

ALERT

# CFTC Proposes Rule 4.7 Changes That Would Impose Significant New Disclosure Requirements for Many CPO-Registered Fund Managers and CTA-Registered Advisers

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On Oct. 2, the Commodity Futures Trading Commission ("CFTC") proposed amendments ("Proposal")<sup>1</sup> to Rule 4.7, the primary disclosure, reporting and recordkeeping relief relied upon by CFTC-registered commodity pool operators ("CPOs") and commodity trading advisers ("CTAs"). Rule 4.7 is most commonly relied upon by managers serving sophisticated investors whose portfolios include substantial exposure to derivatives; these proposals would significantly increase applicable disclosure requirements, mandating the inclusion of certain performance information and break-even expense analysis. The proposed amendments also include changes to Rule 4.7's investor suitability criteria, which are not expected to have as widespread of an impact on fund managers given that these thresholds will not affect managers whose funds are offered to "qualified purchasers" for Investment Company Act exemptive purposes. The technical effect of these proposals on the Rule 4.13(a)(3) ("de minimis") relief relied on by many fund managers to remain exempt from CPO registration is also expected to be moot.

The CFTC has solicited comments on its published Proposal, which will be due by Monday, Dec. 11.

## Background

A registered CPO that offers a fund in full compliance with Part 4 of the CFTC's rules must include a variety of required disclosures and prescribed content in the fund's offering documents. Rule 4.7 currently exempts a registered CPO from nearly all of those requirements, so long as interests in the fund are offered to sophisticated investors who qualify as Qualified Eligible Persons ("QEPs"). A similar framework applies to managed account advisers who are registered as CTAs with respect to account clients who are QEPs. Managers whose commodity interest trading falls below a de minimis threshold are eligible to avoid registration as a CPO in reliance on the 4.13(a)(3) exemption.

## Major Changes

### *Disclosure Requirements*

The CFTC's Oct. 2 amendments effect several technical changes to Rule 4.7 and also codify certain prior no-action relief for the timing of quarterly account reporting for funds of funds. However, by far the most consequential changes are those to the disclosure requirements of Rule 4.7, which would subject private placement memoranda and account brochures delivered in compliance with Rule 4.7 to important parts of the detailed disclosure provisions of CFTC Part 4. Most relevant for managers will be the new disclosure

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<sup>1</sup> See Commodity Pool Operators, Commodity Trading Advisers, and Commodity Pools: Updating the 'Qualified Eligible Person' Definition; Adding Minimum Disclosure Requirements for Pools and Trading Programs; Permitting Monthly Account Statements for Funds of Funds; Technical Amendments, 88 FR 70852, [accessible here](#).



requirements for registered CPOs under certain provisions of CFTC Rule 4.24 ("General Disclosures Required"):<sup>2</sup>

- A description of principal risk factors for the exempt pool, as required by Rule 4.24(g);
- A description of the exempt pool's investment program and use of proceeds, as required by Rule 4.24(h);
- A description of fees and expenses, as required by Rule 4.24(i);
- A description of conflicts of interest, as required by Rule 4.24(j); and
- Performance disclosures, as required by Rule 4.25 ("Performance Disclosures"), with the exception of information required by paragraphs (a)(3) and (c)(2) (involving performance of the commodity pool operator's other investment programs) of Rule 4.25.

While managers already typically include a recitation of principal risk factors, a description of the investment program and conflicts of interest disclosures in fund offering documents, the required break-even<sup>3</sup> expense analysis under CFTC Rule 4.24(i) and capsule performance disclosures of CFTC Rule 4.25 are new requirements that will require significant revisions to offering memoranda. Required disclosures under Rule 4.25 include, for instance:

- The largest monthly draw-down during the most recent five calendar years and year-to-date, expressed as a percentage of the pool's net asset value and indicating the month and year of the draw-down;
- The worst peak-to-valley draw-down during the most recent five calendar years and year-to-date, expressed as a percentage of the pool's net asset value and indicating the months and year of the draw-down; and
- The annual and year-to-date rate of return for the pool for the most recent five calendar years and year-to-date, computed on a compounded monthly basis.

The CFTC will also require managers to keep these disclosures current: The CFTC has proposed largely rescinding the current exemption from CFTC Rule 4.26 ("Use, amendment and filing of Disclosure Document"), including CFTC Rule 4.26(a)<sup>4</sup>, and subject managers will be unable to use disclosure documents older than 12 months. Moreover, the newly required disclosure documents will become subject to the CFTC's recordkeeping rules.

