KEY POINTS

- In many circumstances, the effect of pre-hedging and front-running are identical and so their legitimacy should also be identical.
- The key to the analysis of legitimacy are the questions who makes the profit and who takes the risk.
- Reducing "slippage" is not a sufficient condition to allow pre-hedging.
- The effect of pre-hedging should be clearly articulated by a bank and explicitly agreed by the client.

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Pre-hedging versus front-running: six of one, and half a dozen of the other?

Institutions which provide market liquidity, such as banks, are in possession of very valuable confidential client data – their trading intentions. Trading intentions can generate revenue for the bank with little or no risk. This requires the bank to trade for its own account using the client's confidential information *before* it trades for the client. This behaviour is generally given two labels: "front-running", which is considered to be illegitimate, and "trading-ahead", which is thought to be legitimate. However, their effects are often identical which should imply that their legitimacy should also be the same.

INTRODUCTION

The debate between pre-hedging and front-running has been re-ignited by the recent decision in *ECU Group Plc v HSBC Bank Plc & Ors*.[1] The case itself has been discussed by Sheehan (2022).[2] The central question is whether it is ever permissible for a financial institution (such as a bank) to trade an instrument using a client's confidential information. The financial instrument in question in *ECU v HSBC* were various currencies, however the question has broader application to equities, interest rate swaps, debt, etc. A bank may execute various types of transactions as a direct consequence of obtaining confidential information from its client. A detailed analysis is required to determine which of these transactions is legitimate.

CONFIDENTIAL INFORMATION

Confidential information can take a number of forms.

- A client may simply request a price from a bank to buy (sell) shares in sufficient quantity that it is obvious that such a purchase (sale) would move the market price higher (lower).
- A client, about to issue a fixed interest rate bond, requests the bond coupon to be hedged into a variable rate using interest rate swaps.
- A client places a substantial stop-loss order which is to be executed should the asset price reach a pre-specified level (as in *ECU v HSBC*).

There are a number of other examples all of which share the common feature that the bank has knowledge of their client's trading intention.

THE UNDERLYING ISSUE: "SLIPPAGE"

The execution of any order of sufficiently large size will affect the price of the asset. The issue is analysed here in relation to a client requesting the price of buying an asset, which, if executed, will itself increase the price against the interest of the client. The principles apply equally to other circumstances.

Suppose the share price of company XYZ is $100, and the client wishes to buy 1,000 shares. This number of shares is, say, much larger than the normal volume traded daily. It is then expected that the execution of the transaction will increase the share price. Further suppose that, with all other factors constant, the share price is anticipated to increase by $2 for every 100 shares which are bought in the market. In other words, 100 shares can be bought at $100, the next 100 shares can be bought at $102 and so on. The share price at the end of the execution of the order is then anticipated to be $120. The increase in the share price on execution of the order ($20) is known as the "slippage". Whilst the scenario may be idealised for the purpose of illustration, the problem of slippage is a very real one and often used to justify using confidential client information.

On execution of this order, whilst the share price after the purchase of the full 1,000 shares is $120, the average price paid by the client will be $109.

FRONT-RUNNING

The bank, knowing the client's intention to buy shares in XYZ, buys the shares for itself ahead of the client's order paying an average price of $109 per share. The share price increases to $120. At this point the client's order is executed at $120 per share and the bank profits by $11 per share. In Sheehan's words:

> "... it is generally accepted that front running constitutes illegitimate use of the customer's confidential information ..."

TRADING-AHEAD

Trading-ahead is often justified on the basis that its objective is to minimise the asset price movement when the client's trade is executed. Minimising slippage when executing a client's order is necessary (for the bank to act in the best interest of its client) but insufficient on its own to allow the bank to use a client's confidential information. The following example will illustrate the problem.

As before, the client wishes to buy 1,000 shares in company XYZ currently priced at $100. The bank correctly realises that the execution of the order will increase the price against the interest of the client and so

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trades-ahead. It buys the shares (at an average price of $109) thereby causing the share price to increase to $120. It then sells these shares to the client at $120 pocketing a profit of $11 per share (plus any commission it might have agreed with their client).

