

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-68042; File No. SR-NASDAQ-2012-117)

October 12, 2012

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Proposed Rule Change with Respect to INAV Pegged Orders for ETFs

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that, on October 2, 2012, The NASDAQ Stock Market LLC (“NASDAQ” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASDAQ proposes to amend Rule 4751(f)(4) to include a new Intraday Net Asset Value (“INAV”) Pegged Order for Exchange-Traded Funds (“ETFs”) where the component stocks underlying the ETFs are U.S. Component Stocks as defined by Rule 5705(a)(1)(C) and 5705(b)(1)(D) - hereafter defined as “U.S. Component Stock ETFs.”

The text of the proposed rule change is set forth below. Proposed new text is underlined and deleted text is in brackets.

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4751. Definitions

The following definitions apply to the Rule 4600 and 4750 Series for the trading of securities listed on Nasdaq or a national securities exchange other than Nasdaq.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

(a) – (e) No change.

(f) The term “Order Type” shall mean the unique processing prescribed for designated orders that are eligible for entry into the System, and shall include:

(1) - (3) No change.

(4) “Pegged Orders” are orders that, after entry, have their price automatically adjusted by the System in response to changes in either the Nasdaq Market Center inside bid or offer, [or] bids or offers in the national market system, or in respect of Exchange Traded Funds of U.S. Component Stocks (as defined in Rule 5705), changes in the intraday net asset value (“INAV”), as appropriate. A Pegged Order can specify that its price will equal the inside quote on the same side of the market (“Primary Peg”), the opposite side of the market (“Market Peg”), or the midpoint of the national best bid and offer (“Midpoint Peg”) or, in the case of Exchange Traded Funds of U.S. Component Stocks, the INAV (“INAV Peg”). A Pegged Order may have a limit price beyond which the order shall not be executed. In addition, the Primary Peg, [and] Market Peg and INAV Peg Orders may also establish their pricing relative to the appropriate bids, [or] offers or INAV by the selection of one or more offset amounts that will adjust the price of the order by the offset amount selected. A Midpoint Peg Order is priced based upon the national best bid and offer, excluding the effect that the Midpoint Peg Order itself has on the inside bid or inside offer. Midpoint Pegged Orders will never be displayed. A Midpoint Pegged Order may be executed in sub-pennies if necessary to obtain a midpoint price. A new timestamp is created for the order each time it is automatically adjusted.

(5) – (15) No change.

(g) - (i) No change.

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The text of the proposed rule change is available on the Exchange's website at <http://nasdaq.cchwallstreet.com>, at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

NASDAQ proposes to amend Rule 4751(f)(4) to establish INAV Pegged Orders which will be available for U.S. Component Stock ETFs. This new order type will serve market participants that utilize these ETFs as a vehicle to invest or trade in addition to serving the needs and interests of the Sponsors/Issuers of ETFs.

The ETF INAV Pegged Order will be priced relative to the Intraday Net Asset Value of the fund's underlying portfolio. The term "INAV" is synonymous with commonly used terms such as Intraday Indicative Value (IIV), Intraday Optimized Portfolio Value (IOPV) and Intraday Portfolio Value (IPV) amongst others. The 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. Pursuant to NASDAQ listing rules, the INAV for NASDAQ-listed stocks is disseminated widely to vendors and their subscribers via multiple data feeds, including

UTP Level 1, NASDAQ Basic, NASDAQ Level 2, and NASDAQ TotalView. INAVs are typically disseminated at least once every 15 seconds. Rule 5705(a)(3)(C), for example, requires that the IIV for NASDAQ listed portfolio depository receipts be disseminated at least every 15 seconds.

Typically, INAVs are calculated using the last sale prices of the fund's components. INAVs can vary from the fund's market price and/or can be valued outside of the fund's prevailing bid/ask spread as a result of the supply and demand characteristics of the fund and/or liquidity present in the marketplace. The INAV may remain unchanged for a certain period of time if the underlying values do not change, particularly in periods of low volatility. Additionally, the INAV may become stale as a result of a compromised data feed or disruption to the calculation and/or dissemination agent or other technology related malfunction.

