's shares dropped 34.3 percent. That same day, the N-share-laden PGJ fell more than 4 percent, but MCHI—which excludes N-shares altogether—actually gained 1.8 percent.

Today there's increased speculation about whether the Chinese government (and/or the U.S. Securities and Exchange Commission) will crack down on this structure and tighten regulation on VIEs. While no formal announcements have been made, the perception of N-shares has been somewhat tainted, and it's very possible that the VIE structure could see continued scrutiny for the foreseeable future.

OTHER CHINA-HEAVY ETFS

It's worth discussing several regional or global ETFs with significant China exposure that are subject to the same share class restrictions, based on the indexes they track.

For example, the Vanguard MSCI Emerging Markets ETF (NYSEArca: VWO), the iShares MSCI Emerging Markets Index Fund (NYSEArca: EEM) and the iShares Core MSCI Emerging Markets ETF (NYSEArca: IEMG) track the MSCI Emerging Markets Index. Therefore, all N-shares are excluded.

Even after VWO switches indexes to the FTSE Emerging Index in early 2013, N-shares will still be excluded. However, the "temporary" FTSE Emerging Transition Index that it will track for six months while it winds down its Korea exposure will include P-chips, in anticipation of the reclassification effective March 2013.

The Schwab Emerging Markets Equity ETF (NYSEArca: SCHE) tracks the FTSE All Emerging Index, so it not only excludes N-shares, but also excludes P-chips. This means that until reclassification of P-chips in March 2013, Tencent Holdings, the 12th-largest holding in EEM, is currently missing entirely in SCHE.

Meanwhile, the SPDR S&P Emerging Markets ETF (NYSEArca: GMM) is inclusive of all shares, so Tencent sits as the sixth-largest holding, while Baidu sits as the 12th-largest position.

We see a similar pattern when comparing the three BRIC ETFs, which have an even larger allocation to China.

The iShares MSCI BRIC ETF (NYSEArca: BKF) is the largest BRIC ETF, and has 39 percent of the fund weighted in China. Again, since it tracks an MSCI index, investors won't find any N-shares here.

The Guggenheim BRIC ETF (NYSEArca: EEB) is an extreme case, as it's only eligible to hold depositary receipts and N-shares. EEB includes ADRs of H-shares, like China Mobile and CNOOC, but its 20 percent weighting in China excludes the "Big Four" Chinese banks—ICBC, Bank of China, Agricultural Bank of China and China Construction Bank—since none of these banks floats ADRs in the U.S.

This provides another example of how share class differences drive sector exposure in ways investors may not expect. Such sector differences in turn can lead to starkly different performance results.

Lastly, the SPDR BRIC 40 ETF (NYSEArca: BIK) is inclusive of all Chinese shares, and carries a massive 46 percent weighting in China. From a Chinese exposure perspective, BIK is the most comprehensive.

Note: For more information on other regional or global funds with significant China exposure, see the table at the end of the paper.

CHOOSING THE RIGHT FUND FOR YOU

While there are many different reasons beyond share classes for choosing the right China ETF, investors should fully understand that China funds come with an extra layer of required research.

At the end of the day, the returns in an ETF are driven by its holdings, and the companies and sectors held in China ETFs can differ significantly depending on the types of share classes an ETF is eligible to hold. Seeing the huge discrepancy in returns in PGJ compared with other China ETFs on the day EDU announced the SEC probe proved just how much share classes can affect a fund's returns.

Investors have options. For most investors looking for the broadest, total market exposure to China, funds that are eligible to hold all investable shares—such as GXC and YAO—make the most sense. For those looking for small-cap exposure, that would be HAO.

Still, some investors might want to minimize their exposure to companies listed using VIEs for the reasons mentioned above. If that's the case, then FXI, MCHI, FCHI or ECNS might be the better choices. (Note: Some companies listed in Hong Kong—including Tencent Holdings—use VIEs as well, even though companies listed in the U.S. usually get most of the negative attention.)

For those looking for sector-specific exposure, the good news is that all China sector ETFs, offered mostly by Global X Funds, include all investable shares in their funds.

Inevitably investing in China will go through changes in the coming years as China continues to open its financial markets to the rest of the world. We at IndexUniverse will continue to monitor these changes.

In the meantime, one of the keys to investing in China ETFs lies in knowing the differences between the various share classes, and which funds hold which type of shares. Once that hurdle is crossed and understood, your options should narrow and choosing the right China ETF for your investment needs should become easier.

