

Chapter 5

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§ 5:1 Commodity Pools

Many hedge funds employ futures and derivatives in pursuing their strategies. In so doing, such funds will subject themselves, and their managers and advisers, to both securities regulation and regulation by the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA), a self-regulatory organization to which the CFTC has delegated certain regulatory responsibilities. The CFTC's jurisdiction covers the trading of commodity interests, consisting of futures contracts, security futures products, swaps, and commodity options, including options on commodities and options on futures contracts¹ pursuant to the Commodity Exchange Act² (CEA) and related

1. 17 C.F.R. § 4.10(a).
2. 7 U.S.C. §§ 1 *et seq.*

regulations adopted by the CFTC.³ The CFTC's jurisdiction extends over the commodities industry, including organized commodities exchanges, members of exchanges who execute orders for others or their own account, brokerage firms and their supervisory and sales personnel, and managers of funds that invest and trade in commodities. A hedge fund that trades these instruments will be a "commodity pool," which is defined as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests."⁴ This status will apply regardless of the extent of its futures activities and will apply even if the hedge fund is not predominantly engaged in futures, swaps, or commodity option trading. As is discussed in chapter 18, the CEA regulates an investment adviser that trades commodity interests and, absent an exemption, requires the manager of or adviser to a commodity pool to register as either a Commodity Pool Operator (CPO) or Commodity Trading Adviser (CTA).

In raising capital for a hedge fund that will fall within the definition of a commodity pool, one must comply with the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934, as commodity pools typically raise assets by accepting capital contributions for the sale of interests in the pool that are generally considered securities as defined under both of these statutes.⁵ Consequently, the considerations, discussed in chapter 4 and elsewhere, relating to these statutes in connection with the capital raising process are applicable to commodity pools. In addition, the CEA and its regulations impose additional requirements on commodity pools over and above those required by the securities laws. These requirements will vary depending on whether the hedge fund manager is registered or exempt from registration as a CPO or CTA.

§ 5:2 Disclosure Document

Each CPO that is registered or required to be registered under the CEA and that is not otherwise eligible for certain "relief" must deliver or cause to be delivered to a prospective participant in a commodity pool that it operates or intends to operate a "Disclosure Document" for the pool by no later than the time it delivers to the prospective participant a subscription agreement for the pool.⁶ Similarly, each CTA that is registered or required to be registered under the CEA and that is not otherwise eligible for certain relief must deliver or cause to be delivered to a prospective client a Disclosure Document for the

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3. 17 C.F.R. ch. 1.
 4. 7 U.S.C. § 1(a)(11).
 5. See 7 U.S.C. §§ 1(a)(11), 6m(2).
 6. 17 C.F.R. § 4.21(a)(1).

applicable trading program no later than the time the CTA delivers to the prospective client an advisory agreement.⁷ Where the hedge fund manager is dually registered as both a CPO and CTA, it need only provide participants in the pool the CPO Disclosure Document. The contents of the Disclosure Document are typically contained in the hedge fund's offering memorandum. Where information regarding the pool is distributed in advance of the delivery of the Disclosure Documents, that information must be consistent with or amended by the information in the Disclosure Document and other applicable laws and regulations and, if such information is amended by the Disclosure Document in any material respect, the prospective pool participant must receive the Disclosure Document at least forty-eight hours prior to its subscription being accepted.⁸

The Disclosure Document must be prepared in accordance with CFTC Rules 4.24 and 4.25.⁹ Rule 4.24 sets forth a detailed list of disclosures to be included in the Disclosure Document.¹⁰ These include:

- Prescribed "Cautionary Statements" on the cover page stating that the CFTC has not passed upon the merits of the offering or the adequacy or accuracy of the Disclosure Document;
- One or more prescribed "Risk Disclosure Statement" on the cover page that cross-references a more detailed risk factor section in the Disclosure Document. In addition to general risk disclosures, these prescribed statements also address risks associated with pools that trade foreign futures or options contracts, engage in retail Forex transactions, utilize swaps, and those where the potential liability of a participant in the pool is greater than the amount of the participant's contribution for the purchase of an interest in the pool and the profits earned on the contribution;
- A table of contents;
- The name, address, phone number and form of organization of the commodity pool and CPO;
- As applicable, certain statements regarding the pool, including if it is privately offered pursuant to section 4(a)(2) of the Securities Act or Regulation D, and whether interests in the pool are continuously offered;

7. 17 C.F.R. § 4.31(a).

