The Direct Connection

Before delving into the specifics of locating stocks and placing buy and sell orders, let's take some time to get a clear understanding of how trading works in the stock market. It is possible for you to become one of the very few people who understand just how the market process works. Believe it or not, most people—even traders who have been investing and dabbling in the stock market for years—have no clue how their trades get executed.

To start off, let's consider a typical investor with an online brokerage account. He or she has no idea how his or her trades are executed. And guess what? They don't need to know. All the trader needs to know is how to access the account, place an order, withdraw funds, and so forth. The process of pressing the button to sell a stock and how that translates into cash in the trader's account isn't important at all.

After all, I have no idea how my car works, and I don't need to know how my car works to be able to drive it to the office or the supermarket or even across the country. All I need to know is how to operate the car: how to start it, how to put it in gear, how to use the brake and gas pedals. For my limited purposes, it doesn't matter what is happening under the hood, so long as it happens when I need it to happen.

However, this limited knowledge would never cut it if I wanted to be a professional race car driver. To get the maximum performance out of my car, I would need to know *exactly* what happens when I push the gas pedal or the brake. This extra knowledge would help me achieve maximum acceleration out of turns and minimize pit stops. As you know, in a 500-mile auto race, the difference between winning and often losing comes down to a few feet.

The same thing holds true for you as an active trader. The difference between the winning trades that put food on your table and losing trades that might force you into getting a night job is minuscule. It often comes down to cutting a few cents off the buy and sell prices of your trades. Therefore, we're going to start with a very quick overview of just what happens when you execute an order through an online broker.

Trading Through an Online Broker

Below, you will find a diagram (Figure 1.1) illustrating what happens when you execute a buy order through your online broker.

In most cases, your online brokerage firm is going to do one of two things:

- First, if your broker makes a market in the stock (i.e., it holds shares in its own account or for other clients of the firm) then the broker will sell you some of its shares. Obviously, this is the fastest and least expensive way to get you the shares you have requested.
- Second, if your broker doesn't make a market in the stock, it may sell your order to another firm. This practice is called *payment for order flow.* It would not surprise me if you have never heard of this, but payment for order flow is incredibly common. In fact, this is the way online brokers generate most of their income.

If you're like most people, you probably think that your online broker makes money by charging you a commission to make trades on your behalf. After all, this seems logical—you pay them a fee, and they provide a service for that fee. It is the American way. Well, it *was* the American way, but not anymore.

The sad truth is that a brokerage commissions make up a tiny percentage of the revenue for a typical online broker. Contrary to popular belief, they aren't in the business of selling stock to you or buying stock from you. Your online broker is in the business of selling your trades to another firm, which is willing to pay a lot of money for the *honor* of placing a trade for you. Therefore, in essence, your online broker is getting paid twice: once by you and once by the person who places your trade.

Now, you may be asking, "Why would someone pay my online broker to provide a service? Shouldn't they be charging the online broker instead?" When you dig down deep enough and learn what really happens when you place a trade with your online broker, you'll realize that the answer is "No." This is particularly true when you place a *market order*.

As the name implies, a market order is an order to buy or sell at whatever the market price happens to be at the time. Obviously, this gives the online broker a lot of flexibility in placing your order. While it would be wonderful if your shares were sold to the highest bidder, or bought from the lowest seller, this isn't always the case.