Notably, the CFTC did not make offering memoranda or account brochures subject to National Futures Association ("NFA") pre-approval, a process that is required for a fully Part 4-compliant fund. However,

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<sup>2</sup> The CFTC has adopted parallel amendments to the Rule 4.34 disclosure exemption applicable to CTAs relying on Rule 4.7, but due to the interaction of several generous CTA registration exemptions, including Commodity Exchange Act Section 4m(1) and CFTC Rule 4.14(a)(10) (exemptions for managers with a de minimis number of advisory clients), and Rule 4.14(a)(5) (an exemption from CTA registration for registered CPOs with respect to their advised pools) few managers serving sophisticated investors are required to register as CTAs.

<sup>3</sup> Here, "break even" refers to the trading profit that a pool must realize in the first year of a participant's investment to equal all fees and expenses such that the pool participant will recoup its initial investment.

<sup>4</sup> CFTC Rule 4.26(a) provides that 1) all information contained in the required disclosure document must be current as of the date of the document, provided that performance information may be current as of a date not more than three months prior to the date of the document, and 2) that CPOs may not use a disclosure document dated more than twelve months prior to its date of use.



managers should expect the review of these disclosures to be a part of the NFA exam process and it is not yet clear whether the new rules, if adopted, will include an implementation period. The CFTC has requested comment on this point. Also to be determined is whether the CFTC will require managers to provide existing investors with updated disclosures before new subscriptions are made.

#### *Updates to QEP Standard — Inflation Adjustment Increases to Portfolio Requirement Thresholds*

The CFTC has also proposed increasing the financial thresholds ("Portfolio Requirement") for certain investors to count as QEPs, the classification of investors eligible to participate in a Rule 4.7 vehicle. In the CFTC's view, this increase is warranted due to the effects of inflation since the current thresholds were established. These requirements would only apply to new subscriptions, including by existing investors; managers would not be forced to redeem existing investors who do not meet the updated requirements.

These changes will affect a smaller universe of fund managers; they will not affect private funds offered pursuant to Section 3(c)(7) for Investment Company Act exemptive purposes, as qualified purchasers are not required to satisfy these Portfolio Requirement thresholds. Non-US Persons similarly are not required to meet the Portfolio Requirement.

QEPs fall into two categories — those subject to a "Portfolio Requirement" as outlined in paragraphs (a)(1)(v) and (c)(3) of Rule 4.7 itself, and those exempt from this test in view of some other status (most importantly, non-US Persons and Qualified Purchasers). Under the CFTC's proposal, new subscriptions for investors subject to the Portfolio Requirement will face doubled financial thresholds to count as QEP investments.

	<b>Current Thresholds</b>	<b>Proposed QEP Thresholds</b>
<b>Asset Threshold:</b> owning securities and other assets of the stipulated value.	\$2 million	\$4 million
<b>Deposit Threshold:</b> having on deposit with a futures commission merchant for their own account at least the stipulated amount in initial margin, option premiums or minimum security deposits.	\$200,000	\$400,000

As under the current definition, an investor may also satisfy the "Portfolio Requirement" by owning a portfolio of funds and assets that, when expressed as percentages of the prior two thresholds, have a combined value of at least 100 percent.

#### **Implications and Action Steps**

Affected managers should begin considering the impact of the CFTC's Proposal now.

- Most importantly, subject managers should familiarize themselves with the proposed Rule 4.7 disclosure requirements, particularly the incorporated provisions of CFTC Rule 4.25 (concerning past performance) and Rule 4.24(i) (concerning the break-even fee and expense analysis), and confirm that they will be prepared to produce these additional disclosures. Again, it is unclear



whether managers will enjoy an implementation period, and whether updated disclosures will need to be delivered for Rule 4.7 funds not actively soliciting subscriptions.

- Aside from pro forma updates to subscription documents, managers who operate Section 3(c)(7) funds and rely on Rule 4.7 will be unaffected by the changes to the QEP definition, as they collect Qualified Purchaser representations already, and Qualified Purchasers are QEPs not subject to the Portfolio Requirement. Managers of Section 3(c)(1) vehicles, however, will need to ensure that they are prepared to collect updated QEP representations for any future subscriptions subject to the revised Portfolio Requirement.
- Operators of Rule 4.13(a)(3) funds are unlikely to be substantively affected by the new QEP thresholds, as the Rule 4.13(a)(3) exemption is satisfied by the Accredited Investor thresholds which are lower than those for the QEP definition.<sup>5</sup>

Authored by [Heather N. Wyckoff](#) and [Joshua B. Wright](#).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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New York | Washington DC | London  
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<sup>5</sup> The Accredited Investor thresholds and QEP Portfolio Requirement are not expressed in precisely identical terms, but all Accredited Investors are eligible to participate in Rule 4.13(a)(3) vehicles under CFTC Rule 4.13(a)(3)(iii)(A).