CHAPTER 1

An Overview

- The Stock Markets
- The Exchange System
- NYSE Time Line
- Listed Stocks
- The Specialist System
- Who's Who on the Exchange Floor
- The SuperDOT System

THE STOCK MARKETS

DAY TRADING INVOLVES THE FINE ART of finding stocks that will come under buying or selling pressure. This pressure makes the stock price move significantly up or down. That's the first step. Knowing when these stocks are likely to make their move is the second step. The final step is executing a trade to capture a brief portion of this move, making a profit in the process.

You will not be able to execute these strategies unless you learn how the stock markets work. Every day, millions of shares move back and forth from one investor to another. How is this done? Who are the people who execute these trades for investors? How do you get the best price on your order? Which electronic routing systems are the best for day traders? What does all this back-and-forth mean to the day trader? These are the basics. Learn them well.

In the United States, stocks are bought and sold in two different venues: *stock exchanges* and *over-the-counter markets* (OTCs). This chapter explores the differences between the two systems, particularly the differences that will affect your career as a day trader.

THE EXCHANGE SYSTEM

The largest stock exchange in the world, trading more than 3,000 stocks, is the New York Stock Exchange (NYSE). The NYSE is situated on Wall Street in New York City. It is also known as the Big Board and is considered the center of the stock-trading universe. The NYSE was created in 1792 by 24 traders who got together to trade a few shares in two small, local companies. From this humble beginning, the stock market grew into the beast it is today. Most day traders, however, never set foot inside the NYSE. Including the NYSE, there are seven stock exchanges in the United States, but the NYSE is the granddaddy of them all. The others are smaller, regional exchanges that look to the NYSE as the leader.

An exchange is a place where buyers and sellers physically get together on a central trading floor to buy and sell. Floor trading is essentially an auction in which price is determined by supply and demand. The trades may be routed by computer, but they all eventually come to the market floor for execution. The exchanges are membership organizations. The members trade securities on behalf of their clients or for themselves. Both individuals and big securities firms are members of the NYSE.

NYSE TIME LINES

HISTORIC MILESTONES

1865 The average daily volume is about 34,000 shares traded for 141 companies.

1900 Volume grows to 505,000 shares per day for 369 companies.

1920 Volume is 825,000 shares per day for 689 companies.

1940 Down to 750,000 shares per day for 862 companies, volume explodes.

1960 Average daily volume rises to 3 million shares for 1,143 companies.

1980 Volume is 44 million shares per day for 1,570 companies.

1987 Largest one day percentage drop occurs.

1990 Volume is 157 million shares per day, 1,774 companies.

1997 Volume is 525 million shares per day for 3,028 companies.

1997 All-time record 1.2 billion shares are traded on mini-crash day, October 27.

2000 Both the biggest point jump (499.19) and the biggest point slide (617.78) occur.

2001 Trading in fractions ends.

2003 NYSE Composite Index is relaunched using revised methodology.

2005 ARCA and the NYSE merge.

TECHNOLOGICAL ADVANCES

1878 The first telephone is installed.

1978 The first electronic linkage to other exchanges is installed.

1984 Orders are electronically routed to the floor using SuperDOT system.

1995 Hundreds of old TV-style monitors are replaced with modern flat-panel displays in the world's largest installation of this technology to date.

1996 Floor brokers start using handheld wireless information tools.

LISTED STOCKS

Stocks traded on the NYSE are called *listed* stocks. This means the underlying company has met the requirements necessary to list its stock on the NYSE. One requirement, for example, is market capitalization. To be listed on the NYSE, a company usually must have a market capitalization of at least $100 million. (Market capitalization is determined by multiplying the stock price times total shares outstanding.) These rules were designed to prevent the Mafia from getting money-laundering companies listed on an exchange.

Stocks with a large market capitalization are called *large-cap* stocks. They are usually established companies. For example, IBM, founded in 1911, has a market capitalization of $124.64 billion and is a large-cap stock traded on the NYSE. Other large-caps traded on the NYSE include DuPont, Ford, Coca-Cola, General Electric, Alcoa, and

AT&T. It is important to remember that large-cap stocks traded on the NYSE are not as volatile as OTC stocks. This can be an asset or a liability to the day trader. However, some large-cap stocks, even though they trade on the NYSE, are volatile. Energy stocks and pharmaceuticals are examples.