8. 17 C.F.R. § 4.21(a)(1); for comparable CTA Disclosure Document delivery requirement, see 17 C.F.R. § 4.31(a).

9. Rules 4.34 and 4.35 in the case of a CTA Disclosure Document.

10. 17 C.F.R. § 4.24.

- The names of key parties including each principal of the CPO, the pool's trading manager,¹¹ if any, and its principals, each major CTA and their principals, which of the foregoing persons will make trading decisions for the pool, and, if known, the futures commission merchant and/or retail foreign exchange dealers through which the pool will execute trades, and its introducing broker;
- The business background for the preceding five years of certain key parties including the pool's CPO, trading manager, if any, and major CTAs and each of their principals who make trading or operational decisions for the pool or who supervises such persons;
- A break-even analysis;
- A discussion of principal risk factors relating to investing in the commodity pool (which must include risks relating to volatility, leverage, liquidity, and counterparty creditworthiness) as applicable to the types of trading programs to be followed, trading structures to be employed, and investment activity (including retail forex transactions) expected to be engaged in by the offered pool;
- A description of the investment program and use of offering proceeds of the pool. This disclosure must include a discussion of the following:
 - The types of commodity interests and other interests that the pool will trade, including: (i) the approximate percentage of the pool's assets that will be used to trade commodity interests, securities, and other types of interests, categorized by type of commodity or market sector, type of security (debt, equity, preferred equity), whether traded or listed on a regulated exchange market, maturity ranges and creditworthiness, as applicable; (ii) the extent to which such interests are subject to state or federal regulation, regulation by a non-U.S. jurisdiction or rules of a self-regulatory organization; (iii)(A) the custodian or other entity (for example, bank or broker-dealer) that will hold such interests; and (B) if such interests will be held or if pool assets will be invested in a non-U.S. jurisdiction, the jurisdiction in which such interests or assets will be held or invested;

11. A trading manager is a person, other than the CPO of the pool, that has sole or partial authority to allocate pool assets to CTAs or investee pools. 17 C.F.R. § 4.10(h).

- A description of the trading and investment programs and policies that will be followed by the pool, including the method chosen by the CPO concerning how futures commission merchants and/or retail foreign exchange dealers carrying the pool's accounts shall treat offsetting positions [pursuant to § 1.46] if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and any material restrictions or limitations on trading required by the pool's organizational documents or otherwise. This description must include, if applicable, an explanation of the systems used to select commodity trading advisors, investee pools, and types of investment activity to which pool assets will be committed;
- A summary description of the pool's major CTAs, including their respective percentage allocations of pool assets; a description of the nature and operation of the trading programs such advisors will follow, including the types of interests traded pursuant to such programs; and each advisor's historical experience trading such programs, including material information as to volatility, leverage, and rates of return, and the length of time during which the advisor has traded such program;
- A summary description of the pool's major investee pools or funds, including their respective percentage allocations of pool assets, and a description of the nature and operation of such investee pools and funds, including for each investee pool or fund the types of interests traded, material information as to volatility, leverage and rates of return for such investee pool or fund, and the period of its operation;
- The manner in which the pool will fulfill its margin requirements and the approximate percentage of the pool's assets that will be held in segregation pursuant to the CFA and CFTC regulations; if the pool will fulfill its margin requirements with other than cash deposits, the nature of such deposits; and if assets deposited by the pool as margin or as security deposit generate income, to whom that income will be paid;
- A complete description of each fee, commission and other expense that the CPO knows or should know has been incurred by the pool for its preceding fiscal year and is expected to be incurred for its current fiscal year. Fees and expenses disclosed

