Public Statements & Remarks

Dissenting Statement of Commissioner Summer K. Mersinger On Proposal to Narrow Historical Exemptions for Qualified Eligible Persons in Rule 4.7

October 02, 2023

I regrettably dissent from the Commission's[1] proposed rulemaking to amend Rule 4.7,[2] which for the past 30 years has provided exemptions to registered commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") that operate commodity pools or trading programs for Qualified Eligible Persons ("QEPs"). I say "regrettably" because there are two aspects of this proposal that are consistent with views I have expressed before, and which I support.

First, I agree that it is time for the Commission to consider increasing the monetary thresholds in the "Portfolio Requirement" in the definition of a QEP in Rule 4.7(a) to account for inflation. As I previously have stated, "I believe that it is incumbent upon the CFTC, like any regulatory agency, to continually review its rule set to evaluate whether rules . . . need to be updated because they have simply failed to keep up with the times."[3]

Second, I support proposing a process in our rules that would permit CPOs relying on Rule 4.7 to elect an alternate account statement schedule that is consistent with exemptive letters issued regularly by the Commission. This schedule would address the fact that our current rule is not workable in the context of funds-of-funds, and also would generate more frequent reporting. As I previously have stated, "when one of our rules needs to be fixed because it is unworkable, ambiguous, or inefficient, corrective action by notice-and-comment rulemaking is the gold standard because it allows the Commission to hear from stakeholders and develop regulatory solutions that provide certainty."[4]

However, I cannot support the proposal to narrow the scope of the historical exemptions in Rule 4.7 by imposing universal disclosure requirements to QEPs. It represents a "mandate first, evaluate later" approach based on assumptions, speculation, and poor sourcing. It also fails to fulfill certain fundamental functions of sound notice-and-comment rulemaking.

Rule 4.7 in Brief

Rule 4.7 provides exemptions for registered CPOs and CTAs operating commodity pools and trading programs restricted to QEPs ("4.7 CPOs and CTAs") from, among other things, disclosure, recordkeeping, and use-and-filing requirements that otherwise would apply pursuant to the CFTC's rules. The rationale for the exemptions is that QEPs are sufficiently financially sophisticated, and have sufficient leverage and resources, to protect their own interests when participating in such pools and trading programs.

As explained in the Proposing Release, the definition of a QEP is bifurcated into two categories: 1) those pool participants or advisory clients that need to satisfy a "Portfolio Requirement" to be considered a QEP; and 2) those that do not. The Portfolio Requirement, in turn, can be met by satisfying either a Securities Portfolio Test of $2 million or an Initial Margin and Premium Test of $200,000, or a combination of the two.[5]

The Commission is proposing to double the monetary thresholds of the Portfolio Requirement in the QEP definition to $4 million for the Securities Portfolio Test and $400,000 for the Initial Margin and Premium Test. This proposal is intended to account for inflation since Rule 4.7 was adopted in 1992.

The "Mandate First, Evaluate Later" Approach to Disclosures to QEPs is Not Good Government

At the same time, the Commission also is proposing to narrow the scope of Rule 4.7 by eliminating a significant portion of the current disclosure exemptions available to 4.7 CPOs and CTAs, thereby imposing universal disclosure requirements to QEPs. This is a "mandate first, evaluate later" approach to regulation that I strongly oppose.

1. We May Already be Taking Care of the Stated Concern

The Proposing Release begins by observing that the number of 4.7 CPOs and CTAs, and the number of commodity pools and trading programs relying on Rule 4.7, have ballooned over the years.[6] It then states its primary justification for significantly narrowing the scope of the 4.7 exemptions by imposing universal disclosure requirements to QEPs as follows:

> The definition of QEP in Regulation 4.7 encompasses a broad spectrum of market participants from l fund complexes and other institutional investors with significant assets under management to individu with varying backgrounds and experience, each of which has vastly different resources available to ir upon the disclosure of information regarding the offered 4.7 pool or trading program and then to anal whatever information is provided.[7]