The fair market price of an ETF is more objective than the market price of a cash equity. Mainly, the price of an ETF is based upon the price of the underlying portfolio of the ETF. Therefore, if the components of the portfolio increase in value, so does the fund and, conversely, if the components of the portfolio decrease in value, so does the fund. In the cash equities marketplace, pricing is more subjective in nature. Unfavorable executions occur in the ETF marketplace and this can be as a result of market participants not recognizing the liquidity characteristics of the product they are trading. Executions can occur with drastic variance from the INAV, usually as a result of participants relying on market orders for execution. The INAV Pegged Order type will be available for all U.S. Component Stock ETFs where there is dynamic INAV data and will offer market participants a greater level of transparency as to fair value, by bringing what has historically been a post-trade analytics tool into the pre-trade environment. More importantly, the INAV Pegged Order should minimize the disparity between the market

execution price and the underlying fund's value.

Pegged Orders are orders that, once entered, adjust in price automatically in response to changes in factors such as the NBBO, depending upon the type of Pegged Order. An INAV Pegged Order will specify that its price will equal (or, to the extent an offset is used, be offset from) the prevailing INAV for the relevant ETF. As the INAV changes, so move the INAV Pegged Orders. In the event that the INAV data feed for a particular ETF were to be compromised or temporarily stopped being disseminated, the use of the INAV Pegged Order type for that ETF would be suspended (i.e., no new INAV Pegged Orders would be accepted into the system) and orders utilizing the INAV pegged functionality for that ETF already in the system would be cancelled. The suspension of new INAV Pegged Orders would remain in effect until such time as the Exchange was confident that the integrity of the INAV data feed had been restored.

The proposed rule change is in accordance with Rule 612 of Regulation NMS,<sup>3</sup> which governs sub-penny quoting of National Market System stocks ("Sub-Penny Rule"). The proposed rule change would not result in the display, rank, or acceptance of a bid or offer, an order, quotation, or indication of interest in any NMS stock that is priced in an increment smaller than \$0.01 per share, unless the price of the bid or offer, order, indication of interest is priced less than \$1.00 per share.

NASDAQ intends to use an INAV as opposed to the end of day net asset value ("ED NAV") for a number of reasons. While the ED NAV is more definitive in nature, it does not allow for an intraday fund valuation, thus limiting one of the greatest advantages of the ETF structure, mainly the ability to trade throughout the entire trading session, as compared to the

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<sup>3</sup> 17 CFR 242.600 et seq. See also Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) ("Regulation NMS Adopting Release").

traditional Mutual Fund (which uses ED NAV based execution). Conversely, use of the INAV, while only indicative of the ETF's value, offers investors a trade execution tool which should lead to a greater level of transparency as it relates to the ETF's current value. Relative to the current intraday order entry/execution order types, the INAV Pegged Order type would allow certainty of execution with a greater correlation to the ETF's fair value for those seeking to invest on a more informed basis. However, despite NASDAQ's rationale for using the INAV, investors should note that the INAV is only an estimation of a fund's value, and this might differ from the ED NAV which is more definitive and disseminated on a daily basis at the end of the trading day. Investors should also note that INAVs are only calculated and disseminated during the regular market session.

A Pegged Order may have a limit price beyond which the order shall not be executed. Currently, Primary Peg and Market Peg Orders may establish their pricing relative to the appropriate bids or offers by selecting one or more offset amounts that will adjust the price of the order by the offset amount selected. We propose to introduce this functionality for the INAV Peg also.

A Pegged Order (other than a Midpoint Peg Order) may be both displayed or non-displayed. We propose to introduce this functionality for the INAV Peg also. Where market participants see value in anonymity they can utilize the non-displayed order type, though by doing so, they will be placed lower in the priority queue within each price point. Conversely, those that do not value anonymity can utilize a displayed order type and benefit from a higher priority in the execution queue.

