CHAPTER 4

Trading Securities

INTRODUCTION

Investors who do not purchase their stocks and bonds directly from the issuer must purchase them from another investor. Investor-to-investor transactions are known as secondary market transactions. In a secondary market transaction, the selling security owner receives the proceeds from the sale. Secondary market transactions may take place on an exchange or in the over-the-counter (OTC) market. Although both facilitate the trading of securities, they operate in a very different manner. We will begin by looking at the types of orders that an investor may enter and the reasons for entering the various types of orders.

TYPES OF ORDERS

Investors can enter various types of orders to buy or sell securities. Some orders guarantee that the investor's order will be executed immediately. Other types of orders may state a specific price or condition under which the investor wants the order to be executed. All orders are considered day orders unless otherwise specified. All day orders will be canceled at the end of the trading day if they are not executed. An investor may also specify that an order remain active until canceled. This type of order is known as good til cancel, or GTC.

MARKET ORDERS

A market order will guarantee that the investor's order is executed as soon as the order is presented to the market. A market order to either buy or sell guarantees the execution but not the price at which the order will be executed. When a market order is presented for execution, the market for the security may be very different from the market that was displayed when the order was entered. As a result, the investor does not know the exact price that the order will be executed at.

BUY LIMIT ORDERS

A buy limit order sets the maximum price that the investor will pay for the security. The order may never be executed at a price higher than the investor's limit price. Although a buy limit order guarantees that the investor will not pay over a certain price, it does not guarantee an execution. If the stock continues to trade higher away from the investor's limit price, the investor will not purchase the stock and may miss a chance to realize a profit.

SELL LIMIT ORDERS

A sell limit order sets the minimum price that the investor will accept for the security. The order may never be executed at a price lower than the investor's limit price. Although a sell limit order guarantees that the investor will not receive less than a certain price, it does not guarantee an execution. If the stock continues to trade lower away from the investor's limit price, the investor will not sell the stock and may miss a chance to realize a profit or may realize a loss as a result.

TESTFOCUS!

It is important to remember that even if an investor sees stock trading at its limit price, it does not mean that the investor's order was executed, because there could have been stock ahead of the investor at that limit price.

STOP ORDERS/STOP LOSS ORDERS

A stop order, or stop loss order, can be used by investors to limit or guard against a loss or to protect a profit. A stop order will be placed away from the market in case the stock starts to move against the investor. A stop order is not a live order; it has to be elected. A stop order is elected and becomes a live order when the stock trades at or through the stop price. The stop price is also known as the trigger price. Once the stock has traded at or though the stop price the order becomes a market order to either buy or sell the stock, depending on the type of order that was placed.

BUY STOP ORDERS

A buy stop order is placed above the market and is used to protect against a loss or to protect a profit on a short sale of stock. A buy stop order could also be used by a technical analyst to get long the stock after the stock breaks through resistance.

EXAMPLE

An investor has sold 100 shares of ABC short at $40 per share. ABC has declined to $30 per share. The investor is concerned that if ABC goes past $32 it may return to $40. To protect its profit, the investor enters an order to buy 100 ABC at 32 stop. If ABC trades at or through $32, the order will become a market order to buy 100 shares, and the investor will cover the short at the next available price.

SELL STOP ORDERS

A sell stop order is placed below the market and is used to protect against a loss or to protect a profit on the purchase of a stock. A sell stop order could also be used by a technical analyst to get short the stock after the stock breaks through support.

EXAMPLE

An investor has purchased 100 shares of ABC at $30 per share. ABC has risen to $40 per share. The investor is concerned that if ABC falls past $38 it may return to $30. To protect its profit, the investor enters an order to sell 100 ABC at 38 stop. If ABC trades at or through $38, the order will become a market order to sell 100 shares, and the investor will sell its stock at the next available price.

If in the same example the order to sell 100 ABC at 38 stop was entered GTC, we could have a situation such as this:

ABC closes at 39.40. The following morning ABC announces that it lost a major contract and opens at 35.30. The opening print of 35.30 elected the order, and the stock would be sold on the opening or as close to the opening as practical.

STOP LIMIT ORDERS

An investor would enter a stop limit order for the same reasons it would enter a stop order. The only difference is that once the order has been elected the order becomes a limit order instead of a market order. The same risks that apply to traditional limit orders apply to stop limit orders. If the stock continues to trade away from the investor's limit, the investor could give back all of its profits or suffer large losses.

OTHER TYPES OF ORDERS

An investor may enter several other types of orders:

- All or none (AON)
- Immediate or cancel (IOC)
- Fill or kill (FOK)
- Not held (NH)
- Market on open (MOO)/market on close (MOC)

AON orders: May be entered as day orders or GTC. AON orders, as the name implies, indicate that the investor wants to buy or sell all of the securities or none of them. AON orders are not displayed in the market because of the required special handling and the investor will not accept a partial execution.

