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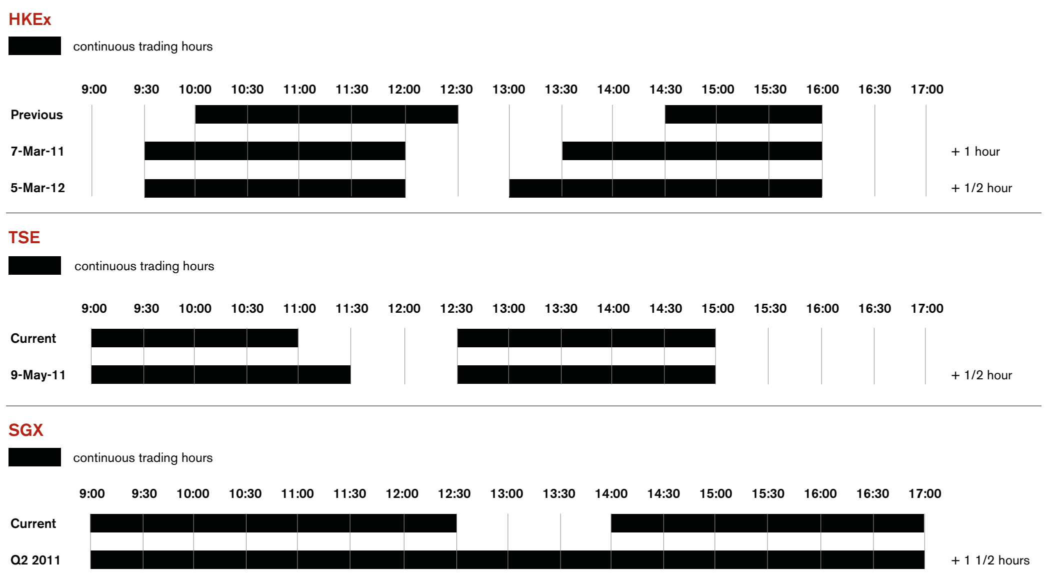
Asia-Pacific Market Hours Changes: A Distraction?

Key Takeaways

- **While the increase in total trading hours in Hong Kong, Japan and Singapore is being touted as a means to respond globalization, there is much more to be done to bring robust competition to the region.**
- **Though trading value in the region has increased in the past decade, the velocity of trading has not.**
- **Clearing costs, trading fees, slow infrastructure, regulatory constraints and inefficient market structures all contribute to Asia-Pacific's relatively low trading volume.**
- **A broader set of trading firms should soon be attracted to the region as competition between marketplaces begins to increase.**

Lunch breaks on several Asia-Pacific exchanges are getting shorter or going away altogether, resulting in a longer overall trading day in Japan, Hong Kong and Singapore (see below). Will this be enough, however, to stimulate the volume growth seen in other parts of the world? For example, in the US, competition between trading venues has ushered in a low latency infrastructure, lower trading fees and a variety of unique order types and functionality. The same has happened in Europe following the introduction of MiFID and is in the process of taking place in Canada. While market structure in each of these regions is not perfect, it has been successful in attracting a wide range of participants, which in turn have added volume and liquidity and reduced spreads. In our opinion, the Asia-Pacific markets will need to do more than simply increase the length of their trading days to attract liquidity to the region.

Market Hours Changes



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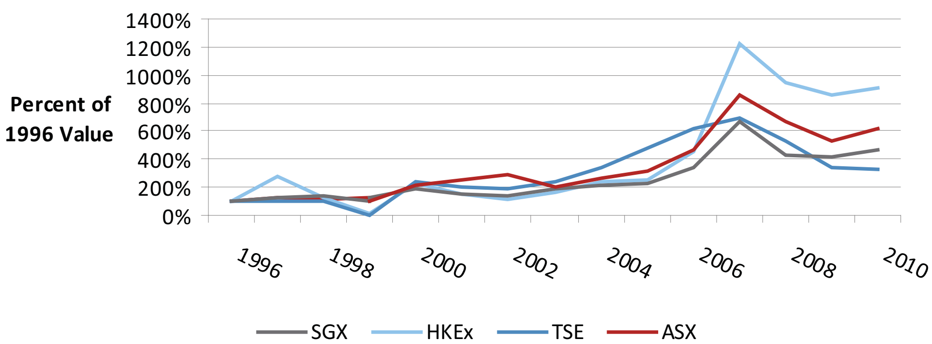
The exchanges have indicated their goals with the changes are:

- Increasing trading opportunities for investors.
- Increasing the ability of investors to respond to moves in Asian markets.
- Improving the convenience and reliability of the markets.
- Responding to changes in securities trading globally.
- Improving price discovery for mainland China-listed securities by increasing the overlap of trading hours with the mainland exchanges.
- Competing with regional exchanges by narrowing the trading hour gap.

