the Nasdaq® trader's toolkit

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acknowledgments

Thanks to all the many professional traders whose experiences led to the writing of this book. Without their input and constant fight to keep ahead of the constant change that is today's electronic market, I doubt this trader would've written a thing. Special thanks to my friends at Nasdaq, the various electronic brokerages, and all the ECNs that have kept me posted on all the newest and latest changes to the execution routes and software platforms. Without your input, this book would never have been written. I owe special thanks to a friend who some years ago tore a dollar bill in half as a bet on who could make their first $5,000 in the market. The thought that this Swedish marine was gunning in earnest to beat me at this game focused my first efforts. That I won the dollar is not significant; that I discovered a new world of amazing possibility is.

contents

chapter 1

introduction

I'd like to start by saying I like "get-rich" books. Often they're fun and simply written, and they make me feel that hope and possibility is right here within my grip. Sometimes the books contain great ideas, sometimes not; sometimes they contain partial truths or outdated formulas. I think they tell us loads about our times and reaffirm a part of our basic human nature. Reading get-rich books from the turn of the century—nineteenth to twentieth, that is—is a lot of fun. For one thing, not much has changed regarding human nature, for all our technological prowess. The urge to trade, to speculate, and, yes, to gamble has been around since before recorded history. Anyone who gets a kick out of the great tech stock rally of the 1990s will get an even bigger kick out of the great tulip rally of seventeenth-century Holland. If one were to line up every get-rich book about the stock market, I suspect the line would be very long indeed.

This is *not* a get-rich book. In my time as proprietary trader, market maker, and head trader at one of the largest direct-access electronic brokerages, I've talked to thousands of people who, like me, have also read all the get-rich stuff and all the "stock-picking" books around. Like me, they are interested and even amused by the writings, but, in their attempts to better their financial lives, they have never encountered anything that deals with the realities of trading your own account in the digital age. There are unlimited books on stock picking, trading strategies, and sophisticated sales pitches, and pompous books by major institutional money managers who manage multibillions. While many of the books are very helpful, none seems to deal with the realities of how to buy and sell stock in the fast-moving electronic market. To that end, I decided to put on paper what I know about transacting in the electronic markets. Consider the following: If you own 1,000 shares of EBAY (eBay), RHAT (RedHat), or CIEN (Ciena), or any of the really volatile stocks—stocks that can drop two points in as many minutes—and you go to sell that stock, using the wrong route can wind up taking several minutes. Several minutes can mean several dollars. And on 1,000 shares, this can mean the difference between a healthy profit and a harsh loss. If this sounds familiar, read on.

So how do you buy and sell stock? You can hire a full-service brokerage to do it for you, and you can even enter your orders online (Charles Schwab, Datek, E*Trade, DLJ Direct, and many others offer excellent full service online) and suffer exorbitant commissions or less than stellar execution—one or the other, sometimes both at once. And if you are investing for the long term, this may be fine. But if you actively trade for a living, eventually you know you just have to do it yourself.

Full-service discount brokerages often take the other side of your trades, and nondiscount brokerages rape you with high commissions *and* take the other side. Eventually, if you trade for a living, you get burned enough to want to cut the broker's and trader's cost out of the equation. And due to new laws and technological advances, *you can*. While formerly reserved for market professionals at extreme, prohibitive cost, direct access to the stock, options (and soon the world's currency) markets is now available to individuals. Some electronic brokerages now offer the individual *direct* access to the securities markets for a small fee. It is a brave new world. If you have a computer and a phone line, you yourself can trade directly with the specialist on the floor of the New York Stock Exchanges (NYSE), and actually appear, along with all professional participants, on the "virtual floor" of the Nasdaq from anywhere in the world. You can have the control, you can do the execution, and you can keep all the proceeds that formerly went to the broker and trader.