Before I discuss how these stocks are traded, here is a list of terms you should know. They apply to the workings of both the NYSE and the OTC:

Best bid. The price a buyer is willing to pay to buy a stock.

Best ask. The price at which someone who owns a stock is willing to sell it.

Broker. One who arranges the sale of a stock.

Dealer. Usually a brokerage, such as Charles Schwab. Brokers sell the stocks that dealers keep in their inventories.

THE SPECIALIST SYSTEM

Exchange trading is carried out by a person called a *specialist.* Specialists control the auction process. Their job is to match buyers with sellers. The specialist looks at an electronic order book of bids and asks and matches them according to price and quantity. The specialist, for example, will match a person willing to buy 100 shares of IBM at $80 with a person willing to sell 100 shares of IBM at $80. Specialists are the people you see running around on the floor of the NYSE. The specialist and his or her clerks are assigned responsibility for one or two stocks. They handle all bids and offers for these stocks.

There is more to a specialist's job than matching buyers and sellers. They are expected to maintain an orderly and fair market. When there is an excess of buy or sell orders, making it impossible to match orders evenly, the specialist steps in. There may be 1,000 people who want to sell IBM at $80, for example, but only 100 people who are willing to pay this price. This situation, called an *order imbalance,* sometimes causes trading to be temporarily suspended. An opening delay usually happens when a news event or extreme imbalance of orders prevents the stock from trading when the market opens. The specialist has 15 minutes from the opening bell to determine a price range at which the stock will begin trading.

A specialist can delay an opening or halt trading until a proper balance of buyers and sellers is achieved. Usually, the stock will start trading at a price far different from its previous price. Some day traders try to profit from these imbalances, which occur frequently.

Specialists profit from the *spread,* the difference between the bid price and ask price, for each market-order transaction in which a spread exists. A market order is an order to buy or sell a stock at the market's current best displayed price.

A good specialist will be assigned responsibility for more stocks than the usual one or two. Specialists may trade for their own firm's accounts as well, buying low and selling high to make a profit.

Specialists are predictable. Novice day traders who want to trade stocks on the NYSE should get to know the habits of the specialists they are dealing with. There are several day trading firms whose members make a good living just by following the actions of the specialists. Their aim is to capture small profits several times a day, just like the specialist.

WHO'S WHO ON THE EXCHANGE FLOOR

In addition to the specialist, here are the people who make the NYSE hum:

Specialist's clerk. The clerk sits next to the specialist. They stand ready to maintain the electronic order book and report executions. The order book contains buy and sell orders at different prices, including the current market price. These are the orders and prices that must be matched.

Floor brokers. Brokers usually represent big-name brokerage firms. They handle large (block trades) or sensitive orders. The brokers deliver these orders to the specialists. They are allowed to negotiate orders with the specialists or other floor brokers in the presence of a specialist.

Floor clerks. These people deliver orders from the floor brokers to the specialists.

Member firms. A big-name brokerage firm that has a seat on the NYSE. If your brokerage firm is not a member, your order will pass through another firm that is a member.

Floor traders. These are independent traders. They trade for their own accounts and can represent institutions when contracted.

Customer. A customer can be a day trader, an investor, or a large institution. Generally, they are not present on the floor, but their orders are the cause of all the activity you see on the floor.

