Front-Running Definition, Example, and Legality

By CORY MITCHELL Updated May 19, 2022
Reviewed by MICHAEL J BOYLE
Fact checked by YARILET PEREZ

What Is Front-Running?

Front-running is trading stock or any other financial asset by a broker who has inside knowledge of a future transaction that is about to affect its price substantially. A broker may also front-run based on insider knowledge that their firm is about to issue a buy or sell recommendation to clients that will almost certainly affect the price of an asset.

This exploitation of information that is not yet public is illegal and unethical in almost all cases. Front-running is also called tailgating.

KEY TAKEAWAYS

- Front-running is illegal and unethical when a trader acts on inside information.
- A straightforward example of front-running occurs when a broker exploits market-moving knowledge that has not yet been made public.
- There are gray areas. An investor may buy or sell a stock and then publicize the reasoning behind it. Transparency and honesty are key.

...How Front-Running Works

Here's a straightforward example of front-running: Say a broker gets an order from a major client to buy 500,000 shares of XYZ Co. Such a huge purchase is bound to drive up the price of the stock immediately, at least in the short term. The broker sets aside the request for a minute and first buys some XYZ stock for their own personal portfolio. Then the client's order is put through. The broker immediately sells the XYZ shares and pockets a profit.

This form of front-running is illegal and unethical. The broker has made a profit based on information that was not public knowledge. The delay in execution may even have cost the client money.

Front-running is similar to insider trading, with the minor difference in this case that the broker works for the client's brokerage rather than inside the client's business.

FAST FACT

Front-running is commonly confused with insider trading, but they are distinct. Insider trading refers to a company insider who trades on advanced knowledge of corporate activities–for example, using their insider knowledge to buy or sell shares ahead of a major announcement.

Exploiting Analyst Recommendations

Another tactic for front-running is acting upon an analyst recommendation that has not yet been published.

The analysts work in a separate division from the broker and concentrate on evaluating the potential of individual companies in order to advise the company's clients. They constantly issue "buy," "sell," or "hold" recommendations for specific stocks. These go directly to clients first and then are picked up by the financial media and reported widely.

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A broker who acts upon that recommendation for personal gain before it reaches the company's clients is front-running.

There is some grey area here. For example, a professional short-seller may accumulate a short position and then publicize the reasons for shorting the stock. This seems perilously close to a short-seller's version of a pump-and-dump scheme, in which a speculator hypes (or bashes) an investment for personal gain.

There is a distinction, however. The short-seller in this example reveals the personal financial stake at the time of the recommendation. And, the information conveyed by the short-seller reflects a genuine fact-based view of the outlook of the stock shorted rather than a falsehood intended to mislead.

> **Warning:** Most types of front-running are prohibited by SEC Rule 17(j)-1, which sets out the ethical requirements for portfolio managers and brokers. This rule has been interpreted to prohibit these insiders from taking advantage of their knowledge of client trades for personal gain. [1]

Index Front-Running

A form of front-running in index funds is common and is not illegal.

Index funds track a financial index by mirroring the index's portfolio. The composition of the index changes periodically in order to balance it accurately as the stocks that make it up change dramatically in price or as stocks are added or removed from the index. That forces the fund's managers to buy or sell some components of the index.

Traders watch the prices of those stocks, and they know when an index fund will update its components. They will front-run the trade by buying or selling shares to gain an edge.

This is not illegal because that information is available to all those who are paying attention.

Example of Front-Running

In 2020, the Financial Industry Regulatory Authority(FINRA) announced penalties against Citadel Securities, arguing that the Chicago-based market maker had front-run against its own clients between 2012 and 2014.

According to the financial regulator, Citadel removed hundreds of thousands of large OTC orders from its automatic trading processes, requiring those trades to be executed manually by human traders. At the same time, Citadel "traded for its own account on the same side of the market at prices that would have satisfied the orders," violating their obligations to their clients. [2]

In a single sample month, FINRA found that Citadel had traded against their customers in nearly three-quarters of the inactive orders. Citadel ultimately agreed to make their clients whole, in addition to a $700,000 fine, without admitting any wrongdoing. [2]

Is Front-Running Illegal?

Yes, front-running is often illegal. Most types of front-running are prohibited by SEC Rule 17(j)-1,

Is Payment for Oder Flow Front-Running?

Payment for order flow (PFOF) is when a broker receives compensation for routing customer orders first to a particular market maker or trading firm. This practice has been criticized for discouraging best-execution for customers, but it is not considered front running since the firm receiving the flow will trade with the customer, not place trades going in the same direction in front of them.

Is Trading Ahead Front-Running?

Trading ahead is when a broker or market maker uses their firm's account to make a trade instead of matching available bids and offers from others in the market. Trading ahead is illegal, but it is not considered by regulators to be the same as front-running.

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1. Securities and Exchange Commission. "Detecting Personal Trading Abuse, https://www.sec.gov/rules/other/f4-433/mccann1.htm."

2. Financial Industry Regulatory Authority. "Letter of Acceptance, Waiver and Consent No. 2014041859401, https://www.finra.org/sites/default/files/fda_documents/2014041859401%20Citadel%20Securities%20LLC%20CRD%20116797%20AWC%20sl.pdf," Pages 1-3.