IOC orders: The investor wants to buy or sell whatever it can immediately and whatever is not filled is canceled.

FOK orders: The investor wants the entire order executed immediately or the entire order canceled.

NH orders: The investor gives discretion to the floor broker as to the time and price of execution.

MOO or MOC orders: The investor wants its order executed on the opening or closing of the market, or as reasonably close to the opening or closing as practical. If the order is not executed, it is canceled. Partial executions are allowed.

TAKENOTE!

The SEC has granted permission for the NYSE to eliminate the use of AON orders and FOK orders.

THE EXCHANGES

The most recognized stock exchange in the world is the New York Stock Exchange (NYSE). There are, however, many exchanges throughout the United States that all operate in a similar manner. Exchanges are dual-auction markets. They provide a central marketplace where buyers and sellers come together in one centralized location to compete with one another. Buyers compete with other buyers to be the highest price anyone is willing to pay for the security, and sellers compete with other sellers to be the lowest price at which anyone is willing to sell a security. All transactions in an exchange-listed security that are executed on the exchange have to take place in front of the specialist/designated market maker (DMM) for that security. The specialist/DMM is an exchange member who is the designated market maker in that security and is responsible for maintaining a fair and orderly market for the stock in which he or she specializes. The specialist/DMM stands at the so-called trading post where all the buyers and sellers must go to conduct business in the security. This is the reason for the crowd that you see on the news and financial reports when they show the floor of the exchange. All securities that trade on an exchange are known as listed securities.

PRIORITY OF EXCHANGE ORDERS

Orders that are routed to the trading post for execution are prioritized according to price and time. If the price of more than one order is the same, orders will be filled as follows:

- **Priority:** The order that was received first gets filled first.
- **Precedence:** If the time and price are the same, the larger order gets filled.
- **Parity:** If all conditions are the same, the orders are matched in the crowd and the shares are split among the orders.

THE ROLE OF THE SPECIALIST/DMM

The specialist is an independent exchange member who has been assigned a stock or group of stocks for which he or she is the DMM. Specialists/DMMs are responsible for:

- Maintaining a fair and orderly market for the securities.
- Buying for their own accounts in the absence of public buy orders.

- Selling from their own accounts in the absence of public sell orders.
- Acting as agents by executing public orders left with them.

A large amount of capital is required in order to fulfill the requirements of a specialist/DMM. As a result, most specialists/DMMs are employees of specialist firms. Although the specialist is not required to participate in every transaction, every transaction for that security that is executed on the exchange must take place in front of the specialist. The specialist may act as either an agent or as a principal if he or she plays a role in the transaction.

THE SPECIALIST/DMM ACTING AS A PRINCIPAL

In the absence of public orders, the specialists/DMMs are required to provide liquidity and price improvement for the stocks in which they specialize. Specialists/DMMs are required to trade against the market and may not trade for their own accounts at prices that would compete with public orders.

EXAMPLE

If the public market for XYZ is quoted as follows:

	Bid	Offer
10 × 10	**20.45**	**20.55**

There is a 20.45 bid for 1,000 shares and 1,000 shares offered at 20.55.

If a public sell order came in to sell the stock, the specialist/DMM could not purchase the stock for his own account at 20.45 because that would be competing with the public. The specialist could purchase the stock for his own account at 20.50 because that would be improving the price that the seller would be receiving. This is known as price improvement. Alternatively, if a public buy order came in, the specialist/DMM could not sell the stock from his own account at 20.55 because that would also be competing with the public. The specialist/DMM could sell the stock to the customer at 20.50 because, once again, that would be providing price improvement for the order.

THE SPECIALIST/DMM ACTING AS AN AGENT

Specialists/DMMs are also required to execute orders that have been left with them. Orders that have been left with the specialist/DMM for execution are said to be "left or dropped on the specialist's/DMM's book." The specialist/DMM is required to maintain a book of public orders and to execute them when market conditions permit. The types of orders that may be left with the specialist are:

- Buy and sell limit orders
- Stop orders
- Stop limit orders
- Both day and GTC orders
- AON orders

The specialists/DMMs will execute the orders if and when they are able to and will send a commission bill to the member who left the order with them for execution. This is known as a specialist bill, and it is usually only about one cent per share. The specialist/DMM is also required to quote the best market for the security to any party that asks. The best or inside market is composed of the highest bid and the lowest offer. This is made up from bids and offers contained in the specialist's/DMM's book and in the trading crowd. The inside market is also the market that is displayed to broker dealers and agents on their quote system.

