31 December 2008

Hong Kong Exchanges and Clearing Limited
12th Floor, One International Finance Centre
11 Harbour View Street
Central
Hong Kong

Dear Sirs,

Consultation Paper on Introduction of a Price Control Mechanism During the Closing Auction Session in the Securities Market

[redacted] appreciates the opportunity to comment on the Exchange's consultation on the introduction of a price control mechanism during the Closing Auction Session ("CAS") in the securities market.

Under this consultation paper, the Exchange has suggested the following Approaches:

Approach 1 – Impose a price control limit based on a pre-set percentage from nominal prices at 4 pm

Approach 2 – Impose a price control limit based on a pre-set number of spreads from nominal prices at 4 pm

Approach 3 – Impose a price control limit based on the day high and day low prices at 4 pm plus and minus a pre-set number of spreads

The Exchange also suggests the suspension of CAS as a whole.

Our Comments on Approach 1, 2 and 3

The imposition of any price control limit would create artificial pricing barriers. Hence, in our view, the 3 proposed approaches have the potential to impair price discovery during CAS.

In addition, although constraining the closing price within a specified range of the nominal price may be an effective way to prevent price dislocation, it would also introduce potential issues of disallocation of executed volume, especially for small orders.

This is in direct contradiction to the best interest of the market and the aims of the CAS, namely, the provision of a fair and market-driven method of closing a trading session and determination of closing prices based on aggregated market demand and supply.

Approaches 1 and 2
These approaches will cause a substantial majority of the trading to occur before the CAS, and in particular, at 4 pm so as to mark the nominal price on which the CAS price limit will be based.

Approach 3
Where there is major order imbalance at either end of the price limit parameters, there could be extreme price moves. This could happen when a stock is traded at day high or day low at 4 pm and then closed at the opposite end of the price limit during CAS.

Alternative Suggestion for a new Closing Process

We believe any approaches to be adopted by the Exchange should take into account of three important attributes:

1. early price discovery;
2. cater for short selling activities; and
3. minimize the opportunity for price / market manipulation.

We would therefore suggest re-engineering the whole closing process. Our suggested model is discussed under item 6 below.

Our Comments on Suspension of Closing Auction

The introduction of the CAS is a move in the right direction. Suspension of the CAS will only reinstate the age-old issues with the previous closing mechanism, such as: market inefficiencies in the closing minutes of trading, widening of bid ask spread near market close, difficulty to facilitate portfolio valuation and index rebalancing activities at close; and stock price manipulation.

Our Responses to Consultation Questions

(1) Do you support Approach 1, Approach 2, Approach 3 or suspending the CAS as a whole? Please state.

As discussed above, we are not in favor of any of these approaches or the suspension of the CAS as a whole. That said, if the Exchange is to adopt one of these suggestions, we would prefer Approach 1 because:

a. Approach 1 has a pre-defined percentage price limit for all stock price ranges as compared to varied price moves under Approach 2; and
b. Approach 1 would not generate such extreme price moves as one may envisage under Approach 3.

(2) **If Approach 1 is adopted,**

a. **Do you prefer the price limit to be set at 5%, 10% or other percentages?**
b. **How much lead time would your firm require for its implementation?**

If Approach 1 is adopted despite our comments above,

a. we would prefer the price limit to be set at between 5-10% of the nominal price at 4:00 p.m.
b. our firm would need 4 weeks to implement this.

(3) **If Approach 2 is adopted,**

a. **Do you prefer the price limit to be set at 10 spreads, 24 spreads or other spreads?**
b. **How much lead time would your firm require for its implementation?**

If Approach 2 is adopted despite our comments above,

a. we would prefer the price limit to be set at not less than 48 spreads of the nominal price at 4:00 p.m.
b. our firm would need 4 weeks to implement this.

(4) **If Approach 3 is adopted,**

a. **Do you prefer the outstanding orders priced outside the pre-set range to be cancelled instead of carrying forward to the CAS?**
b. **For securities without the day high and day low prices at 4 pm, do you prefer disallowing order input during the CAS for these securities or not imposing a price control limit at all?**
c. **Do you prefer the price control limit to be set at 0 spreads (i.e. simply using the day high and day low prices as limit), 10 spreads or other spreads above the day high and below the day low prices?**
d. **How much lead time would your firm require for its implementation?**

If Approach 3 is adopted despite our comments above,

a. we would prefer the outstanding orders priced outside the pre-set range to be carried forward to the CAS;
b. for securities without day high and day low prices at 4 p.m, we would prefer not imposing a price control limit at all;
c. we would prefer the price limit to be set at not less than 48 spreads of the nominal price at 4:00 p.m.
d. our firm would need 4 weeks to implement this.

