



HowToTrade

LEVEL 2 TRADING [PDF]

[Visit our website](#)





Table of Contents

- **First, What is Level 2 Data?**
- **How Does Level 2 Market Data Work and How to Read Level 2 for Day Trading?**
- **The Benefits of Using Level 2 Trading Data**
- **How to Trade with Level 2 Data – Tips and Strategies**
- **Level 2 Trading in Different Markets**
- **What are the Benefits and Limitations of Level 2 Trading**

What Is Level 2 Trading and Why Is It So Important?

Trading is all about getting information and knowing how to interpret this data to find successful trades. If so, then you can assume that the most crucial factor for success in trading is the reliability and the format in which a trader receives the information.

Level 2 quotes are by far the ultimate market data source to get more detailed and complete information.

First, What is Level 2 Data?

Level 2 market data is an order book that gives retail traders and institutional players a more detailed set of information about the traded asset. Unlike the level 1 order book that shows the last bid prices and ask prices, level 2 shows the complete list of bid and ask the market maker who placed the order, and the quantities (the size of the order).

In most cases, level 2 order boxes show around 5-10 best bid and ask prices, though, in some exchanges, you may get access to up to 40 bid and ask prices. To be able to use level 2 market data, a trader must have access to assets traded on an exchange. So, for example, when trading assets on a stock exchange, options, or futures contracts (commodities, forex, indices, etc.) – a trader can get access to level 2 data.

How Does Level 2 Market Data Work and How to Read Level 2 for Day Trading?

Level 2 is often perceived as a complex data service; however, knowing how to read and understand level 2 trading is actually very straightforward.

Simply put, a level 2 market depth order book shows the asset's supply and demand offer in real-time. In addition, the vast majority of level 2 order books on different trading platforms look pretty much the same, so once you learn how to read and analyze level 2 data, you'll be able to use it on any trading program.

As you can see in the image below, the list of buyers is on the left side of the screen, and the list of sellers is on the right side. In this example, the first buyer offers to buy 600 shares of Intel at 29.33 via the INCA market maker (Instinet). On the right side of the screen, the first seller is willing to sell 1000 shares at 29.36 via the NFSC market maker. This is, in a nutshell, how level 2 market data works on the NASDAQ stock exchange.



Moreover, **the level 2 order book** also shows a time sales box where you can see every transaction made on the specific market, including the price and quantity. If the transaction is displayed in red, it means that the order was made on the bid side. If the transaction is displayed in green, it then means that the order was made on the ask side.

Note that the time and sales screen is an extremely valuable asset for [day trading](#). Because the market is highly manipulated by market makers who place orders and suddenly disappear or use various automated order types – the time and sales will help you get facts and see only the executed trades.

The Benefits of Using Level 2 Trading Data

Trading with level 2 data is a necessary trading tool for active intraday traders and scalpers. Almost [every proprietary trader](#) uses a level 2 order book to analyze the markets and place orders. Many of these traders will tell you that it's impossible to day trade without using the level 2 data service.

Some of the key benefits of using level 2 trading data include:

1. More Information

The main benefit of using a level 2 order book is, obviously, the wealth of data and information related to the specific asset. While level 1 gives you the first buyer and seller, level 2 gives you much more information.

Additionally, level 1 could be highly misleading as many traders use a unique [technique known as AX trading](#). By using this technique, a trader is placing 100 shares to sell, but the order book shows just one share (yes, it's possible to do that). In the level 1 order book, you would think that selling pressure is rising (as you'll see one share on the bid side), while in **the level 2 order**, you can see how buyers are eager to buy more as you can see the full list of buyers and you can identify this trick.

In some scenarios, you can also know when a big institution enters a specific market. In commodity futures and bond futures markets, you can even identify when governments are entering and buying (or selling) in large amounts. In forex trading, this phenomenon is known as [order blocks forex](#).

Furthermore, once you learn how to identify when a big player is entering the market, you can take a direction with the institution or big investors that have a significant position in the market or the other way. With level 2 data, there are many tricks and new ways to predict where the market might go next.

