

The Nitty-Gritty Of Executing A Trade

Have you ever wondered what happens when you buy or sell a stock through a stockbroker? Trading is as simple as clicking a mouse, but it is actually quite a complicated matter behind the scenes. When entering an equity order on your [computer](#) or through your broker, you are, on some occasions, trading with another person through an [exchange](#), but on other occasions you are only making a trade with your [broker](#). These are the two main types of trades that investors will encounter: [principal](#) and [agent](#) transactions. Let's look at this in more detail.

Principal Trading

Principal [trading](#) occurs when a brokerage buys securities in the [secondary market](#), holds these securities for a period of time and then sells them. The purpose behind principal trading is for firms (also referred to as [dealers](#)) to create profits for their own portfolios through price appreciations. So when an investor buys and sells [stock](#) through a brokerage firm that acts as the principal to a trade, the firm will use its own inventory on hand to fill the order for the client. With this method brokerage firms earn extra income (over and above the commissions charged) by making money from the [bid-ask spread](#) of a particular stock. (To learn more, see [Why The Bid-Ask Spread Is So Important?: "The Basics Of The Bid-Ask Spread"](#).)

For instance, if you were looking to buy 100 shares of ABC at \$10, the principal firm would first check its own inventory to see whether or not the shares are available to sell to you. If they are available, the firm would sell the shares to you and then report the transaction to the necessary exchange. This reporting may be, for ensuring regulations and safeguarding clients, the most important action of a principal trade. The [Securities and Exchange Commission](#) and exchanges require that the brokerage firms complete the trades at prices comparable to those of the market.

Agency Trading

An agency transaction is the other popular method for executing a client's orders. More complicated than regular principal transactions, these deals involve the search for and transfer of securities between clients of different brokerages. The increasing number of participants in the securities market and the need for extremely accurate bookkeeping, clearing, settlement and reconciliation make ensuring the smooth flow of the securities markets quite a task.

Agency transactions are comprised of two distinct parts. First, your brokerage needs to bring your request to the appropriate market in order to find a party wishing to assume the opposite position. So, if you wish to buy at a certain price, the broker needs to find someone wishing to sell at the same price and vice versa. Once both parties are found, the exchange records the transaction on its ticker tape, and an exchange of money and securities between the parties occurs on settlement.

The second portion of the agency transaction occurs after the trade is completed and has been properly documented on the exchange. This portion is commonly referred to as [clearing](#). While all brokers maintain individual books recording the entire amount of buy and sell orders transacted by clients, the actual act of clearing these transactions is handled by a larger

institution. In North America, the institution handling the vast majority of clearing and safekeeping duties is the [Depository Trust Clearing Corporation](#) (DTCC). In 2001 alone, the DTCC delivered over \$120 trillion worth of cash and securities.

The basic act of clearing involves matching buys and sells. Once the transactions are executed on the exchange, details of the trades are sent to a subsidiary of the DTCC (called the [National Securities Clearing Corporation](#)), and are subsequently recorded and matched for accuracy. After all the trades sent by member firms to the DTCC are matched for buys and sells, the DTCC then notifies all member firms of their associated obligations, and arranges the transfer of appropriate [funds](#) and securities. Thus, rather than having individual brokers dealing with one another after every trade on a securities exchange, the DTCC acts as middleman collecting all transactions and streamlining the transfer of stocks and cash. This reduces the amount of time required for delivery and receipt of obligations and provides flexibility for brokerages in choosing dealing partners. This entire clearing process usually takes three days to complete.

It is important to note that the DTCC not only facilitates but also guarantees delivery. If one party fails to deliver the securities or cash to the other, the DTCC will step in and fulfill the obligations of the failing party.

Brokers are required to inform you as to whether a filled trade was an agency or principal transaction; you are usually notified in your trade confirmation sent in the mail (or electronically). Although you cannot specify to your broker how you want the trade to be filled, as a client you have the right to know how your transaction was completed.

Conclusion

Although this information might not make you any more money in the market, it is important for investors to understand the process of filling orders. These two ways of transacting orders not only help reduce the risk for investors, but also give brokerage clients a relatively liquid and efficient way of placing and executing trades.

by Investopedia Staff

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