The following examples illustrate how the proposed rule change would operate (note that the price of the order updates in response to changes in the INAV):

### Example 1

- The best bid is \$20.00 and the best offer is \$20.06 at 10:00:00 a.m. INAV is updated and published as \$20.03 at 10:00:02.
- An INAV Peg Order to buy entered at 10:00:04 would be priced at \$20.03.
- The best bid would update to \$20.03 (at approximately 10:00:04).
- The best offer would remain at \$20.06.

### Example 2

- The best bid is \$20.00 and the best offer is \$20.06 at 10:00:00. INAV is updated and published as \$19.98 at 10:00:02.
- An INAV Peg Order to sell entered at 10:00:04 would be priced at \$19.98 and subsequently execute at \$20.00 (at approximately 10:00:04).

### Example 3

- The best bid is \$20.00 and the best offer is \$20.10 at 10:00:00 a.m. INAV is updated and published as \$20.03 at 10:00:02.
- An INAV Peg Order to buy with a +.03 offset entered at 10:00:04 would be priced at \$20.06 (\$20.03 +.03) (at approximately 10:00:04).
- The best bid would update to \$20.06 (approximately 10:00:04).
- The best offer would remain at \$20.10.

INAV Peg Orders will allow the market participant to achieve a greater sense of control over the execution price as it relates to the fund's value by benchmarking to the estimated intraday fund's value. This added value to the investing public will be strongly supported by the ETF Sponsor community. ETF Sponsors routinely deal with investors that have been subject to inferior executions. These complaints are almost unanimously as a result of people using market

orders where the prevailing bid/ask in the market does not necessarily correlate to the fund's value, and the quoted size does not meet the demand of the order. The INAV Peg will also help to protect investors against any unintended overpayment for the security.

## 2. Statutory Basis

The proposed rule change is consistent with Section 6(b) of the Act,<sup>4</sup> in general, and furthers the objectives of Section 6(b)(5),<sup>5</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system. The INAV Pegged Order will allow market participants the option to enter an order without concern about the value of the fund's underlying portfolio being drastically different and therefore resulting in an inferior execution, as the order will be dynamically repriced/updated throughout the life of the order as the value of the underlying portfolio changes. Additionally, it provides a more intelligent form of market order. Instead of having the order execute at the prevailing price (regardless of what that price might be relative to the fund's value) the INAV Pegged Order gives participants the option to collar the execution at a price that relates to the actual value of the fund's components. Whilst it is acknowledged that there is an inherent lack of execution determinism with a Pegged Order, market participants will be free to elect this order type for U.S. Component Stock ETFs where there is dynamic INAV data, but they will not be limited to this option, or required to use this option. For those market participants who are more interested in securing execution certainty, a conventional market order will still be available.

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<sup>4</sup> 15 U.S.C. 78f(b).

<sup>5</sup> 15 U.S.C. 78f(b)(5).

The Exchange believes that the proposed change to Rule 4751(f)(4) meets the requirements of Section 6(b)(5) of the Act<sup>6</sup> in that it will improve the stability, quality, and transparency of the national market system. In the event that the INAV data feed were to be compromised or temporarily stopped being disseminated, the use of the INAV Pegged Order type would be suspended (i.e., no new INAV Pegged Orders would be accepted into the system) until such time as the Exchange was confident that the integrity of the INAV data feed had been restored and orders utilizing the INAV pegged functionality already in the system would be cancelled. In addition, the Exchange is not aware of any circumstance where this order type could be used to manipulate the underlying value of the fund, and Nasdaq MarketWatch will perform all usual market surveillance activity on the use of the INAV Pegged Order.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. To the contrary, NASDAQ believes that the INAV Peg Order is pro-competitive in that it will offer enhance [sic] the attractiveness of NASDAQ's listings and trading venues.<sup>7</sup>

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which

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<sup>6</sup> Id.

<sup>7</sup> See Form 19b-4 at 11.

the Exchange consents, the Commission shall:

- A. by order approve or disapprove such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2012-117 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2012-117. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F

Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2012-117 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>8</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>8</sup> 17 CFR 200.30-3(a)(12).