Page 2208 - 2214

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India's Front Running Laws: A Viable Protection for the Average Investor against High Frequency Traders?

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ABSTRACT

The rise of High Frequency Trading in the United States and the rest of the world has changed the face of the financial system in India. A host of new consequences have emerged which couldn't possibly have been foreseen earlier. Naturally the existing laws are incapable of dealing with issues relating to High Frequency Trading, when the existing laws were written its safe to assume that the authors did not have the value of a microsecond in mind, and it certainly couldn't have occurred to them that the time taken by a human to blink his eye can be considered slow in the financial markets one day. These consequences were laid bare in the flash crash of 2010 in the US. The absence of laws to regulate High Frequency Trading and calculate the value of a microsecond to a trader has created an opaque market, made further opaque, by the traders themselves to secure their strategies and profits. Many of these strategies and methods have been researched in detail by certain journalists and authors and deemed to be predatory, foremost among them being American financial journalist Michael Lewis who laid bare the predatory tactics of the High Frequency Traders in his book "Flash Boys." This article has been written to discuss the legality of High Frequency trading in the face of Indian front running regulations and to explore whether they provide sufficient protection to the average investor from predatory trade strategies exploiting advantages in speed and information asymmetries.

I. WHAT IS HIGH FREQUENCY TRADING?

Since the year 1983, gradually after NASDAQ introduced electronic trading, a new category of traders emerged- High Frequency Traders. They have no similarity to earlier value investors or private equites, and despite a superficial similarity with algorithmic traders, the two are significantly dissimilar. Value investors and private equites are concerned with the numbers of a company like its P/E ratio, book value, cashflow statements, profit and loss statements, balance sheets etc. whereas algorithmic traders are interested in none of the aforementioned but rather on the historical price data of stocks and movements of stock prices with co-relation

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to specific events, they use computer algorithms to predict future movements of stock prices based on past data, however High Frequency Traders exist solely to exploit information asymmetries in market which occur in the briefest of milliseconds. They employ a variety of strategies to earn their profits some which are dubious, while others are outright predatory. High Frequency Traders exploit their knowledge of a discrepancy between the actual price of a stock and the price for which it is available on the market. Such price discrepancies are miniscule and occur for the briefest of time, a few milliseconds at most, however a few milliseconds are all that a High Frequency Trader needs. Owing to modern technology like supercomputers and fiber wires, which grants them a window into the future in a sense and an immense amount of speed, they can execute Buy-Buy-Sell strategies or Sell-Sell-Buy strategies. The key requirement of a High Frequency Trader is speed, in terms micro or milli seconds, the time taken by a human to blink his eye can be considered slow compared to the speed which is required by a High Frequency Trader, this speed advantage is exploited by a High Frequency Trader to gain an informational advantage unavailable to the common investor, furthermore they can execute orders, buy or sell, in micro seconds as well, it is through the exploitation of this informational advantage that they make their profits. There are a significant number of High Frequency Trading firms operating in India, a few of which are owned by brokerages with proprietary trading divisions.

(A) Profit Making Strategies Employed by High Frequency Traders.

American financial journalist and author Michael Lewis has researched and described a variety of these strategies in his book “Flash Boys” a few which I shall discuss here briefly.

i) One of the key advantages of a High Frequency Trader is gaining the knowledge of the actual price of a stock a few micro or milli seconds before it is updated in the market value. A High Frequency Trader might obtain this information in many possible ways, two of which are:

a) Co-location: It means, setting up their own servers as close as possible to the servers of the stock exchange, and with the help of technology obtain the actual price of stock value before the rest of the market does, just a few micro seconds earlier, before it is updated in the market value.

b) Using superior technology than that of the stock exchange and using data on existing trades to calculate the market value of stock before it is updated in the stock exchanges.

c) Using price discrepancy between two different exchanges.