While there are certainly compelling reasons to reduce or remove the lunch break, we believe there are other important factors impeding the growth of Asian trading volumes and market appeal. Until these issues are addressed, trading velocity – a measure of turnover and market activity – will not increase in the region.

Trading value on Asia-Pacific's four developed markets – Japan, Hong Kong, Singapore and Australia – has grown dramatically over the past decade. Leading the pack is Hong Kong, with the HKEx's turnover increasing more than 8x since 1996, primarily because of China's rapid economic growth and the number of Chinese IPO's that have used Hong Kong as their primary means of accessing foreign capital.

Value Traded in Local Currency Normalized to 1996



Source: World Federation of Exchanges

Examining trading volumes for longtime (1997-present) component stocks of the Hang Seng Index shows that average daily volume in many of these names has actually *fallen* since 1997, indicating that it's the number of new issues – not increased trading velocity – that has primarily driven HKEx trading growth.

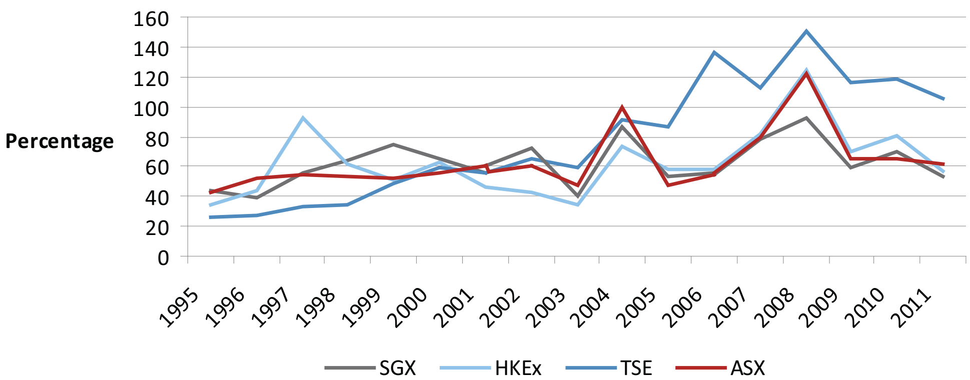
Longest Lasting Hang Seng Names: Change in Average Volume

	Average Volume 1997	Average Volume 2010	2010 vs 1997
CHEUNG KONG	7,495,013	4,621,403	-38%
HANG SENG BK	3,315,889	1,948,048	-41%
CLP HLDGS LTD	6,185,933	2,720,398	-56%
SUN HUNG KAI PRO	4,761,683	5,904,433	24%
SWIRE PACIFIC-A	3,579,454	2,064,343	-42%
WHARF HLDG	4,253,256	4,665,558	10%
HSBC HLDGS PLC	17,190,476	23,345,343	36%

Source: Bloomberg

An analysis of trading velocity also shows that Singapore, Australia and Hong Kong have returned to 2003 levels following 2008's trading upsurge caused by the global financial crisis. The exception is the Tokyo Stock Exchange, whose trading velocity has increased dramatically.

January Turnover 1995-2011



Source: World Federation of Exchanges

Another factor worth considering is the impact of the trading day extension on volume profiles. Will existing volume simply spread out evenly, thus reducing liquidity proportionally throughout the day? How will volatility and spreads be impacted? And finally, how much new trading must be attracted to each exchange for available liquidity profiles to remain unchanged at any given moment? While these questions remain open, we discuss below what we believe will be the primary roadblocks to increased trading in the four Asia-Pacific markets.

Factors Impacting Volume Growth on the Hong Kong Exchange:

- **Lack of Competition:** Most of the constraints listed below follow from this point. Without true competition – for both execution and clearing – the HKEx is not incentivized to build a low latency infrastructure, lower fees or create an efficient market structure.

- **High Clearing Costs:** At 12 basis points (10 bps stamp duty plus 2 bps HKEx clearing fee), total clearing costs are much higher in Hong Kong than in other markets, generally making short-term trading difficult if not prohibitive. With only a single central clearing counterparty in Hong Kong, there is no competition for clearing and thus no downward pressure on fees. Additionally, unlike in the UK, there is no stamp duty exemption for market makers.

- **Infrastructure:** Compared to other exchanges of its size, the HKEx has low capacity, high latency and a slow market data feed.

- **Fees:** Monthly fees charged by the exchange are based on incremental order throughput over a standard throttle rate, thereby providing a disincentive to placing orders and trades.

