

Our Comments on

Consultation Paper

The Introduction of A Closing Auction Session



Hong Kong Stockbrokers Association

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Overall Comments

1. The current method of calculating the closing price has been in use since 1987 with only a minor enhancement in 1993 when the number of price points were increased from 3 to 5. In view of the adoption of a Closing Auction Session by most of the major markets, we agree that it is appropriate for us to review the mechanism for determining the closing price.
2. In general, we agree that a Closing Auction Session will likely provide a closing price which better reflects the end of day trading, and is more readily understood by the market participants and the general public.
3. However, we do have a number of concerns regarding the operational aspects of the Closing Auction, and the regulatory implications.

Operational Issues

1. Our major operational concern is with regards to the input and amendments of orders during the Closing Auction Session.
2. We understand that outstanding limit orders at the end of the continuous trading session will be carried over into the Closing Auction Session automatically by AMS3 without any intervention required on the part of the broker. This will go a long way towards reducing the lead time for brokers to amend their systems to cater for the Closing Auction.
3. Carrying forward unfilled orders is necessary as there will be insufficient time for brokers to re-input the orders. However, we believe that there will be insufficient time in the proposed 5 minutes Order Input Period for brokers to contact clients to determine whether they wish to change their unfilled orders from limit orders to at auction orders, and to make the appropriate changes. Thus, it is likely that the bulk of the orders will remain as auction limit orders.
4. As AMS3 only accepts orders within 25 price spreads during the continuous trading session, client orders beyond this are normally put "on hold" and released to AMS3 when the market price moves into range.

Under the Closing Auction mechanism, the price may fluctuate within a very wide range causing the release of "on hold" orders to AMS3. However, if the price moves back before the released orders reach AMS3, then they will be rejected as



out of the price range. As the price fluctuates, we envisage that brokers may find it difficult to enter “on hold” orders on a timely basis with the result that clients orders may not be entered prior to the Pre-Order Matching Period and therefore not included in the order matching.

5. The Consultation Paper envisages that in the Pre-Order Matching Period, only at-auction orders will be accepted and orders cannot be canceled or modified. We are concerned that if an error is made in the input, the broker will be exposed to unacceptable market risks as errors will have to be carried overnight into the next trading day before they can be unwound. This is unlike an Opening Auction where the error can be made good during the following continuous trading session.
6. We do not consider that a Random Closing should be considered as this will re-introduce arbitrariness into the process and detract from the original aim of the Closing Auction i.e. ensuring that the closing price fairly is fairly reflected.
7. As the closing price determined will impact derivatives trading, the closing time for derivatives trading should be extended accordingly.
8. Similarly, the closing price as determined by the closing auction should be included in the calculation of the Final Settlement Price.

Regulatory Issues

1. We are concerned that the Closing Auction Session, and in particular the use of at-auction orders, may be exploited by market manipulators to “mark the close”.
2. In the April 2007 issue of the SFC Enforcement Reporter, the SFC re-iterates that “marking the close” i.e. placing orders at the market close to fix or influence an artificial closing price, is considered market manipulation and is illegal under the SFO. The SFC expects that brokers should not execute such orders for clients.
3. However, under the proposed Closing Auction mechanism, brokers may be asked by clients to place an at-auction order which may result in a closing price that is far beyond the previously traded prices. As the final price is based on the order flow, the broker placing an at-auction order for a client has no way of knowing what price will result from such an order, and therefore cannot be held responsible for lack of monitoring.



Summary

1. We are in agreement that a Closing Auction Session will provide a fairer and more transparent closing price. However, we believe that there are a number of client service, operational and regulatory issues that need to be addressed.
2. We will be in a better position to determine that lead required for amending systems once the details of the Closing Auction are finalized.