Yet, this justification fails to consider that the increasing numbers of pools and trading programs relying on Rule 4.7, and of QEPs that may not have the wherewithal to protect their interests, may result from the erosion in the Portfolio Requirement's monetary thresholds due to inflation—which the Commission is now proposing to address. If the Commission appropriately adjusts the Portfolio Requirement thresholds for becoming a QEP to return them to levels comparable to when the Commission adopted the disclosure exemptions in Rule 4.7, then there is no logical reason why it should also eliminate those disclosure exemptions with respect to QEPs that still satisfy the new (higher) thresholds and are entirely capable of protecting their interests.[8]

In short: Before imposing universal disclosure requirements that many QEPs do not need, the Commission should evaluate whether adjusting the Portfolio Requirement, as it is proposing to do, will address its stated concern about differences between QEPs. As regulators, we should always evaluate first, and then, if appropriate, adopt regulations based on the results of that evaluation. This proposal's "mandate first, evaluate later" approach has it exactly backwards.

2. We Should Not Act Based on Speculation and Assumptions

Another rationale the Proposing Release offers for imposing universal disclosure requirements to QEPs is that "the Commission has . . . witnessed a significant expansion and growth in the complexity and diversity of commodity interest products offered to QEPs via 4.7 pools and trading programs," and "product innovation in the commodity interest markets has continued at a rapid and unrelenting pace."[9] The primary examples cited are swaps and digital assets.

Yet, the Proposing Release offers no evidence to support its paternalistic conjecture that QEPs may not appreciate the nature of the risk associated with trading swaps in commodity pools and trading programs that rely on the exemptions in Rule 4.7. And there is no logical reason why such swap trading should now require a significant narrowing of the exemptions in Rule 4.7 more than a decade after Congress enacted a full regulatory regime for swaps in the Dodd-Frank Act[10]—which the Commission has fully implemented. The Proposing Release does not cite to any provision of the Dodd-Frank Act or its legislative history suggesting Congress felt that the development of swap trading warranted a reconsideration of the scope of the exemptions provided by Rule 4.7 in general—or universal disclosure requirements to QEPs in particular.

As for digital assets and technological innovation, the Proposing Release recognizes that it is relying on mere speculation. It candidly acknowledges that: 1) "Given the relatively recent development of digital assets, **it remains unclear** as to whether the underlying markets . . . are subject to market fundamentals similar to those of the traditional commodities"; and 2) "As the financial system continues to experience a period of rapid evolution in the era of artificial intelligence and other technological advancements, the Commission expects to see continued development of novel investment products that . . . **may** in fact deviate from the typical operations of markets now subject to the Commission's oversight."[11]

Throughout the 30 years since Rule 4.7 was adopted, there has been a steady expansion of the number, complexity, and diversity of available derivatives products, and derivatives markets have undergone transformational changes resulting from technological innovation (none greater than the migration from open-outcry pit trading to all-electronic trading). Yet, through it all, there has never been any suggestion that the exemptions under Rule 4.7 needed to be significantly narrowed as a result.

We should not act based on what we don't know. More specifically, we should not impose universal disclosure requirements to QEPs based on speculation about hypothetical future developments. As markets continue to evolve and innovate as they always have done, we as regulators should evaluate first and then adopt regulations only as appropriate based on the results of that evaluation. Once again, this proposal has it exactly backwards.

3. The Justifications for Acting Now are Poorly Sourced

Certainly, regulators must often act quickly when confronted with urgent circumstances. But that is hardly the case here.

The Proposing Release contains no indication that QEPs are clamoring for the Commission to require disclosures by 4.7 CPOs and CTAs. Indeed, one of the principal sources cited in support of the assertion that there is a problem that needs to be addressed is a roundtable—on CPO risk management practices—convened by CFTC staff way back in 2014.[12]

Other support for the claim that the Commission needs to act consists of footnote citations to individual cases of alleged wrongdoing by 4.7 CPOs and CTAs. These footnotes cite news clippings reporting on allegations in deposition testimony, statements of litigation counsel, and litigation documents—with no indication whether these allegations were proved to be true.[13] And in some of the cases, it appears that the 4.7 CPO or CTA was alleged to have committed fraud, or violated the Commission's existing requirement "to provide all disclosures necessary to make information provided, in the context in which it is furnished, not misleading."[14]

Overall, the sourcing in the Proposing Release is woefully insufficient to support a proposal to impose universal disclosure requirements to QEPs on 4.7 CPOs and CTAs. There is no reason the Commission cannot undertake a proper evaluation of whether there really is a problem that needs to be addressed and, if so, the appropriate means to address it.

