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Expert Analysis

Analyzing Proper Pleading Standard For Commodity Manipulation Claims

Commodity manipulation litigation is on the rise. The Commodity Futures Trading Commission (CFTC), the independent government agency responsible for prosecuting conduct involving the manipulation of commodity futures and options markets, has recently stepped up its enforcement efforts.¹

This, in turn, has resulted in a number of follow-on private class actions alleging similar commodity manipulation claims on behalf of purchasers and/or sellers who traded commodity futures contracts at artificial prices.

Defendants in these cases routinely launch attacks on the sufficiency of the pleadings. Typically, defendants take the position that commodity manipulation claims brought under the Commodity Exchange Act (CEA)² are governed by the heightened pleading standard under Federal Rule of Civil Procedure 9(b), while plaintiffs take the position that such claims are subject to Rule 8's simple notice pleading standard. District courts are split on the question, and some inconsistent decisions have been issued.

The District Court for the Southern District of New York is leading the way in developing a "case-specific" approach where, depending on the type of commodity manipulation alleged, the court will apply either Rule 8 or a "flexible," or less stringent, Rule 9(b). As this approach is recognized in more jurisdictions around the country, expect to see more uniform results involving the proper pleading standard in commodity manipulation cases.

Congress' purpose in enacting the CEA was to prevent, deter and redress price manipulation of commodity futures and options contracts.³ The statute has both an anti-manipulation provision and an anti-fraud provision.⁴

Conduct involving "manipulation" in a commodity futures market can take many forms, and therefore it was not defined in the CEA. As stated in *Cargill Inc. v. Hardin*, and oft-quoted in commodity manipulation cases, "[w]e think the test of manipulation must largely be a practical one if the purposes of the [CEA] are to be accomplished. The methods and techniques of manipulation are limited only by the ingenuity of man."⁵ Manipulation has been broadly defined as "an intentional exaction of a price determined by forces other than supply and demand."⁶ Two of the more complex forms of manipulation are the "squeeze" and the "corner."⁷ However, manipulation can take many other forms, such as "marking the close" and the false reporting of trade data.

Most courts have held that the elements of a CEA commodity manipulation claim are: (1) ability to influence



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market prices; (2) specific intent to influence market prices; (3) existence of artificial prices; and (4) challenged conduct caused the artificial prices.⁸ Notably, fraud is not an element of a CEA commodity manipulation claim.

In *CFTC v. Enron Corp.*, the CFTC alleged that Enron manipulated August 2001 natural gas futures contracts prices by purchasing large amounts of natural gas within a short time. The court held, without explanation, that the claims need not be pleaded with heightened particularity under Rule 9(b).

In support, the court cited *Three Crown Ltd. Partnership v. Caxton Corp.*,⁹ a case that noted the CEA has separate provisions for fraud and manipulation, suggesting that commodity manipulation claims, as opposed to fraud claims, need not be pleaded with specificity.

In *In re Natural Gas Commodity Litigation (Natural Gas I)*,¹⁰ traders of natural gas futures contracts alleged that several energy companies manipulated prices of natural gas futures contracts by falsely reporting trade data to

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industry publications that collect such information to calculate and report prices. Defendants did not challenge the pleading standard.

Southern District Judge Victor Marrero held that the plaintiffs adequately alleged a CEA commodity manipulation claim under Rule 8. He noted that "no court has required a plaintiff to plead a claim for manipulation under [the CEA] with the same particularity that Fed. R. Civ. P. 9(b) requires of claims charging fraud."¹¹

Judge Marrero revisited the pleading standard issue in *In re Natural Gas Commodity Litigation (Natural Gas II)*, which alleged the same unlawful conduct as in *Natural Gas I* against a new defendant.¹² In *Natural Gas II*, however, the defendant moved to dismiss the pleadings because Rule 9(b) was not satisfied. Judge Marrero, in a more

fulsome analysis, developed a case-specific approach that involved closely examining the nature of the unlawful conduct alleged.

