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Takeaways From CFTC's Private Fund Rule Amendments

By **Rita Molesworth** (February 12, 2025)

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The U.S. Commodity Futures Trading Commission is generally known as the regulator of the derivatives markets, including futures contracts, options on futures, and swap transactions. Congress has also placed within the CFTC's remit the oversight and regulation of asset managers and advisers who solicit or transact on behalf of others in derivatives.

CFTC rules imposed on these commodity pool operators, or CPOs, and commodity trading advisers, or CTAs, have many parallels to the U.S. Securities and Exchange Commission rules applicable to investment advisers and investment companies. CPOs and CTAs are subject to disclosure, reporting and recordkeeping obligations.

As with the SEC regime, the extent of such obligations often depends on the financial or other sophistication level of the investors whose money is managed.

This article discusses the CFTC's recently adopted amendments to Rule 4.7 of the Commodity Exchange Act, which will become operative this spring. The rule, made final on Sept. 12, permits CPOs and CTAs to avail themselves of exemptions from certain specific compliance obligations when their customers are "qualified eligible persons," or QEPs, as that term is defined in Rule 4.7.

The amendments double the monetary thresholds necessary to qualify as a QEP. Interestingly, the agency proposed, but ultimately did not adopt, rules that would have imposed detailed and substantive disclosure and reporting requirements similar to those currently required for CPOs and CTAs that advise non-QEP investors.[1]

Private fund managers and advisers should review their offering documents and relevant agreements to ensure compliance with the amended rule. The compliance date for the higher thresholds is March 26.

In addition to amending the suitability provisions in Rule 4.7, the CFTC also adopted its proposal to codify reporting relief for CPOs of Rule 4.7 funds-of-funds. Under the amended rule, CPOs may follow an alternative schedule for reporting performance information to investors in a pool that itself invests in other investment vehicles.

For several years, CFTC staff provided bespoke no-action relief to CPOs of these funds-of-funds. This portion of the amendments became available to CPOs as of the effective date, Nov. 25.

Background on Rule 4.7

CFTC Rule 4.7 is a corollary to certain SEC rules involving nonpublic offerings of securities. The CFTC adopted Rule 4.7 in 1992 to better align its rules with the SEC's rules with respect to offerings to sophisticated investors pursuant to Regulation D.

Since its adoption, Rule 4.7 has exempted an eligible CPO or CTA 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, an increasing number of CPOs and CTAs rely on Rule 4.7. As of 2023, the CFTC observed that more than 80% of all commodity pools were operated pursuant to Rule 4.7.

Reasoning that the Rule 4.7 thresholds had never been increased[2] and that the overwhelming percentage of pools were operated pursuant to Rule 4.7, in October 2023, the CFTC proposed amendments to Rule 4.7 that would have:

1. Doubled the monetary thresholds of the portfolio requirements for a QEP;

2. Required 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, and risks and information regarding fees and expenses; and

3. Codified the ability of CPOs of Rule 4.7 funds-of-funds to follow an alternative periodic account statement reporting schedule.[3]

The CFTC stated that the proposed amendments were intended to ensure that investors in the complex derivatives markets receive relevant and comprehensive information.

Many of the comments to the proposal supported increasing the monetary thresholds to reflect the effects of inflation since Rule 4.7 was adopted.

The commenters generally opposed, however, the CFTC's proposed prescriptive disclosure regime for Rule 4.7 CPOs and CTAs. Commenters argued that the sophistication of permitted investors rendered a disclosure mandate unnecessary in the first instance.

They also reasoned that increasing the monetary thresholds obviated any such need even further. In a seminal 1953 case, SEC v. Ralston Purina,[4] the U.S. Supreme Court held that certain investors are able to "fend for themselves." In other words, financially sophisticated investors know to ask for information about an offering they contemplate buying.

Such information includes, in the case of investment vehicles: a description of the trading strategy, risk factors, conflicts of interest of management, tax implications, past performance (of the fund and of the manager), as well as the types of reporting they will receive. Because sophisticated investors have access to such information, the Supreme Court reasoned that they are able to bear the economic risk of investments and do not need the protections of a registration regime designed for retail investors.