But trading your own account directly entails certain responsibilities. Anyone who has ever traded through a direct-access–oriented electronic brokerage knows you don't just buy or sell. The securities markets *are markets*; there has to be a buyer if you're going to sell, and as a trader you have to locate that buyer and sell to him. We all know about the electronic communications networks (ECNs), and some brokerages claim their network is "the best"—but why? In what way? Every route of execution works differently in different situations. Given certain circumstances, all are truly amazing; in other circumstances, they fail dismally. The best of the electronic brokerages offer full access to a multitude of routes, so you can point and click to designate one or another, but which route is best to use in which situation? Anyone who does not take this question seriously has obviously never traded his or her own account.

And no discussion about which route is the fastest, surest way to transact would be possible without a thorough discussion of the road map of buying and selling: the Nasdaq Level II Quotes Montage. What is Level II and, more important, how do you interpret it? How do you tell what the market makers are doing? And what games and tricks do market makers play? Even though doing so will not endear me to my market-making friends, in this book I'm going to outline just what it is that market makers do, how they do it, and how to spot it. And it's okay that they'll be upset, because I'm the least of their problems. The world is changing. An electronic revolution in the truest sense is sweeping the world's equity markets, and many pillars of strength in the financial communities are reinventing themselves to avoid obsolescence.

This is, therefore, the first book about the new tools of the trade. What are those tools; how do you use them? With a little knowledge and today's technologies, you can buy and sell stock faster and more transparently than market makers themselves.

It's possible to turn a small trading account into an account worth millions. Many people worldwide have done just this. But it is more important to note that many more people have lost everything on the anvil called Speculation. Unscrupulous get-rich-quick schemes can be found in all industries and are especially prevalent in the fields of gambling and stock speculation. These may consist of simple or complex "systems" that can be purchased from a so-called expert, or they may be sold as very expensive courses guaranteed to turn anyone into a successful trader. The least scrupulous systems usually recommend a particular brokerage (which will give you a huge credit line) and "scalping" as a business plan to people new to trading. (Scalping is the practice of holding position for often no more than mere seconds, in order to capture a small gain. Practiced scalpers often do this hundreds of times a day.) People brand new to trading, by the way, are the *last* people who should use huge lines of credit or scalp. Many traders make great livings scalping, but for reasons to be discussed shortly, it is one of the hardest ways to make a buck long term. Additionally, it is a craft—and one not easily learned. Scalping with great success requires experience and knowledge. Knowledge and experience must be acquired, through hard work, practice, and study. I hope this book will shorten part of the learning curve.

Are great traders born, or do traders become great? It's the age-old question of education or evolution. I believe that they become great and that those few traders who actually turn their accounts into massive empires worth more than the gross domestic product of many small countries also have a certain gift, a knack for the game. And they are persistent. And they educate themselves, through all means available, including the jungle of hard knocks: the stock market.

This book may help you turn your account into the massive sort of empire described. But it is my hope that you don't read it with that in mind. I'll leave that to the get-rich books. Trading is a ruthless, competitive game, where the losses are real and instantaneous. Day trading, in particular, is a hard, hard game. The purpose of this book is not to turn you into a supertrader, to give you some secret that will make you rich overnight. Rather, this book's single purpose is to assist you to become a successful trader, defined in the following way: one who understands the game, understands the risks involved, and has the necessary skills and tools to minimize risk and implement a trading plan. The goal: Profit and loss will be limited by the quality of your trading thesis, not your ability to execute.

That's all. If you are one of the gifted, that's your business. If you are one of the gifted and have the persistence to work hard and accept the heartbreak that will come with inevitable loss from time to time, and the foresight to continually educate yourself in an ever-evolving game, my hat's off to you. This book may be the start of something wonderful.

day trading defined

Simply put, day trading is the practice of profiting from intraday moves in the equity market and closing all positions by end of day. Day trading can be highly profitable. Scalping (a kind of day trading) also can be profitable—at least for a time. I think, however, that to limit yourself only to scalping is to take tremendous risk for minimal gain; it's missing the big picture. Many stocks move four, five, or more points in a single day. It would be silly to ignore all the real potential out there and take more risk for tinier profits. (Chapter 9 explains my view in depth.) Many active day traders don't scalp. Preferring to capture larger intraday moves they'll hold a stock from seconds to hours, and capture a large part of the move.