Using this superior knowledge High Frequency Traders may chose to buy a stock when its actual price is higher than the market value displayed, and then sell it when the market value is updated and raised. Also he may do the inverse and short when the actual price is lower than the market value. Such transactions will occur in microseconds, faster than a person can blink, and the difference in prices will be that of a few paisa, however when such trades are executed at massive volumes the profits yielded will be enormous as well. This strategy insulates the trader from any risk of the market, this might appear dodgy to some because an informational asymmetry is being exploited and the high frequency trader assumes no risk at all. However the next strategy discussed seems to be outright predatory.

ii) When someone executes a buy or sell order on his terminal, be it an individual investor or a trader acting on someone's behalf, there is a delay in the time between clicking "submit" order and the order actually reaching the exchange. So if a customer executes a large buy order, High Frequency Traders obtain this information by placing tiny orders beforehand, or from "dark pools" of a financial institution where the orders are delayed for a while, and with the knowledge of the buy order which is on the way to the exchange, they buy up the required number of stocks in the stock exchange and sell it back to the buyer at a higher price whose order arrived a few micro seconds later. Some Financial institutions may even voluntarily grant access to their dark pools to High Frequency Traders in exchange of a fee but that is almost impossible to detect. This is effectively a Buy-Buy-Sell pattern which is termed as front running and is considered illegal, vice versa, they may also implement a Sell-Sell-Buy pattern. The high frequency trader in such transactions assume absolutely zero risk. There are many other technical ways by which a High Frequency Trader may obtain information about a buy or sell order before it reaches the exchange and exploit it. Such order information is especially prone to exploitation if the brokerage has proprietary traders.

(B) Impact of High Frequency Traders on the Market.

The impact of High Frequency Trading is widely disputed, its proponents strongly assert their belief that High Frequency Trading firms are an important component of the free market and capitalism. They back their views by asserting further that High Frequency Trading has increased liquidity in the market and reduced the bid-ask spread, that is the difference between the price the buyer wants and the price the seller wants.

While its opponents see High Frequency Traders as unnecessary middle men, who are driving up prices and introducing inefficiency to the system by promoting wild fluctuations in stock prices, and much like any other system the financial markets will be better off without the presence of such middle men.

Whichever way we decide to look its indisputable that High Frequency Trading has significant impact on the market which affects the average investor as well.

However, regardless of these debates, this article shall mainly examine the legality of High Frequency trading and whether the existing laws against front running provide sufficient protection to the average stock market investor.

II. What is front running?

Frontrunning is defined as "Buying or selling securities ahead of a large order so as to benefit from the subsequent price move."[2] in major law lexicon by P. Ramananthan Aiyer.

Black Law's dictionary define it as "A broker's or analyst's use of non-public information to acquire securities or enter into options or futures contracts for his or her own benefit, knowing that when the information becomes public, the price of the securities will change in a predictable manner. This practice is illegal. Front-running can occur in many ways. For example, a broker or analyst who works for a brokerage firm may buy shares in a company that the firm is about to recommend as a strong buy or in which the firm is planning to buy a large block of shares."[3]

Therefore front running is effectually- exploitation of an information asymmetry between a person and the general investor population by the person through insider relations or otherwise.

(A) India's Existing Front Running Laws and Regulations.

SEBI recognised front running as an undesirable manipulative practice, in its Consultative Paper dated March 16, 1995, and accordingly brought it within the ambit of the erstwhile SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 1995 ("**1995 PFUTP Regulations**")[4]

The erstwhile SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 explained front running as, *"'front running' means usage of non-public information to directly or indirectly, buy or sell securities or enter into options or futures contracts, in advance of a substantial order, on an impending transaction, in the same or related securities or futures or options contracts, in anticipation that when the information becomes public; the price of such securities or contracts may change."*[5]

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[2] P. RAMANATHA AIYER, MAJOR LAW LEXICON (4th ed. 2010).
[3] BLACK'S LAW DICTIONARY (9th ed.).
[4] Rohan Banerjee & Khyati G, *What is Front Running? – A Q&A Piece in Light of the SEBI Order Against Dealers of Reliance Securities Ltd.*, CYRIL AMARCHAND MANGALDAS BLOGS (April 3, 2021) https://corporate.cyrilamarchandblogs.com/2020/09/what-is-front-running-a-qa-piece-in-light-of-the-sebi-order-against-dealers-of-reliance-securities-ltd/#_ftn4.
[5] SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 Reg 5(2) explanations.

Currently, Regulation 4(2)(q) of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 ("**2003 PFUTP Regulations** states:

"Dealing in securities shall be deemed to be manipulative, fraudulent or an unfair trade practice… if it involves any order in securities placed by a person, while directly or indirectly in possession of information that is not publicly available, regarding a substantial impending transaction in that securities, its underlying securities or its derivative;"[6]

In the world of financial trading, a front-runner is commonly referred to as someone who gains an unfair advantage with inside information.[7]

Therefore the aforementioned regulations clearly describes what is frontrunning and who can be classified as a front-runner. That is, someone with inside information of a subsequent price rise or fall exploiting it to make a profit by taking up a position before the larger transaction is executed.

