What is front running and how can it be prevented?

"Information is a valuable commodity. When only a select few are privy to certain information–such as material non-public information about an imminent block transaction–the information is even more valuable."

Front running is a prevalent type of abusive trading practice that has plagued our financial markets throughout history. Front running occurs when a broker utilizes insider information regarding an imminent large customer order, known as a block transaction, to effectively "trade ahead" of such customer order for itself with the intention to profit.

For example, a broker receives an order to buy 50,000 shares of ABC Company for a client. Anticipating that ABC will increase in price due to the large order, the broker purchases shares of ABC for their own account. Since the broker purchased shares for their own account ahead of the customer order (regardless of whether or not they profit from the sale of these shares), they have engaged in front running.

Regulating Front Running

Front running is not explicitly addressed by federal securities or commodities laws, but rather it is prosecuted pursuant to common law, case law interpreting federal statutes, and rules enforced by self-regulatory organizations (SROs). The Financial Industry Regulatory Authority (FINRA) banned front running by its members by enacting FINRA Rule 5720. FINRA pledged to remain focused on enforcing the front running prohibition in 2018 through the employment of a new surveillance program.

The SEC

"Investors have the right to expect that their brokers won't misuse their order information."
-Scott W. Friestad, Associate Director in the SEC's Division of Enforcement[1]

The Securities and Exchange Commission (SEC) finds authority to prosecute front running under the broad anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Exchange Act of 1934, which proscribe fraudulent or manipulative conduct in relation to the purchase or sale of a security.

Courts have also interpreted those section as permitting private rights of actions through which defrauded customers may independently seek redress for front running (see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 390 (1982)*).

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[1] SEC Charges Merrill Lynch for Missing Customer Order Information and Charging Undisclosed Trading Fees, SEC Release No. 2011-22 (Jan. 25, 2011), available at https://www.sec.gov/news/press/2011/2011-22.htm.

Front running falls into a category of fraudulent activity pursued by the SEC known as insider trading, which is prosecuted under two main theories, both of which require scienter (the state of mind to deceive):

- The Classical Theory: The classical theory of insider trading applies when an insider violates a fiduciary duty to its company or investors by trading on material nonpublic information obtained by means of the insider's position.[2]

- The Misappropriation Theory: Alternately, this theory applies when a non-insider trades on information in violation of a relationship of trust and confidence, like a family relationship where there is a pattern of sharing of confidences.[3]

In front running enforcement actions, the SEC typically bases its claims on the classical theory, alleging that brokers traded on "material nonpublic information" in violation of a fiduciary duty owed to their clients, known as the duty of best execution.

The duty requires "reasonable efforts to maximize the economic benefit to the client in each transaction" (see *In re Application of E.E. Hutton & Co., SEC Release No. 34-25887 (July 6, 1988)*) . It is violated when a broker competes with its customer by front running the order (see *United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985)*).

The court emphasized: "In trading ahead of his customers without telling them what he was doing, he was misleading them for his own profit, and conduct of this type has long been considered fraudulent."

The CFTC

According to the U.S. Commodity Futures Trading Commission (CFTC), front running is "illegal because it allows the broker to profit from information that comes at no cost to the broker 'automatically' in his capacity as a broker" (see *CFTC v. Sarvey, 2012 WL 426746, *4 (N.D. Ill. 2012)*) .

The CFTC has prosecuted front running in derivatives markets pursuant to its authority under Sections 4b(a) of the Commodity Exchange Act (CEA), which mimics the language of the Exchange Act's anti-fraud provisions. In an effort to increase oversight of insider trading, it created the Insider Trading & Information Protection Task Force in 2018.

CFTC actions have similarly involved brokers taking advantage of their positions within firms to exploit customer information (see *In re Sitzmann, CFTC Docket No. 96-5, 1997 WL 82610 (CFTC Feb. 27, 1997)*). Other cases have involved employees using inside information to front run orders by their own firms (see *In re Motazedi, CFTC No. 16-02, WL 7880066 (Dec. 2, 2015)*).

