

Understanding the Primary and Secondary Markets in ETFs

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Key Takeaways

- The dual-market system behind ETFs, primary and secondary markets, enables intraday liquidity and tight pricing spreads that distinguish them from mutual funds.
- Authorized participants play a critical behind-the-scenes role in maintaining ETF efficiency by creating or redeeming shares in response to investor demand.
- Understanding how primary market mechanisms stabilize ETF pricing can help investors make smarter decisions about liquidity and cost efficiency.

ETFs have surged in popularity thanks to their transparency, low costs and tax efficiency. But behind the scenes, a unique dual-market system powers their liquidity and accessibility. To fully grasp how ETFs function—and why they're so efficient—it's crucial to understand the **primary** and **secondary markets**.

What Are the Primary and Secondary ETF Markets?

These two markets play distinct roles in the life of an ETF:

- The **primary market** is where **ETF shares are created or redeemed**. This is not where most investors operate; this market is primarily used by **authorized participants (APs)**, typically large institutional traders.
- The **secondary market** is where **everyday investors buy and sell ETF shares** on an exchange, just like a stock. This is where you, as a retail or institutional investor, are likely engaging with ETFs.

Let's dive into both.

The Primary Market: Where ETFs Are Born

When demand for an ETF increases (or decreases), the number of shares can change thanks to a process involving **creation and redemption**. This happens in the primary market and involves the following:

- **Authorized Participants**

APs are typically large banks or trading firms that have agreements with the ETF issuer. They are the only ones allowed to interact directly with the fund.

- **Creation Process**

If an ETF is in demand, APs **create new shares**. They do this by delivering a basket of the underlying securities (or sometimes cash) to the ETF issuer in exchange for new ETF shares.

- **Redemption Process**

If there's less demand, APs can **redeem shares** by returning ETF shares to the issuer and receiving the underlying securities in return.

This process ensures that the **supply of ETF shares adjusts with demand**, helping the ETF price stay close to its net asset value (NAV).

The Secondary Market: Where Investors Trade

This is the market most investors are familiar with. You buy and sell ETF shares on exchanges like the NYSE or NASDAQ through a broker.

Key features of the secondary market:

- **Intraday Liquidity:** Unlike mutual funds (which trade once per day at NAV), ETF shares trade all day at market prices.
- **Bid/Ask Spread:** This is the difference between the price a buyer is willing to pay and the price a seller is asking. It reflects the liquidity and efficiency of the ETF.
- **Market Makers:** These are firms that help ensure there's always a buyer and seller by quoting prices and standing ready to trade.

How Do the Two Markets Work Together?

The interaction between the primary and secondary markets is what makes ETFs unique:

- When buying or selling volume in the secondary market increases significantly, APs step in via the primary market to create or redeem shares.
- This arbitrage activity ensures ETF prices stay in line with NAV, keeping ETFs efficient and liquid.

Example

If an ETF's market price trades above its NAV, APs can buy the underlying securities, create new ETF shares and sell them at the higher market price—capturing a profit and pushing the ETF price back toward NAV.

Why This Matters to Investors

- **Liquidity Isn't Just in Trading Volume:** Even if an ETF doesn't trade much, the underlying securities may be liquid—meaning APs can still create or redeem shares easily.
- **Efficient Pricing:** Thanks to the arbitrage mechanism, ETFs tend to trade close to their fair value.

- **Lower Costs:** The structure reduces the need for the fund manager to buy/sell securities because of investor flows, which can reduce trading costs and taxes.

Final Thoughts

The dual-market structure is what sets ETFs apart from mutual funds and individual stocks. While most investors only see the secondary market, the **primary market acts as a crucial stabilizing force** that keeps prices in check and ensures liquidity.

Understanding both markets can help investors better assess ETF liquidity, pricing and overall efficiency.

For more on the basics of ETFs, how they work and the risks and benefits to investors, visit our [ETF Education page](#).

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