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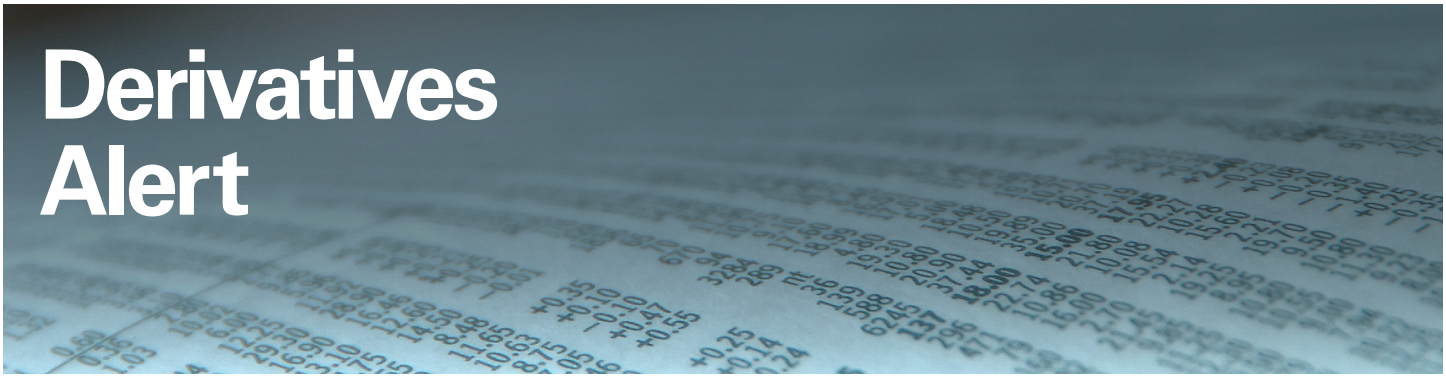
Derivatives Alert



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Southern District Decision Highlights Challenges for Private Litigants Pursuing Manipulation Claims Under the CEA

The U.S. District Court in the Southern District of New York recently dismissed a class action lawsuit alleging that Total, S.A., Total Gas & Power North America, Inc., and Total Gas & Power Limited (collectively, "Total") manipulated physical and financial natural gas prices in violation of the Commodity Exchange Act (CEA), 7 U.S.C. §§ 1 *et seq.*, and engaged in monopolization of the physical natural gas market in violation of the Sherman Act, 15 U.S.C. § 2. *Harry v. Total Gas & Power N. Am., Inc.*,—F.Supp. 3d—, 2017 WL 1134851 (SDNY Mar. 27, 2017) (*Total Gas*). The decision highlights important hurdles private litigants routinely face in pursuing manipulation claims that government agencies do not.

Total Gas is yet another recent example of litigants bringing private causes of actions under the CEA and the antitrust laws in reliance on allegations developed in enforcement proceedings initiated by the U.S. Commodity Futures Trading Commission (CFTC) (and, here, by the Federal Energy Regulatory Commission (FERC), as well).[1] In December 2015, Total agreed to a $3.6 million civil monetary penalty to settle CFTC allegations of manipulating natural gas prices on occasions in 2011 and 2012.[2] And, in April 2016, the FERC issued an order to show cause accompanied by an Enforcement Staff report and recommendation (FERC R&R) against Total recommending $225 million in penalties and disgorgement for alleged natural gas price manipulation.[3] Total continues to litigate FERC's claims.[4]

According to the *Total Gas* court, "The great bulk of the substantive allegations made in the [complaint] are lifted directly from those included in the CFTC Order and the FERC R&R." Slip op. at 12. But as the district court's decision illustrates, the CFTC or FERC obtaining a substantial monetary penalty does not guarantee private litigants similar success.

[1] *See, e.g., In Re: Libor-Based Fin. Instruments Antitrust Litig.*, 1:11-md-02262 (SDNY); *In re Foreign Exchange Benchmark Rates Antitrust Litig.*, 1:13-cv-07789 (SDNY); *Alaska Elec. Pension Fund v. Bank Of Am. Corp.*, 1:14-cv-07126 (SDNY) (ISDAfix).