In any case, watching the market intraday allows you to buy during rallies and sell short (see Chapter 11) on sell-offs, thereby profiting from volatility. The securities markets become more volatile everyday. On an awful day, like those of the March 2000 sell-off, prepared traders reaped massive, life-changing profits.

Day traders close all positions by the end of the day. Why close all positions by end of day? Doing this insulates the trader from adverse happenings overnight. Say you own 1,000 shares of a biotech company whose new technological widget is widely expected to win approval from the Food and Drug Administration (FDA). Then the news comes out after market hours, and it is bad: The FDA doesn't approve. By market open the next day, the price of your 1,000 shares has been cut in half. Similar situations happen all the time. Holding no positions overnight contains losses. You may lose potential profit as well, but you must decide if you are better safe than sorry. But note: I am not giving a carte blanche recommendation for closing all positions by end of day; in fact, many of the best profits I have seen came from holding overnight. I'm just explaining the reasoning behind the day traders' approach. As a trader, you may find that you sleep better if you are flat at market close . . . or not. But this book is not just about day trading, short-term speculation, or position trading (several day to several month price targets) or investing for the long term. It is about how to actually buy and sell your positions in the fastest, most agile way possible and how to determine which approach to execution best serves your needs at a particular time. Countless profitable trades have become losses due to a lack of information about the execution systems that everyone uses.

is it possible to profit by scalping?

Yes. Absolutely. But keep in mind it is very difficult, and there are bigger fish out there. In an average day, a scalper may buy a $10 stock and sell it for 10 1⁄8. An eighth doesn't sound like a lot, but keep in mind that on 1,000 shares, that's $125. And when you realize the average scalper makes dozens of such trades a day, it adds up fast. Of course, so do the commissions.

The best scalpers sometimes trade 300 or more times a day. They are like sharks swimming in shallow water, waiting for a moment of weakness. And those moments occur all the time. But this is not to say that scaping is easy! And, truth be told, with scalping as a plan you will miss out on all the major moves, like Yahoo! going from $27 a share to a split-adjusted $340. But the Yahoo! move would have been in your long-term investment account, right? At least it should have been. Successful traders speculate only with a small percentage of their total account. Day trading is a highly risky endeavor and should be done only with purely speculative capital—that is, money you can afford to lose.

But scalping, in my personal opinion, is a largely uneconomic activity. New order-handling rules regulating the Nasdaq make scalping profitably much, much more difficult. And scalping involves much higher risk, because you need to buy or short more shares to beat commission costs. It is truly sad, in my opinion, that scalping holds such an allure, and that often the traders most eager to scalp—and trade the most volatile, hardest-to-trade stocks—often are the newest to trading. Avoid get-rich-quick thinking! Scalping in today's market (as opposed to before August 1998, when Nasdaq order-handling rules were different) really requires skill; you have to fully understand the order execution systems and have split-second decision-making powers. You *develop* this kind of knowledge with experience. It doesn't come from a five-day course. And as far as I know, this is the first book that deals with how execution systems actually work.

I'll say it again here and later in the book: As a rule, scalping for an eighth in today's markets is uneconomic for those brand new to trading. It may enrich your broker and seminar instructor, but until you have a firm understanding of the basics of trading, with scalping as an m.o., you probably will be the one getting scalped.

swing trading

Swing traders tend to take a more conservative approach. They watch a comparatively small number of highly volatile or strongly trending stocks and employ strict risk management controls to hold a position open from hours to several days. Getting to know some few stocks well can be an excellent way of avoiding some of the risk taken by scalpers, who often know nothing about the stocks they trade. Many of the stocks swing traders work with move several or more points intraday or over several days. At the time of this writing, I can name almost a dozen stocks that move 5 to 20 points intraday every day. Swing traders tend to take buy or sell positions with time frames already in mind. And in the same way that the best day traders close all positions every day, swing traders close positions once their particular thesis/time frame is proven wrong. Some swing traders approach trading with a momentum-driven philosophy, buying stocks during periods of unusual buying pressure and holding overnight for potential gap-ups (opening in the morning at a higher price than where it closed) to sell before the market opens; others buy stock splits with the intention of holding for several days to capture speculative price run-ups. Coupled with strict money management, these sorts of knowledge-driven, risk-averse plans can often be easily and safely accomplished.

