the hong kong society of financial analysts limited
香港財經分析師學會

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Hong Kong Exchanges and Clearing Limited
11th floor, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

Dear Sirs,

Re: <u>Consultation Paper on the Reduction of Minimum Spread (the "Consultation Paper")</u>

We believe that a reduction in spreads as proposed will be very beneficial to the HKSE and that HKEx should implement these changes as soon as possible. Indeed, we would prefer that phases one and two are combined and that all price ranges of stocks see adjusted spreads at the same time. Our reasons are quite simple:

1) As mentioned in the consultation paper, the system has not been changed since 1994. However, international trading practices have changed considerably and many markets have changed their systems over the years to meet those changes. For example, the New York Stock Exchange and NASDAQ only recently moved from the antiquated fractional pricing system to a decimal system, decreasing spreads in the process. Hong Kong must keep up with the times and be seen to be keeping up with the times to compete with global exchanges.

2) As market participants, we are very concerned with levels of market liquidity and are in favor of any changes that will increase liquidity. We strongly believe that the dollar value of derivative and index arbitrage trading strategies outweighs the dollar value of spread trading strategies. Many of the index arbitrage strategies have the potential to trade very large volumes of stock as the proposed reduction in trading spreads can help them lowering their transaction costs. The increased liquidity they bring to the market will help all participants, including small investors.

3) Wide spreads, such as the 1% spreads for HK$5.00 priced securities, actually encourages market manipulation, as stocks need only be pushed one or two spreads in either direction to achieve a large move in price. For example, China Life Insurance Company 'H' (stock code 2628), which currently trades at roughly HK$5.00 per share, has a market capitalization of HK$137bn, meaning that every spread changes the outstanding value of that company by roughly HK$1.37bn. The stock is roughly 9.3% of the 'H' share index. Thus, if an 'H' share portfolio had a market weighting in China Life, each spread would move the value of the portfolio by 9 basis points. Thus one can easily see that there is a lot of incentive to push the price of that stock. And even if there is no manipulation, a 9 basis points move of the fund's performance depending on whether the stock closes the month on the bid or on the offer is an absurdity!

4) As noted in the paper, many international exchanges use similar spreads as proposed here. Investors and brokers have adapted to those spreads and back offices do not report any major issues.

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The bottom line here is that Hong Kong **MUST** move with the times and encourage modern trading practices if it is to remain competitive. We believe that this change is long overdue and encourage the HKEx to adopt these changes as soon as possible. We also believe that the reasons for doing so are compelling enough to implement the proposed two phases at once. We feel it would be overly cautious to do the two-phase approach. Hong Kong needs to be proactive and be a leader, not a meek follower, of the rapid changes taking place in global financial markets. We applaud the HKEx in its current initiative and encourage it to be bold when introducing the changes.

Yours Faithfully,

For and on behalf of
The Board of The Hong Kong Society of Financial Analysts

Richard Mak, CFA
President