“Front-running; an Unethical Behavior"

Front-running is an investing tactic that anticipates the impact of upcoming trades on the price of a security. It is the illegal practice of a stock broker executing orders on a security for its own account while taking advantage of advance knowledge of pending orders from its customers. When orders previously submitted by its customers will predictably affect the price of the security, purchasing first for its own account gives the broker an unfair advantage, since it can expect to close out its position at a profit based on the new price level. The front running broker either buys for his own account (before filling customer buy orders that drive up the price), or sells (where the broker sells for its own account, before filling customer sell orders that drive down the price).

The most common example of front-running is when an individual trader buys shares of a stock just before a large institutional order for the stock which will cause a rapid increase in the stock's price. This information can be obtained legally through monitoring the bids and asks on the market and the investing transactions of institutional investors. It can also be obtained illegally, such as when the research analysts of an investment bank pass insider information to the brokerage arm of the business, or when a money manager takes a position in a stock before convincing a client to make a large investment in that same security.

One example for Front Running is if an Investment Advisor (Stock Broker) knows that his firm wants to buy 1 Mn shares of ABC Company. However, before placing the order for his firm, the trader passes on the information to his known source or buys 10,000 shares on his own account at, say, Rs 100 per share. When he goes to buy 1 Mn shares of ABC for his organization, the price may jump to Rs 105 per share. The Advisor then sells his shares at say Rs 104 per share, making a neat profit of Rs 4.00 per share or Rs 40,000 in a short duration of time, many a time in the same day itself. His organization is hurt to the extent that they have paid more to buy those 1 Mn shares caused due to front running. Using this method, the trader acts in an unethical manner, putting his own interest above that of his organization, and thereby causing a fraud.

Another example for Front Running is when a stock broker finds out a report will be released which will, in the future, drive up the price of a share. The broker purchases the share, waits for the report to be released, and then sells his personal shares to his clients at an inflated rate. Also analysts and brokers who buy up shares in a company just before the broking house is about to recommended the stock as a strong buy are practicing front running.

It is illegal for brokers or asset managers to practice front-running using trading information about their own or another broker's clients, and this is punished by the Securities and Exchange Commission

Front running could happen in all types of stocks, be it large-cap, mid-cap or even small-cap. However, mid-cap and small cap (companies with relatively low market capitalization) stocks are more susceptible to front running due to their lower float and liquidity. Also if there is a large order, a small-cap or a mid-cap stock could fluctuate far more than a large-cap stock. Hence, the extent of profit a trader could make by front running in case of a mid-cap or a small-cap stock could be far higher than with a large-cap stock.

Rule 14 of the Securities and Exchange Commission of Sri Lanka Act no 36 of 1987 (as amended) states that no person shall directly or indirectly trade in securities of a company ahead of a significant purchase or sale of securities of that company, for his client, with the intent to profit by trading in such securities thereafter.

Front running is tempting for those with access to inside information. In most cases, the practice is highly unethical and may be illegal due to the obvious information advantage of industry insiders compared to equally capable investors outside the firm.

Punishment for "Front Running"

Section 51 (2) of the Securities and Exchange Commission Act of no 36 of 1987 (as amended) states that a person who is found guilty shall be liable on conviction after summary trial by a Magistrate to of imprisonment of either description for a period not exceeding five years or to a fine not less than Rs 50,000 and not exceeding Rs 10 Million or to both such imprisonment and fine.