HKEX Consults on Reducing Minimum Spreads for Hong Kong Securities

The Hong Kong Stock Exchange (**HKEX**) has published a Consultation Paper seeking feedback on proposals to reduce the minimum spreads – or tick sizes – of certain Hong Kong securities, including equities, REITs and equity warrants, in two phases. Suggested by the Hong Kong Government-appointed Task Force on Enhancing Stock Market Liquidity, the proposals aim to improve Hong Kong market liquidity and the global competitiveness of the Hong Kong market by lowering bid-ask spreads and transaction costs.

The HKEX is requesting feedback on the proposals and has set a cut-off date for comments of September 20, 2024.

Rationale for Proposed Minimum Spread Reductions

Minimum spread is the smallest price change for stocks traded on an exchange. It determines the bid-ask spread – the difference between the highest bid price and the lowest ask price for a security – which is a transaction cost and impacts trading liquidity. The current spread cost when trading securities on the HKEX is apparently higher than in many other major markets, and reducing minimum spreads could help lower this cost. However, these reductions could potentially thin the order book depth and deter trading in less liquid stocks, causing a net decrease in liquidity. Thus, the HKEX's proposals seek to maintain a balance between spread cost reduction and overall trading quality and liquidity.

The HKEX recognises that minimum spreads affect the bid-ask spread and, consequently, the trading liquidity of stocks, particularly those that are "tick constrained" or trading at or near the minimum spread. A stock is considered to be "tick constrained" if trading of the stock is restricted by its minimum spread, which is indicated by its bid-ask spread almost always being at or very close to the minimum spread. The Consultation Paper warns that too small a minimum spread could fragment orders across multiple price points, thereby thinning the order book depth and reducing execution efficiency. This could deter various investor groups, such as active traders who seek prompt execution, block investors who aim for fewer price points to limit slippage, and retail investors who might prefer wider spreads for economic benefits from passive round-trip trades.

Hong Kong Equities Market Liquidity Profile

Average Daily Turnover (**ADT**) is used as a measure of liquidity and generally provides an indication of the level of market interest in a stock. The Consultation Paper notes that stocks priced at or below HK$0.5, which constitute over 34% of the Hong Kong market by number, have minimal ADT and are therefore less liquid. These low-priced stocks are therefore not ideal candidates for spread reduction given their already thin order books.

Stocks priced between HK$0.5 and HK$500, however, account for a significant portion of ADT and have better trading liquidity, making them more suitable for spread reduction. The HKEX emphasises the importance of selecting stocks with sufficient order book depth for spread reduction, to avoid compromising net trading liquidity. Higher-priced stocks above HK$0.5 are noted to generally have deeper order book depth, suggesting they are better equipped to handle the potential negative effects of spread reduction and may be ideal candidates for spread reduction.

The Consultation Paper notes the diversity of investors in the Hong Kong market which includes institutional investors, market makers and retail investors which each exhibit different trading behaviours and preferences regarding minimum spreads. The HKEX has considered these varying needs and behaviours in proposing changes to minimum spreads, acknowledging that different investor groups have distinct interests in various types of stocks. Retail investors, for example, tend to prioritise overall trading profit over spread cost when making investment decisions about specific stocks.

Transaction Costs and Minimum Spread Models on Other International Exchanges

The bid-ask spread in the Hong Kong market is comparatively higher than that on other major exchanges like Japan, Mainland China, the UK and the US. The HKEX considers that there is potential to reduce transaction costs in Hong Kong by lowering the minimum spread, although this is just one of several factors influencing costs, with others including the inherent liquidity of stocks. Current transaction costs in Hong Kong also include stamp duty, exchange and regulatory fees, levies and broker commissions, all of which affect trading behaviour.

Globally, exchanges typically follow one of three minimum spread arrangements:

- a uniform spread at all price levels, as seen in Mainland China and the US, where a standardised minimum spread and board lot size apply across all stocks;

- a single spread table for all stocks, which uses a tiered approach to set minimum spreads that increase by price band, as used by the HKEX and the Australian, Korean, Singapore and Taiwanese stock exchanges; and

- multiple spread tables, as used by the London and Japanese stock exchanges, which group stocks based on specific liquidity measures, such as trading volume or ADT, and assign stocks with higher liquidity or ADT to spread tables with smaller minimum spreads.

Several of these exchanges have reduced their minimum spreads or adjusted their spread arrangements over the last 20 years. The Japanese stock exchange, for example, introduced a tighter spread table for certain stocks twice, in 2014 and again in 2023, with an assessment in 2024 indicating success in reducing investor execution costs, but a decrease in order book depth at individual price points due to order dispersion.

