

MEMO# 26934

January 22, 2013

SEC Seeks Further Comment on NASDAQ Proposal on INAV Pegged Orders for ETFs; January 23rd Conference Call (NASDAQ to Attend Part)

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 6-13
ETF ADVISORY COMMITTEE No. 6-13
EQUITY MARKETS ADVISORY COMMITTEE No. 4-13 RE: SEC SEEKS FURTHER COMMENT ON NASDAQ PROPOSAL ON INAV PEGGED ORDERS FOR ETFs; JANUARY 23RD CONFERENCE CALL (NASDAQ TO ATTEND PART)

The Securities and Exchange Commission ("SEC") recently issued an order instituting proceedings to determine whether to approve or disapprove a NASDAQ proposed rule change to adopt a new Intraday Net Asset Value ("INAV") pegged order for ETFs comprised of U.S component stocks, and seeking further comment. [1] The proposed new order type would allow market participants to enter a buy or sell order at an ETF's published INAV, plus or minus a specified offset. The SEC originally published the proposal in October, and ICI submitted the only comment letter. [2] The Letter did not object to the creation of new order type pegged to INAV but did question the purpose and benefit of an INAV pegged order and sought further clarity on the operation of the proposed order type. The Letter recommended that the SEC seek additional information from NASDAQ and consider the benefits of the proposed INAV pegged order before determining whether to approve it.

Comments on the Release will be due to the SEC 21 days after publication in the Federal Register, and so we anticipate that comments will be due the week of February 11. We will hold a member call on Wednesday, January 23rd at 2:00 p.m. ET to discuss the Release. Representatives from NASDAQ will be joining the latter part of the call to discuss their views of the Release and the order type in particular. If you are not available for the call, please try to have someone from your firm join the discussion. Given the short time period for comments, it will be important to hear your views on the call.

Please RSVP to jodom@ici.org in order to receive the dial-in information. This call is for ICI members only – please do not forward this email or the dial-in information to persons outside of your firm.

If you cannot participate on the call, please provide any comments on the Release to Mara Shreck at mshreck@ici.org by Friday, February 1.

Summary of the Release

After summarizing the Letter and the Exchange's response to the points raised in the Letter, the Release states the SEC's belief that the Proposal continues to raise a number of questions as to whether the use of the proposed INAV Pegged Order type is consistent with the protection of investors and the public interest and whether it is designed to promote just and equitable principles of trade. The Release seeks comment on a number of issues, including those described below.

1. INAV as a fair value estimate of the securities underlying the ETF; potential for investor confusion. The Release notes that the Letter stated that market participants may misunderstand INAV as being the "fair value" estimate of the securities underlying the ETF. It also notes NASDAQ's statement in response that for domestic equity products, INAV represents the best proxy for fair value and the only representation of fair value currently available for individual investors and is the most up-to-date real time fund valuation data source that is publicly available. The Release seeks comment on whether the INAV represents a proxy for fair value of the assets of an ETF and whether market participants could be confused as to what INAV represents. (Release at pp. 16-17)
2. INAV updated every 15 seconds. The Release notes that the Letter states that investors may not understand that the INAV may be an inaccurate reflection of an ETF's up-to-date market value because it is only updated every 15 seconds even though the actual INAV could change significantly during this same 15 second period. It also notes NASDAQ's statement in response that although INAV is only updated every 15 seconds, it is still of value and beneficial to investors as the execution will still be benchmarked against the prevailing published INAV. The Release requests comment on whether tying the execution of an INAV Pegged Order to the published INAV (updated every 15 seconds) could potentially result in market participants' orders being executed at prices that do not reflect an up-to-date INAV. (Release at pp. 17-18)
3. Greater transparency. The Release notes that NASDAQ states that the INAV Pegged Order type should lead to greater transparency as it relates to the ETF's current value and as a result should increase investor confidence. The Release asks whether commenters agree with this view. (Release at p. 18)
4. Potential for calculation errors. The Release notes that the Letter states that the calculation of INAV may be susceptible to errors, based on, for example inaccurate reporting of ETF baskets, faulty data from pricing vendors, or errors in the calculation process. The Release seeks comment on whether: (i) a potential for calculation errors could undermine the purpose, design, and operation of the proposed INAV Pegged Order type; (ii) general safeguards in the marketplace protect against poor execution; and (iii) whether the lack of accountability with respect to those parties responsible for the calculation of INAV could undermine the purpose, design, and operation of the INAV Pegged Order type. (Release at pp. 18-19)
5. Potential negative bias. The Release notes that the SEC questions whether this proposed order type could inherently be negatively biased in that INAV Pegged Orders likely would be executed when the market is moving against the investor (for example, an investor's INAV to buy would be executed only when the market price of

the ETF is falling). The Release also notes NASDAQ's statement that an execution pursuant to INAV would only ever occur within the prevailing bid-offer spread and asks whether commenters believe that this mitigates these concerns. (Release at pp. 19-20)

6. Suspensions and cancellations. The Release notes that in response to the Letter's questions about suspensions and cancellations of existing INAV Pegged Orders where the INAV data feed stops being disseminated or is compromised, NASDAQ clarified that it would only suspend the use of the order type if it were to detect a technological problem with the relevant feed and that it would use its current systems and processes to detect any such problems and to communicate with market participants about issues relating to the data feed. The Release asks if this is sufficient detail regarding how suspensions and cancellations would be handled. (Release at p. 20)
7. General purpose and benefit of INAV pegged order. The Release notes that the Letter states that investor concerns over inferior executions could be addressed through the use of limit orders and so questions the general purpose and benefit of INAV Pegged Orders. It also notes NASDAQ's statement that the new order type should help investors achieve greater transparency and a fair execution price. The Release asks if commenter agree with NASDAQ's assertion and what other benefits might result from the new order type. (Release at pp. 20-21)

Mara Shreck
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endnotes

[1] See SEC Release No. 34-68672; File No. SR-NASDAQ-2012-117 (January 16, 2013), which is available at <http://www.sec.gov/rules/sro/nasdaq/2013/34-68672.pdf> ("Release").

[2] See Institute [Memorandum](#) to ETF (Exchange-Traded Funds) Committee No. 40-12; ETF Advisory Committee No. 45-12; and Equity Markets Advisory Committee No. 35-12, dated November 13, 2012 [Memorandum No. 26681] (summarizing the comment letter) ("Letter"). The Letter is available at <http://www.ici.org/pdf/26681.pdf>.