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November 8, 2012

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: NASDAQ Stock Market LLC Proposal With Respect to INAV Pegged Orders for
ETFs (File No. SR- NASDAQ-2012-117)

Dear Ms. Murphy:

The Investment Company Institute¹ appreciates the opportunity to comment on the recent proposal by the NASDAQ Stock Market LLC (“NASDAQ”) to implement a new order type, pegged to intraday net asset value (“INAV”), for exchange-traded funds (“ETFs”) comprised of U.S. component stocks.² As we understand it, 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 any specified offset. The order would be priced as of the time it was entered; that price would update as the INAV changed, and the order would execute when or if an offer (for a buy order) or bid (for a sell order) was available at the established price. A market participant could also set a limit price beyond which the INAV pegged order would not be executed.

The Institute has on several occasions discussed the need to carefully examine the increasing amount and complexity of order types that exchanges continue to create to cater to market participants.³ With that in mind, ETF sponsors and other Institute members have raised a number of

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.8 trillion and serve over 90 million shareholders.

² See NASDAQ Stock Market LLC: Notice of Filing of Proposed Rule Change With Respect to INAV Pegged Orders for ETFs, 77 Fed. Reg. 64167 (October 18, 2012) (“Notice”).

³ See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated October 23, 2012, available at <http://www.ici.org/pdf/26600.pdf> (submission on the SEC’s Technology and Trading Roundtable); Letter from Karrie

questions and concerns about NASDAQ's proposal. As a preliminary matter, we question the purpose and benefit of an INAV pegged order. We also seek further clarity on the operation of the proposed order type, and raise a number of concerns about the value of pegging orders to INAV.

While we do not necessarily object to the creation of a new order type pegged to INAV, we recommend that the Securities and Exchange Commission ("SEC" or "Commission") request additional information from NASDAQ to further explore these questions and concerns, and consider the benefits of the proposed INAV pegged order, before determining whether to approve it. Our views are discussed in more detail below.

Purpose and Benefit of an INAV Pegged Order

As a preliminary matter, ICI members questioned the purpose and benefit to market participants of an order type pegged to INAV. The Notice states that "ETF Sponsors routinely deal with investors that have been subject to inferior executions,"⁴ and that the vast majority of these complaints result from people using market orders where the prevailing market price either does not correlate to the fund's value, or the quoted size does not meet the demand of the order (or both). We believe the use of limit orders generally addresses these concerns.⁵ Moreover, the problems with execution typically occur in ETFs that would not be covered by the new order type, *i.e.*, those based on fixed income and non-US equity securities.⁶ Most ETFs comprised of US equities are very liquid and trade with fair price execution. In light of the questions and concerns raised by Institute members, we recommend that the Commission carefully consider whether an INAV pegged order offers a benefit to the marketplace that outweighs any potential risks.

Questions about the Operation of the INAV Pegged Order

McMillan, General Counsel, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to the International Organization of Securities Commissions, dated October 11, 2012, available at <http://www.ici.org/pdf/26598.pdf> (comment letter on IOSCO market surveillance consultation). We believe that many of these order types facilitate strategies that can lead to disorderly markets or benefit certain market participants at the expense of long-term investors. While the INAV pegged order type does not seem to enable or facilitate such strategies, the complexity of the proposal and questions regarding its benefits highlight the need for the Commission to examine the proliferation of order types more broadly.

⁴ Notice at 64169.

⁵ Investor confusion regarding order types likely explains the inopportune use of market orders. Educating investors on the proper use of existing order types may be preferable to the creation of another order type. Many ETF sponsors and others have undertaken educational efforts aimed at explaining order types for investors. *See, e.g.*, www.understandETFs.org, a collaborative effort by ETF providers to enhance investor understanding of ETFs.

⁶ Nonetheless, we would oppose the extension of the proposed order type to fixed income and non-US equity ETFs, because INAV for these funds is frequently not a good proxy for the fund's value.

We have a number of questions about the operation of the INAV pegged order in specific circumstances. The Notice states that if an INAV data feed temporarily stopped being disseminated or was “compromised,” the use of the order type would be suspended for that ETF, and INAV pegged orders already in the system would be cancelled. Far more specificity is necessary about how this would operate in practice.

Most importantly, what constitutes a “compromised” INAV, and how will NASDAQ identify one and determine whether to suspend new orders and cancel existing ones? NASDAQ listing rules require that INAV be calculated by NASDAQ or an independent third party, using prices from an independent market data provider or other independent pricing source⁷; ETF sponsors provide information about the ETF’s holdings but are not involved in the calculation process. Is NASDAQ proposing to audit the calculation of each INAV to ensure it is accurate, or will an INAV only be considered compromised if it varies by some predetermined amount or percentage from the ETF market price? How will NASDAQ determine the appropriate amount? Will it vary or remain constant day to day? What if INAV is technically accurate but flawed for other reasons, such as if there is a substantial market movement in a component security right after INAV updates, and therefore 15 seconds before it updates again?