[2] *In the Matter of Total Gas & Power N. Am. and Tran*, Dkt. 16-03 (CFTC Dec. 7, 2016).

[3] *Total Gas & Power N. Am., Inc.*, Order to Show Cause and Notice of Proposed Penalty, 55 FERC ¶ 61,105 (Apr. 28, 2016).

[4] *Total Gas & Power N. Am., Inc., v. FERC*, 2016 WL 3855865 (S.D. Tex. July 15, 2016) (dismissing Total's suit challenging the legitimacy of the FERC proceedings on various constitutional and statutory grounds), *appeal argued*, C.A. Dkt. 16-20642 (5th Cir. Apr. 5, 2017).

Private Litigants' Actual Damages Pleading Requirement and Standing

In late 2015 and 2016, the CFTC, the FERC and private litigants each brought respective actions against Total for manipulating natural gas markets. Each agency and the private plaintiffs either found or alleged that Total engaged in a manipulative scheme to trade natural gas contracts for physical delivery at four regional trading hubs with the intent to benefit Total's financial swaps positions. Common among the allegations were that the value of Total's swap positions depended on the price differential or "basis" between the regional hub index price for physical natural gas and the NYMEX natural gas futures price. The private plaintiffs further alleged that (1) plaintiffs traded natural gas futures on NYMEX and (2) there is a close and inextricably linked price relationship between the regional hub index prices and the NYMEX price. Nevertheless, the *Total Gas* court dismissed the claims, holding that the plaintiffs lacked standing because they did not plead any plausible allegation that Total's conduct would impact NYMEX futures prices.

The CFTC and private litigants each brought similar CEA claims. First, they each asserted traditional price manipulation claims under pre-Dodd-Frank authority, now codified at CEA Sections 6(c)(3) and 9(a)(2) and CFTC Rule 180.2. The CFTC charged only attempted price manipulation under these provisions, whereas the private plaintiffs alleged a completed price manipulation.[5] Second, they each brought claims under the new Dodd-Frank authority prohibiting the use of manipulative or deceptive devices, now codified at CEA Section 6(c)(1) and CFTC Rule 180.1.[6] Unlike traditional price manipulation claims, Section 6(c)(1) as implemented via Rule 180.1 prohibits both reckless and intentional conduct and does not require a showing that the defendant intended to create, or in fact created, an artificial price.[7]

A key difference between public and private enforcement under the CEA is that private plaintiffs, unlike the CFTC or FERC, will have standing to sue only if they have suffered "actual damages" resulting from the defendant's conduct. CEA Section 22; *see also Total Gas*, slip op. at 34 (private antitrust plaintiff must allege that it "suffered an antitrust injury"). That distinction proved dispositive in *Total Gas*, as the court determined that the plaintiffs' CEA claims had to be dismissed for failing to plausibly allege that the defendants' alleged manipulative conduct caused the plaintiffs economic harm. *Id.* at 18; *see also id.* at 36-37 (dismissing antitrust claim on same ground).

Finding a plausible link between Total's alleged conduct and the plaintiffs' damages proved to be a hurdle these plaintiffs could not surmount. The plaintiffs alleged that Total engaged in excessive physical trading at the regional hubs to manipulate the price differential between the regional hubs' index prices and the NYMEX price (the NYMEX-Hub basis price), and that manipulating the NYMEX-Hub basis price would benefit Total's financial basis swaps. (Compl. ¶ 73.)[8] Yet, the *Total Gas* court concluded that the plaintiffs' trading in NYMEX futures contracts alone did not rise to the level of a plausible allegation that Total's conduct caused them actual damages. The court suggested that damages would be plausible for a person that traded contracts linked to the hub index price or the NYMEX -Hub basis price, but it was not plausible that a person trading contracts linked to the NYMEX price on its own could be harmed. *See Total Gas*, slip op. at 20. The court found it significant that the plaintiffs had not alleged that "they purchased any financial instruments — or any physical natural gas — whose prices were based on or directly tied to monthly index prices at th[e] [regional] hubs." *Id.*