The Need for a Solution

"What had once been the world's most public, most democratic, financial market had become, in spirit, something more like a private viewing of a stolen work of art."

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[2] United States v. O'Hagan, 521 U.S. 642, 651-52 (1997).

[3] Carpenter v. U.S., 484 U.S. 19 (1987).

-Michael Lewis, Flash Boys: A Wall Street Revolt (2014), pg 69

Headlines are flush with details of million-dollar penalties paid by large banking institutions and brokerages for their front running activities. Just this year, HSBC paid over $100 million pursuant to a criminal investigation and allegations that it "misused confidential client information for its own profit." Credit Suisse faced a $135 million fine for using an algorithm to front run customer orders. Similarly, Bank of America admitted to "systematically misleading clients" regarding trade order routing from 2008 to 2013.

Institutions have taken steps to create compliance programs aimed at restricting front running. Starting in the 1980s, exchanges started to introduce intermarket surveillance systems purposed on detecting and deterring front running. Some have sought to prevent front running by routing orders through the firm in a way that bypasses trading desks.

Despite these efforts, the potential for front running has not been eliminated:

- Even with preventative procedures in place, regulators have pursued firms for failing to adequately implement such procedures.

- Exchanges have been accused of looking the other way when it comes to front running activities on their platforms, blindly hiding behind their policies and rules.[4]

- Bad actors continue to defraud investors in new ways made possible by modern technology, like complex algorithms and high-frequency trading (HFT).

- With the sheer volume of transactions happening in the fragmented marketplace, regulators simply lack the resources to detect every instance of manipulation ex ante, forcing focus on ex post investigations of possible manipulation.[5]

Regulators have indicated that cryptocurrency markets are particularly susceptible to manipulative practices like front running. As described in our previous post, the New York Attorney General's Report also pointed out the prevalent deceptive practices occurring on many virtual currency trading platforms.

Eliminating Front Running through Technology

"As computer technology expands and enhances, trading records may turn out to be the only means needed to prove front-running in the future–eliminating completely the circumstantial and evasive nature that currently characterizes front-running."[6]

While some have used technology to craft more cunning ways to defraud customers

[4] California Public Employees' Retirement System v. New York Stock Exchange Inc. et al., docket number unavailable, complaint filed (S.D.N.Y. Dec. 17, 2003).

[5] Lin, Tom C. W., The New Market Manipulation (July 3, 2017). Emory Law Journal, Vol. 66. Temple University Legal Studies Research Paper No. 2017-20. Available at SSRN: https://ssrn.com/abstract=2996896.

[6] Bovi at 135.

and evade detection, market participants have long-acknowledged the potential of technology to make fraudulent activity like front running more detectable and thus less prevalent.

Recently, CFTC Chairman Chairman Christopher Giancarlo emphasized the enormous potential for distributed ledger technology to permit more effective market surveillance, enforcement, examinations, policy development, and reform–what he called "quantitative regulation." He spoke of a day "where rulebooks are digitized, compliance is increasingly automated or built into business operation."

LGO's Solution: An Anti-Front Running Protocol

At LGO, we are working to make Chairman Giancarlo's vision a reality and set the standard for the entire crypto-asset ecosystem. LGO promotes transparency at all stages of a transaction, including execution. We seek to reintroduce trust into the industry by integrating an anti-front running protocol directly into our platform, making it "fair by design." This protocol protects the order flow from malicious treatment and prevents many of the manipulative ills presently afflicting crypto markets.

LGO utilizes the blockchain as determinable proof of order placement where anyone can view and verify all transactions occurring on the platform. Pursuant to its commitment to maintain a fair and orderly market, LGO does not engage in proprietary trading, but if it did, its trades would be viewable and auditable on an immutable, shared record.

By combining the security and transparency requirements of traditional exchanges with the promise of blockchain technology, LGO provides a solution that is absent in the current marketplace. We believe that this is the future of a healthy, robust crypto environment.

Conclusion

Front running continues to harm the integrity of our modern markets. LGO offers a unique solution that leverages blockchain technology to make front running provably impossible.

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