TITLE: Direct Access Execution: ECNs, SOEs, SuperDOT, and Other Methods of Trading

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PUBLISHER: McGraw-Hill

ISBN: 0-07-136391-2

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The book Direct Access Execution by Simit Patel is a well written guide for those who wish to enter the financial markets using the latest technology. The text is organized in a logical fashion, with the first chapter providing an overview of the financial markets, and their potential for individual investors. Next, the author provides a summary of the various methods of trading in these markets, with a specific focus on electronic methods. The remainder of the book provides a detailed explanation of each method of trading, and discusses their strengths and weaknesses for the individual investor.

Patel does a good job describing the mechanics of the domestic financial markets, and uses many examples to illustrate the main concepts involved. The claimed target audience is for lay people, but the book moves beyond a basic level to a more sophisticated one early on. While the author touts this manual as being aimed at beginners, the language becomes very technical as the chapters progress. This is not a reflection of the author's literary skill, but necessarily follows from the fact that many of the financial concepts presented are quite complex.

The book focuses on various electronic trading methods, from online brokers to Electronic Communication Networks (ECNs). The author educates the reader about the details and advantages of these methods, discussing such topics as day trading salons and E*Trade accounts. Patel's reasoning is much like a lawyer's: he always presents both sides of an issue. After presenting various techniques and methods of trading, the author is quick to point out their weaknesses and potential pitfalls to individual investors. In addition, towards the end of the book, he addresses the concern of which electronic method is appropriate for a particular investor and strategy. This is particularly useful for a reader who is interested in using electronic trading to invest, or changing the electronic method currently used.

Patel first explains how securities are publicly traded. On an exchange, a buyer's offer to buy is known as a *bid*, and a seller's offer to sell is called an *ask*. On the NYSE, *specialists* match up the bids to the asks, and allow the brokers to complete the trade. 90% of the trades on the NYSE have equal bids and asks. With the NASDAQ, however, the *market makers* buy the security from the seller at the ask price, and sell it to the prospective buyer at the bid price. The difference between these prices is known as the *spread*, which the market makers are allowed to keep as profit for the trade. Therefore, the individual investor never really transacts at the best price, it is always marked up by the market makers. Patel explains these concepts to the reader as background for how the markets work, and how electronic trading methods fit into this model.

Pa1tel describes how ECNs cut out the middleman entirely. An ECN is essentially a massive bulletin board where investors can post the price that they are willing to buy or sell a security. When there is a match, a trade executes. There is no spread, since market makers are not involved. ECNs are essentially an alternative marketplace that functions to bring together investors who whish to trade shares on a particular security.

The author also explains many of the trading platforms from a historical view. The market crash of 1987 caused the Securities and Exchange Commission (SEC) to force certain areas of the market to develop technology. As the author explains, the New York Stock Exchange (NYSE) employs the use of specialists to maintain order and liquidity in the market. Each listed security has a single specialist who is legally mandated to ensure that all transactions are completed, even if it means dealing using their own account. For example, suppose the price of a security is dropping and an investor wishes to sell her shares, however, there is not a broker willing to buy the shares and fill the order. The specialist must step in and purchase the shares for his own account. Contrast this with NASDAQ, which employs the use of market makers who perform a similar function to specialists. The difference is that there are multiple market makers for each listed security, and the market maker's duties are not as strictly enforced. Market makers can also trade among themselves, and manipulate the market, to the detriment of the unseasoned investor.

During the market crash of 1987, investors panicked and attempted to sell their shares. The market makers, in turn, simply refused to pick up their phones and fulfill these orders. The SEC reacted by mandating the creation of the Small Order Execution System (SOES), which is a direct access system that matches bids and asks and executes orders. This system forces liquidity and automatically ensures that at least part of an investor's order is fulfilled. Patel's description of the financial markets and the history that has shaped them allows the reader to appreciate the purpose and role that electronic trading has in our markets.

In addition to the historical reasons for the creation of electronic systems, the author provides the audience with information regarding trading strategies. For example, some investors practice a technique known as gaming. Gaming is when a party places an order for a trade, usually through and electronic system, and then promptly cancels it. This process is repeated with the ultimate purpose of artificially increasing demand. The investor is then able to sell their position at a higher price. Although this is clearly not a complete work on trading strategies, it does give the reader a sense of the techniques that can be employed, and the dangers that can imperil the naïve investor.

The author raises a very important policy issue throughout the book. It should be noted that the publication date for this book is 2001, and it was likely written before the dot-com bubble burst. Patel notes that ECNs, online brokers, and other forms of electronic trading facilitate easier access to the markets, and allow for more trading. This expanded market increases liquidity, which from a purely capitalist point of view, benefits investors through increased competition and a wider market by allowing more trades to be fulfilled. In reality, this increased liquidity has translated into volatility. Twenty years ago, the markets were more exclusive, and were only friendly to larger and wealthier investors. Direct Access trading has changed all that, and now allows smaller, more novice investors to access these same markets. As the book alludes, having novice investors participating in the markets is not always a desirable event. Market makers and specialists provide equilibrium in the market, but with ECNs, there are no stabilizing devices since the investors trade directly with one another. Although this book predates the "dot-com bust", it would be an interesting study to examine the aggregate impact of all of these smaller investors, and how much ECN's and electronic trading contributed to the current bear market.

Much of this book is concerned with methods for *trading*, rather than *investing*. These two concepts are distinguished in that *investing* usually involves holding a position for a relatively long period, and selecting the security based on the quality of the underlying company or issuer. In contrast, a person engaged in *trading* buys and sells a security fairly rapidly for the purpose of making money on the difference in price.

As a result, the focus is on the speed and costs of the transactions. Again, although the issue is raised but not addressed directly, the fact that so many investors trade in a speculative manner may have a deleterious effect on the market as a whole. Stocks are selected purely based on their price, not the underlying company. This serves to increase volatility in the markets, and also allows more novice investors to get hurt. The author issues numerous related warnings throughout the book that should be heeded by the novice investor. Day trading and electronic trading allow much easier access to the markets, but also make it much easier for investors to get hurt. Patel warns, "As we have seen, at the heart of the Nasdaq's chaotic democracy is what is currently at the heart of the rest of the financial world: technology."

I highly recommend *Direct Access Execution* for a novice investor exploring different ways to invest in the domestic markets, electronic or otherwise. The reader can expect an overview of the markets and the role that technology plays in them. This book is fair, and does not promote one method of trading over another, but rather gives a brief overview of the investing mediums that are available to an individual investor. It is not an exhaustive resource, however, and does not make such a claim. The work is simply a guide to allow a layperson to select and explore the method of investing for which he or she is best suited.