position trading

Successful traders often take positions for a number of weeks to months based on their observance of short- or intermediate-term trends. "The trend is your friend" is what they'll tell you. Short- to intermediate-term trends are not sexy or exciting because they don't provide the instant gratification of day trades. But they get results. And you can make educated decisions based on reason, and plan, and remove as much risk as possible. Take a look at the oil services industry during spring and summer 1998. A trend like this is gold for the taking.

trading vs. investing

Trading is *not* investing. Trading involves taking a specific position for a specific reason. Traders must consider opportunity cost, price, slippage, risk, and a multitude of other factors in real time. Trading and speculation are similar: For various reasons, you think X is going to happen, and so you do Y to take advantage of it. If X happens, you get out with a profit. If it doesn't, you get out with a loss. You are actively involved and watching events as they occur.

Investing, on the other hand, involves much longer time frames and complex strategies. You may own a stock for its earnings, for its growth, or for any number of reasons. The main thing is, you *own* it long term—3, 5, 10 years. Think of retirement. Investing is what you should do with the majority of your account and certainly with your individual retirement account (IRA). Some firms allow individuals to actively trade their IRAs. I can't understand this. IRA money has *got* to be there for retirement! Don't do anything risky with it, especially if you are approaching retirement age. Consult a professional financial advisor for strategic financial planning before risking anything in a self-directed trading account. Don't speculate until you truly have money you can afford to lose.

If you are reading this book, you've probably already made the decision to actively trade your own account. Maybe you've even started to and are considering switching from a full service brokerage to one that offers direct access to the markets. If so, the following section will be of interest.

full-service vs. direct-access brokerage

The choice of whether to use a full-service or a direct-access brokerage is a fairly simple one, based on the number of trades you are doing. If you are doing two or fewer trades a week, you will do fine with one of the better online discount brokerages, for the following reasons:

- *Discounted commissions* (and probably less-than-wonderful execution). You are clearly not subject to the intraday vagaries of the market, so you probably won't need absolute control of your executions. Remember: Direct-access trading will require your full attention. You will need to become an expert trader to enjoy the benefits of direct access, but if you are only doing a few trades a week, you are not trading enough to make the effort worthwhile. You will probably benefit from the low commissions found at the discount houses. The money you will lose due to slippage is probably less than the monthly cost of a top-of-the-line, real-time, front-end order execution platform.

- *Full, easily-accessed information.* Most of the better full-service online brokerages offer news, financial reports, and well-designed account information, all set up for easy access for someone whose life doesn't revolve around the markets. The news may not be real time, but you probably can afford the 15- to 20-minute delay, since your trading plan probably doesn't include scalping based on news hot off the press.
- *24-hour access.* You can peruse your account at leisure from the luxury of your home over the Internet.
- *You will still be able to work at your job.* Unless you're going to devote yourself to a new career, there's no reason to get a full direct-access trading platform. It's overkill.

If you actively trade your account intraday and are committed to trading full time, you probably want to consider a direct-access electronic brokerage, for the following reasons:

- *Control.* There is no control like the ability to trade anytime direct. Real-time information coupled with the best, fastest execution systems in existence has no substitute. Of course, there is a price to pay: You will be truly responsible for your decisions. Sometimes taking responsibility is not a good thing, if you aren't ready (with knowledge) and fully committed. Trading direct requires full commitment. Remember: The traders at the market-making firms whom you are trying to beat are trained, licensed, practiced, and sharp. There aren't many professional suckers working for the majors; the high stakes of the game weed them out.
- *Lower costs overall.* Electronic brokerages will charge a hefty data feed fee and higher ticket charges than a discount online

brokerage. However, you will not be subject to the slippage that occurs when using a full-service discount brokerage. Remember: Nothing in life is free. If the brokerage is charging you a discounted commission, the additional money used to pay the broker and trader a living wage is coming from somewhere.

