PART B: DETAILED QUESTIONS FOR RESPONSE

Please indicate your preference by providing comments as appropriate. Where there is insufficient space, please attach additional pages as necessary.

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

(2) If Approach 1 is adopted,

   (i) Do you prefer the price limit to be set at 5%, 10% or other percentages?

   (ii) How much lead time would your firm require for its implementation?

(3) If Approach 2 is adopted,

   (i) Do you prefer the price limit to be set at 10 spreads, 24 spreads or other spreads?

   (ii) How much lead time would your firm require for its implementation?

(4) If Approach 3 is adopted,

   (i) Do you prefer the outstanding orders priced outside the pre-set range to be cancelled instead of carrying forward to the CAS?
No.

(ii) 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?

If a security has not high and low at 4pm, high and low for the day should be set to previous close for the purposes of calculating the price control limit

(iii) 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?

A percentage limit would be more sensible and less prone to future changes in spreads, which is artificial and has potentially confusing effects at price-tick boundaries.

(iv) How much lead time would your firm require for its implementation?
n/a

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

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

- End -

To:

Corporate Communications Department

Hong Kong Exchanges and Clearing Limited

12th Floor, One International Finance Centre

1 Harbour View Street, Central, Hong Kong (2524-0149)

From:

YUEN, Yui Chi Peter (Mr)

Re:

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

Dear Sir/Madam,

I support the HKEx's recent move to effect stabilization measures on the closing auction and I believe that some form of stabilization measure is useful in order to limit the effects that a number of common institutional market practices such as index rebalances and hedging of derivatives instruments may have on market stability. As stated in my previous correspondences with you, I am of the belief that the HKEx's current closing auction session has in some cases, such as the MSCI index reconstitution on 30 May 2008, been complicit in increasing volatility and perhaps allowed for certain participants to partake in market manipulation. I write to register the following views, which are discussed below:-

1. That a closing auction mechanism has been beneficial to the market and should be retained
2. That the HKEx's proposal for a price control mechanism based on some function of day high/low (i.e. option three) would be beneficial
3. That additional measures not mentioned in the current consultation paper should be considered to improve liquidity and stability both in the closing auction and in general.

I also wish to thank you for your extensive conversations with market participants like myself with regards to improvements on the closing auction and for adopting some of our suggestions.

1. **Retention of the Closing Auction Mechanism**

As the original author of the "Asian Closing Price Mechanisms" report that is referenced in your original consultation document in 2006, I would firstly like to note that I am a strong supporter of HKEx's adoption of a closing auction and it is natural for me to reiterate my belief that option four (4) as stated in the current proposal (i.e. the removal of the closing auction), would be a backward step for the HKEx. Indeed, many institutional participants will echo my view that the introduction of a closing auction mechanism has led to improvements in both liquidity and a simplification in the execution of hedging strategies for both index funds and market participants engaged in derivatives hedging. I am sure I need not reiterate the importance of having a derivatives-friendly market mechanism to the HKEx which will need to continue innovating in order to retain its title as the number one equity warrants market globally.

2. **Adopting a Price Control Mechanism based on Option Three**

In terms of robustness against manipulation, I am of the opinion that option 3 is superior to mechanisms that are based on a single price (i.e. options 1 and 2). The use of high/low as a benchmark allows the mechanism to take into account the natural changes in intraday prices for individual stocks - that is, more naturally volatile stocks and volatile days will have constraints suited to its specific market conditions and not be affected unduly by arbitrary constraints as would happen via options 1 and 2.

However, in addition to that suggested in the consultation document, care must be taken to ensure that:-

i. Reasonable methods are in place that considers stocks that have not traded on a given day. This can be achieved either by removing the price control completely or by setting the high and low of the day to be the previous day's close for the purposes of calculating the price limits (which would need to be wider than the high/low range of the day). Such measures ensures that even illiquid stocks have a reasonable trading range at the closing auction; and

ii. Price controls are based percentages rather than spreads. The HKEx should consider using percentage limits due to the fact that the use of high/low fluctuations are inherently a measure of percentage change (in fact, it is very similar to the so-called Parkinson's volatility measure) and a percentage limit on top of the high/low benchmark is the natural measure to use. Furthermore, percentage limits are not subject to potentially confusing changes due to future tick size changes or asymmetries due tick size boundaries.