While the final rule does not include amendments to the Rule 4.7 disclosure obligations, the CFTC noted that it will continue to consider the issue and other regulatory alternatives.

CFTC Commissioner Summer K. Mersinger issued a statement supporting the final rule, noting that the final rule achieved the balance that she believed was missing in the proposal.

In her dissent to the rule proposal in October 2023, Mersinger disagreed with imposing universal disclosure requirements on 4.7 CPOs and CTAs. Then-CFTC Commissioner Caroline D. Pham concurred in releasing the rule proposal, but expressed concern that it 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," and asked commenters to weigh in on these issues.[5]

Pham also published a statement supporting the final rule. On Jan. 20, 2025, Pham was named acting chairman of the CFTC.

Portfolio Requirement Thresholds for QEPs

As amended, the definition of QEP will include a person who (1) owns securities and other investments worth at least $4 million; (2) has on deposit with an FCM, generally, at least $400,000 in initial margin and option premiums;[6] 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%.

Consistent with the requirements of current Rule 4.7, the QEP status determination will continue to be made at the time of subscription or initiation of a managed account. A CPO will not be required to redeem existing investors who do not satisfy the higher thresholds; a CTA will not be required to terminate advisory relationships with clients who are currently QEPs but who would not satisfy the increased threshold.

Notably, however, investors who satisfied the prior QEP standard when making an initial investment will not be permitted to contribute additional amounts to a Rule 4.7 pool or establish a new account if they do not satisfy the updated portfolio requirement thresholds under the final rule.

Alternative Periodic Reporting Schedule for Rule 4.7 Fund-of-Funds CPOs

CPOs of funds-of-funds often have difficulty complying with the quarterly account statement schedule in Rule 4.7(b)(3). The rule requires the distribution of quarterly performance information 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 these CPOs to follow an alternate account statement schedule wherein monthly account statements are delivered to investors within 45 days of the end of that month. Among other reasons for such relief, CPOs of funds-of-funds cannot control the timing of when they receive the financial information from underlying funds that is necessary to prepare the fund-of-funds' account statements.

As amended, Rule 4.7 codifies the prior exemptive relief, and a CPO of a fund-of-funds will be permitted to distribute to investors an account statement within 45 days of each month's end in lieu of a quarterly statement within 30 days of each quarter's end. The CFTC noted that this approach would provide such CPOs with additional time to gather necessary account statement information, and would actually provide pool participants with more frequent and accurate reporting.

Effective and Compliance Dates

The effective date for these amendments was Nov. 25. The compliance date for the increased portfolio requirement thresholds is March 26. The optional monthly account statement reporting schedule for funds-of-funds CPOs took effect on the effective date. Compliance is required upon election of that schedule by the CPO.

Takeaways

The amended rule serves to further align suitability criteria for investors in private funds. In the face of skepticism from two commissioners, the CFTC settled on a rule that enjoyed unanimous support.

Rule 4.7 remains generally parallel to SEC Regulation D. Neither requires the types of prescriptive disclosures that have to be included in offerings to retail investors. Both rules rely on the concept that investors who satisfy certain sophistication criteria have the ability to seek out the information that is most relevant to them and their circumstances.

Whether a reconstituted CFTC in the Trump administration will further consider additional disclosure and reporting obligations in the Rule 4.7 context remains to be seen. A big market event could prompt such a review. Irrespective of any further action, CPOs and CTAs should take care to ensure that all information presented to investors is accurate.

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[1] Unlike pools operated (or accounts managed) under a Rule 4.7 exemption, these full Part 4 pools and accounts are available to retail investors.

[2] The definition of "accredited investor" in Regulation D was amended in 2011, among other things, to exclude from an individual's net worth the value of the person's primary residence.

[3] See 88 Fed. Reg. 70852 (Oct. 12, 2023). For a discussion of the October 2023 rule proposal, please see our Client Alert, available here.

[4] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

[5] https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement100223.

[6] The current thresholds for the portfolio requirement in Rule 4.7 are $2,000,000 in securities and investments, and $200,000 in initial margin and option premiums.