- must include (i) management fees; (ii) brokerage fees and commissions, including interest income paid to futures commission merchants, and any fees incurred to maintain an open position in retail forex transactions; (iii) fees and commissions paid in connection with trading advice provided to the pool; (iv) fees and expenses incurred within investments in investee pools, investee funds, and other collective investment vehicles, which fees and expenses must be disclosed separately for each investment tier; (v) incentive fees; (vi) any allocation to the CPO, or any agreement or understanding that provides the CPO with the right to receive a distribution, where such allocation or distribution is greater than a pro rata share of the pool's profits based on the percentage of capital contributions made by the commodity pool operator; (vii) commissions or other benefits, including trailing commissions paid or that may be paid or accrue, directly or indirectly, to any person in connection with the solicitation of participations in the pool; (viii) professional and general administrative fees and expenses, including legal and accounting fees and office supplies expenses; (ix) organizational and offering expenses; (x) clearance fees and fees paid to national exchanges and self-regulatory organizations; (xi) for principal-protected pools, any direct or indirect costs to the pool associated with providing the protection feature; (xii) any costs or fees included in the spread between bid and asked prices for retail forex transactions; and (xiii) any other direct or indirect cost;
- A full description of any actual or potential conflicts of interests involving key parties including the CPO, major CTAs and the pool's trading manager, if any, and their respective principals, any other person providing services to the pool or soliciting participants for the pool, or acting as a counterparty to the pool's retail forex transactions, and disclosure of any related party transactions;¹²

12. The NFA has provided examples of some of the more common conflicts of interest it encounters when reviewing Disclosure Documents, and provided guidance on addressing these conflicts. In general, these conflicts center on relationships that a CPO/CTA, its principals and employees have with other commodity firms as well as other persons or entities that provide services to the CPO/CTA, their commodity pools or accounts. Particular attention should be paid to fees or other compensation paid by or to the CPO/CTA directly or indirectly. The highlighted relationships that require disclosure include where (i) the CPO/CTA, or an affiliate, is also an Introducing Broker or Futures Commission Merchant; (ii) the principal of the CPO/CTA is also the principal or associated person of an

- Any material administrative, civil or criminal litigation over the prior five years involving certain key parties including the pool's CPO and major CTAs;
- Disclosure of whether the pool's CPO and CTAs intend to trade for their own account and if so, whether investors can inspect the records of such trades and any written policies relating to such trading;
- Past performance in accordance with Rule 4.25;¹³
- Certain disclosures if the pool is principal protected;
- A complete description of any restrictions on the transferability of interests in the pool and the frequency, timing, manner and valuation of redemptions from the pool;
- The extent to which investors will be liable for obligations of the pool beyond their investment;
- The pool's policies on distributions;
- A discussion of applicable federal income tax laws;
- The minimum amount of subscriptions required to enable the pool to commence operating;
- The beneficial ownership of the pool by certain key parties including the CPO and major CTAs and their principals; and
- A statement regarding periodic reports to be provided to pool participants.

It should be noted that while many of the disclosure items listed above, or some version of them, would typically be found in the offering materials of a hedge fund whose adviser is not subject to registration with the CFTC, a number of them are not. For example, the break-even analysis listed above consists of a tabular presentation of the amount of income and gain that the commodity pool would have to generate over twelve months in order to offset all expenses allocable to an investor in the pool and enable the investor to receive its initial investment in full upon a subsequent withdrawal from the fund.¹⁴ Past performance, if provided to investors, must be presented

Introducing Broker or Futures Commission Merchant; (iii) the CPO receives payments from a CTA; and (iv) loans are made by commodity pools to principals of the CPO or other affiliated persons or entities. *See* NFA Notice 1-07-25 (May 24, 2007).

13. 17 C.F.R. § 4.25. *See infra* section 6:2.2.

14. 17 C.F.R. §§ 4.10(j); 4.24(d)(5).

in accordance with Rule 4.25. All performance must be provided on a monthly basis for five full years and year-to-date and must be presented net of all fees, expenses and performance allocations.¹⁵ In addition, the largest monthly drawdown during the five-year period and year-to-date as well as the worst “peak-to-valley” drawdown during those periods must be disclosed.¹⁶ Where the pool has less than a three-year operating history, the CPO must generally disclose the performance of any other pool operated by it during the same five-year period.¹⁷

