Public Statements & Remarks

Statement of Commissioner Kristin N. Johnson: Proposed Amendments to CFTC Regulation 4.7

Heighten Disclosure and Enhance Customer Protections

October 02, 2023

History of Disclosure-Centered Regulation

Federal regulation expressly establishes that customer protection is a core principle of and central to the oversight mission of the Commodity Futures Trading Commission (CFTC or Commission). For almost a century, mandatory disclosure has played a critical role in market regulation, directly shaping the development of the U.S. capital and derivatives markets.[1] Requiring disclosure of material information mitigates inherent asymmetries of information.

The Commission allocates resources among registration and supervision responsibilities and enforcement actions to foster effective oversight of market participants and transactions. This approach not only enhances the integrity of markets, but effectively protects customers from material misrepresentations and fraud.

Congress has judiciously introduced federal markets legislation, often in response to nationwide or global market-wide crises, and has carefully balanced federal regulation with the role and significance of state regulatory oversight.

One hundred years ago, Congress passed the Grain Futures Act—the statute that was superseded by the Commodity Exchange Act (CEA) and that established the Grain Futures Administration (GFA, the predecessor of the CFTC)—authorizing the GFA to regulate certain commodity futures. A decade later, in the wake of the stock market crash of 1929 and the conclusion of the roaring ‘20s—a period characterized by a surging economy and intense market speculation accompanied by pervasive fraud in retail securities markets[2]—Congress adopted the Securities Act of 1933 (Securities Act). The stock market crash of 1929 triggered staggering losses by retail investors and initiated a long period of industrial decline and widespread unemployment, ultimately leading to deeply depressed macroeconomic conditions.

Consistent with an adage made popular by U.S. Supreme Court Justice Louis Brandeis—“[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman”[3]—Congress adopted a disclosure-centric approach.

Disclosure increases transparency, reduces asymmetries of information, and mitigates fraud and manipulation as well as other misconduct in our financial markets. In the absence of mandatory disclosures, investors may have limited access to the material information needed to make a reasonable investment decision. Mandatory disclosure neutralizes incentives to misrepresent material information.

It is incumbent upon the Commission to continue to carry out this mandate reflected in the principles of federal markets regulation and firmly established in the CEA.

Novel Financial Products and Evolving Derivatives Markets

Novel financial products, such as digital assets and innovative technologies like distributed digital ledger or blockchain technology and generative artificial intelligence, increasingly dominate regulatory discourse and popular discussions. The derivatives markets offer futures on digital assets, which are priced on a volatile spot market, employ technology that is highly complex and rapidly changing, and offer novel market structures including market structures designed to permit retail customers direct access to trading and clearing platforms. In some contexts, trading structures eliminate intermediaries such as a futures commission merchants (FCM), raising important questions regarding the best approach for preserving important customer protections such as segregation of customer assets.

As our markets are evolving, more and more vulnerable customers increasingly engage in complex derivatives activities. It is important that these customers have an opportunity to consider critical, material information when making an investment decision. Disclosure serves a valuable role in protecting customers.

Consequently, regulators must continuously revisit regulation to ensure that it remains fit for purpose. Our regulations must keep pace with innovation in our evolving markets. In particular, we must refresh our understanding of which customers may benefit from disclosure when investing, directly or indirectly, in derivatives markets.

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I support the notice of proposed rulemaking (NPRM) regarding commodity pool operators (CPOs), commodity trading advisors (CTAs), and commodity pools operated under CFTC Regulation 4.7. The NPRM addresses regulatory gaps that have arisen due to, at least in part, the changing dynamics in the derivatives markets. The proposed amendments adapt the CFTC's existing regulations to reinforce, preserve, and promote customer protection safeguards. CFTC Regulation 4.7 dictates the disclosure obligations of CPOs and CTAs by establishing the test for classifying a natural person as a retail investor to whom extensive disclosures and financial reports must be delivered or a financially sophisticated investor with respect to whom a more streamlined process may be warranted.

