Proskauer

CFTC Proposes Changes to Rule 4.7

October 19, 2023

On September 29, 2023, the CFTC approved a proposal to amend certain provisions of its regulations relating to commodity pools, specifically Rule 4.7. The proposal would be the first major change to Rule 4.7 in over 30 years. The proposal would update the Portfolio Requirement thresholds within the definition of "Qualified Eligible Person" ("QEP") and would require Commodity Pool Operators ("CPOs") and Commodity Trading Advisors ("CTAs") that are currently exempt under Rule 4.7 to provide certain minimum disclosures to potential and current participants in pools and advisory clients. The proposal also addresses the timing of certain pools' financial reporting.

Qualified Eligible Persons

Rule 4.7 provides exemptions to CPOs and CTAs from certain regulatory requirements where the prospective and actual pool participants and/or advisory clients are QEPs. Certain categories of investors, including, among others, certain insurance companies, employee benefit plans and most operating companies, non-profit organizations and natural persons, are required to meet a "Portfolio Requirement" to qualify as a QEP. These monetary thresholds are intended as a proxy for the experience and knowledge the CFTC believes necessary to be eligible to invest in complex commodity interest products, including swaps. In the proposal, the CFTC noted that the Portfolio Requirement thresholds have not been changed since they were originally adopted in 1992 and no longer reflect a higher level of sophistication and resources. The proposal would double the Portfolio Requirement thresholds and require the potential pool participant to either:

- own securities of issuers not affiliated with such person and other investments with an aggregate market value of at least $4 million,
- have at least $400,000 of exchange specified initial margin, option premiums and required minimum security deposits for retail forex trades on deposit with a futures commission merchant ("FCM") at any time during the six month period prior to the purchase of the pool participation, or
- own a portfolio comprised of a combination of (i) and (ii) above where the fractional portion of each test, when combined, would be equal to or greater than 100%.

The proposal does not make any other changes to the QEP definition (e.g., qualified purchasers as defined under SEC rules do not need to meet the Portfolio Requirement test). It is also important to note that the Portfolio Requirement must be met at the time of sale of any pool participation units or when the advisory account is opened, as applicable. As a result, investors that currently qualify as QEPs but would fail to meet the higher thresholds, if implemented, would be able to remain participants in any pools in which they currently hold units, but would not be able to make additional investments.

Disclosures

The CFTC is also proposing to require that CPOs and CTAs claiming exemptions under 4.7 make certain minimum disclosures to prospective and current pool participants and advisory clients. Currently, these CPOs and CTAs are exempt from the required disclosures under Part 4 of the CFTC’s regulations so long as any disclosures they do make include all of the information necessary so as not to be misleading.

CPOs relying on Rule 4.7 would be required to make the following minimum disclosures to pool participants:

- A description of the principal risk factors
- A description of the trading and investment program, (including a list of custodians and CTAs), and use of proceeds
- A complete description of fees, commissions and other expenses
- Any actual or potential conflicts of interest on the part of the CPO, any major CTA, the trading manager, and any other person providing services to the pool, acting as a counterparty to swap transactions, etc.
- Certain performance information including past performance of the pool

CTAs relying on Rule 4.7 would be required to make the following minimum disclosures to advisory clients:

- Identification of each principal of the CTA, FCM and/or any registered foreign exchange dealer (“RFED”) and any introducing broker
- A description of the principal risk factors for their trading program
- A description of the trading and investment program (including its approach to offsetting transactions) and the types of commodity interests the CTA intends to trade

- A complete description of fees
- Any actual or potential conflicts of interest on the part of the CTA, any FCM or RFED, any introducing broker, or any principal of any of the foregoing
- Certain performance information including past performance of the account or trading program

While most private placement memoranda produced by CPOs relying on Rule 4.7 already include much of the required information, some disclosures, particularly performance “capsules” for the fund being offered, will need to be presented in the required CFTC format. Similarly, Form ADV Part 2A brochures produced by CTAs relying on Rule 4.7 will already include much of the required disclosures but, if the proposal is adopted without change, then either the Form ADV Part 2A brochure would need to be amended, or a separate disclosure statement prepared, to include past performance for the relevant trading programs presented in the required CFTC format.

Fund of Funds Monthly Reporting

Rule 4.7 includes an exemption from the requirement that CPOs provide their pool participants with a monthly account statement. CPOs operating pools exempt under Rule 4.7 are instead permitted to distribute quarterly account statements within 30 days after the end of the quarter. Funds of Funds often have difficulty complying with the timing of this requirement as they may not receive the required information from the investee fund with enough time to produce the disclosures for their pool participants. The CFTC staff has routinely granted exemptive letters permitting the CPOs of Funds of Funds who have requested relief to distribute monthly account statements within 45 days of month-end. The CFTC is proposing to amend Rule 4.7 to extend the relief granted in those letters to all applicable Funds of Funds. CPOs of Funds of Funds exempt under Rule 4.7 would be permitted to distribute monthly account statements to the pool participants within 45 days of month-end, provided that the CPO notifies its QEP pool participants that they are electing this alternative disclosure schedule.

The CFTC is seeking comment on several issues raised in the proposal, including whether the increase to the Portfolio Requirement thresholds is based on appropriate inflation indices, whether the CFTC should require CPOs and CTAs to disclose additional information to pool participants, and what specific challenges would CPOs and CTAs face if these changes were implemented. Comments to the proposal can be submitted to the CFTC until December 11, 2023.

Related Professionals

- **Christopher M. Wells**
- **Elanit Snow**
  Senior Counsel