Endnotes

1. *Gillis, Paul L. "Variable Interest Entities in China," Accounting Matters (Sept. 18, 2012).*
2. *Dutton, Edward Drew and Wu, Niping. "Investing in China: New Risks?" Debevoise & Plimpton Private Equity Report, vol. 11, No. 4 (Summer 2011), pp. 3-5.*
3. *Roberts, David and Hall, Thomas. "VIE Structures in China: What You Need to Know," Topics in Chinese Law, An O'Melveny & Myers LLP Research Report (October 2011), pp 1-3.*

China ETFs

FUND NAME	FUND TICKER	UNDERLYING INDEX	ELIGIBLE SHARE CLASSES
iShares FTSE China 25	FXI	FTSE China 25	H, Red Chips
SPDR S&P China	GXC	S&P China BMI	All Investable Shares
iShares MSCI China	MCHI	MSCI China	H, B, Red Chips, P-chips
PowerShares Golden Dragon China	PGJ	Nasdaq Golden Dragon China	N
iShares FTSE China (Hong Kong Listed)	FCHI	FTSE (HK Listed) China	H, Red Chips
Guggenheim China All-Cap	YAO	AlphaShares China All-Cap	All Investable Shares
First Trust China AlphaDEX	FCA	Defined China	All Investable Shares
Market Vectors China	PEK	CSI 300	A (Swap)
RBS China Trendpilot ETN	TCHI	RBS China Trendpilot	N
Guggenheim China Small Cap	HAO	AlphaShares China Small Cap	All Investable Shares
iShares MSCI China Small Cap	ECNS	MSCI China Small Cap	H, B, Red Chips, P-chips
WisdomTree China Dividend ex-Financials	CHXF	WisdomTree China Dividend ex Financials	H, Red Chips, P-chips
Global X China Materials	CHIM	Solactive China Materials	All Investable Shares
Global X China Consumer	CHIQ	Solactive China Consumer	All Investable Shares
Global X China Energy	CHIE	Solactive China Energy	All Investable Shares
Global X China Financials	CHIX	Solactive China Financials	All Investable Shares
Global X China Industrials	CHII	Solactive China Industrials	All Investable Shares
EGShares China Infrastructure	CHXX	INDXX China Infrastructure	All Investable Shares
Guggenheim China Real Estate	TAO	AlphaShares China Real Estate	All Investable Shares
Global X Nasdaq China Technology	QQQC	Nasdaq OMX China Technology	All Investable Shares
Guggenheim China Technology	CQQQ	AlphaShares China Technology	All Investable Shares

Emerging Markets ETFs with a Heavy China Weighting (> $100 million AUM)

FUND NAME	FUND TICKER	UNDERLYING INDEX	CHINA WEIGHT (%)	ELIGIBLE SHARE CLASSES
Vanguard MSCI Emerging Markets	VWO	MSCI Emerging Markets	19	H, B, Red Chips, P-chips
iShares MSCI Emerging Markets	EEM	MSCI Emerging Markets	18	H, B, Red Chips, P-chips
iShares Core MSCI Emerging Markets	IEMG	MSCI Emerging Markets Investable Market	17	H, B, Red Chips, P-chips
WisdomTree Emerging Markets Equity Income	DEM	WisdomTree Emerging Markets Equity Income	16	H, Red Chips, P-chips
SPDR S&P Emerging Markets Small Cap	EWX	S&P Emerging Markets Under USD2 Billion	19	All Investable Shares
iShares MSCI BRIC	BKF	MSCI BRIC	41	H, B, Red Chips, P-chips
Schwab Emerging Markets Equity	SCHE	FTSE All Emerging	19	H, Red Chips
iShares MSCI Emerging Markets Minimum Volatility	EEMV	MSCI Emerging Markets Minimum Volatility	14	H, B, Red Chips, P-chips
SPDR S&P Emerging Asia Pacific	GMF	S&P Aisa Pacific Emerging BMI	38	All Investable Shares
PowerShares FTSE RAFI Emerging Markets	PXH	FTSE RAFI Emerging Markets	14	H, Red Chips
BLDRS Emerging Markets 50 ADR	ADRE	BNY Mellon Emerging Markets 50	18	N
Guggenheim BRIC	EEB	BNY Mellon BRIC Select ADR	38	N
SPDR S&P BRIC 40	BIK	S&P BRIC 40	51	All Investable Shares
SPDR S&P Emerging Markets	GMM	S&P Emerging BMI	21	All Investable Shares
iShares S&P Emerging Markets Infrastructure	EMIF	S&P Emerging Markets Infrastructure	27	All Investable Shares
First Trust Emerging Markets AlphaDex	FEM	Defined Emerging Markets	29	All Investable Shares