In addition to the plaintiffs' failure to allege a plausible impact on their NYMEX futures transactions, the court deemed it "fatal" that they failed "to allege a single specific transaction that lost value as a result of the defendants' alleged misconduct[.]" *Id.* at 26. In the absence of such specific allegations, the plaintiffs' alleged damages were "merely conceivable." *Id.* at 28. Given the allegation that "the alleged manipulation was varying in direction compared to prices at Henry Hub," the court reasoned that "there may be some days when plaintiffs were actually *helped*, rather than harmed, by the alleged artificiality, depending on their position in the market." *Id.* at 27 (quoting *In re LIBOR-Based Fin. Instruments Antitrust Litig.*, 27 F. Supp. 3d 447, 461 (S.D.N.Y. 2014)). These failures to plausibly allege damages meant that the plaintiffs' CEA manipulation claims and their related principal-agent and aiding-and-abetting claims had to be dismissed. *Id.* at 28.

[5] Under the CEA, the CFTC may pursue attempted or completed price manipulation charges. The elements of attempted price manipulation are (1) the requisite manipulative intent and (2) an overt act in furtherance of that intent. But private litigants do not have standing to bring a cause of action for attempted price manipulation. Therefore, plaintiffs must prove all four elements of completed price manipulation to prevail on a price manipulation claim under the CEA. *See* CEA Section 22(D)(ii). The four elements to establish a violation for completed price manipulation are: (1) defendants possessed an ability to influence market prices; (2) an artificial price existed; (3) defendants caused the artificial prices; and (4) defendants specifically intended to cause the artificial price. *Total Gas*, slip op. at 17, *citing In re Amaranth Natural Gas Commodities Litig.* (*Amaranth III*), 730 F.3d 170, 173 (2d Cir. 2013).

[6] For simplicity, this article refers to violations of Sections 6(c)(3) and 9(a)(2) and Rule 180.2 as "price manipulation" and violations of Section 6(c)(1) and Rule 180.1 as "fraud-based manipulation."

[7] "[F]inal Rule 180.1 implements the provisions of CEA section 6(c)(1) by prohibiting, among other things, manipulative and deceptive devices, *i.e.*, fraud and fraud-based manipulative devices and contrivances employed intentionally or recklessly, regardless of whether the conduct in question was intended to create or did create an artificial price." Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41398 (July 14, 2011).

[8] Third Amended Class Action Complaint, *Anastasio v. Total Gas & Power N. Am., Inc.*, 1:15-cv-09689, Dkt. 51, ¶ 73 (SDNY Apr. 15, 2016).

Attempted Versus Completed Price Manipulation

In a CFTC settlement negotiation, one consideration for the defendant will be whether the CFTC is willing to limit the charges to *attempted* price manipulation. When considering a CFTC settlement for price manipulation while private civil claims loom, defendants may find some marginal benefit in settling with the CFTC for attempted rather than completed price manipulation. Limiting the discussion in a CFTC settlement order to attempted price manipulation denies private litigants an often important source of information for alleging facts to support claims in the civil complaint. In particular, it will be difficult to rely on a CFTC charge for attempted (*i.e.*, unsuccessful) manipulation to support the plaintiffs' contention that they incurred actual damages. The CFTC may be open to this approach because establishing a violation for attempted price manipulation requires the CFTC to prove only two elements — manipulative intent and an overt act in furtherance of that intent. In addition, the civil monetary penalties are the same whether the CFTC can establish attempted or completed price manipulation.

Private plaintiffs, on the other hand, would likely prefer that the CFTC's price manipulation settlements include findings that a defendant perfected a completed manipulation. There is only one element that overlaps between attempted and completed price manipulation — intent. If the CFTC finds a defendant engaged in completed manipulation, it will make private plaintiffs' jobs easier when drafting their complaint as they draw on the CFTC's findings to support four elements of their case rather than just one. Moreover, a CFTC finding that prices were in fact artificial will assist plaintiffs in alleging actual damages.