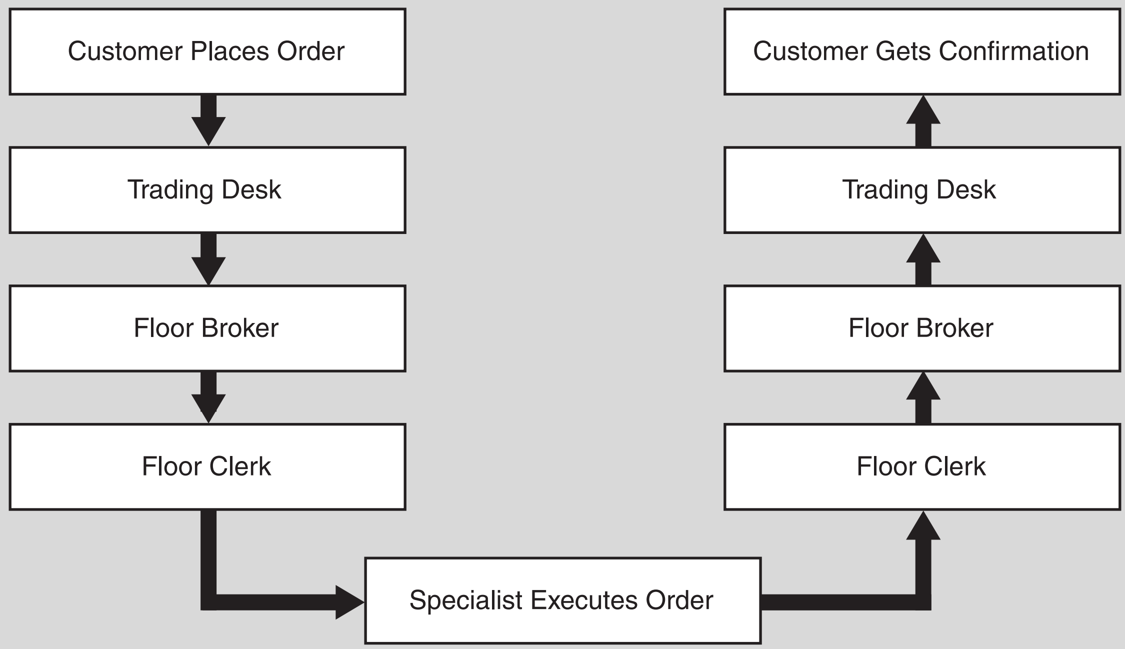
There are 17 trading posts on the trading floor. Each post is semicircular and about 15 feet across. Each post trades an average of 150 securities. The specialists are stationed outside the trading posts in designated spots. The clerk sits inside the post and communicates with the specialist through a window. Display monitors hang above the post windows so the clerk and the specialist can watch the floor broker and the order books at the same time. Huge conduits rise up from the trading floor, carrying data lines to the exchange computers.

THE SUPERDOT SYSTEM

Buy and sell orders on the NYSE are routed to the exchange floor by an electronic system called Super Designated Order Turnaround, or SuperDOT. The best way to understand the miracle of this system is to compare it with the routing methods used before the SuperDOT was implemented.

Figure 1.1 gives you an idea of the long process needed to route orders in the old days. As you can see, getting a trade executed in the old days took time. The trader called a stockbroker and placed the order. The stockbroker called the order in to the trading desk. The desk relayed the order to a floor broker at the NYSE. The order was then passed to a floor clerk, who would give it to the specialist for execution. After the order was executed, a confirmation (or trade report) would flow backward through the same process until it reached the trader.

1.1 Historical Buy and Sell Order Routing System Used on the New York Stock Exchange

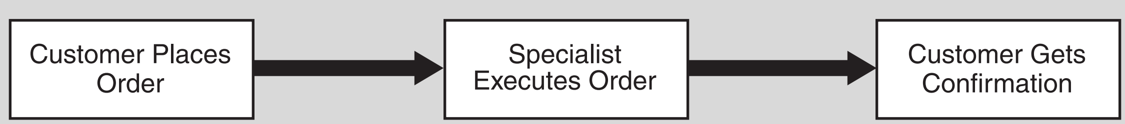


► **WHEN THERE IS AN EXCESS** of buy and sell orders, the specialist steps in.

Every transaction required multiple pieces of paper, which were crumpled up to distinguish them from paperwork that might have been accidentally dropped. That was why, in the old days, the floor of the stock exchange was littered with small scraps of paper. The SuperDOT system has eliminated most but not all of the paperwork. Paper is still used for negotiating large and special orders.

SuperDOT is fast and reliable. Orders go directly to the specialist. This minimizes the time involved, and trade reports are made within seconds, except on the busiest days. Brokers who trade on this system have what is called *direct*

1.2 SuperDOT System (Super Designated Order Turnaround System)



► **COMPANIES WITH SMALL MARKET CAPS** are handled on the Bulletin Board and the Pink Sheets.

access to the NYSE market. If you are a day trader and your broker is a NYSE member, your order will most likely be delivered through SuperDOT.

A quick look at the flowchart in Figure 1.2 gives you an idea of how streamlined this new process is. It is important to note that SuperDOT is not an automatic-execution system. Orders are routed electronically through SuperDOT, but they are still executed by specialists. If there is an order imbalance or if you have placed a limit order, SuperDOT will automatically deliver your order, but that doesn't guarantee that your order will be executed. If there is no match, the trade will not be filled.