INVESTING BROKERS

Markdown

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What Is a Markdown?

A markdown in finance is the difference between the highest current bid price among dealers in the market for a security and the lower price that a dealer charges a customer. Dealers will sometimes offer lower prices to stimulate trading; the idea is to make up for the losses with extra commissions.

KEY TAKEAWAYS

- A markdown in finance is the difference between the highest current bid price among dealers in the market for a security and the lower price that a dealer charges a customer.
- Subtracting the price on the inside market from the price a dealer charges retail customers gives a spread. This spread is known as a markdown if the spread is negative; it is called a markup if it is positive.
- Markups are more common than markdowns because market makers can usually obtain more favorable prices than retail customers.

Understanding Markdowns: Bids and Spreads

In finance, bid prices are how much buyers are offering to pay. Ask prices are the amounts that sellers are willing to accept. The difference between the highest bid price and the lowest ask price is called the bid-ask spread.

The inside market is the trading in a particular security that occurs between market makers (dealers that meet specific criteria). The inside market usually has lower prices and smaller spreads than the market for retail investors.

Markdowns and Markups in Finance

Subtracting the price on the inside market from the price a dealer charges retail customers gives a spread. This spread is known as a markdown if the spread is negative. The spread is called a markup if it is positive.

Markups are more common because market makers can usually obtain more favorable prices than retail customers. Market makers can buy securities in bulk, and inside markets are more liquid.

However, there are situations wherein markdowns occur. For example, a municipal bond issue might not have as much demand as a dealer thought it would. In this case, they might be forced to reduce the price to clear their inventory. Dealers might believe that by marking prices down, they can generate enough trading activity to make up for their losses through commissions.

> Financial firms do not have to disclose markups and markdowns in principal transactions

Markdowns and Disclosure

It is important to note that financial firms do not have to disclose markups and markdowns in principal transactions. So an investor can easily be unaware of the price difference. A principal transaction occurs when a dealer sells a security out of its own account and at its own risk. An agency transaction occurs when a broker facilitates a transaction between a customer and another entity.

In the U.S., many companies combine the roles of broker and dealer. These firms are broker-dealers. When you purchase a security from a broker-dealer, the financial transaction might be either a principal transaction or an agency transaction.

Broker-dealers are required to disclose how a trade is completed in the trade confirmation, along with any commissions.[1]

However, they are not required to disclose markups or markdowns, except under certain circumstances.

Special Considerations: Excessive Spreads

Regulators generally consider markups and markdowns of more than 5% to be unreasonable, but this is only a guideline. Markdowns of more than 5% can be justified in light of prevailing market conditions. Relevant market conditions include the type of security, the dealer's broader pattern of markups and markdowns, and the price of the security.[2]

As a general rule, the best brokers keep spreads far below excessive levels because of intense competition in financial markets. High spreads are also more likely to be an issue with thinly traded securities.