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Comments On The

Consultation Paper On the Reduction of Minimum Spreads

Hong Kong Stockbrokers Association Limited

5 October 2004

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Executive Summary

1. While we support any in initiatives that aim to improve the HK market, we are not convinced by the arguments presented in support of a reduction in the minimum trading spreads.

2. The Consultation Paper suggests that reducing the trading spread may have the following effect:

   a. increase competitiveness of our market,

   b. improve market operating efficiency, and

   c. boost market liquidity.

3. In addition to the above, we believe that the trading spread reduction may also:

   a. reduce the need for brokers to make up out of their own pockets when handling special discretion orders involving average prices, or closing prices, and

   b. improve the reasonableness of quotes offered by market makers in derivative products.

4. We are concerned that the HKEx may be proceeding with a change that will only benefit a segment of the market (viz. the issuers of derivative instruments) at the expense of the rest of the market (including both institutional and retail investors).

5. As stockbrokers, we are concerned as to the costs of implementing the required changes and the attendant confusion in the market place among investors, which may lead to erroneous trades, and disagreements between brokers and clients.

6. While we understand that HKEx have to remain competitive, we believe that it must also consider the effect of the change on local investors who make up the majority of investors in terms of number, and the impact of the change on local trading volumes.

7. We do not agree that there is a pressing need for any change to the trading spread at this moment, nor do we agree that it is appropriate. In the event that a change has to be made in spite of the studies and evidence, we will agree under protest to a trial of your phase 1 proposal. Any further change beyond phase 1 proposal is totally unacceptable.

8. We wish to point out that the consequences of any changes to the trading spread (if any) and the results of phase 1 must be carefully evaluated. We believe that it is too hasty to comment on any further changes to the spread table and certainly too

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early to set a timetable for further changes. We urge the HKEx to review the trading spread table from time to time and consult the market before making any changes.

9. We would also need assurance from the HKEx that it would not pass the costs of implementing the changes to the brokerage community.

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Why is it necessary to change?

Academic Studies

1. Various academic studies on trading spreads (also called tick size in some markets) have pointed out that reducing the trading spreads do not necessarily, in and of themselves, lead to improvements in the market.

2. On the contrary, the "event driven" studies of markets that have implemented changes (such as the US, Tokyo and EuroNext) suggest that there were in fact deterioration in terms of transparency and market depth.

3. A study based on the HKG market reached a conclusion that "market quality … increases after a reduction in tick size". However, this study eschewed the "event driven" methodology, and chose to look at *different* stocks on either side of a price spread threshold without taking into account other factors such as the fundamentals of the different stocks, different trading patterns etc. As such, we believe that the findings do not support the conclusion drawn.

Actual Experience

4. A better case study is available. The SEHK implemented a change in the trading spread table in 1994 on an experimental basis. From 1 June 1994 trading spreads were reduced 50% across the board during a 4 months evaluation period.

5. During the evaluation, trading volumes fell substantially and the SEHK reverted to the original trading spreads for stocks trading below HK$10. Although it was suggested that the brokerage industry may have "engineered" the fall in volumes, this does not stand up to scrutiny as it goes against the profit motive. In fact, trading volumes may have decreased due to the lack of daytrading opportunities caused by the reduced spreads. Furthermore, the confusion in price spreads caused numerous disagreements between investors and exchange participants, and the exercise was an unmitigated disaster causing untold damage to the reputation of our market.

6. Actual experience has shown that reducing trading spreads has the effect of reducing market liquidity and not increasing it as has been suggested. Day trading is a major component of our trading volumes and contributes significantly to the liquidity of the market. Reducing spreads benefits liquidity demanders at the expense of liquidity suppliers.

7. There is no solid proof that smaller price spread can have positive effects in improving turnover, but 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 changes benefits one segment

of the market at the expense of the market as a whole.

Front Running

8. Studies in other markets suggest that *reducing* the trading spreads actually *increases* the potential for front running by making it cheaper to "improve" the price posted by "limit orders" and reduce the downside risk of the market moving against a front running trade.

9. Reducing spreads would force investors to change their trading behavior and use market orders instead of limit orders, or to reduce the size of limit orders so as to disguise their trading. This of course will reduce market liquidity and transparency.

10. Front running is an irregular activities should be prevented by better internal control, supervision and education. This reason must not be misused as a supporting reason to the spread changes. Besides, smaller price spread with a narrow market depth may not prevent front running from happening.

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Impact of the Change

1. The reduction in trading spreads will impact all participants in the market including the HKEx and its subsidiaries, investors, and brokers. All the existing systems for trading and settlement will need to be modified to accommodate the changes.

2. As the changes are market wide, we envisage that there will need to be market wide rehearsals of the trading and settlement systems to familiarize the participants with the new spreads. Education of retail investors will be of primary importance so as to reduce the incidence of wrong orders and misunderstandings.

3. From the brokers' standpoint, our operating costs will increase in line with the expected increase in order amendments and cancellations. We will need to provide for additional capacity to do the same level of business. We expect that the HKEx will also be in the position of having to increase throughput capacity in order to cope with the increase in orders posted.

4. It will also take more confirmed trades to execute a large order, which may be spread over a wide spectrum of prices. Since the HKEx charges brokers for each completed trade (i.e. trading tariff), transaction costs will also increase for all brokers. Since the removal of the minimum commission, the ability of brokers to pass this increase on to the clients is minimal. Therefore, the HKEx should consider lower or abolish the trading tariff should the reduction in trading spreads take effective.

5. The narrowed spread may lead to extremely large volatility in share price, and the current market depth may not be enough to avoid a drastic fall or rise when an error order is entered into the AMS system.

6. To offset the consequence of unnecessary volatility, we agree that the HKEx should extend its current 8 price spread restriction (both bid and ask side) so as to allow a larger market depth to build up.

7. In addition, we urge the HKEx to consider implementing some kind of "Circuit Breaker" system. For example, when the share price dropped substantially for certain percentage compare to previous closing price, the relevant stock will be suspended for a short period of time. The suspension can provide more time to HKEx in approaching relevant listed companies for reason; while on the other hand, investors can have more time in noticing such price drop.

8. We would also need assurance from the HKEx that it would not pass the costs of implementing the changes to the brokerage community.