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PERFORMANCE THROUGH INNOVATION
BARCLAYS GLOBAL INVESTORS

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Re: Consultation Paper on the Reduction of Minimum Spreads

In reference to the above consultation paper seeking views on reducing minimum spreads for securities trading Hong Kong, we believe this proposal could dramatically reduce quoted bid-ask spread costs in Hong Kong by as much two-thirds by the end of Phase 2 from their current levels of 45-50 basis points. Indeed, it is quite likely that following the reduction in tick size, Hong Kong would move from the highest bid-ask spreads in Asia to among the very lowest. This assumption is predicated on the belief that Hong Kong's experience will resemble that of other markets where the minimum tick or price increment was reduced.

While the previous discussion might indicate that the proposal is obviously beneficial, the picture is more complex. Previous academic research of decimalization in the United States and other regulatory efforts to reduce the minimum price increment are generally agreed that such changes immediately translate into smaller bid-ask spreads. This research also shows that quoted depths are correspondingly smaller. Consequently, retail traders who use market orders are the obvious beneficiaries of such changes. Limit order providers and institutions, however, face a more difficult situation. The reduction in tick size makes it easier for incoming orders to undercut pre-existing limit orders, diminishing the value to posting liquidity. Thus, dealers and market makers generally oppose reductions in tick size. Similarly, for institutional traders whose orders are large, the reduction in depth can offset the smaller spreads, so the net effect on liquidity and trading costs is not obvious. Traders who have the technology to process real-time information, access multiple sources of liquidity, and use automation to breakup orders over time will generally benefit at the expense of more traditional traders who demand liquidity at specific points in time. At BGI, we believe our technology and trading skill allows us to adapt to this new environment, thereby profiting from smaller spreads. The consequent cost savings to our clients, especially in higher turnover strategies, could be substantial.

Kind Regards,

Joseph Ho
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