

CLIENT ALERT

# CFTC Proposes to Raise Qualification Threshold and Mandate New Disclosures: Proposed Changes to Rule 4.7 Would Impact Private Fund Managers

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## AUTHORS

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The Commodity Futures Trading Commission has proposed amendments to Rule 4.7 that would: (1) double the monetary thresholds of the portfolio requirements for a “Qualified Eligible Person;” (2) require CPOs operating pools and CTAs advising accounts under Rule 4.7 to deliver, and regularly update, an offering memorandum or disclosure document, which would include performance information and a break-even table, conflicts of interest, risks and information regarding fees and expenses; and (3) codify the ability of CPOs of 4.7 funds of funds to follow an alternative periodic account statement reporting schedule. If adopted, these amendments will impose significant new disclosure and recordkeeping requirements on private fund managers. These amendments would require such managers to provide investors with many of the same disclosures currently required for CPOs and CTAs that do not avail themselves of the exemption.

### ***Background on Rule 4.7***

The CFTC adopted Rule 4.7 in 1992 to align CFTC rules with the SEC’s rules with respect to offerings to sophisticated investors pursuant to Regulation D. Rule 4.7 exempts an eligible commodity pool operator or commodity trading advisor from many of the disclosure, reporting and recordkeeping requirements under Part 4 of the CFTC rules that are generally applicable to registered CPOs and CTAs. The CFTC noted that, in recent years, significantly more CPOs and CTAs rely

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on Rule 4.7 than those that do not. The CFTC stated that the amendments are intended to ensure that investors in the increasingly complex derivatives markets receive relevant and comprehensive information.<sup>1</sup>

### ***Increases to the monetary thresholds of the portfolio requirement for QEPs***

The current definition of “Qualified Eligible Person” includes a person who (1) owns securities and other investments worth at least \$2,000,000; (2) has on deposit with an FCM, generally, at least \$200,000 in initial margin and option premiums; or (3) owns a portfolio of funds and assets that, when expressed as percentages of the first two thresholds, has a combined value of at least 100%. The CFTC is proposing increases to these monetary thresholds to reflect the effects of inflation since Rule 4.7 was adopted.<sup>2</sup>

The proposed rule would increase the “securities and other investments” amount to \$4,000,000 and the “initial margin and option premiums” amount to \$400,000. The QEP status determination would continue to be made at the time of subscription—i.e., CPOs and CTAs would not be forced to make mandatory redemptions or terminate advisory relationships for subscribers or clients who are currently QEPs but who would not satisfy the proposed increased threshold.

### ***Minimum disclosure requirements for CPOs and CTAs***

Rule 4.7 currently provides exemptions from Part 4 disclosure and reporting requirements. If enacted as proposed, the rules would impose new minimum disclosure requirements and require 4.7 CPOs and CTAs to deliver an offering memorandum or disclosure document to prospective pool participants and advisory clients. CPOs of 4.7 pools would be required to include in the pool offering memorandum certain substantive disclosures, such as descriptions of the pool's principal risk factors, its investment program, use of proceeds, custodians, fees and expenses, conflicts of interest, and a break-even table and performance of the pool calculated pursuant to CFTC rules. Similarly, CTAs of 4.7 trading programs would be required to disclose descriptions of CTA principals, the principal risk factors of the investment, the CTA's trading program, fees, conflicts of interest, and performance calculated pursuant to CFTC rules.

The proposal includes a requirement for these offering memoranda and disclosure documents to be updated at least every 12 months. Such disclosure would have to be supplemented or amended as necessary to address any material

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<sup>1</sup> Commissioner Summer K. Mersinger issued a dissenting statement, disagreeing with the proposal to the extent it would impose universal disclosure requirements on 4.7 CPOs and CTAs. Similarly, Commissioner Caroline D. Pham expressed concern that the proposal would “impose overly broad obligations that would be burdensome and unnecessary for sophisticated clients, and would present operational challenges and costs without a persuasive cost-benefit analysis . . . .”

<sup>2</sup> It is worth noting that 4.7 commodity pools are one category of funds included in the Volcker Rule's definition of a “covered fund.” Consequently, the rule change may impact any Volcker analysis with respect to 4.7 pools.

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changes. While these 4.7 CPOs and CTAs would not have to file offering materials and disclosure documents for review and pre-approval by the CFTC or the NFA, such materials would be subject to examination by the CFTC and the NFA.<sup>3</sup>

### ***Codification of exemptive letter relief routinely issued to CPOs of 4.7 funds of funds***

CPOs of 4.7 funds of funds often have difficulty complying with the quarterly account statement schedule in Rule 4.7(b)(3), which requires distribution of a quarterly statement within 30 days after the end of the reporting period. Such CPOs have regularly requested, and the CFTC has routinely issued, exemptive relief to permit them to follow an alternate account statement schedule consisting of monthly account statements delivered within 45 days because, among other reasons, these CPOs cannot control the timing of when they receive financial information from the underlying funds.

The proposed rule would codify such relief by allowing CPOs of funds of funds to distribute monthly account statements within 45 days of each month-end. The proposal notes that this approach would provide CPOs of 4.7 pools that are funds of funds with additional time to receive and gather account statement information and would also ensure that their participants receive more frequent and accurate reporting.

### ***Conclusion***

The proposed amendments to Rule 4.7 would have a significant impact on many private fund managers. The amendments would expand the scope of disclosures that many private fund managers will need to provide to investors. The amendments would also expand the recordkeeping obligations of these managers. Comments on the proposal are due 60 days after publication in the Federal Register.

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If you have any questions regarding this client alert, please contact one of the authors, any member of our CFTC team listed below, or the Willkie attorney with whom you regularly work.

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<sup>3</sup> The rule would require CPOs and CTAs to maintain such materials with their other books and records and make them available upon request to the CFTC, the NFA and the DOJ in accordance with Rule 1.31.

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Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

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