In reaching its decision, the court relied on *Rombach v. Chang*,¹³ in which the U.S. Court of Appeals for the Second Circuit affirmed dismissal of a complaint alleging violations of various federal securities laws, including §11 of the Securities Act of 1933. The circuit held that, even though §11 claims do not require proof of fraud to establish liability, Rule 9(b)'s heightened pleading standard applied to such claims "insofar as the claims are premised on allegations of fraud."¹⁴

The *Rombach* Court held that plaintiffs could not avoid complying with Rule 9(b) because "the wording and imputations of the complaint are classically associated with fraud."¹⁵ For example, the court found that there were allegations that statements issued by defendants were inaccurate, misleading and contained untrue statements of material facts.

Similarly, the *Natural Gas II* court found that the alleged manipulative conduct sounded in fraud, and thus Rule 9(b) applied. The court found that even though fraud was not specifically alleged, the complaint alleged a scheme to manipulate commodity prices that was "classically associated with fraud": the dissemination of 'inaccurate, misleading, and false trading information,' and participation in 'a variety of fraudulent trade reporting strategies.'¹⁶

The court saw no basis for limiting the rule articulated in *Rombach* to securities fraud cases: "a complaint that sounds in fraud must comply with Rule 9(b)'s requirements even if the complaint does not allege a cause of action requiring proof of fraud."¹⁷

The *Natural Gas II* court did not end its analysis there, however. It further found that plaintiffs need only satisfy the "flexible Rule 9(b) standard" typically employed in market manipulation claims under the securities fraud laws. To satisfy this lower pleading standard, the court held that a commodity manipulation claim need only specify "[1] what manipulative acts were performed, [2] which defendants performed them, [3] when the manipulative acts were performed, and [4] what effect the scheme had on the market for the securities at issue."¹⁸

Commission's Approach

The CFTC appears to take a different approach. In two of its cases against natural gas traders involving the same allegations of false reporting of trade information as in *Natural Gas*, the CFTC noted that, under the CEA, and unlike the Securities Act, acts of commodity manipulation (whether fraud-based or market-power based, under CEA §9(a)) and acts of fraud (under CEA §4b) are distinct claims set forth in separate provisions of the CEA. Thus, the CFTC argued that conduct not

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expressly prohibited under its anti-fraud provision—such as false reporting or manipulation—was subject to Rule 8's notice pleading standard.

In *CFTC v. Johnson*, the court declined to apply Rule 9(b) to the commodity manipulation claims based on false reporting; instead, as contended by the CFTC, it applied Rule 8 “[i]n light of the trader-defendants’ failure to cite any case supporting the imposition of such a requirement.”¹⁹

In addition, the court found that Rule 9(b) did not apply to claims of attempted manipulation, relying on its earlier decision in *Enron*. Notwithstanding, the court noted that if it were to apply the Rule 9(b)'s heightened pleading requirements, it would apply the flexible standard articulated in *Natural Gas II*.

In *CFTC v. Reed*, the court found that it was not clear whether Rule 9(b) applied.²⁰ However, it held that the complainant's allegations were sufficient even if Rule 9(b) applied, relying on *Natural Gas II* where the court held similar allegations satisfied flexible Rule 9(b).

After 'Natural Gas II'

Following the *Natural Gas II* court's application of a case-specific approach to pleading a CEA commodity manipulation claim, several cases were decided that applied that reasoning but with inconsistent results, including three in the Southern District.

In *Premium Plus Partners v. Davis*,²¹ plaintiffs alleged defendants engaged in unlawful trading activities in an eight-minute trading window that resulted in a price manipulation of 30-Year Treasury options.

Distinguishing *Natural Gas II*, the court conducted a fact-based analysis and held that the manipulation claim was not premised on fraud, and thus Rule 9(b) did not apply: “Defendants are not alleged to have made any statements (false or otherwise) in connection with the alleged market manipulation.”²² The court noted that it was not endorsing a rule that Rule 9(b) could never apply to a CEA commodity manipulation claim.

