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Richard Rizzo – Stock Market Trader & Professional Trading Education Provider

How to Add or Removing Liquidity From The Stock Market Place:
The understanding of Adding and Removing liquidity is hard to grasp at first, but it's quite simple once you get it. One basic principal you should know before trying to figure it all out is this... Most Direct Access Traders looking to get the best price fill will at a particular moment will come out of pocket to pay the ECN fee or will pay even more by using an alternate ECN provider that charges little or no fee for the execution. Therefore, a typical intraday trader cannot escape coming out of pocket one way or the other for the cost of ECN's, and have two choices as explained below.

Choice 1: Removing Liquidity By Executing Your Limit Order At The Best Available Price
In most cases, this is the best choice and is preferred by most experienced day traders who understand that entering or exiting a position to the exact penny is most important to make a profit or avoid a loss. In most cases, this choice will TAKE LIQUIDITY from the market and result incurring an ECN charge of apprx $.0025 per share from the desired destination. (examples: ARCA, NSDQ, BATS, NSDQ, NYSE, NITE, TRIM, etc…)

Choice 2: Adding Liquidity By Executing Your Limit Order At An Undesirable Price
Richard Rizzo has found through his statistics, that this choice is NOT preferred by most experienced traders because it may result in executing your order at an undesirable price. This would result in losing out on $0.01 penny per share or more, and may cost you four times the cost of a $0.0025 ECN fee. Keep in mind that for every $0.01 penny away from your desired limit price is apprx Four Times the ECN fee. ($0.0025 X 4 = $0.01 penny)

Again, you will come out of pocket either way so it's best to just TAKE liquidity and pay the ECN charge and make things more simple and more profitable for you in most cases. Another problem with trying to add liquidity may result in the trader "missing the set-up" entirely as explained in more detail below.

Long Positions – Adding / Removing Liquidity

LONG POSITIONS - REMOVING Liquidity:
Placing your Limit Order ABOVE the "Current Price" and waiting for it to execute when it "Rise Up" to your limit will always "REMOVE" liquidity as you will be a "REMOVER" of stock in the current market place. For example, if the current price is $29.90 and your strategy is to BUY at $30.01 LIMIT, your order will REMOVE LIQUIDITY from the current market place. This is true for the reason that you're "REMOVING" and NOT "contributing" to the liquidity in the market place.

LONG POSITIONS - ADDING Liquidity:
Conversely, placing your Limit Order BELOW the "Current Price" and waiting for it to "Fall Down" to your limit will always "ADD" liquidity as you will be a "Contributor" of stock to the current market place. For example, if the current price is $30.05 and your strategy is to BUY at $30.01 LIMIT, your order will ADD LIQUIDITY to the current market place if the price falls to your limit as you are contributing to the liquidity in the market place. However, placing a limit order in this fashion will often defeat the purpose entering at the bottom of a trading range with the strategy of selling at the top. Why? Because in most cases a stock with strong upward momentum will often continue to rise after breaking out of the top of its range and continue to travel upwards. As a result, your limit order will most likely fail to trigger as the stock may NOT come down to your limit price.

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Short Positions – Adding / Removing Liquidity

THE EXPLANATION ABOVE IS OPPOSITE FOR SHORTING STRATEGIES EXPLAINED BELOW:

SHORT POSITIONS - REMOVING Liquidity:
Placing your Limit Order BELOW the "Current Price" and waiting for it to execute when the price "Falls Down" to your limit price will always "REMOVE" liquidity from the market place. This is true because you will be a "REMOVER" of liquidity and NOT a contributor. For example, if the current price is $30.05 and your strategy is to SHORT at $29.99 LIMIT, your order will REMOVE LIQUIDITY from the current market place if the price falls to your desired limit.

SHORT POSITIONS - Adding Liquidity:
Conversely, placing your Limit Order ABOVE the "Current Price" and waiting for it to "Rise Up" to your limit will always "ADD" liquidity as you will be a "Contributor" of stock to the current market place. For example, if the current price is $29.92 and your strategy is to SHORT at $29.99 LIMIT, your order will ADD LIQUIDITY to the current market place as you are contributor of liquidity to the market place. However, placing a limit order in this fashion will often defeat the purpose of shorting at the TOP of a trading range with the strategy of "covering" at the bottom. Why? Because in most cases a stock with strong downward momentum will often continue to fall after breaking through the bottom of its range and continue to travel downward. As a result, your limit order will most likely fail to trigger as the stock may NOT come back up to your limit price.

Conclusion :

Richard Rizzo feels that stock market intraday traders should know that most expert day traders often do not enter limit orders in a way to purposely ADD Liquidity. In most cases, this practice will cause more damage than good. The whole premise of "Breakout Trading" is to position yourself at a limit price immediately above/below the breakout threshold for a long/short position. If the trader does not act and enter immediately at the moment of break out, they will most likely miss the trade or enter at a bad price. Missing your entrance price by 1 penny or more will cost a trader 4 to 5 times the cost of the ECN fee of 1/4 of a penny per share.
In conclusion, most expert traders are mainly concerned with their preferred execution price and not their commission or ECN cost. Those who try to evade the ECN cost by focusing on adding liquidity often get filled $.01 or more pennies away from their desired price. The loss incurred from an undesired price execution will ultimately result in costing a trader 5 times the ECN charge or more.
I would also add that most expert "breakout" day traders usually REMOVE liquidity more than 95% of the time and only ADD Liquidity approximately 5% of the time. Adding liquidity 5% of the time often happens by random and is not achieved on purpose.