

**COMMENTS
ON
CONSULTATION PAPER
ON
THE REDUCTION OF MINIMUM SPREADS**

4th October 2004

DL Brokerage Limited

Executive Summary

Hong Kong Exchanges and Clearing Limited (“HKEx”) had issued a Consultation Paper on The Reduction of Minimum Spreads (the “Paper”) in August 2004, the Paper also invited wide market response on the Proposal. Our Company has been an active Exchange Participant since 1986 and restructured into a Limited Company in 1993, we have conducted a limited in-house survey on this issue with our clients, which composed of both individuals and corporate clients, also our traders who have to communicate with clients as their day-to-day job responsibilities. Some of our clients had also submitted their own comments directly to HKEx in the form of a Questionnaire, which was provided by the Hong Kong Stockbrokers Association.

After careful discussion with our clients, traders and also incorporated with our past experience in trading and settlement, we have concluded our view as NOT to support the proposed reduction of minimum spreads. However, we do support HKEx to further conduct a study to relax the quotation rules from 8 spreads to 20 spreads for order input, which will improve the market quality in respect of market depth and transparency. We also provide our comments and opinions in relating to the contents of the Paper as for the HKEx’s consideration.

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Comments and Arguments

1. Smaller price spread will improve market quality, i.e. liquidity, efficiency.

We are of the view NOT to agree with this point, since 1994 we have been using the current spread table, we are not aware of any problem with the current spread table. Besides, the trading behavior of all our clients, traders, back office staffs has already been accustomed to the current system, and it has been proven to be fluent and never been recognized as an obstacle to any market development.

In view of liquidity, we might gain some liquidity for those big institutional orders, but on the other hand we will definitely create constraint to those day trading activities. Day trading activities has been counting a significant portion to the market turnover and we cannot afford to damage it, we do not agree that smaller spread might boost further business from the institutional clients since their total concluded investment have no direct relationship with the minimum price spread. Besides, in consideration that transaction cost which counts for around 0.724% of the trade, how further reduction in the minimum spread will stimulate new transaction is still questionable.

In view of market efficiency, once we are changing the investment habits of the investors, especially the local individuals with less professional background, they will hesitate to participate as active as they used to be. Once their trading behavior is not harmonized, confusions or even conflicts between investors and traders is expected and this had already become a disaster ten years ago and damaging the market efficiency.

Nevertheless, we only agree that to enhance our system to relax the quotation rules from 8 spreads to 20 spreads for order input, will improve the market quality in respect of market depth and transparency. But HKEx should conduct a cost effective study in proceeding this system enhancement.

2. Increase Competitiveness of our Market.

We are of the view NOT to agree with this point, as the statistic provided in the Paper, Hong Kong is ranking around the best leading place among the other regional markets that are directly competing with us. It is not fair to compare with other leading market such as the US market, they are practically different in respect of their market making system and also no stock is allowed to trade below one dollar. Besides, price spread is actually not a significant factor as important as the time zone difference.

Baring in our mind, the Hong Kong market has been expanding continuously during the past ten years period, the attraction of our market is mainly because of the open up of the China economy and our up keeping with the international financial standard, our capacity is highly relied on our advance AMS and CCASS systems but without the influence of changing any of our price spread table.

3. Maintaining an Orderly Market

Since the unified stock exchange in 1986, to the mutualization of exchanges in 2000, Hong Kong has been experienced several major market crash and minor market disorder. In 1994 while the Stock Exchange had tried to introduce the new price spread table, which implied to a 50% cut across the board. During the evaluation, trading volume dropped due to the confusion and conflicts among investors and traders, the investor's public were forced to change their trading habit and hence their traditional trading behavior were then confused. It really became a disaster to the market, and eventually the Stock Exchange had reverted to the original trading spreads for stocks trading below HK\$10.00. Being an international financial centre, maintaining an orderly market is far more important than implementing any market wide changes, especially that is lack of general market support.

4. Smaller spread can prevent Market Misconduct Activities.

Some market comments might suggest that to reduce the price spread can help to prevent market misconduct activities, Front Running, since smaller spread will minimize the temptation for misconduct. We have a different view in this point, all market misconducts are treated as breach of the SFO and will subject to disciplinary penalty. These irregular activities should be prevented by better surveillance system, internal control, supervision and investors education. Furthermore, after the new SFO has been enforced, we all expect to have a better market environment and misconduct activities will further be minimized. Technically we agree that reduced price spread will discourage misconduct, but size of the order really drives the temptation, hence this is not a supporting reason to spread changes since it will create other market confusion that is far worse than what we expect.

5. Mission of HKEx.

We understand that HKEx is having the mission for continuous market development, improving the market competitiveness, efficiency, ... etc., and all of these have to link with the public interest. HKEx cannot proceed any changes that will only benefit a segment of the market but at the expense of the rest of the market, especially those smaller local investors that have less professional training or education. For those institutional investors, big brokerage firms and issuers of derivative instruments, they have sufficient resources in customizing their trading system, with top professional traders for their trade execution, and we can see their participation have been playing a more and more important role and is already dominating the daily market turnover. To reduce the price spread further, it will just benefit these market activities to further dominating the market, but in return all the smaller investor's public will be suffered. HKEx should have played a more important role, to protect the smaller group of investors and participants in order to balance the market as a whole without basis.

6. Cost of Implementing.

It is expected that any system enhancement or changes will involve cost, especially change in price spread will subsequently incur cost of changes in trading, settlement and back office system as well, and we cannot underestimate the cost since that will be a market wide enhancement. We urge that HKEx should consider carefully before implement any changes that might not benefit the market but in the same time increase implementation cost to everybody.

7. Investors Education.

From time to time, HKEx and SFC have been criticized for not doing enough Investors Education, which will directly protect and benefit the investor's public. Hong Kong have over one million retail investors, and lots of them are not well educated to protect themselves and they are not well prepared to accept new products and changes. We urge HKEx to consider carefully before implement the price spread change since this will force all investors to change their trading behavior, once they cannot accustom to the new system, they will become losers of the experiment and will damage our image as an international financial centre.

Conclusion

In concluding our views, we are not supporting any of the proposals in reduction of the price spread. Since we have been using the current price spread table for the past ten years, and it has been proven no problem.

Hong Kong has been the leading market within the Asian Pacific Region and also being the top ranking international financial centre in the world. Our success is not built on our price spread but rather our advance AMS, CCASS together with our up keeping international financial standard that can maximize our market capacity with the open up of the China economy.

As what we are concerning of, the reduction of price spread might be of some benefit to a segment of the market, but definitely will be at the expense of the majority of the market (even they might not counting majority in terms of market turnover). HKEx supposed to play an important role in balancing the different interest of the market, especially for those smaller group which is lack of professional education and strong financial backing, their interest should also be well balanced without basis. Without solid proof that further reduced price spread can have positive effects in improving turnover, there is absolute evidence that it created really a disaster to the market ten years ago. HKEx must understand that maintaining an orderly market is far more important than to implement any market wide changes that is lack of general market support.