More recently, the Southern District issued three decisions on the proper pleading standard for a CEA commodity manipulation claim.

In *In re Crude Oil Commodity Litigation*,²³ plaintiffs alleged that defendants manipulated the price of light sweet crude oil futures contracts. The court, applying the case-specific approach articulated in *Natural Gas II*, found that, although “plaintiffs have apparently carefully avoided the word ‘fraud’ in their complaint,” it was not dispositive of the issue, and the allegations had to be examined to determine whether the manipulation claim “sound[ed] in fraud.”²⁴

The court held they did, finding that the alleged conduct involved concealing the availability of crude oil supplies, making false and misleading statements such as “talking up” non-existent commercial needs, “bidding up” and/or “trashing” spot market prices, and creating a “false impression” of available supplies.

It concluded that, since the crux of the allegations were essentially fraud-based in that defendants misled the market about supply and demand, the stricter Rule 9(b) applied.

The litigation against hedge fund giant Amaranth produced some differing results. After an investigation following the fund's collapse, the CFTC commenced an action in the Southern District alleging attempted manipulation of natural gas futures contracts prices as well as a cover-up claim.

The CFTC alleged that Amaranth manipulated the price of natural gas futures contracts by engaging in conduct commonly referred to as “marking the close,” which involves purchasing large numbers of futures contracts leading up to the contracts’ expiration day, followed by the sale of those contracts several minutes

before the close of trading that day. A class action in the Southern District alleging the same misconduct soon followed. The parties in both cases disagreed as to the appropriate pleading standard.

In *CFTC v. Amaranth Advisors*,²⁵ Judge Denny Chin focused on the two Southern District cases addressing the issue on point, *Crude Oil and Natural Gas II*, finding that each employed a “case-specific approach” whereby the alleged manipulative scheme was analyzed to determine whether it sounded in fraud, thereby potentially implicating Rule 9(b).

Judge Chin followed this approach, and held that the “marking the close” allegations were not premised on allegations of fraud, and thus Rule 8 applied. He contrasted Amaranth's conduct with that alleged in *Crude Oil and Natural Gas II*, which he determined involved false statements or the concealment of information.

He found that “the CFTC’s theory of attempted manipulation is not based on misleading statements or omissions, but rather on a particular trading strategy. The manipulation is not based on false statements of fact intended to deceive a buyer or seller, but on the timing of large numbers of trades intended to change the closing price.”²⁶

However, with respect to the scheme in which the CFTC alleged that Amaranth sought to cover up its

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manipulative conduct by submitting a letter containing false statements to NYMEX, Judge Chin held that Rule 9(b) applied.

While the court determined that making a false statement to a government entity was not fraud in the classic sense in that it was not inducing someone to surrender something of value based on the false statement, it found that it still sounded in fraud because “false statements issued to cover up illicit activities can prevent NYMEX from carrying out its enforcement duties if it relies on those statements.”²⁷

Another Approach

In the class action litigation against Amaranth,²⁸ also in the Southern District, Judge Shira A. Scheindlin took a different approach.

She relied on the Second Circuit's decision in *ATSI Communications Inc. v. Shaar Fund, Ltd.*,²⁹ a securities fraud action under the Security Exchange Act in which the circuit determined “a claim for market manipulation is a claim for fraud, [so] it must be pled with particularity under Rule 9(b).”³⁰

Noting plaintiffs’ argument that *ATSI Communications* was inapplicable because it dealt with securities fraud, not commodity manipulation, the court reasoned “there is no principled reason to distinguish between commodities manipulation and securities manipulation in selecting the applicable pleading standard...market manipulation is inherently deceptive.”

The court added, however, that a claim of manipulation need not be pleaded with the same degree of specificity as a typical misrepresentation claim, noting that it could involve facts solely within a defendant's

knowledge. Thus, the court held that flexible Rule 9(b) was the appropriate pleading standard as opposed to the stricter Rule 9(b) standard ordinarily applicable to fraud-based claims.