The Commission has a variety of tools at its disposal to undertake such an evaluation. For starters, our staff could convene a roundtable specifically devoted to this issue, so that the Commission would not have to look to comments at a roundtable in another context that occurred nine years ago. The Commission or staff also could issue a Request for Comment or an Advance Notice of Proposed Rulemaking—both tools that have been utilized recently[15]—in order to evaluate the necessity of taking action (and what action might be appropriate to take).

In sum: Given its poor sourcing, the proposal to impose universal disclosure requirements to QEPs is a solution in search of a problem. The Proposing Release fails to justify its "mandate first, evaluate later" approach. The Commission should evaluate first, and act later based on that evaluation, if appropriate, consistent with established principles of good government.

The Proposal Fails to Fulfill Fundamental Functions of Sound Rulemaking

A sound notice of proposed rulemaking is characterized by, among other things: 1) transparency as to the agency's plans; and 2) requests for comment on key issues. This Proposing Release is deficient on both counts.

1. The Commission Should be Fully Transparent About its Plans

The Proposing Release is not fully transparent about the Commission's plans on two key issues.[16] First, it says little about how the proposed amendments to Rule 4.7 would be implemented. This is especially critical with respect to the proposed increases to the Portfolio Requirement monetary thresholds, which would create a class of pool participants and advisory clients that qualify as QEPs under existing Rule 4.7, but would no longer qualify as QEPs under amended Rule 4.7.

Would these "former QEPs" be permitted to make additional investments in commodity pools and trading programs that are exempt under Rule 4.7 and in which they currently are investing? The Proposing Release explains that it would continue the requirement of existing Rule 4.7(a)(3)[17] that a CPO must assess QEP status at the time of sale of a pool participation, and that a CTA must do so at the time the person opens an exempt account.[18] But it does not explain that, as a result, "former QEPs" would not be able to make additional investments in exempt commodity pools they are currently participating in (although they could make additional investments to trading programs in these circumstances).

I appreciate the rationale of existing Rule 4.7(a)(3) with respect to a participant in an exempt commodity pool whose financial resources drop below QEP thresholds. But I am not sure that same rationale should apply where a participant drops below QEP thresholds because the Commission is "moving the goalposts" by increasing those thresholds. I imagine there may be QEPs that are comfortable with their 4.7 CPOs, pleased by the performance of the 4.7 exempt pools in which they are participating, and satisfied with the information disclosures they have received—and that would like to be able to contribute additional funds to those investments.

The Commission should be forthright that the proposal would deny them this opportunity if they fall on the wrong side of the increased thresholds being proposed, and seek comment from potentially affected QEPs specifically on that issue. To shroud the issue in mystery in the Proposing Release is inconsistent with sound notice-and-comment rulemaking.

Second, the Proposing Release does transparently reveal that the CFTC would use universal disclosure requirements to QEPs imposed on 4.7 CPOs and CTAs as "an additional level of oversight" by "incorporating the review of [the new mandatory disclosures] into existing examination processes used by the Commission . . ."[19] What it does not reveal, however, is where the Commission plans to find the resources for "an additional level of oversight" by reviewing the disclosures that would be required of the approximately 1700 CPOs and CTAs that rely on Rule 4.7 with respect to thousands of commodity pools and trading programs.[20]

What Commission programs or functions will have to be cut or curtailed in order for it to perform this new task? The public is entitled to know whether the CFTC's review of required disclosures to QEPs that are capable of protecting their own interests may come at the expense of, say, reductions in enforcement resources to prosecute those who defraud retail customers, or the Commission's oversight of derivatives exchanges and clearinghouses for which we are responsible by statute. But once again, the Proposing Release is silent.[21]