Neither the CFTC nor the courts have developed a clear set of elements required to establish a violation for fraud-based manipulation under Sections 6(c)(1) and Rule 180.1, so limiting a CFTC settlement to an attempted violation of Rule 180.1 may not have the same impact that it could for traditional price manipulation under Sections 6(c)(3) and 9(a)(2). On the other hand, private plaintiffs pursuing a fraud-based manipulation claim will be hard-pressed to use the facts in a CFTC order to establish actual damages that were purportedly the result of an *attempted* fraud-based manipulation.

Standard of Intent for Price Manipulation

The *Total Gas* decision also touches on a recurring theme in recent CEA price manipulation cases litigated in federal court versus through administrative settlements. It is well-settled that the standard for the intent to manipulate a price or attempt to manipulate a price is the same. *In re Indiana Farm Bureau Assn. Coop., Inc.*, 1982 WL 30249 at *4 (CFTC Dec. 17, 1982). The Second Circuit has described this intent standard as a specific intent to create an artificial price. *See Amaranth III*, 730 F.3d at 173. But in a previous Skadden client alert[9] we identified an effort by the CFTC to lower the intent standard at least for purposes of proving an attempted manipulation in *CFTC v. Donald Wilson & DRW Inv.*, LLC, 13-cv-7884 (SDNY 2013).

Consistent with its analysis in the Total settlement order, the CFTC recently argued in *DRW* that the standard for intent in an attempted price manipulation case requires the government to prove that the defendants only intended to affect the price of a commodity (but not to create an artificial price). The *DRW* court's decision casts serious doubt on the CFTC's new interpretation:

> The CFTC interprets this language[10] as holding that the intent standard is merely the 'intent to affect market price.' … *The CFTC's interpretation is incorrect*. The CFTC must prove that Defendants had the specific intent to affect market prices that did not reflect the legitimate forces of supply and demand. This means that there is 'no manipulation without intent to cause artificial prices.'

CFTC v. Donald Wilson & DRW Inv., LLC, 2016 WL 7229056 at *7 (SDNY Sept. 30, 2016) (emphasis added) (quoting *Amaranth III*, 730 F.3d at 183).

In its Total settlement, the CFTC refrained from using the word "artificial" anywhere in the order and instead used the "intent to affect price" language for attempted price manipulation. *See* CFTC Order at 8. The district court in *Total Gas*, like the *DRW* court, retained the specific intent to create an artificial price standard. Slip op. at 17. And the court went one step further, finding additional grounds for dismissal of all the CEA claims in the plaintiffs' failure plausibly to allege that the defendants "specifically intended to cause the artificial price of physical or financial instruments purchased by the plaintiffs." *Id.* at 29 (internal quotation marks and citation omitted). Relying on *Hershey v. Energy Transfer Partners, L.P.*, 610 F.3d 239 (5th Cir. 2010), which held that a plaintiff alleging manipulation under the CEA must allege that the defendant intended to manipulate the price of the commodity underlying the contract that plaintiff purchased, the court rejected the plaintiffs' argument that it was sufficient for them to allege that the defendants' specifically

[9] *CFTC Aims to Lower the Bar on Proving Manipulation in Pending Cases*, Skadden Client Alert, January 2016.

[10] The 'language' referenced by the court is the standard of intent fashioned by the CFTC in its seminal decision on price manipulation under the CEA: "[T]he accused acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand … ." *Indiana Farm Bureau*, 1982 WL 30249 at *7. The court in *DRW* reaffirmed that this language is synonymous with a specific intent to create an artificial price.

intended to manipulate prices at the four regional hubs. T*otal Gas*, slip op. at 30-31. Instead, "[a] plain reading of the CEA requires the plaintiffs to allege intentional manipulation of the commodity underlying the individual contracts for which the plaintiffs claim damages." *Id.* at 31.

Manipulative and Deceptive Devices — CFTC Rule 180.1

In addition to alleging the traditional attempted or completed price manipulation claims under CEA Section 6(c)(3) and 9(a)(2), both the CFTC and private plaintiffs alleged that Total's conduct violated the new Dodd-Frank prohibition on using manipulative or deceptive devices under CEA Section 6(c)(1) and CFTC Rule 180.1.