(5) **If suspension of the CAS is adopted, how much lead time would your firm require for its implementation?**

We do not recommend that the CAS be suspended given our comments above. However, if suspension is adopted, our firm would need 4 weeks to implement this.

(6) Do you have other proposed measures to reduce price volatility during the CAS or other comments or suggestions regarding the CAS? Please state.

We would like to suggest an alternative Closing Process that is fair, transparent and easy to understand. We have approached this from considering the principles outlined in your Consultation Conclusions Paper (http://www.hkex.com.hk/consul/conclusion/cac.pdf), namely:

- The introduced closing auction mechanism must be fair, transparent, and easily understood by market participants;
- The closing auction should reflect other relevant trading practices where possible in order to simplify the implementation efforts by HKEx and market participants. Incremental enhancements to the introduced mechanism could be considered after market-wide acceptance for the revised closing auction procedures has been established; and
- Sufficient lead-time should be given to ensure market readiness.

Important Attributes

With the aforementioned principles in mind, we suggest the following attributes of an effective method for closing price determination:

1. **Early price discovery:**

An early establishment (and communication) of an equilibrium price attracts providers of liquidity to offset any perceived market inefficiencies in the closing minutes. The longer the time window available to these opportunistic providers of liquidity, the more efficient the result.

2. **The inclusion of short-selling liquidity, with the caveat that the market is sensitive to certain perceived effects of short selling:**

Short-sellers are a useful source of liquidity in offsetting large buy orders that may cause dislocations. The HK borrow requirements and uptick rule are effective controls on short-selling.

3. **The prevention of modification or cancellation of orders of either a certain type or after a certain phase of the closing establishment:**

Preventing the last-second modification or withdrawal of orders is an effective tool in the establishment of a true and appropriate closing equilibrium price.

4. A short 'lock' period during the auction process, as the equilibrium price is determined:

This is used to allow communication of the established equilibrium price to all market participants. This is most effectively used when a prevention of modification/cancellation comes into force, in order to allow the equilibrium price information to be absorbed by the market.

5. The ability to place orders that can only reduce the difference between the last pre-close print and the established equilibrium price:

This ability allows liquidity providers to contribute to the establishment of a fair closing price, while preventing the liquidity providing function from increasing any dislocation between the last pre-close price and the established equilibrium price.

Suggested Closing Process

We suggest the following combination and sequence of these attributes as one potential fair, transparent and easily understood closing process:

1. 16:00: Last traded price sets/fixes the uptick for short-sellers.
2. 16:00 - 16:05: An input period, that is identical to the existing input period, but shorter. As in the existing input period, the outstanding AMS/3 orders from the continuous trading sessions are carried forward to the closing auction. As in the existing input period, new-orders, modifications, cancellations are possible.
3. 16:05: End of the input period. All modification and/or cancellation of orders is prevented from this point.
4. 16:05 - 16:06: Equilibrium price distribution period. The auction order book is temporarily locked, and new orders are rejected by the exchange. During this period the exchange publishes the IEP and IEV.
The period should be as short as possible, but long enough for he IEP/ IEV information to be effectively absorbed by the market.
5. 16:06 - 16:10: Liquidity provision period. New orders that have the effect of reducing the absolute difference between the last pre-close price and the IEP are accepted to the order book. All other new orders are rejected by the exchange.
6. 16:10: Market closing time. Establishment and distribution of the closing price.

Key Attributes of the suggested Closing process

1. It is fair, transparent, and easy to understand;

2. It is easily implementable by the exchange, and requires little additional work by market participants;

3. It encourages the early disclosing of closing orders;

4. The publication of the largest potential dislocation from the last pre-close print happens before the close is established, enabling liquidity providers to step in;

5. The liquidity provision period allows the provision of additional liquidity in a manner that cannot cause further dislocation from the last pre-close print; and

6. Short sellers are able to participate in the process, but are still constrained by the same uptick rules as for continuous trading.

If you have any questions or want to discuss further on our comments, please contact [redacted] of our Compliance Department at [redacted].