Updating Our Understanding of The Legal Standard for "Financial Sophistication"

Adopted in 1979, Part 4 of the CFTC's regulations requires CPOs and CTAs to deliver disclosures and regular financial reports to pool participants or advisory clients.[4] This framework acts as an important layer of protection for customers, by providing customers with material information about the commodity pool or trading platform, which may include investment objectives, past performance record, conflicts of interest, risk disclosures, or other prescribed information.

CFTC Regulation 4.7, adopted in 1992, creates an exemption from certain Part 4 requirements for CPOs and CTAs that privately offer or sell pool participations solely to qualified eligible persons (QEPs) pursuant to an exemption under the Securities Act or direct or guide the commodity trading accounts of QEPs. As a result, QEPs or wealthy individuals do not receive any of the specific disclosures otherwise provided to non-QEPs or retail investors (*e.g.*, offering memoranda, brochures, or disclosure statements) and receive streamlined financial reporting.

A natural person, investing capital in a commodity pool or whose trading account invests in derivatives, would be a QEP if the individual is an “accredited investor,” as defined by the SEC in Regulation D under the Securities Act, and also meets the CFTC’s portfolio requirement.[5] The portfolio requirement is designed to ensure that a person’s investments reach a specified threshold related to the person’s securities portfolio and derivatives account. This functions as a proxy for identifying individuals who, based on the size of their investments, have “substantial investment experience and thus a high degree of sophistication with regard to investments as well as financial resources to withstand the risk of their investments.”[6]

Recognizing that classifying individuals as QEPs may result in reduced regulatory protections, it is therefore critical that the Commission is careful in setting out the standard for determining that an individual is a QEP.

An individual customer may experience substantial losses if the market moves against the customer’s positions. This concern is heightened by the fact that the participation interests acquired in an exempt pool offering are not registered offerings subject to the SEC’s robust public offering disclosure regime outlined in public offering registration obligation.

Commodity pools are commonly hedge funds that may use leverage to magnify returns, engage in speculation, and take directional positions. These types of structured investment strategies may result in amplified losses for customers.

While our markets are undergoing unprecedented changes, robust customer protections must remain consistent and effective. Natural persons who currently meet the outdated thresholds in the portfolio requirement test introduced in 1992 are not necessarily sophisticated investors in today’s markets. What’s worse, under the existing regulation, individuals that meet the QEP test may not be receiving disclosures to be fully apprised of the risks associated with investing in novel derivatives instruments, whether directly or through a commodity pool, and our evolving markets.

Two-Part Recalibration of Customer Protection Measures

This NPRM has two important objectives.[7]

First, it doubles the financial thresholds of the portfolio requirement test to account for inflation since the exemption was adopted in 1992, thereby recalibrating the standard for determining which pool investors or advisory clients are QEPs.[8] If this proposed amendment is adopted, certain pool participants and advisory clients that do not receive disclosures or receive streamlined financial reporting under the existing regulation will benefit from the full range of customer protection measures in Part 4 of the CFTC's regulations. The proposed thresholds are not even as high as those that were originally proposed in 1992, and so I do not find the amended portfolio requirement to be too restrictive or limiting today, more than 30 years later.[9] Perhaps the thresholds could be higher.

Second, the NPRM sets a new minimum standard of disclosure regarding pools and trading programs that must be provided to all QEPs or wealthy investors, while retaining the more robust disclosure and reporting requirements applicable to non-QEPs or retail investors.[10] The adoption of this amendment will result in heightened customer protections for QEPs that currently are entitled to none. I strongly believe that as a market regulator, we must, when warranted, carefully recalibrate how investors participate in our evolving markets to ensure that CPOs and CTAs provide a prospective or actual investor, whether such investor is a QEP or not, with information that is sufficient and adequate to enable the investor to assess the material risks and rewards of the commodity pool or trading program. Disclosure is key to remediating the dangers of information asymmetry.

I appreciate the staff's efforts in heightening disclosure and enhancing customer protections and their cooperation in implementing my comments to refine the preamble and regulatory text concerning the specific disclosures that will be required under the proposed rule.

I am looking forward to thoughtful comments and responses from market participants. In particular, I welcome perspectives on the potential impact of the proposed rule changes on natural persons who are investing in exempt pools operated by a CPO, or are advisory clients of a CTA, that is relying on the exemptions under CFTC Regulation 4.7 and navigating our complex and evolving derivatives markets.