2. Putting the "Comment" back in "Notice-and-Comment" Rulemaking

It is somewhat startling how few questions the Proposing Release asks regarding its proposed amendments to Rule 4.7. Most notably, it does not even request comment on the foundational question of whether universal disclosure requirements to QEPs are needed. As discussed above, the Commission's justifications for the proposed requirements are poorly sourced and based largely on assumptions and allegations—but the Proposing Release does not ask the public if those assumptions and allegations are accurate.[22] It appears that the Commission has already made up its mind that universal disclosure requirements to QEPs are necessary, and is not interested in whether QEPs, other market participants, or the public agree with that.

Nor does the Proposing Release ask: 1) whether current QEPs that fall below the increased Portfolio Requirement monetary thresholds for QEP status should be permitted to make additional investments in a commodity pool exempt under Rule 4.7; or 2) whether reviewing mandatory disclosures to QEPs that are able to protect their own interests is an appropriate use of the Commission's limited resources.

Accordingly, since the Commission declines to ask these questions, I will. I invite comment—especially, but not exclusively, from QEPs—on the following questions regarding the amendments that the Commission is proposing to Rule 4.7:

1. Do QEPs agree that the Commission should impose universal disclosure requirements on 4.7 CPOs and CTAs? Why or why not?

2. Is the Commission correct in its preliminary belief that universal disclosure requirements to QEPs are necessary to address unequal bargaining power of QEPs? Would they be necessary if the Commission's proposed increases to the Portfolio Requirement monetary thresholds in the QEP definition are adopted?

3. Is the Commission correct in its preliminary belief that universal disclosure requirements to QEPs are necessary in light of significant expansion and growth in the complexity and diversity of commodity interest products offered to QEPs via 4.7 pools and trading programs, and in light of the rapid pace of innovation in the commodity interest markets?

4. Is the Commission correct in its preliminary belief that the development of markets for swaps and digital assets necessitates universal disclosure requirements to QEPs?

5. Are there alternative, more tailored, means by which the Commission could achieve its policy objectives than the universal disclosure requirements to QEPs that it is proposing? If so, please describe.

6. Should QEPs under existing Rule 4.7 that would no longer qualify as QEPs under the proposed amendments to the Portfolio Requirement thresholds in Rule 4.7 be permitted to contribute additional funds to exempt commodity pools operated by 4.7 CPOs in which they currently are participating? Why or why not?

7. Should the Commission impose universal disclosure requirements to QEPs that are capable of protecting their own interests in order to incorporate the review of such disclosures into its existing examination processes if such review comes at the expense of other Commission responsibilities? Why or why not?

8. To what extent will the proposed universal disclosure requirements to QEPs impact the benefits that 4.7 CPOs and CTAs derive from relying on the exemptions in Rule 4.7? Is it likely that 4.7 CPOs and CTAs will decide to no longer rely on the remaining exemptions afforded by Rule 4.7 if the proposed universal disclosure requirements to QEPs are adopted?

9. If a 4.7 CPO or CTA is registered as an investment adviser with the SEC and not subject to an exemption regarding disclosures required by the SEC, should the CFTC accept compliance with disclosures required by the SEC as sufficient to satisfy the proposed universal disclosure requirements to QEPs under Rule 4.7, too?

10. Is the Commission's PRA estimate of 1.5 annual burden hours per response for the disclosures proposed to be required of 4.7 CPOs and CTAs appropriate? If not, what would be an appropriate estimate?

Conclusion

Given my support for certain aspects of this proposal, and given my support for obtaining public input on initiatives to improve our rulebook generally, I wish that I could support the issuance of the Proposing Release. Unfortunately, because of its "mandate first, evaluate later" approach to the issue of disclosures to QEPs by 4.7 CPOs and CTAs, and its serious omissions in transparency and requests for comment, I cannot do so. Accordingly, I respectfully dissent.