3. Further Measures to Improve Market Liquidity and Stability

Finally, as discussed with your colleagues previously, I would call on the HKEx to take extra steps to improve the currently used auction design. As pointed out in your previous consultation documents, the design of a closing auction should have at least the following goals in mind:-

1. Allow for precise hedging for index funds and derivative instruments

2. Increasing liquidity

3. Reduce the opportunity for gaming and market manipulation

4. Reduce volatility and encourage market stabilization

However, in contrast to these stated goals, it is my belief that the current 'pre-order matching' system whereby market orders are allowed but limit orders are disallowed actually encourages gaming, increases volatility and makes hedging more difficult and risker. My reasons below:-

1. *Index Rebalances*

Because most index rebalances are executed by brokers under a guaranteed close agreement, brokers can maximize their profit by causing large price spikes at the close.   Under the current auction rules, brokers can manipulate the price by not placing any volume during the order-input period and placing their entire order at market (which can amount to several days of trading volume) at the last minute during the pre-order matching period.   Because no limit orders are allowed, arbitrageurs, who have historically provided liquidity in previous rebalances, are unable to (short) sell or place opposing buy limit orders to offset a spike in the indicative closing price. (The ability to place at-auction market orders (which cannot be canceled) does not help as arbitrageurs would fear too many other arbitrageurs joining in and resulting in price volatility in the other direction). This situation suggests that the current pre-auction period actually encourages gaming and price volatility.

2. *Derivatives Hedging*

The volatility created by index rebalances may have been exacerbated by the hedging activities of brokers who must hedge warrants.   Because Hong Kong has the largest listed warrants market in the world, banks tend to hold very large 'short gamma' positions which they tend to hedge by increased buying when a stock goes up and increased selling when a stock goes down.   When warrants market makers were confronted with large price movements on Friday, they may have been forced to send even more at-auction market orders in the same direction during the pre-order matching period.   Furthermore, 'long gamma' participants who wanted to hedge would have been completely unable to send opposing limit orders for hedging.   There are other, more esoteric reasons, for holders of complex derivatives (such as variance swaps) to influence the closing price.

In order to provide more opportunities for market stabilization and to alleviate the aforementioned issues, the design of the closing auction could be modified in one of at least several ways:

a.   *Random Closing Time*

While this was proposed by me and a number of other respondents to your original consultation document in 2006, this was rejected on the grounds of being overly complicated. However, random close mechanisms have proven themselves in a number of other markets to reduce the incidence of gaming. In such a scenario, a random closing auction time, say, from 16:08-16:12 where both market and limit orders could be submitted (but perhaps not amended or canceled) would, in my opinion, contribute significantly to a reduction of volatility and opportunities for market manipulation. In this light, I urge you to reconsider your decision on the adoption of a random closing time.

b.   *Reversal of Order Input and Pre-Match periods*

In the current system, it is possible for one or more participants to manipulate the market by causing large price spikes at the close. Under the current auction rules, participants can manipulate the price by not placing any volume during the order-input period and placing a large order at market at the last minute during the pre-order matching period. Because no limit orders are allowed, arbitrageurs, who would otherwise try to profit by providing liquidity, are unable to (short) sell or place opposing buy limit orders to offset a spike in the indicative closing price. In contrast, the option to place at-auction market orders (which cannot be canceled) does not help as arbitrageurs would fear too many other arbitrageurs joining in and resulting in price volatility in the other direction. By reversing the system to allow for market orders in the first period but not the second period, this problem could be lessened. An example methodology is presented below:-

i.   *Order Input Period (16:00-16:05):* Both limit and market orders can be placed, amended or removed.

ii.   *Pre-matching Period (16:05-16:10):* Only LIMIT orders can be placed. No orders can be amended or removed. In addition, limit orders are subject to the requirement that they cannot be deeper than say, nine (9) levels from the last traded price/day high-low range etc.

c. Short Selling

Another stabilising force would be to allow short selling so that strong upwards price movements can be stabilized by short sellers hoping to profit.

At the very least, given the SFC's strict view on short-selling (which I believe to be unproductive), short-sell orders should be allowed at the last ask price as of continuous trading (although this could mean that index traders could try to manipulate the effective range of short-sellers by ramping the pre-close auction price). The ideal case, if the SFC would agree, is to allow short-selling at any price as long as borrow is secured. This would ensure that participants have the best tools and opportunity to help create a stable market.

In addition to being a negative force against intraday market stability, it is arguable whether the existing short-sell rules are fair, given that large institutions have a variety of legal ways of circumventing the short-sell rules while retail and smaller brokers are effectively bound by the restrictions.