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[1] Mandatory disclosure serves as a theoretical and practical linchpin in capital markets regulation. Unless an offering is otherwise exempt from registration, Section 5 of the Securities Act requires issuers who seek to raise capital to register the offering with the Securities and Exchange Commission (SEC) prior to offering the securities to investors for sale. *See* 15 U.S.C. §§ 77a-77mm. To complete the registration process, issuers must compile and distribute extensive disclosures describing, among other matters, the nature of the issuer's business; the educational and professional profiles of executives appointed to senior management positions and individuals selected to serve on the board of directors; tangible and intangible property; risk factors; and the financial health—current and forecasted earnings and revenues—of the firm.

[2] Investigative Congressional hearings revealed that more than half of the $25 billion in securities distributed between the end of World War I and the stock market crash of 1929 were worthless. H.R. REP. NO. 73-85, at 2 (1933); s*ee also* U.S. Senate Hist. Off., Subcommittee on Senate Resolutions 84 and 239, http:// www.senate.gov/artandhistory/history/common/investigations/Pecora.htm (,%20http:/%20www.senate.gov/artandhistory/history/common/investigations/Pecora.htm). Detailed accounts of issuers' intentional dissemination of false and misleading information punctuated evidence of fraud and stunning acts of avarice. During this period, securities listed on the New York Stock Exchange declined from a pre-crash high of $89 billion to $15 billion in 1932. One critical investigative report suggested that "had there been full disclosure," issuers' schemes "could not long have survived the fierce light of publicity and criticism." Ferdinand Pecora, *Wall Street Under Oath: The Story of Our Modern Money Changers* (1939).

[3] Louis D. Brandeis, Other People's Money And How The Bankers Use It, 92 (1914).

[4] 17 C.F.R. § 4.7. On January 2, 1979, the CFTC adopted rules for the regulation of CPOs and CTAs. *See* Commodity Pool Operators and Commodity Trading Advisors; Final Rules, 44 Fed. Reg. 1918 (Jan. 8, 1979). These rules became effective April 1, 1979.

[5] 17 C.F.R. § 4.7(a)(3)(ix)-(x). The portfolio test applies to certain legal entities and natural persons. Generally, the portfolio test is satisfied if the natural person owns securities of unaffiliated issuers and other investments with a market value of at least $2,000,000 (Securities Portfolio Test); has on deposit with an FCM for such person's account at least $200,000 in initial margin, option premiums, or minimum security deposits (Initial Margin and Premium Test); or owns a portfolio of funds and assets that, when expressed as percentages of the first two thresholds, meet or exceed 100%. 17 C.F.R. § 4.7(a)(1)(v).

[6] Exemption for Commodity Pool Operators With Respect to Offerings to Qualified Eligible Participants; Exemption for Commodity Trading Advisors With Respect to Qualified Eligible Clients, 57 Fed. Reg. 34,853, 34,854 (Aug. 7, 1992). To clarify, in respect of natural persons, the portfolio requirement does not facilitate the concurrent use of an exemption from registration under the Securities Act and the CFTC Regulation 4.7 exemption because the QEP status is not completely harmonized with the accredited investor status of the SEC.

[7] The NPRM also revises the timing of certain pools' periodic financial reporting, based on long-standing no-action letters, to permit funds of funds to provide account statements within 45 days of the month-end rather than 30 days of the quarter-end and makes technical adjustments to reorganize CFTC Regulation 4.7 to improve its structure and utility (*e.g.*, to fix cross-references).

[8] The Commission is proposing to update the portfolio requirement's thresholds by doubling the Securities Portfolio Test to $4,000,000 and the Initial Margin and Premium Test to $400,000.

[9] As originally proposed in 1992, the portfolio requirement had two components: (1) $5,000,000 in securities or (2) $1,000,000 deposited as initial margin and options premiums with an FCM for commodity interest trading. 57 Fed. Reg. at 34,855.

[10] The new minimum standards will require the disclosure of principal risk factors, investment programs, use of proceeds, custodians, conflicts of interest, fees and expenses, and past performance, and the retention of disclosures as business records.

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