Past Minimum Spread Review in ETPs Conducted by the Exchange

On June 1, 2020, the HKEX implemented reduced minimum spreads for Exchange Traded Products (**ETPs**) by 50% to 90% across various price bands to enhance trading flexibility and decrease transaction costs for investors. This change led to a narrowing of bid-ask spreads for over 70% of listed ETPs in Hong Kong, with a notable average reduction of 54% among highly traded ETPs with an ADT exceeding HK$100 million. The HKEX also improved the market-making regime for ETPs, which likely contributed to the reduced spreads.

Application of HKEX's Proposed Minimum Spread Reductions

The Consultation Paper's proposals are based on its reviews of the liquidity profile of the Hong Kong securities market, international practices, recent reductions in minimum spreads in the ETP market and initial market feedback. The proposed changes would apply to equities, REITs, and equity warrants (**Applicable Securities**), while the minimum spreads for debt securities, Exchange Traded Options, ETPs and structured products would remain unchanged. This is because minimum spreads for ETPs were reduced in 2020 and are trading efficiently, while structured products and debt securities exhibit different trading behaviours and characteristics, for example, structured products are typically priced below HK$2.

Proposed Minimum Spread Reductions

The HKEX proposal includes a phased approach to reduce minimum spreads.

In Phase 1, it proposes:

- a 50% cut in minimum spreads for securities priced between HK$10 and HK$20; and
- a 60% cut in minimum spreads for securities priced between HK$20 and HK$50.

This group represents a significant portion of ADT and has both relatively high tick-to-price ratios and sufficient order book depth to absorb the change. The HKEX plans to observe the effects of phase 1 for six months before considering the implementation of phase 2, with its decision informed by the results of phase 1 and feedback from the market and regulators.

Phase 2, if implemented, would:

- introduce a 50% reduction in minimum spreads for securities priced between HK$0.5 and HK$10, which currently have high tick-to-price ratios and reasonable order book depth; and
- exclude the most liquid stocks to avoid impacting visible liquidity.

Price Bands Excluded from Spread Reductions

Certain price bands are not included in the proposed spread reductions:

- stocks priced between HK$0.01 and HK$0.25, and HK$0.25 and HK$0.5, which represent a small portion of equity ADT and are favoured by retail investors for their larger spread, will keep their current minimum spreads; and
- stocks priced above HK$50 will also not change as their tick-to-price ratios already align with the targeted range and international practices.

The proposed changes to minimum spreads under phases 1 and 2 are summarised in the tables below.

PROPOSED MINIMUM SPREADS FOR PHASE 1				
Price Band in HK$	**Original minimum spread**	**Proposed minimum spread**	**Original tick-to-price ratio (bps)**	**Proposed tick-to-price ratio (bps)**
From 0.01 to 0.25	0.001		40-1000	
Over 0.25 to 0.50	0.005		100-200	
Over 0.50 to 10.00	0.010		10-200	
0.50 to 1.00	0.010		100-200	
1.00 to 2.00	0.010		50-100	
2.00 to 5.00	0.010		20-50	
5.00 to 10.00	0.010		10-20	
Over 10.00 to 20.00	**0.020**	**0.010 (-50%)**	**10-20**	**5-10 (-50%)**
Over 20.00 to 100.00	**0.050**	**0.020 (-60%) /0.050**	**5-25**	**4-10 (-60%) / 5-10**
20.00 to 50.00	**0.050**	**0.020 (-60%)**	**10-25**	**4-10 (-80%)**
50.00 to 100.00	0.050		5-10	
Over 100.00 to 200.00	0.100		5-10	
Over 200.00 to 500.00	0.200		4-10	
Over 500.00 to 1,000.00	0.500		5-10	
Over 1,000.00 to 2,000.00	1.000		5-10	
Over 2,000.00 to 5,000.00	2.000		4-10	
Over 5,000.00 to 9,995.00	5.000		5-10	