- *Be the middleman—and own his profit.* If the stock is bid 10 by $10^1/_4$, and you buy it at your discount broker, the broker may take the other side: Buy it at 10 and sell it to you at $10^1/_4$. On 1000 shares, that's $250 the broker will keep for his trouble. And when you go to sell the stock, the broker may do it again. So those two $9 commissions really cost you $500. When you add it all up, if you are aggressively trading your own account several times a day, you're missing out on a lot of money.
- *Work from anywhere.* The better direct-access brokerages offer remote trading platforms. In other words, you can load the software onto your laptop computer and trade from anywhere as long as you have a good Internet connection. I had a client who called to say hi while trading the New York Stock Exchange directly during a visit to the Great Pyramids at Giza, Egypt. But trading really isn't a vacation. It's a hard, often boring job. The fact that some people travel while doing it shouldn't make you lose sight of the rigors. And I didn't say whether my friend in Egypt made any money, did I? If it's a vacation you want, take one! Don't imagine trading your own account will be a stress-free Shangri-La; quite the opposite. With responsibility comes pressure. Putting your butt on the line every day is no joke. The fact that you can do it from home might actually ruin your home as a sanctuary.

Before you start to trade directly, you'll need to get the facts. You'll need a firm grasp of Level II interpretation (understanding just what the Level II quotes mean) and an understanding of all the order-execution routes. The rest of this volume provides the map and all the routes are marked.

chapter 2

the toolbox

This analogy is goofy but appropriate: While you might use a steak knife to screw in a screw, and it will work, eventually, there are better ways to do the job. You might also cut a steak with a screwdriver, and it will work, eventually, but there are better ways to do the job. The proper tool for the job is nowhere more important than here, the cyber jungle of the trader. New tools for buying and selling stock that used to only be available to institutions are now available to retail traders, and they have turned the market on its ear. They are the real-time Level II quotes, and the various execution routes by which you can execute against these quotes—or represent your own quotes—directly in the Nasdaq quotes montage (see Chapter 3), competing directly against major institutions and other traders alike. If you have command of these tools, including Level II, SuperSOES, and ECNs, which are now legal and affordable to individual users, you can buy at the bid, sell at the ask, and actually participate in the Nasdaq market at dealer prices, the same way a market maker does, without the legal responsibilities of being a market maker. And the SuperDot, the execution vehicle long in use by institutions and brokerages for trading the New York Stock Exchange direct, is now available for personal use as well.

These tools truly enable the individual to buy at the bid, sell at the ask, and move in and out of positions with greater speed and agility than the market makers themselves. (See Chapter 10 for a description of what it is that market makers do, how they do it, and the unique legal responsibilities of making a market.)

No wonder market makers don't want you to have access.

The following chapters discuss all the new means available to individuals to purchase and sell both listed and over-the-counter (OTC) securities, methods that recently were available only to institutions.

As well as in-depth discussion of the Level II montage, the "order book" of the Nasdaq, and SuperMontage—the new proposal-stage next generation Level II, by the end of this chapter, you'll have a thorough understanding of what Level II is, how it works, how to interpret it, and why you might want to have access to it if you're trading over-the-counter stocks. Coupled with a thorough understanding of the methods with which you can buy and sell securities, this information will enable you to buy at the bid, sell at the offer, ascertain in real time the strength and direction of a stock *before* it moves, and enter and exit positions with greater speed and agility than the market makers themselves.

understanding Level II

If you have ever traded your own account, undoubtedly you have run into situations where it seemed impossible to sell or buy stock, no matter what you did. The hard truth is that in different situations, which can be readily identified once you have an understanding of Level II, some order-entry "routes" have distinct advantages over others.