III. Can HFT be classified as front running

Given the definition of frontrunning discussed earlier, it is evident that some of the HFT strategies which we discussed fall within the ambit of frontrunning. When the frontrunning laws were written it is entirely possible they weren't written with the value of microseconds in mind. However the reality requires us to look at the fact that even a few microsecond advantage in obtaining information before the regular public can be used to generate enormous profits.

Furthermore the possibility of proprietary traders obtaining inside information about the orders of customers of the institution is a real threat, and therefore every such organization and firm needs to be strictly regulated and monitored. Knowledge of customer's orders can be used to buy up existing shares and selling them back to the customer at a slightly higher price, it not only adds to the volatility of the market but the average investor loses money in such transactions, and in cases of large order such small increments in prices may result in overall massive increases in cost. Such orders are effectively Buy-Buy- Sell or Sell-Sell-Buy and can be classified as frontrunning.

It also raises the question whether using co-location to obtain the updated market prices of stocks before the general investor populace and using it to make sure-fire trades illegal or not? Given the fact that the HFT trader adds volatility and assumes zero risk by exploiting his advance knowledge of updated prices. It surely has elements of front running and the regulators

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[6] SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, Reg. 4(2)(q).

[7] Nancy Folbre, The Front-Runners of Wall Street, The New York Times , April 7, 2014.

should certainly act on them and provide a definitive answer so that such an information asymmetry doesn't exist between High Frequency Traders and average investors.

IV. Conclusion

SEBI has assured High Frequency Traders that they are not against High Frequency Trading and have also reassured investors that their interests won't be compromised and it would intervene from time to time to make sure no unfair trading practices are taking place.[8]

However thus far a total of zero High Frequency Traders were prosecuted or even investigated for front-running or any other similar unfair trade practices. It is hard to believe that such a murky and opaque domain of the financial sector with potential for massive profits shall be left completely un-exploited, solely reliant of the honesty of traders.

Estimates say that around 50% of the trading on Indian stock market is done by algorithmic trading[9] and since HFT is considered as a subset of algorithmic trading it is hard to estimate what percentage of profits High Frequency Traders make. Profit estimate of High Frequency Traders vary wildly with some estimating their profits to be Rs. 40 crores a day.[10] A remarkable fact observed amongst High Frequency Traders in the US is that for over 4000 days of trading High Frequency Traders made losses of absolute zero.[11]

The laws relating to front running written thus far have neither taken into account nor calculated the value of a micro second and the role of modern technology in firmly establishing such informational asymmetries, therefore they are incapable of providing a viable protection to average individual investors should a High Frequency Trading firm choose to implement predatory trading strategies.

However with the advent of present technology and High Frequency Traders a microsecond assuredly has a value, and it has the ability to provide an unfair advantage, and existing laws need to be adapted to accommodate its value, and thus protect average investor from predators in the market who indulge in unfair trade practices, exploiting such time and information advantages.

[8] Ankit Doshi, Not against high-frequency trading use, Sebi tells brokers, Mint, April 22, 2016.
[9] Bharadwaj Sharma, Algorithmic trading share in total turnover grows to 50% in 8 years, Financial Express, May 08, 2018.
[10] Sree Iyer, *What is high frequency trading and how it affects you?,* MONEYLIFE NEWS AND VIEWS (20 April, 2015) https://corporate.cyrilamarchandblogs.com/2020/09/what-is-front-running-a-qa-piece-in-light-of-the-sebi-order-against-dealers-of-reliance-securities-ltd/#_ftn4.
[11] Sree Iyer, *What is high frequency trading and how it affects you?,* MONEYLIFE NEWS AND VIEWS (20 April, 2015) https://corporate.cyrilamarchandblogs.com/2020/09/what-is-front-running-a-qa-piece-in-light-of-the-sebi-order-against-dealers-of-reliance-securities-ltd/#_ftn4.

The Stock Market is the corner-stone of capitalism and therefore its reliability and integrity needs to upheld and maintained by the regulator with its laws and regulations, so that all investors may feel safe and be safe from unfair and predatory trade practices undertaken by any immoral individual.

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