"Outline the differences between a broker and a dealer (or marketmaker) in financial markets, including discussions of how they are remunerated and what risks they run."

A financial market consists of diverse financial assets traded between buyers and sellers. In addition to enabling exchange of previously issued financial assets, financial markets make possible the borrowing and lending by facilitating the sale by newly issued financial assets. Examples of financial markets include the New York Stock Exchange (which is involved in the resale of previously issued stock shares), the U.S. government bond market (which is involved in the resale of previously issued bonds), and the U.S. Treasury bills auction (sales of newly issued T-bills). A financial institution is an organization whose primary source of profits is through financial asset transactions. Examples of such financial institutions include discount brokers, banks, insurance companies, and complex multi-function financial institutions such as Merrill Lynch.

Financial institutions participate in financial markets by creating and/or exchange of financial assets. In the financial market there are four institutions that carry out in this type of trade. One of which is a broker which is a commissioned agent of a buyer/seller who facilitates trade by locating a seller/buyer to complete the desired transaction. A broker does not take a position in the assets he or she trades; there is no maintaining of inventories in these assets on behalf of the broker. The commissions they charge to the users of their services determine the profits of brokers. Examples of brokers include real estate brokers and stockbrokers.

Diagrammatic Illustration of a Stock Broker:

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      Payment    ----------------   Payment
    ------------>|               |------------->
Stock            |               |      Stock
Buyer            |  Stock Broker |      Seller
  <--------------|<--------------|<-------------
      Stock      | (Passed Through)|   Stock
      Shares     ----------------      Shares
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Dealers, like brokers, facilitate trade by matching buyers with sellers of assets; they do not engage in asset transformation. Unlike brokers, however, a dealer can and does "take positions" (i.e., maintain inventories) in the assets he or she trades that permit the dealer to sell out of inventory rather than always having to locate sellers to match every offer to buy. Also, unlike brokers, dealers do not receive sales commissions. Rather, dealers make profits by buying assets at relatively low prices and reselling them at relatively high prices (buy low - sell high). The price at which a dealer offers to sell an asset (the "asked price") minus the price at which a dealer offers to buy an asset (the "bid price") is called the bid-ask spread and represents the dealer's profit margin on the asset exchange. Real-world examples of dealers include car dealers, dealers in U.S. government bonds, and Nasdaq stock dealers.

Diagrammatic Illustration of a Bond Dealer:

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     Payment    -----------------   Payment
    ------------>|             |------------->
Bond            |    Dealer     |            Bond
Buyer           |              |            Seller
   <-------------|  Bond Inventory |<-------------
      Bonds     |              |   Bonds
                 -----------------
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