You must understand Level II and how it works as a prerequisite for understanding how and why the various tools (SelectNet, SuperSOES, SuperDot, and ECNs) work. With understanding, Level II can be like a map, showing you the fastest route to your destination. You then can select the route, and you're on your way.

Regarding the fastest route: Some routes will create a near-instantaneous fill, whereas others, *in the same circumstances*, will result in "nothing done." Understanding just how these tools work and when to use each one is an absolute necessity to trading effectively. If you have been trading your own account, then you know that there is no single sure-fire way of instantaneously entering or exiting a position that works equally well for all situations. This book will provide you with an understanding of how all the tools work and when to use them. Fortunately, there are not so very many routes, and all can be mastered quickly and easily. The advantages and disadvantages are as easy to know as the knife vs. the screwdriver.

Now the hard, boring stuff.

Level I

There are three "levels" of quotes in the Nasdaq market. Level I is what brokers generally have access to. It is also referred to as the "inside market," and it is what is given when you ask your broker for a quote. You may ask for a quote in Microsoft (MSFT) and your broker will respond something like this "Microsoft is currently bidding $93^{13}/_{16}$ by $^{7}/_{8}$" or "Microsoft is bid $93^{13}/_{16}$, offered $93^{7}/_{8}$." Simply put, that means that a market participant is willing to pay \$$93^{13}/_{16}$ to buy a certain number of shares and that a market participant (maybe the same one) is willing to sell a certain number of shares at \$$93^{7}/_{8}$. So if you want to sell MSFT, you can currently sell it at \$$93^{13}/_{16}$ per share; if you'd like to buy it, you can, at \$$93^{7}/_{8}$ per share. This is also the sort of quote you get from Yahoo! or any full-service traditional or online brokerage.

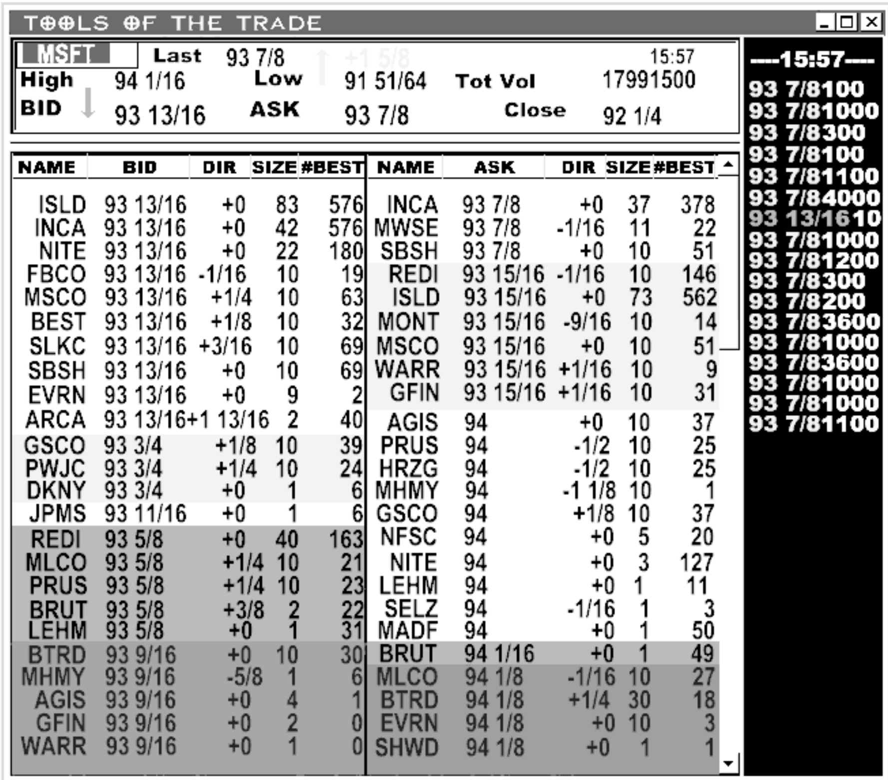
	Bid	*Ask*
MSFT	$93^{13}/_{16}$	$93^{7}/_{8}$

But Level I is only the very tip of the iceberg. It tells you what the best bid and offer (offer = ask) are; in other words, it says what is the most you can sell your shares for or the cheapest you can buy shares. But there is much much more information to know. Suppose you could tell that in the next few moments, the price probably will go up? Or suppose you could tell it probably will go down? You don't need a crystal ball. But you do need practice, knowledge, and, most important, Level II.