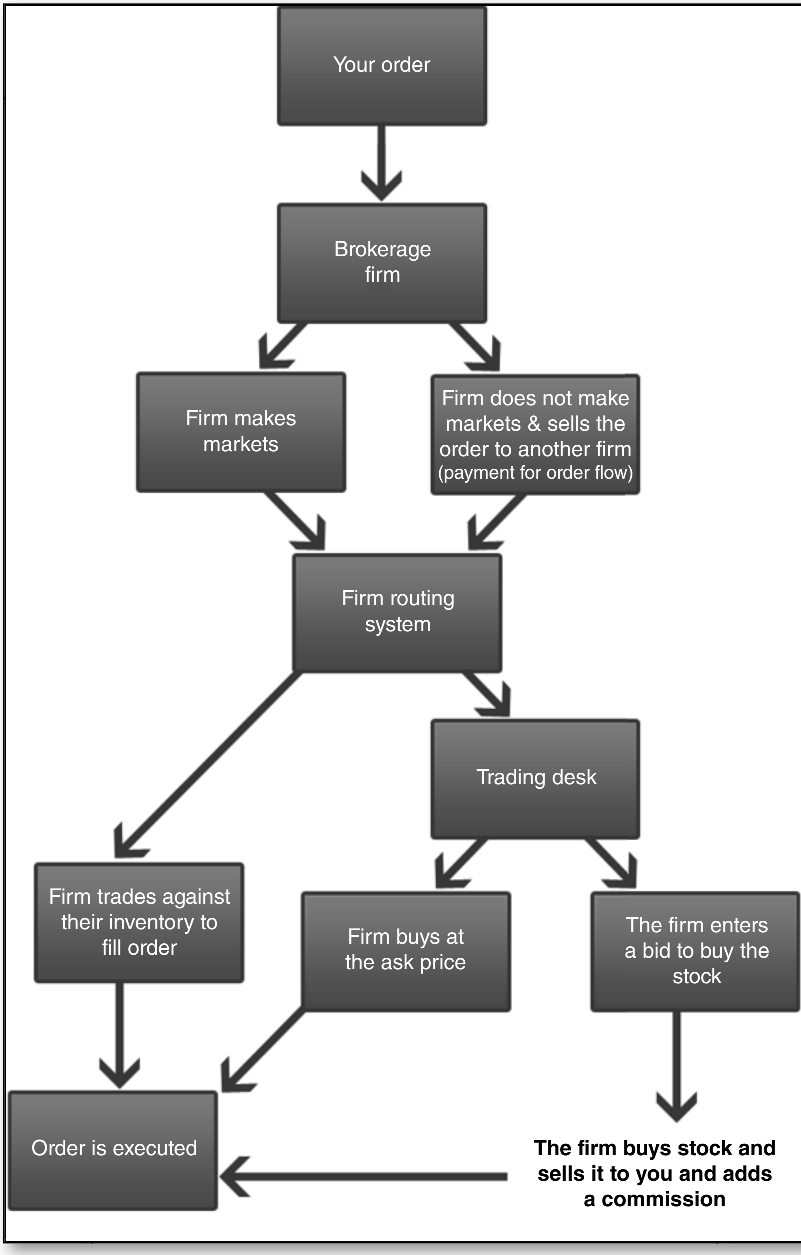

FIGURE 1.1 Order Flow—The Steps Between Placing Your Order and When It Is Executed with an Online Brokerage Firm

In fact, it is almost never the case when your order is executed by a third party through a payment-for-order-flow arrangement.

In this case, the third party, usually another brokerage firm, takes your order and matches it with an order from one of its other customers. In other cases, your order is matched with the firm's transactions on its own account.

Are you starting to see the problem yet? Let's suppose that you execute a market order online to buy 100 shares of ABC stock, which is currently trading at $15. Your online broker then sells this trade to XYZ brokerage firm. XYZ surveys the market and finds out there are some people willing to sell their shares for $15 and other people willing to sell at higher prices (like $15.05, $15.10, and even $15.15). If XYZ is also looking to buy shares for its regular customers or its own account and there aren't enough $15 shares to go around, guess who gets the shares at $15.05, $15.10, or $15.15? You guessed it—*you*!

In short, payment for order flow allows a brokerage firm to line up its orders and choose who gets which shares and at what price. Without this system, your online broker and XYZ firm would both have to rush to the market. You'd have a chance at getting the best price, but with payment for order flow, XYZ can simply buy off the competition.

What makes this system doubly dreadful is that you don't even get to share in what is, essentially, bribe money. Your online broker sells you out and then keeps the windfall profits, in addition to whatever you're charged for the privilege of allowing them to do a number on you in the first place!

Perhaps the most astonishing part of this whole scheme is that it's perfectly legal. If you read the fine print on the back of your monthly statement or at the bottom of your online brokerage agreement, you will see that the online broker has disclosed that your orders may have been placed by a third party. In essence, you've been warned, albeit in tiny text.

One countermeasure that you can employ against payment for order flow is to place only *limit orders* through your online broker. In a limit order, you specify the maximum price at which you're willing to buy stock and the minimum price at which you're willing to sell. As a result, the ultimate party placing the trade won't have the power to distribute the absolute worst prices to your transaction. Even then, there is no guarantee that you will get the very best prices. It is entirely possible that you may not be allotted any shares at all if the brokerage firm can sell the shares to another person at a more profitable rate.

Direct Access

Fortunately, there is an alternative to using online brokerage services—*direct access*. As the name implies, you have direct access to the market through a direct access service. Instead of relying on an online broker to make a trade, you go right out into the market yourself and make the trade. Doing so cuts out the middle man, which is precisely what the online broker truly is.

In a sense, using direct access is like having a manual transmission in your vehicle, whereas using an online broker is like having an automatic transmission. In many ways, having an automatic transmission is easier—you don't need to operate a clutch or a stick shift; as a result, you don't have to concentrate as much on the road and can use your free hand to operate the radio, eat fast food, or put on makeup (although I certainly don't recommend it!).

When you drive a car with an automatic transmission, you give up a little control. You can't accelerate and decelerate like you can with a stick shift. With an online broker, you can't get in and out of a stock as quickly, nor do you have as much control over the price.

This may not be an issue for long-term investors, but it definitely affects an active trader in more ways than one, because day traders operate on the slightest of margins. The time it takes an online broker to receive your order and then route it can mean the difference between a winning trade and a losing trade. For this reason, direct access is a *must* for day traders.

To be sure, I am not implying that all online brokers are a bad lot. Things have certainly changed: numerous online brokers now offer value-added services (like access to Level II quotes, which will be explained in Chapter 3). But unless you are provided direct access to the market, there is no point in continuing with an online broker. It's similar to paying for a Lamborghini and then using public transportation for getting around town.