2. Easier to Know the Market Sentiment with Level 2 Market Data

Undoubtedly, as you have more information about the specific asset, you may better understand and feel the sentiment in the market. Just visualize it like a food market where buyers and sellers battle to get the best prices for their interests.

Well, that's level 2 market data – the ultimate tool for centralized exchanges to present a real sense of a market. For that reason, many traders who utilize the [naked trading strategy](#) usually use level 2 market data to analyze the markets.

3. You Get the Best Prices

Another benefit of using level 2 data quotes is that you can negotiate to get the best available prices. In other words, you can change your orders, set subsequent orders, etc. This is particularly important when you trade derivatives and options. For example, let's assume you are trading the Apple stock 146 June call option contract with a level 2 market data, and the Apple share price (underlying asset) is trading at 146.14.

The orders placed in the market are based on the price movement of the AAPL share price, and thus, every price movement impacts the option price. In this case, let's say the Apple stock price action is rising, and you placed an order to sell the option at 2.48 when the bid price is 2.41. Then, as soon as you noticed the price is rising, you can immediately change your order to 2.50, 2.55, or even higher to get the highest price.

To sum up, here's a comparison table of all the different types of market data – level 1, level 2, and level 3.

Market Data Level	Data
Level 1	Best bid and ask price + quantity on each side
Level 2	Market depth of typically up to the 5-10 best bid and offer prices + quantity + market maker
Level 3	Market depth of typically up to the 10-20 best bid and offer prices + quantity + market maker

How to Trade with Level 2 Data – Tips and Strategies

As we have previously mentioned, the level 2 order book is a valuable and effective trading tool. So, you need to get familiar with several techniques and trading strategies when using level 2 market data. Those include:

1. Low Liquidity Can Be an Advantage

A common technique among day traders is to find markets with low liquidity and set orders on both sides or get an execution on one side and switch to the other. It's a risky strategy, but it may generate consistent profit over the long run if you learn how to master this technique.

By being completely neutral when using this trading strategy, you basically wait in the

queue on the bid or ask side. Then, once the order is executed, you can place another order on the other side and wait again in the queue.

2. Scalping Trading

Scalpers typically try to capture minimal price movements – a few ticks, cents, etc. They use one-minute or five-minute charts and often make many daily transactions to collect small profits.

To [scalp trade](#), they must use level 2 trading data and various automated order types. As they usually buy and sell large numbers of shares, futures contracts, or forex lots – they use sophisticated market orders to open and close their traders without showing the number of shares they hold.

3. Trading Breakouts

Even though it is possible to trade breakouts with a level 1 order book, doing it with a level 2 data book is much clearer and more effective.

When you look at the price ladder with level 2 data, and you see the pressure building up or down to break the highest or lowest level of the day (or week/month, etc.), then you can easily find the right entry-level and make profits while trading the breakout. Ultimately, you can build a trading strategy entirely around this concept.

4. Follow the Prints

As we mentioned earlier, the time and sales screen is a vital tool to understand the flow in the chosen market. If you know how to read it correctly and avoid all the false order placements made by market makers, you can find many trade entry and exit points. That is why [order flow analysis](#) is one of the best methods on how to use level 2 data for day trading.

For example, if you notice print after print of sell orders on the bid side, that means sellers are willing to sell the asset at any given price on the bid side. There's no doubt that the momentum is bearish in such a scenario, and you'll enter a short-selling position (or exit an existing long position).

Level 2 Trading in Different Markets

Generally, you can trade almost any asset using level 2 market data. As long as the asset is listed on an exchange, you'll be able to get access to level 2 trading. But the benefits of using level 2 market data have a higher impact on some markets than others.

Level 2 Option Trading

Level 2 options trading offers more flexibility in terms of how traders can trade options. In my view, if you are planning to trade options, the first thing you should do is to get access to level 2 options data. Even if you are not going to use level 2 as a trading strategy, it's a must-have tool you need to trade options.

The main reason is that options are derivative instruments tied to the underlying asset. So, the option's price often stays the same for several minutes or even hours. But the orders in the level 2 order book change constantly, and in many cases, you can use it to your advantage.