Level II

Figure 2.1 is a Level II snapshot of Microsoft and all the market participants. Nasdaq market makers have something called Level III. As shown in Chapter 3, although the Nasdaq Level III screens are organized differently, it is important to note that as far as information

figure 2.1 Nasdaq Level II quotes montage (MSFT)



TOOLS OF THE TRADE

MSFT Last 93 7/8 +1 5/8 15:57
High 94 1/16 Low 91 51/64 Tot Vol 17991500
BID 93 13/16 ASK 93 7/8 Close 92 1/4

NAME	BID	DIR	SIZE	#BEST	NAME	ASK	DIR	SIZE	#BEST
ISLD	93 13/16	+0	83	576	INCA	93 7/8	+0	37	378
INCA	93 13/16	+0	42	576	MWSE	93 7/8	-1/16	11	22
NITE	93 13/16	+0	22	180	SBSH	93 7/8	+0	10	51
FBCO	93 13/16	-1/16	10	19	REDI	93 15/16	-1/16	10	146
MSCO	93 13/16	+1/4	10	63	ISLD	93 15/16	+0	73	562
BEST	93 13/16	+1/8	10	32	MONT	93 15/16	-9/16	10	14
SLKC	93 13/16	+3/16	10	69	MSCO	93 15/16	+0	10	51
SBSH	93 13/16	+0	10	69	WARR	93 15/16	+1/16	10	9
EVRN	93 13/16	+0	9	2	GFIN	93 15/16	+1/16	10	31
ARCA	93 13/16	+1 13/16	2	40	AGIS	94	+0	10	37
GSCO	93 3/4	+1/8	10	39	PRUS	94	-1/2	10	25
PWJC	93 3/4	+1/4	10	24	HRZG	94	-1/2	10	25
DKNY	93 3/4	+0	1	6	MHMY	94	-1 1/8	10	1
JPMS	93 11/16	+0	1	6	GSCO	94	+1/8	10	37
REDI	93 5/8	+0	40	163	NFSC	94	+0	5	20
MLCO	93 5/8	+1/4	10	21	NITE	94	+0	3	127
PRUS	93 5/8	+1/4	10	23	LEHM	94	+0	1	11
BRUT	93 5/8	+3/8	2	22	SELZ	94	-1/16	1	3
LEHM	93 5/8	+0	1	31	MADF	94	+0	1	50
BTRD	93 9/16	+0	10	30	BRUT	94 1/16	+0	1	49
MHMY	93 9/16	-5/8	1	6	MLCO	94 1/8	-1/16	10	27
AGIS	93 9/16	+0	4	1	BTRD	94 1/8	+1/4	30	18
GFIN	93 9/16	+0	2	0	EVRN	94 1/8	+0	10	3
WARR	93 9/16	+0	1	0	SHWD	94 1/8	+0	1	1

----15:57----
93 7/8100
93 7/81000
93 7/8300
93 7/8100
93 7/81100
93 7/84000
93 13/1610
93 7/81000
93 7/81200
93 7/8300
93 7/8200
93 7/83600
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93 7/81000
93 7/81100

goes, the information on a Level III Nasdaq workstation screen is fundamentally identical to that on a Level II screen. In other words, if you have Level II, you have all the same information that the market makers do.

Now you can see why the Nasdaq market makers are so miffed: Their playing field has been leveled, and now any Tom or Jane can compete with them on near-equal terms.

Life was hard enough for market makers before, but at least all the professional participants had the unwritten practice of maintaining nice fat spreads. But now, in come Tom and Jane Trader. And