

ETF Share Transactions Based on Nonpublic Information: An Illegal Secret Ingredient?

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Those with nonpublic information about a merger or acquisition involving a company appear to be profiting by trading in shares of exchange-traded funds based on indexes that include such companies' shares, according to a recent study by Swedish and Australian researchers.

Securities law liability could very well be simmering in the background for people engaging in this type of activity. The SEC, for example, is known to have recently expanded the range of circumstances in which it has alleged insider trading violations. In this connection, we have previously reported on an SEC action against an executive who used nonpublic information about his company's impending merger to trade options on the shares of a competitor company. See "[SEC Cultivates Shadow Trading Theory](#)," *Expect Focus – Life, Annuity, and Retirement Solutions* (April 2022). The competitor company's value was likely to be affected by the merger, even though the company wasn't involved in the transaction.

Since the SEC has been willing to pursue that type of "shadow trading" activity, it likely also would pursue insider trading in ETF shares, although the exact parameters of such insider trading liability are far from clear. Presumably, any such liability would not be limited to M&A but would extend to other types of material nonpublic information as well.

The study's authors found that ETFs focusing on the industry or sector that include the companies involved in an M&A transaction were most likely to be used for trading on the basis of the M&A information. This is not surprising, as the shares of the companies involved in the transaction would be most likely to comprise a significant proportion of that type of index. However, at least in theory, insider traders also could seek to use other types of ETFs or even non-ETF mutual funds.

Accordingly, those responsible for developing and implementing firms' insider trading compliance procedures would be well advised to continue to be alert to the expanding range of possible

violations.

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