We also have questions about the proposed cancellation and suspension of INAV pegged orders, as well as about those that may be executed based on a flawed INAV. First, how will market participants be notified that their orders have been cancelled due to a problem with INAV calculation? Has NASDAQ explored how frequently this could happen? We question the benefit of allowing or encouraging the use of an order type that may be subject to cancellation due to an independent malfunction (such as an erroneous data feed) even when the rest of the market is performing normally. Additionally, what about orders that are executed before an error is detected? Will those orders be cancellable? What party, if any, is liable for a poorly executed INAV pegged order due to a compromised INAV? All of these questions should be explored in more detail and adequately addressed before the proposed order type is permitted.

Concerns About Pegging Orders to INAV

ICI members share a number of concerns about the utility of INAV as a reference point for pricing an ETF order. Although these concerns, in and of themselves, are not a reason to deny market participants additional options for order type, we believe they merit serious consideration in light of the other concerns we raise about the INAV pegged order. Our concerns fall into two categories: the constitution of INAV – that is, what it actually represents (and does not represent), and the susceptibility of INAV to error.

⁷ See NASDAQ OMX Listing Rule 5705. We understand that typically a third party calculation agent is used.

What INAV Does – and Does Not – Represent

Institute members are concerned that market participants may misunderstand INAV. Indeed, the Notice provides an indication of the potential for misunderstanding when it states that “[t]he INAV is intended to approximate the fair value of the securities held in the portfolio by the ETF and should closely represent the value of the fund during the trading day.”⁸

First and foremost, INAV is *not* a “fair value” estimate of the securities underlying the ETF. As the Notice indicates, INAV is typically calculated using the last sales price of the fund’s components. For U.S. component stock ETFs, this is usually, but not always, a good estimate of the value of the ETF. At times, particularly for securities that do not trade frequently, the last sale price may not be reflective of the security’s value. Unlike a fund’s end-of-day net asset value, INAV does not attempt to adjust for such variations.

Likewise, INAV is not a fair value estimate of the ETF itself. Some U.S. component stock ETFs may trade at a consistent premium or discount, which is not taken into account in the INAV calculation. For example, ETFs, most often those that are niche-focused, may contain a number of stocks that are difficult – and therefore costly – to borrow. This will make shares of the ETF more costly to create, since market makers often assemble a creation basket by borrowing the component securities. For these ETFs, market makers typically will wait for the shares to trade at a premium sufficient to cover these costs before creating shares and selling them into the market. In such cases, an INAV pegged order to sell at INAV would likely disadvantage the seller, since the shares frequently trade at a premium to INAV. We recognize that the proposed order type *could* be used with an offset to account for this premium, but are concerned that market participants may believe INAV represents the fair market value of the ETF, and therefore reflects such nuances.

Likewise, some market participants may not understand that INAV can be an inaccurate reflection of an ETF’s market value because it can get stale, even though it is updated every 15 seconds. Professional equity traders operate at speeds calculated in fractions of a second. In such markets, 15 seconds can be an eternity, and establishing an order price based on data that is nearly 15 seconds old could result in poor execution. For example, a market participant may enter an order to buy an ETF at INAV shortly after, in an unrelated transaction, a large buy order was executed for one of the ETF’s component securities, temporarily spiking the price of that security and therefore inflating the INAV calculation on which the ETF order was based. Within a few seconds the price of the component security may drop as the market adjusts, but the market participant’s order at the inflated INAV will stand, and will likely be executed.

Finally, as noted above, INAV calculations are based on the ETF’s creation basket, which in some cases does not include all of the securities in a fund’s portfolio. In such cases, ETF sponsors take

⁸ Notice at 64168.

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great care to publish baskets that mimic the market characteristics of the full portfolio, but there may be instances in which the INAV, because it is based on the constituents of a sampled basket, deviates from the actual intra-day net asset value of the ETF. Investors who do not understand how INAV is calculated for a particular ETF may be unaware that INAV does not always mirror the value of the full portfolio. Such investors might well have chosen to submit a different type of trade order had they understood the limitations of INAV.

The Potential for Error in INAV

As noted above, many parties participate in the calculation, publication, and dissemination of INAV. The ETF sponsor provides an independent calculation agent with the daily list of securities constituting an ETF's creation basket (which for U.S. equity ETFs is typically, but not always, a pro rata slice of the ETF's portfolio). The calculation agent separately obtains market pricing information for each of the component securities from a third party source, such as the exchange or a pricing vendor, and calculates the estimated per-share value of an ETF share. This process creates several opportunities for errors: for example, an ETF may report a basket inaccurately; a calculation agent may receive faulty data from a pricing vendor; or an error may be made in the calculation process. We understand that such errors are not infrequent. ETF sponsors attempt to monitor INAV and correct such errors as soon as practicable, but at times INAV pegged orders would likely execute before these errors are identified. If calculation agents and pricing vendors could be held liable by investors using INAV pegged orders for inaccuracies in INAVs, it is possible, if not likely, that firms would cease providing such services, making it impossible to disseminate INAVs, or would charge significantly more for their services, resulting in increased expenses for ETF investors.

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In light of the unanswered questions about the operation of the proposed INAV pegged order, we recommend that the SEC seek additional information from NASDAQ and carefully consider the potential risks and benefits of the proposal.

The Institute appreciates the SEC's attention to our comments. If you have any questions, or would like to discuss any of the matters in this letter, please contact me at 202/218-3563 or Mara Shreck at 202/326-5923.

Sincerely,

/s/ Dorothy Donohue

Dorothy Donohue
Deputy General Counsel