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Does internalization diminish the impact of quote aggressiveness on dealer market share?

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Abstract

We analyze data provided by NASDAQ to examine how quote aggressiveness affects dealer market share and whether the practice of internalization mitigates the impact of quote aggressiveness. Our empirical results show that although internalization does not reduce the impact of *price* aggressiveness on dealer market share, it mitigates the impact of *size* aggressiveness. This result suggests that although internalization may not affect the dealer's incentive to post aggressive prices, it may reduce the incentive to post large depths. We find that aggressive quotes are more effective in raising dealer market share in stocks with a less competitive (more concentrated) market structure. Our results also show that the effective spread is wider (narrower) for stocks with a smaller price (size) elasticity of dealer market share.

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1. Introduction

Brokers and dealers on NASDAQ frequently internalize their order flow or route through payment for order flow agreements. Internalization is the direction of order flow by a broker-dealer to an affiliated market maker. Payment for order flow agreement involves either direct monetary payments or in-kind goods and services provided by dealers to brokers in return for routing customer orders. Chung et al. (2004) show that a large portion of NASDAQ order flow is internalized and stocks with greater internalized trades exhibit wider spreads.¹ Although a number of prior studies show either analytically or with experimental data that internalization exerts a negative impact on dealer competition and market quality, there is relatively little empirical evidence on the issue.

In this study, we examine whether internalization adversely affects market quality by reducing dealers' incentives to post aggressive quotes. To address this question, we first investigate the relation between dealer market shares and quote aggressiveness. Whether dealers who quote more aggressively have larger market shares is an interesting question given the fact that a significant portion of NASDAQ volume is internalized. If dealers who quote aggressively have the same market share as dealers who do not quote aggressively, dealers would have little incentives to post competitive quotes. If dealers do not post competitive quotes, investors are likely to incur larger trading costs. We then address a related, perhaps more intriguing question whether inter-stock differences in internalization can explain inter-stock differences in the elasticity of dealer market share with respect to quote aggressiveness. If the practice of internalization reduces the incentive to quote aggressively because such practice lowers the effect of quote aggressiveness on market share, then internalization may have an adverse effect on market quality.

Prior studies suggest that order preferencing (i.e., internalization and payment for order flow) reduces the incentive to post aggressive quotes. Godek (1996) holds that order preferencing weakens the linkage between quote aggressiveness and order flow and diminishes the incentive to narrow the spread. Huang and Stoll (1996) and Bessembinder (1999) suggest that internalization and payment for order flow are likely sources of wider spreads on NASDAQ. Bloomfield and O'Hara (1998) show that order preferencing may significantly degrade market performance if preferenced orders are a large share of the market or are received by virtually all market makers. Ackert and Church (1999) provide experimental evidence that payment for order flow and internalization limit dealers' incentive to improve price. Christie and Schultz (1994), Battalio and Holden (1996), Dutta and Madhavan (1997), and Kandel and Marx (1997, 1999) suggest that order preferencing facilitates collusion and thus results in wider bid-ask spreads.²

Although prior studies offer both analytical predictions and experimental evidence regarding the effects of order preferencing on execution costs, they offer limited evidence

¹ Hansch et al. (1999) find that preferenced (internalized) trades pay higher (lower) spreads for a sample of London Stock Exchange stocks. They find no significant relation between the extent of preferencing or internalization and spreads across stocks.

² Benveniste et al. (1992), Easley et al. (1996), Battalio et al. (1997), SEC (1997), Battalio and Holden (2001), Battalio et al. (2001a, 2001b), Chung et al. (2004), and Peterson and Sirri (2003) also examine the effect of order preferencing on market quality.

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