

# Preferencing, Internalization and Dealer Inventory

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## Abstract

This paper examines how preferencing and internalization affect the quote-setting behavior of risk-averse dealers who differ in their inventory position. Discretionary order handling is larger with internalization since dealers are allowed to pass internalized orders to an external best-quoting dealer, which they are usually not allowed to do with preferenced trades. When competition is weak, both practices impede price competition between dealers and lead to wider market spreads. However, in a very highly competitive market, internalization is still detrimental to market spreads whereas preferencing is not any more.

**Keywords** : Dealership market, preferencing, inventory. **JEL Classification** : D44, G15.