Trading-ahead has ostensibly fulfilled the objective of minimising slippage for the client (to zero), because the price at which the client bought the 1,000 shares equals the then market price ($120). However, the client would have been $11 ($120 minus $109) better off had it suffered the slippage!

In these examples, the mechanics of trading-ahead and front-running in XYZ shares as well as the bank's profit (to the client's detriment) in doing so is indifferent. If the risks and rewards are the same, then, presumably, the legal consequences ought also to be the same.

Principle 11 of the Global FX Code states:

> "A Market Participant should only Pre-Hedge Client orders when acting as a Principal, and should do so fairly and with transparency."[3]

Why would a client agree to pre-hedging if *transparency* includes a clear explanation of its effect? In any case, how can it be done *fairly* if the profits of the pre-trading sit with the bank. If the bank fairly gives up its profit to its client, then that is entirely equivalent to the client simply executing the order in the market without pre-trading. This raises the question of when, if ever, it might be in the client's interest for the bank to engage in pre-trading.

EXAMPLE OF A STOP LOSS ORDER

Assume a client leaves an order to buy 1,000 shares of XYZ should the share price increase from its current market price of $100 to $130. Without pre-hedging/front-running, the bank would monitor the share price and execute the order should it reach $130. If this were to occur, the bank would start buying the shares on behalf of its client. The average purchase price would be $139 with share price ending at $150 after the order execution is complete. Accordingly, the client would pay $139 per share. This is standard fare for stop-loss orders. The only revenue the bank earns is its agreed commission.

Now assume that the stop-loss order was placed at $120 (rather than $130). The bank could realise that an immediate execution of the order would trigger the stop-loss order. The bank buys the 1,000 shares at an average price of $109 thereby pushing the share price up to $120 which in turn triggers the stop loss order. The client buys the shares at $120 (note that it would perceive that there had been no slippage because its purchase price is equal to the stop-loss price) and the bank pockets $11 (plus its normal commission). In this case the bank used the client's information to cause the stop-loss to be triggered and to profit from it. Presumably this is illegitimate irrespective of the action being labelled as front-running or trading-ahead.

A REGULATOR'S OPINION

The Financial Conduct Authority, the UK's regulator, when confirming its recognition of the revised FX Global Code stated:

> "Pre-hedging practices where market participants do not communicate their practices to clients in a manner that allows the client to understand the potential impact on the execution of their order are not consistent with the Codes. This includes practices where market participants do not have appropriate controls to monitor potential conflicts of interest, and do not have controls in place to limit access to confidential information relating to anticipated orders."[4]

For any order of sufficient size, the client should specify whether or not pre-hedging is permissible and the circumstances in which it may be executed. Disputes and misunderstandings are less likely if the decision to pre-hedge is left not just to the bank.

The bank will need to have in place information barriers to manage conflicts of interest, for example, to ensure confidential client information is not passed to other departments, such as their proprietary traders.

CONCLUSION

Whether it is legitimate for a bank to use their client's confidential information to trade prior to transacting for their client depends on where the profits from such trading sit rather than what it is called. In many circumstances, the effects of front-running, considered to be illegitimate, are no different to the effects of trading-ahead, considered to be legitimate. The examples given here are somewhat clear cut. More sophisticated trading strategies predicated on confidential client data can be implemented which make the legal analysis of their legitimacy much more complicated. A discussion of these is beyond the scope of this article. ■

Disclaimer: This article is not advice, and the author accepts no liability for reliance upon any of the facts or matters stated. Financial and legal advice on the issues discussed should be sought in the ordinary way.

1 [2021] EWHC 2875 (Comm.).
2 'Anticipating an FX spot trade: front running or just trading ahead?' (2022) 2 JIBFL 74.
3 https://www.globalfxc.org/docs/commentary_principle_11_role_prehedging.pdf
4 FCA confirms recognition of the revised FX Global Code and the Global Precious Metals Code | FCA.

Further Reading:

- Anticipating an FX spot trade: front running or just trading ahead? (2021) 2 JIBFL 74.
- Legal issues arising from the use of automated FX trading platforms (2018) 3 JIBFL 139.
- LexisPSL: GFXC updates FX Global Code and publishes disclosure templates and pre-hedging guidance.