The CFTC determined that Total employed a manipulative device by trading large volumes of physical natural gas during the settlement periods (*i.e.*, bid week) of the various regional hubs with the intent to benefit related financial positions. CFTC Order at 10. In a previous Skadden client alert[11] we identified potential problems — in particular, the CFTC's apparent position that trading in large volumes can constitute a *per se* violation — with a nearly identical determination in the CFTC's settlement in the "London Whale" case. *In re JPMorgan Chase Bank, NA.*, Dkt. No. 14-01 (CFTC Oct. 16, 2013).

The CFTC has consistently asserted that CEA Section 6(c)(1) and Rule 180.1 prohibit market manipulation but do not require proof of an artificial price, and that they require the CFTC to prove only "recklessness" rather than "specific intent." The lack of clarity around the elements of a violation has created concern among market participants. To date, just one court has analyzed Rule 180.1 in a market manipulation context. In *CFTC v. Kraft*, 153 F.Supp. 3d 996, 1009 (N.D. Ill. 2015), the district court considered very similar allegations to the Total and JP Morgan settlements: The CFTC asserted that trading large volumes with an intent to affect prices was a manipulative device. But the *Kraft* court took a narrower read of Rule 180.1 and held that violations under CEA 6(c)(1) and Rule 180.1 are limited to fraudulent conduct and subject to the heightened pleading standards for fraud.[12]

In *Total Gas*, the plaintiffs alleged that Total submitted false and misleading reports to price reporting agencies, and that the false reports were manipulative devices in violation of Rule 180.1. However, the court did not analyze the intent element of the plaintiffs' Rule 180.1 claim. Instead, the court relied on the *Hershey* analysis described above to hold that the claims failed to allege that Total's intent (whether specific intent or reckless intent) was to manipulate the commodity underlying the plaintiffs' futures contracts — plaintiffs' allegations focused on the prices of the four regional hubs, rather than Henry Hub, which underlies the NYMEX futures contract.

Antitrust Claims

The plaintiffs' antitrust claim fared no better. The district court ruled that the plaintiffs lacked antitrust standing, because they neither plausibly alleged antitrust injury nor that they would be appropriate plaintiffs to pursue the asserted antitrust violations. *Id.* at 34-46. As for antitrust injury, the court identified precisely the same deficiency that sank the plaintiffs' CEA claims: the plaintiffs did not supply facts to support their allegation that the defendants' anticompetitive conduct in the physical natural gas market at the four regional hubs caused anticompetitive harms in the markets in which the plaintiffs participated: the physical market at Henry Hub and the market for derivatives priced with reference to Henry Hub. *Id.* at 35-44. It followed from this failing that the plaintiffs also were not "efficient enforcers of the antitrust laws," because "[t]here exist more direct victims of the misconduct alleged, namely, those who purchased physical natural gas at the regional hubs during the time period in which the defendants are alleged to have manipulated the index prices at those hubs, and those who purchased derivative instruments tied to those index prices." *Id.* at 45. The district court accordingly dismissed the plaintiffs' complaint in its entirety.

Conclusion

The contrasting outcomes of the CFTC and private actions here illustrate at least one significant difference between public and private enforcement. Plaintiffs pursuing private claims under CEA Section 22(a) must allege and prove "actual damages" resulting from CEA violations; as the *Total Gas* decision demonstrates, that is a difficult — and sometimes insurmountable — hurdle to overcome, even at the pleading stage of the case.

[11] *The CFTC's Fraud-Based Manipulation Authority Raises Questions*, Skadden Client Alert, January 2014.

[12] As *Kraft* proceeds, the parties are likely to continue to challenge each other on the boundaries of a Rule 180.1 claim for market manipulation. For instance, Kraft already sought interlocutory review of whether its large futures position, coupled with an alleged intent to affect market prices but absent any other alleged false communications to the market, could constitute (1) a violation of Rule 180.1, or (2) price manipulation under CEA Sections 6(c)(3) or 9(a)(2). The district court denied Kraft's motion for interlocutory review in July 2016.