[1]This Statement will refer to the Commodity Futures Trading Commission as the "CFTC" or the "Commission."
[2] CFTC Rule 4.7, 17 C.F.R. § 4.7.
[3] Opening Statement of Commissioner Summer Mersinger Regarding CFTC Open Meeting on June 7, 2023, section regarding Amendments to Part 17 Large Trader Reporting Requirements Proposed Rule (June 7, 2023), available at Opening Statement of Commissioner Summer Mersinger Regarding CFTC Open Meeting on June 7, 2023 | CFTC (https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement060723).
[4] Dissenting Statement of Commissioner Summer K. Mersinger Regarding CFTC's Regulatory Agenda, section entitled "'Kicking the Can Down the Road' Rather than Working on Rulemaking Solutions" (January 9, 2023), available at Dissenting Statement of Commissioner Summer K. Mersinger Regarding CFTC's Regulatory Agenda | CFTC (https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement010923).
[5] *See* Proposing Release at 7-9.
[6] *See id.* at 5-6.
[7] *Id.* at 16.
[8] The analysis of costs and benefits in the Proposing Release suggests that there is reason to believe the proposal to increase the Portfolio Requirement's monetary thresholds may take care of the stated concern based on differences in QEPs' ability to protect their interests. It states: "To the extent persons who meet the higher Portfolio Requirement thresholds are (on average) more financially sophisticated or resilient than those who no longer qualify, this proposed amendment [to increase the Portfolio Requirement thresholds] should result in individuals and entities, both QEPs and non-QEPs, being offered pools and trading programs that are regulated in a manner commensurate with their respective needs for customer protection." Proposing Release at 66-67.
[9] *Id.* at 19, 20.
[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").
[11] Proposing Release at 21 (emphases added).
[12] *See id.* at 16-17.
[13] *See id.* at 17-18 n.46-47. Footnote no. 46 also cites to a CFTC reparations case from 2018 that resulted in a default judgment and thus was not litigated.
[14] CFTC Rules 4.7(b)(2) (CPOs) and 4.7(c)(1) (CTAs), 17 C.F.R. §§ 4.7(b)(2), 4.7(c)(1).
[15] *See* Request for Comment on the Impact of Affiliations on Certain CFTC-Regulated Entities (June 28, 2023), available at CFTC Staff Releases Request for Comment on the Impact of Affiliations of Certain CFTC-Regulated Entities | CFTC (https://www.cftc.gov/PressRoom/PressReleases/8734-23), and Risk Management Programs for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 88 Fed. Reg. 45826 (July 18, 2023), respectively.
[16] One of the Commission's Core Values is "Clarity," *i.e.,* "Providing transparency to market participants about our rules and processes." *See* The Commission, CFTC Core Values, Clarity, available at The Commission | CFTC (https://www.cftc.gov/About/AboutTheCommission).
[17] CFTC Rule 4.7(a)(3), 17 C.F.R. § 4.7(a)(3).
[18] Proposing Release at 12.
[19] *Id.* at 26 and 23, respectively.
[20] *See id.* at 5-6 (citing statistics).
[21] The Commission also should be more transparent about the estimates in its analysis required by the Paperwork Reduction Act ("PRA"). The Proposing Release estimates the annual burden hours per response of the disclosures proposed to be required of 4.7 CPOs and CTAs to be 1.5 hours. *See* Proposing Release at 56 (CPOs) and 59 (CTAs). But the Proposing Release does not explain how it arrived at this estimate—which strikes me as very low.
[22] After presenting its justifications for imposing universal disclosure requirements to QEPs, the Proposing Release "requests comment on all aspects of the proposed amendments **outlined below** that would require certain information be disclosed to prospective QEP pool participants and advisory clients under Regulation 4.7 . . ." Proposing Release at 27 (emphasis added). That is, the Proposing Release requests comment on the disclosures to QEPs "outlined below" that it is proposing to require of 4.7 CPOs and CTAs—but not on the **preceding** discussion of whether universal disclosure requirements to QEPs are needed in the first place.

-CFTC-