- **Retail Heavy:** Retail investors – who tend to have longer time horizons and trade in lower volumes than institutions – comprise a larger portion of the overall participant base in Hong Kong than in most other markets.

- **Inefficient:** For example, opening auction market orders only match if there are two or more corresponding matched orders. A single order will not match.

- **No Closing Auction:** The HKEx eliminated its closing auction in March 2009. The closing price is now determined based on the median of five nominal prices in last minute of trading. As a result, the close can be chaotic and illiquid.

- **Lack of Anonymity:** Orders and trades on the HKEx are identified by broker.

Since its open was made a half hour earlier and its lunch break a half hour shorter on March 7, many traders have found their attention split between Hong Kong and Singapore, making it more difficult to obtain quality fills. It remains to be seen if this difficulty is merely early growing pains or a larger structural issue.

Factors Impacting Volume Growth on the Singapore Exchange

- **Lack of Competition:** Similar to Hong Kong, there is little reason for the SGX to build a low latency infrastructure when they are the only game in town.

- **High Clearing Costs:** Clearing costs of four basis points, with a maximum charge of SGD600 (approximately USD475) per trade, are paid by the investor, not the broker. This is extremely expensive relative to other developed markets; for example, the cost of clearing in Japan is JPY75 per trade (less than 1USD). It should be noted that the SGX has lobbied the Monetary Authority to lower these costs.

- **Infrastructure:** In June 2010, SGX announced that it had partnered with Nasdaq OMX to develop a new trading platform – SGX Reach – powered by NASDAQ OMX's Genium INET. The release is scheduled for 2011. Given Genium's position as one of the fastest trading engines globally, this release will obviously greatly improve the latency, capacity and scalability of the SGX platform. That being said, the ASX rolled out this technology late last year and has had recent stability issues.

Factors Impacting Volume Growth on the Tokyo Stock Exchange

Both volume and turnover have increased in Japan, largely due to the existence of competition and fair access to a central clearing counterparty. The TSE competes against the Osaka Stock Exchange, JASDAQ and, more recently, several new proprietary trading systems (PTSes) that are beginning to make inroads. Additionally, the TSE in January 2010 introduced its next-generation Arrowhead trading engine, which has cut order response and data distribution times dramatically. The addition of colocation space at the TSE has also increased trading flow.

That said, constraints to the continued growth of trading in Japan include:

- Rigorous PTS license requirements, which impede the growth of competition.
- Little on shore trading due to onerous regulatory requirements.
- Reluctance of domestic investment to supporting alternative liquidity venues.
- Lack of recognition of Commission Sharing Agreements (CSAs) by the Japan FSA. As a result, execution cannot be rewarded to the same extent it is in other markets, thereby constraining the penetration of electronic trading.
- Under the Tender Offer Bid rules, a person or entity using an “off market” venue to acquire more than five percent of a listed company’s voting shares from more than 10 shareholders within a period of 60 days must submit a formal takeover or tender offer to the company's shareholders. If the trade is done on the TSE, the aquiring entity only needs to file a major shareholding report. This effectively limits the trading of stocks by PTSes to less than five percent of a company’s outstanding shares over a 60 day period.

Factors Impacting Volume Growth on the Australia Securities Exchange

While Australia already has a continuous trading day, the ASX has recently added new order types, announced a new infrastructure build and plans to launch a new market – PureMatch – later this year. All of these moves are generally intended to attract new trading participants and support electronic and high frequency trading, with Chi-X Australia* set to launch by the end of the year. Australia is a prime example of the prospect of competition spurring the development of trading infrastructure.

* Chi-X Australia is a wholly owned subsidiary of Chi-X Global Inc., a subsidiary of Instinet Incorporated.

Conclusion

While recent market structure developments have been controversial in Europe and North America, they have been necessary to incentivize liquidity provision as the market structure has moved away from a quote-driven market maker system. As this incentive is not present in Asian markets, it generally impedes liquidity provision and therefore increases many of the costs (spread, impact and clearing) of trading. The importance of competition lies in its ability to attract new participants and spur improvements in functionality and infrastructure on incumbent markets, all of which supports increased trading.

The question of what the Asia-Pacific markets should ideally look like is not an easy one, as simply copying the models of other regions will not suffice. But that's not to say that lessons can't be learned. To that end, we suggest the following:

- A fair and transparent process for allocating colocation resources.
- A regulatory environment that supports competition between marketplaces.
- A competitive clearing environment.
- Move cautiously in sanctioning internalization and watch the North American and European experiences as examples.
- Prohibition of early/preferential access to orders.

While the changes in trading hours are significant and signal a move forward, it is clear that competition is not fully formed in Asia-Pacific. For trading volumes to grow, the issues impeding competition in the region must first be addressed.

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