For Every Seller There's a Buyer

How Markets Work

by Virginia B. Morris, Editorial Director, Lightbulb Press

It's easy to imagine a marketplace. Think of a farmers' market, a suburban mall or something a bit more exotic, like a Moroccan bazaar. It's a place of constant activity, with goods and money always changing hands. The securities marketplace is at least as busy — though it isn't always a physical place. The goods for sale are the stocks, bonds and other products that investors want to buy or sell.

Trading Securities

Traditionally, stocks are traded through an auction system on the floor of a stock exchange. Brokers representing investors who want to buy compete against brokers representing investors who want to sell until two parties agree on a price that satisfies them both and the deal is struck. Individuals called specialists oversee the trading in each different stock, making sure there's enough activity. The New York Stock Exchange (NYSE) is the best-known stock exchange in the United States and the largest in the world. On average, more than 1.5 billion shares change hands at the NYSE every day.

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But the electronic age has revolutionized the traditional exchange. An increasing number of transactions on the NYSE are executed through a computer-based order-matching system, and the other major U.S. stock marketplace, The Nasdaq National Market, has been entirely electronic since it was founded in 1973. The Nasdaq has no trading floor. Transactions are handled through an elaborate telecommunications system linking traders, called market-makers, from all over the country.

Most bonds are traded via telephone and computer networks as well, with brokers who represent buyers seeking bond issues from brokers who have them to sell. Here, too, buyers and sellers compete because there's a limited (though large) supply. To speed up the fulfillment of client orders, brokerage firms often keep an inventory of bonds in their firms' accounts to have them readily available.

Primary and Secondary Markets

The stock and bond marketplaces where trading takes place make up what's called the secondary market. All the buying and selling that occurs in the secondary market is in stocks and bonds that some investor already owns.

For example, suppose you own 100 shares of Stock A, which has increased in price since you purchased it. You decide you'd like to sell Stock A and use the proceeds, or money, you get from the sale to buy Stock B because you think that stock will gain in value as well. So you give your broker an order to sell Stock A and buy Stock B. Your broker passes on the order to a person in the firm who does the trading. He or she sells Stock A to a firm acting for someone who wants to buy Stock A and purchases Stock B from a firm acting for someone who wants to sell that stock.

For those stocks or bonds to be available for trading, they have to be created by a publicly traded company that's permitted by the U.S. Securities and Exchange Commission (SEC) to offer investments to the public. The company can choose to issue shares of stock in an initial public offering (IPO) or to float a bond. When that investment is sold for the first time, the issuing company collects the money that's raised in the sale. In fact, gaining access to that capital is the reason a company issues securities in the first place.

But once the stocks or bonds have been purchased, any further trading produces no money for the issuing company. For example, if you buy a stock for \$10 a share and sell it for \$15 a share, the \$5 difference is yours, minus any sales charges or fees you must pay. The potential for capital gain and the possibility the company will pay dividends to its shareholders are probably why you invested in the stock in the first place. Of course, there's no guarantee you'll make money: Securities prices move up and down all the time, based on investor demand — which itself is based on a raft of other forces, including what's happening in the economy as a whole — and supply of available shares.

Working With a Broker

To buy or sell most stocks or bonds you need a brokerage account. Exceptions include bonds issued by the U.S. government, which you can buy directly, and stocks of companies that allow you to buy shares directly from them. You give orders to buy or sell through a brokerage account and you receive confirmation when the order has gone through. You can use a full-service broker or a discount broker, communicating either by phone or online. Or you might open an account with a firm that operates exclusively online.

In most cases you pay a brokerage commission, or sales charge, each time you buy or sell. But some brokers offer fee-based accounts, charging you a percentage of your account value each year to cover the services they provide. In that case commissions on at least some of your trades are waived. Some online brokerage accounts charge a fixed-rate fee per trade, which is usually the least expensive way to invest.

Market Regulation

You and other investors are willing to put your money into U.S. securities markets because you're confident your orders will be followed, you'll own the securities you pay for and you'll receive payment for the ones you sell. That's the case, at least in part, because of a multi-level, public and private collaboration on regulation.

The markets, as self-regulatory organizations (SROs), make and enforce the rules to keep things honest. The industry is regulated as well by the states and by the federal government through the SEC.