The Disclosure Document must be current as of its date, and performance information may be current as of a date not more than three months prior to the date of the Disclosure Document, and the CPO may not use a Disclosure Document dated more than twelve months prior to the date of its use.¹⁸ Notwithstanding the detailed requirements contained in CFTC regulations regarding the contents of a commodity pool’s disclosure document, these rules do not relieve a CPO from the obligation to disclose all material information to existing or prospective pool participants even if the information is not specifically required under the CEA or regulations. One copy of the Disclosure Document generally must be filed electronically by the CPO with the NFA not less than twenty-one calendar days prior to the date the pool operator first intends to deliver it to prospective pool participants, and amendments must similarly be electronically filed within twenty-one calendar days of the date on which the CPO first knows or has reason to know of the defect in the Disclosure Document requiring the amendment.¹⁹ Similarly, CTAs must make their electronic filings of their Disclosure Documents and amendments within comparable time frames.²⁰ The filing process also requires CPOs and CTAs to enter certain key information on their operations and activities into a standardized form accessed through the NFA’s website.²¹ The amendment must also be distributed to all existing pool participants within that twenty-one-day period and to each previously

15. 17 C.F.R. § 4.25(a)(1)(i).

16. 17 C.F.R. §§ 4.10(k), (l); 4.25(a)(1)(i).

17. 17 C.F.R. § 4.25(c).

18. 17 C.F.R. § 4.26(a).

19. 17 C.F.R. § 4.26(d). *See* Electronic Filing of Disclosure Documents, 74 Fed. Reg. 9568 (Mar. 5, 2009) (electronic filing requirement effective April 6, 2009).

20. 17 C.F.R. § 4.36(d).

21. Key information includes identification of contact persons, relationships with futures commission merchants or introducing brokers, and past performance history and related data for the offered pool or trading program. *See* Electronic Filing of Disclosure Documents, 74 Fed. Reg. 71,968 n.6 (Nov. 26, 2008).

solicited prospective pool participant prior to accepting or receiving from them funds, securities or property.²² A registered CPO of a pool that is offered and sold solely to accredited investors in a Rule 506 offering under Regulation D need not file with the NFA in advance, but may solicit and accept subscriptions from investors upon filing the Disclosure Document with the NFA and providing it to investors.²³ The NFA, pursuant to its Rule 2-35, requires that the Disclosure Document be written using plain English. An NFA Interpretive Notice regarding this rule states that the Disclosure Document should be written using the active, rather than passive voice, using short sentences and paragraphs, breaking up the document into short sentences, using titles and subtitles that specifically describe the contents of each section, using definite, concrete words that are part of everyday language, avoiding legal jargon and highly technical terms, using glossaries to define technical terms that cannot be avoided, avoiding multiple negatives, stating something once where it is most important rather than repeating information, and using tables and bullet lists.²⁴

Certain CPOs and CTAs that are NFA members that engage in certain “forex”²⁵ transactions must, pursuant to NFA Compliance Rule 2-41, prepare a Disclosure Document, which it must file with the NFA at least twenty-one days before soliciting the first potential commodity pool participant or potential client that is not an eligible contract participant,²⁶ and deliver the Disclosure Document to the prospective pool participant or client no later than the time it delivers the subscription agreement for the commodity pool or the agreement to manage the client’s account. These forex disclosure documents must provide disclosures similar to those required under CFTC Part 4 regulations.²⁷ In addition, an NFA member operating a pool subject to

22. 17 C.F.R. § 4.26(c).

23. 17 C.F.R. § 4.8.

24. NFA Compliance Rule 2-35(a)(1).

25. Foreign currency futures and options, and any other agreement, contract, or transaction in foreign currency that is offered or entered into on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis, not executed on or subject to the rules of a contract market, a derivatives transaction execution facility, a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934, or a foreign board of trade. NFA Bylaw 1507(b)(1) and (b)(3).

26. “Eligible contract participant” is defined in 7 U.S.C. § 1a(18).

27. Effective Date of NFA Compliance Rules 2-41 and 2-42: Disclosure by Forex Pool Operators and Trading Advisors, NFA Notice I-08-26 (Oct. 16, 2008). See 17 C.F.R. §§ 4.24, 4.25, 4.26 (for commodity pools); §§ 4.34, 4.35, 4.36 (for managed accounts).

these rules must provide periodic (monthly or quarterly) account statements and an annual report to the pool participants in accordance with CFTC Regulation 4.22.²⁸

