Securities Regulation Daily Wrap Up, COMMODITY FUTURES—N.D. Ill.: Stiff new pleading requirements for commodities 'manipulative or deceptive device', (Dec. 22, 2015)

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

In an issue of first impression, an Illinois federal district court ruled that a Commodity Exchange Act provision on the use of a "manipulative or deceptive device" specifically prohibits fraudulent manipulation and must meet heightened pleading requirements for fraud allegations. The court found that the CFTC had adequately pleaded under several theories that Kraft Foods had manipulated wheat markets, and denied Kraft's motion to dismiss (*CFTC v. Kraft Foods Group, Inc.*, December 18, 2015, Blakey, J.).

Alleged manipulation. A global food company, Kraft Foods typically buys the wheat it uses in snack foods in the cash wheat market, and uses the futures markets to hedge its cash wheat positions. The CFTC alleged that in 2011, Kraft responded to high cash prices for wheat by taking a $90 million long position in wheat futures for which it did not have a bona fide commercial need. The type of wheat in the futures contracts is of lower quality than cash wheat and is delivered in an inconvenient location, so Kraft was not actually going to use this wheat. Instead, the CFTC asserted, Kraft took the enormous futures position to make sellers think that Kraft intended to take delivery of the futures wheat. Kraft hoped this would in turn lower the price of cash wheat in the Toledo region, which was the wheat Kraft actually needed for production.

According to the CFTC, Kraft's actions constituted use of a "manipulative or deceptive device" in violation of Section 6(c)(1) of the Commodity Exchange Act, as well as manipulation and attempted manipulation of the price of cash wheat and wheat futures in violation of Sections 9(a)(2) and 6(c)(3) and CFTC Regulation 180.2. The CFTC also alleged that Kraft violated position limits and engaged in noncompetitive trading.

Manipulative or deceptive device. Section 6(c)(1) prohibiting the use of a "manipulative or deceptive device" is a relatively new section that was added to the Commodity Exchange Act (CEA) by the Dodd-Frank Act. The CFTC argued that the disjunctive "or" created two separate causes of action, one for manipulation and one for fraud. The court disagreed, finding that the statute prohibited only *fraudulent* manipulation involving deception, misrepresentation, or some other form of fraud. The court noted that the provision was borrowed from Section 10(b) of the Securities Exchange Act of 1934, and courts have consistently found that Section 10(b) sounds in fraud. Case law interpreting long-standing manipulation provisions in Section 9a(2) and 6(c)(3) could not be applied to Section 6(c)(1) because those provisions have very different language, said the court.

Having found that Section 6(c)(1) sounds in fraud, the court ruled that claims brought under this provision must meet heightened pleading requirements under Fed. R. Civ. P. 9(b). The CFTC had to identify what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the commodities at issue. The court found that the CFTC had adequately pleaded these elements. The CFTC alleged detailed facts showing that Kraft took a huge futures position for wheat that it did not intend to use, in a successful attempt to mislead others in the market into thinking that Kraft would take delivery of its futures position and not buy cash wheat. This move did decrease cash wheat prices, generating millions of dollars in profit for Kraft.

The court also explicitly adopted a scienter requirement supported by long-standing precedent under commodities and securities laws and confirmed by the CFTC in its final rulemaking. Under this standard, the CFTC had to show that Kraft acted "intentionally or recklessly." Through emails showing evidence of direct intent, as well as circumstantial evidence, the CFTC sufficiently pleaded scienter.

Classical manipulation. Turning to the CFTC's more traditional manipulation claim under Section 9a(2) and 6(c)(3) and Regulation 180.2, the court said the CFTC had met a four-part test. The CFTC adequately alleged that Kraft had the ability to influence prices, and intended to and did create an artificial price. The court also ruled that the CFTC had adequately pleaded attempted manipulation.

Because the CFTC adequately alleged both of its manipulation claims, the court denied Kraft's motion to dismiss.

The case is No. 15 C 2881.

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Companies: Kraft Foods Group, Inc.; Mondelez Global LLC

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