Conclusion

In analyzing the proper pleading standard for a CEA commodity manipulation claim, the case-specific approach, as articulated and developed in *Natural Gas II*, appears to be taking hold.

This means that, depending on the type of conduct alleged, either Rule 8 (in cases alleging manipulation based on the exertion of market power) or flexible Rule 9(b) (in cases involving manipulation based on, or sounding in, fraud) is the applicable pleading standard.

Further refinement of this approach can be expected in the near future, as several courts are considering the issue. In turn, this should lead to more consistent application and results.

1. The Federal Energy Regulatory Commission also has been active in prosecuting violations of its Market Behavior Rule 2, which proscribes manipulation by “[a]ny person making natural gas sales for resale in interstate commerce...from engaging in actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for natural gas.” 18 C.F.R. §284.403(a) (2005).

2. 7 U.S.C. §1 et seq.

3. See *Leist v. Simplot*, 638 F.2d 283, 304 (2d Cir. 1980), aff'd sub nom. *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Curran*, 456 U.S. 353 (1982).

4. §§9(a) and 22(a) of the CEA, 7 U.S.C. §§13(a) and 25(a) (prohibits manipulation) and Section 4b of the CEA, 7 U.S.C. §6b (prohibits fraud).

5. 452 F.2d 1154, 1163 (8th Cir. 1971).

6. *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991).

7. In a corner, the manipulator gains control of the available supply of the commodity underlying, and thus deliverable under, a futures contract. The manipulator can thus dictate the price at which the short sellers must pay to cover their positions. In a squeeze, the manipulator acquires a dominant futures position and/or an amount of the cash supply to allow it to demand artificial prices from traders who must make delivery in the face of a shortage of supply. See 13 Jerry W. Markham, *Commodities Regulation: Fraud, Manipulation & Other Claims* §15.1 (2005); *CFTC v. Enron Corp.*, 2004 WL 594752, at *5 (S.D. Tex. March 10, 2004).

8. *Enron*, 2004 WL 594752, at *4.

9. 817 F. Supp. 1033, 1043 n.19 (S.D.N.Y. 1993).

10. 337 F. Supp. 2d 498 (S.D.N.Y. 2004). Labaton Sucharow is interim co-lead counsel.

11. *Id.* at 509. The court also noted that the CEA has separate provisions for fraud and manipulation.

12. 358 F. Supp. 2d 336 (S.D.N.Y. 2005).

13. 357 F. Supp. 2d 164 (2d Cir. 2004).

14. 358 F. Supp. 2d at 342, citing *Rombach*, 355 F.3d at 171.

15. *Id.*, citing *Rombach*, 355 F.3d at 172.

16. *Id.* at 343.

17. *Id.*

18. *Id.*, citing *SEC v. U.S. Envtl. Inc.*, 82 F. Supp. 2d 237, 240 (S.D.N.Y. 2000).

19. 408 F. Supp. 2d 259, 270 (S.D. Tex. 2005).

20. 481 F. Supp. 2d 1190, 1200 (D. Colo. 2007) (comparing *Enron* (applying Rule 8 to commodity manipulation claim) to *Natural Gas II* (applying Rule 9(b) to commodity manipulation claim).)

21. 2005 WL 711591 (N.D. Ill. March 28, 2005).

22. *Id.* at *15.

23. 2007 WL 1946553 (S.D.N.Y. June 28, 2007). Labaton Sucharow was appointed interim co-lead counsel.

24. *Id.* at *5.

25. 554 F. Supp. 2d 523 (S.D.N.Y. 2008).

26. *Id.* at 531.

27. *Id.* at 535.

28. *In re Amaranth Natural Gas Commodities Litig.*, 2008 WL 4501247 (S.D.N.Y. Oct. 6, 2008). Labaton Sucharow is additional counsel for plaintiffs in this case.

29. 493 F.3d 87 (2d Cir. 2007).

30. *Amaranth*, 2008 WL 4501247, at *11, quoting *ATSI*, 493 F.3d at 101.