When quoting the inside market, the specialist/DMM will add all of the shares bid for at the highest price and all of the shares offered at the lowest price to determine the size of the market. Certain types of orders are not included when determining the inside market; they are:

- Stop orders
- AON orders

A specialist/DMM may not accept the following types of orders:

- Market orders
- Immediately executable limit orders
- NH orders
- IOC orders
- FOK orders

Market orders and immediately executable limit orders are filled as soon as they reach the crowd so there is nothing to leave with the specialist. In the case of a NH order, once a floor broker is given discretion as to time and price, it may not be given to another party.

A specialist's/DMM's book may look something like the following example:

Buy	XYZ	Sell
5 Goldman 10 Schwab	20	
	20.05	
	20.10	1 Prudential 5 Fidelity
	20.15	2 Morgan
5 Merrill Stp	20.20	

The inside market for XYZ based on the specialist's book would be:

	Bid	Ask
15 × 6	**20.00**	**20.10**

Buyers are bidding for 1,500 shares and sellers are offering 600 shares of XYZ.

> **TAKENOTE!**
>
> The buy stop entered over the market by Merrill is not contained in the quote, because the order has not been elected.

CROSSING STOCK

A floor broker from time to time may get an order from both a buyer and a seller in the same security. The floor broker may be allowed to pair off, or cross, the orders and execute both orders simultaneously. In order for the floor broker to cross the stock, the specialist/DMM must allow it and the floor broker must announce the orders in an effort to obtain price improvement for the orders. The floor broker must offer the stock for sale at a price above the current best bid and may purchase the stock using the buy order if no price improvement has been offered. This will then complete the cross, and both orders will be filled.

DO NOT REDUCE (DNR)

GTC orders that are placed underneath the market and left with the specialist for execution will be reduced for the distribution of dividends. Orders that will be reduced are:

- Buy limits
- Sell stops

These orders are reduced because, when a stock goes ex dividend, its price is adjusted downward. To ensure that customer orders placed below the market are only executed as a result of market activity, the order will be adjusted down by the value of the dividend.

EXAMPLE

A customer has placed an order to buy 500 XYZ at 35 GTC. XYZ closed yesterday at 36.10. XYZ goes ex dividend for 20 cents and opens the next day at 35.90. The customer's order will now be an order to purchase 500 XYZ at 34.80 GTC.

If the customer had entered the order and specified that the order was not to be reduced for the distribution of ordinary dividends, it would have remained an order to purchase 500 shares at 35. The order in this case would have been entered as:

Buy 500 XYZ 35 GTC DNR

Orders placed above the market are not reduced for distributions.

ADJUSTMENTS FOR STOCK SPLITS

GTC orders that are left with the specialist must be adjusted for stock splits. Orders that are placed above and below the market will be adjusted so that the aggregate dollar value of the order remains the same.

EXAMPLE

A customer has placed a GTC order. Let's look at what happens to the order if the company declares a stock split:

Type of Split	Old Order	New Order
2:1	Buy 100 at 50	Buy 200 at 25
2:1	Sell 100 at 100	Sell 200 at 50
3:2	Buy 100 at 100	Buy 150 at 66.67
3:2	Sell 100 at 60	Sell 150 at 40

Notice that in all of the examples the value of the customer's order remained the same. To calculate the adjustment to an open order for a forward stock split, multiply the number of shares by the fraction and the share price by the reciprocal of the fraction, such that:

Buy 100 at 50 after a 2:1 stock split

$100 \times 2/1 = 200$

$50 \times 1/2 = 25$

The value of the order was $5,000 both before and after the order. If the stock undergoes a reverse stock split, all open orders will be canceled.

STOPPING STOCK

A specialist/DMM, as a courtesy to a public customer, may guarantee an execution price while trying to find an improved or better price for the public customer. This is known as stopping stock.

EXAMPLE

An order comes to the crowd to purchase 500 ABC at the market when ABC is quoted as follows:

	Bid	Ask
15 × 20	**40**	**40.20**

If the specialist/DMM stopped the customer, the specialist/DMM would guarantee that the customer would pay no more than 40.20 for the 500 shares. The specialist/DMM would then try to obtain a better price for the customer and try to attract a seller by displaying a higher bid for that customer's order. ABC may now be quoted after the specialist stopped the stock as:

	Bid	Ask
5 × 20	**40.10**	**40.20**

In this case, the specialist/DMM is trying to buy the stock for the customer 10 cents cheaper than the current best offer. If, however, a buyer comes into the crowd and purchases all of the stock that is offered at 40.20, the specialist/DMM must sell the customer 500 shares from his or her own account at no higher than 40.20.