Webb-site.com looks at the problems with the new closing auction mechanism at HKEx, and explains how these could have been avoided.

Fixing the closing auction
2nd June 2008

If you are wondering why the closing auction system introduced by HKEx last Monday is proving somewhat easy to manipulate, its because everyone knows when the auction will end, at 4.08pm. A few seconds before that, they can jack up or push down the price, particularly in thinly-traded stocks. Introducing a random closing time for the auction in each stock, say between 4.04pm and 4.08pm, would make it more expensive to fix the price, thereby reducing manipulation. A fixer would have to sustain the price for up to 4 minutes, in the face of rational investors who may take the artificially high bids or low offers he had made.

When the closing auction was first discussed, your editor David Webb was a director of HKEx. Before the public consultation, he proposed using a random closing time, but the Board chose to go with the existing morning opening auction system, rather than learn from what markets in Australia, London and Germany had done. The consultation paper included the random closing time as an alternative (paragraphs 40-42), but did not recommend it.

Unlike opening prices, closing prices can affect fund valuations, warrant expiries and the settlement value of other derivatives, as well as the price at which share options are granted. There are plenty of reasons why a participant might want to push a price up or down. The random-closing refinement would have involved additional investment in system modification by both brokers and HKEx itself. Surely it is better to adopt a state-of-the-art system in one go than to change it in steps, repeating other markets' mistakes along the way. But the Board disagreed with our proposal.

However, HKEx did say in its conclusions paper that it would:

> "closely monitor trading behaviour and will evaluate the need for imposing random closing or other control measures for enhancing the closing auction mechanism if warranted".

Now would be a good time to do that, don't you think?

As a secondary issue, we also argued on the Board that once the auction is closed, the final "pre-order-matching period" should not be allowed to affect the closing price as it currently can. This would give investors certainty that any buy or sell orders given during that period would be transacted (if matched) at the known price fixed by the preceding auction.