PROPOSED MINIMUM SPREADS FOR PHASE 2				
Price Band in HK$	**Original minimum spread**	**Proposed minimum spread**	**Original tick-to-price ratio (bps)**	**Proposed tick-to-price ratio (bps)**
From 0.01 to 0.25	0.001		40-1000	
Over 0.25 to 0.50	0.005		100-200	
Over 0.50 to 10.00	**0.010**	**0.005**	**10-200**	**5-100**
0.50 to 1.00	0.010	0.005 **(-50%)**	50-100 **(-50%)**	
1.00 to 2.00	0.010	0.005 **(-50%)**	25-100 **(-50%)**	
2.00 to 5.00	0.010	0.005 **(-50%)**	10-25 **(-50%)**	
5.00 to 10.00	0.010	0.005 **(-50%)**	10-20 **(-50%)**	
Over 10.00 to 20.00	0.010		5-10	
Over 20.00 to 50.00	0.020		4-10	
Over 50.00 to 100.00	0.050		5-10	
Over 100.00 to 200.00	0.100		5-10	
Over 200.00 to 500.00	0.200		4-10	
Over 500.00 to 1,000.00	0.500		5-10	
Over 1,000.00 to 2,000.00	1.000		5-10	
Over 2,000.00 to 5,000.00	2.000		4-10	
Over 5,000.00 to 9,995.00	5.000		5-10	

Impact of Minimum Spread Reductions

The proposed changes are quantified as follows:

- Phase 1 would affect 283 securities (about 11% of Applicable Securities, representing 29% of ADT); and
- Phase 2 would impact 1,345 securities (about 51% of Applicable Securities, accounting for 24% of ADT).

Spread table arrangement

In Hong Kong, a uniform spread table is applied to all securities, which sets minimum spreads that escalate with price bands but does not differentiate based on liquidity. This system maintains a consistent tick-to-price ratio, which is considered beneficial for executing strategies within a particular product segment.

However, a significant drawback of the single spread table approach is that it does not account for the liquidity of individual stocks. Highly liquid stocks may be limited by large minimum spreads (tick constrained), while the orders for less liquid stocks may be scattered across numerous price levels, which can dilute visible liquidity and hinder effective price discovery.

A multiple spread table model for setting minimum spreads in equity markets based on both price and liquidity can mitigate the issues of dispersed liquidity in less liquid stocks. This model is complex, however, and requires regular updates to account for changes in stock liquidity, and demands greater engagement from market participants to incorporate data into their systems and test algorithmic trading strategies.

Initial market feedback showed a preference among market participants for a single spread table, favouring simplicity, consistency and lower costs in the Hong Kong equities market. The Consultation Paper therefore proposes maintaining the single spread table model for Applicable Securities.

Other Matters Affected by the Proposed Minimum Spread Reductions

Quotation Rules

The proposed reduction of minimum spreads for Applicable Securities will result in tighter price limits for order input, which will be governed by the quotation rules in terms of number of minimum spreads. In view of this, the

HKEX considers that there needs to be a review of the quotation rules in conjunction with the proposed minimum spread review.

Order input prices during the Continuous Trading Session are governed by the relevant quotation rules under the Rules of the HKEX. The quotation rules are intended to ensure that only orders priced within a specific range are entered into the HKEX's trading system to allow smooth price discovery and manage the trading system's capacity.

The allowable price limits for Applicable Securities are currently set within ±24 spreads, but with the proposed reduction of minimum spreads, these limits could be reduced by 50% to 60%. To mitigate the impact of this reduction, the HKEX is considering adjusting the quotation rules for Applicable Securities. It is looking to adopt a dual structure price limit system, which is already in use for ETPs and would additionally adopt a percentage-based quotation limit which is adopted by other exchanges such as the Shanghai, Shenzhen and Korean stock exchanges.

The proposal would involve setting order input price limits based on a fixed number of spreads or a percentage of the reference price, whichever is greater. The HKEX is proposing to adopt the same quotation rules as apply to ETPs. The price limits for Applicable Securities would then be the greater of ±24 spreads or ±3.5% from the reference price. This approach aims to address the narrowing price limits issue and align the quotation rules across all securities, facilitating easier adoption and technical implementation by market participants.

The HKEX also proposes to align the rules for opening quotations and transactions concluded outside the HKEX's trading system.

Market System Adaptability

If the HKEX expands the minimum spread reduction to price bands below HK$10, the minimum spread could be reduced to HK$0.005 for securities in the HK$0.05 to HK$10 price band. Initial feedback from some market participants suggested that some systems may need upgrades to handle more than two decimal places, for example for Exchange Traded Option trades, indicating that some market participants may need additional time to adjust to these changes.

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CHARLTONS
易周律师行

Hong Kong Office

Dominion Centre 12th Floor
43-59 Queen's Road East Hong Kong

enquiries@charltonslaw.com

www.charltonslaw.com
Tel: + (852) 2905 7888
Fax: + (852) 2854 9596