Level 2 Data in the Stock Market

As stocks and ETFs are traded on centralized exchanges, this is the easiest way to access level 2 trading. As a matter of fact, most banks and online brokerage firms offer level 2 stock trading as part of their basic packages. Furthermore, with a quick search, it is even possible to get stocks and ETFs level 2 data for free online.

Day trading stocks, ETFs, and especially penny stocks using level 2 data is highly recommended. Most active Penny stocks trade on the OTC and have a low trading volume, meaning it is fairly easy to manipulate prices. For that matter, level 2 can be incredibly useful. For instance, when you notice an important market maker placing a large bid and the order flow is changing – it would potentially be a successful trade. Here's an example of what level 2 data looks like on a web page.

Source: [OTCMarkets.com](https://otcm.com)

OTCM



OTC Markets Group Inc.

Class A Common Stock

58.9999 ↑ 0.4999
0.85%

58.75 / 59.00 (100 x 100)

Real-Time Best Bid & Ask: 09:48am 06/07/2022
Delayed (15 Min) Trade Data: 09:34am 06/07/2022

Overview	Quote	Company Profile	Security Details	News	Financials	Disclosure	Research
OPEN	58.9999	DAILY RANGE	58.9999 - 58.9999	VOLUME	100	DIVIDEND	0.72
PREV CLOSE	58.50	52WK RANGE	41.25 - 66.94	AVERAGE VOL (30D)	2,509	NET DIVIDEND YIELD	1.22
BEST BID	58.75 x 100	BEST ASK	59.00 x 100	MARKET CAP 	693,618,939	SHARES OUT 	11,856,734

REAL-TIME LEVEL 2 QUOTE

MPID	BID PRICE	SIZE	TIME	MPID	ASK PRICE	SIZE	TIME
NITE	58.75	100	09:45	NITE	59.00	100	09:48
OTCX	58.50	200	09:42	CDEL	59.10	313	09:46
RAJA	58.00	100	09:35	GTSM	59.44	100	06/06
CDEL	58.00	100	09:46	CSTI	60.95	100	08:30
MONR	56.06	100	06/03	OTCX	62.10	200	08:03
GTSM	53.82	100	06/03	ETRF	65.50	100	09:30
CSTI	53.82	100	08:30	MONR	65.95	100	06/01
ETRF	53.82	100	09:30	RAJA	65.95	100	09:35
WBSI	42.00	100	03/10	WBSI	175.00	1	02/23

Level 2 Data Futures Trading

The futures market is the most important and developed financial market worldwide. This is where commodities, metals, global indices, interest rates, bonds, and FX currency pairs are traded and shipped worldwide. So, being the most developed market, it is not surprising that you get access to level 2 data, meaning you can trade any asset listed on the specified exchange with level 2.

However, take into consideration that this service is usually costly. Assuming you'd like to open a futures trading account and get access to level 2 data, you need to focus on one market. Otherwise, it could be expensive as brokerage firms charge a high fee for providing level 2 data.

Level 2 Data in the Forex Market

Getting access to level 2 data in the forex market is perhaps the most complicated of all.

The reason is that the forex market is decentralized, where there's no exchange or physical location where traders buy and sell currency pairs.

Yet, if you wish to trade currency pairs with level 2 data, you can do it in the following ways: trade FX currency pairs via future contracts or open an account with an Electronic Communication Network (ECN/STP) or Direct Market Access (DMA) forex broker. The first option requires a high initial deposit and typically high fees. The second option requires a lower initial deposit though you must check with the brokerage firm that they indeed offer access to level 2 data.

What are the Benefits and Limitations of Level 2 Trading

Below, we mention some of the key advantages and disadvantages of using level 2 market data:

Pros

- A level 2 market data shows more detailed information about what is happening in the market – easy to absorb the market sentiment.
- There are many strategies and trading techniques that are not available when using a level 1 order book.
- Easier to scalp trade assets with low liquidity – setting orders on both sides
- Ideal trading tool for active day traders
- The time and sales box is an extremely valuable tool

Cons

- Less suited for long term investors
- Many tricks of market makers may cause unexpected losses
- Not available for all markets – CFDs, FX currency pairs (not futures), etc
- Level 2 trading can be confusing when trading volatile assets