§ 5:3 Reporting and Record-Keeping

Rule 4.22 under the CEA provides that a registered CPO must distribute to pool participants certain reports and maintain certain records, absent the availability of relief from certain of these requirements.²⁹ From a reporting perspective, the CPO must periodically distribute to each pool participant, within thirty calendar days after the last day of the applicable reporting period, an "Account Statement" that contains a Statement of Income (Loss) and a Statement of Changes in Net Asset Value, for the prescribed period. These financial statements must be presented and computed in accordance with generally accepted accounting principles. The Account Statement must also disclose any material business dealings between the pool, the pool's CPO, CTA, futures commission merchant, or their principals that have not previously been disclosed in the pool's Disclosure Document, other Account Statements or Annual Reports. The Account Statement must be distributed at least monthly in the case of pools with net assets of more than \$500,000 at the beginning of the pool's fiscal year, and otherwise at least quarterly. An Account Statement for the last reporting period of the pool's fiscal year need not be distributed if the Annual Report is sent to pool participants within forty-five calendar days after the end of the fiscal year.

The CPO must also distribute an Annual Report to each participant in each pool that it operates, and must electronically submit a copy of the Annual Report and key financial balances from it to the NFA within ninety calendar days after the end of the pool's fiscal year. The Annual Report provides the net asset value of the pool as of the end of each of the pool's two preceding fiscal years, either the net asset value per outstanding participation unit in the pool or the total value of the participant's interest in the pool as of the end of each of the pool's two preceding fiscal years; a statement of financial condition as of the close of the pool's fiscal year and preceding fiscal year; and statements of income (loss), changes in financial position, and changes in ownership equity. The Annual Report must be certified by an independent public accountant.

Rule 4.23 sets out the record-keeping requirements for a CPO, which are in certain respects similar to the record-keeping requirements for a registered investment adviser and include an itemized

28. NFA Compliance Rule 2-42. *See also infra* section 5:3.

29. 17 C.F.R. § 4.22.

daily record of each commodity interest transaction, copies of confirmations of trades, a journal of all receipts and disbursements of money, securities and other property, general ledgers of all asset, liability, capital, income and expense accounts, certain financial statements and copies of all communications with existing and prospective pool participants.³⁰

Books and records may be maintained at the CPO's main business office. Alternatively, a CPO may maintain its books and records with certain permissible third parties, including the commodity pool's administrator, distributor, or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the pool. In order to maintain books and records at a third-party location, the CPO must file, when registering or delegating its recordkeeping obligations (whichever is later), a statement with the NFA that identifies the name, main business address, and telephone number of the person who will be keeping required books and records in lieu of the CPO, as well as such person's contact details; specifies the books and records such person will be keeping; and contains a set of representations. These representations may include agreements: to update the statement when necessary; remain responsible for ensuring that all books and records are kept in accordance with CFTC regulations; upon request by a representative of the CFTC, obtain original books and records from the third party within forty-eight hours (or seventy-two hours where the records are kept by a third party outside the United States); and to disclose in the pool's Disclosure Document the location of books and records kept by a third party.³¹ The CPO must also file with the NFA a statement from each third-party record-keeper acknowledging that the CPO intends it to be a third-party record-keeper, agreeing to maintain the records in accordance with CFTC regulations, and to keep books and records open to inspection. As there is currently no similar third-party option available to CTAs, where a firm is dually registered as both a CPO and CTA, it must continue to maintain its CTA-related records at its main business office.

§ 5:4 Exemptions from Disclosure, Reporting, and Record-Keeping Requirements

There are several exemptions from certain of the disclosure, reporting, and recordkeeping obligations otherwise applicable to a registered CPO if it manages a commodity pool that meets the requirements of the exemption.

30. 17 C.F.R. § 4.23.

31. 317 C.F.R. § 4.7(b)(5); 17 C.F.R. § 4.23(c).

§ 5:4.1 Rule 4.12(b)

Rule 4.12(b)³² provides that any person who is registered as a commodity pool operator, or who has applied for such registration, may claim certain disclosure relief for a particular commodity pool, by filing a claim of exemption with the NFA, if the pool:

- Is offered and sold pursuant to the Securities Act or pursuant to an exemption from the Securities Act, including an offering pursuant to Rule 506 of Regulation D;
- Is generally and routinely engaged in the buying and selling of securities and securities-derived instruments;
- Will not enter into commodity futures and commodity options contracts for which the aggregate initial margin and premiums exceed 10% of the fair market value of the pool's assets, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; provided, that in the case of an option that is in-the-money at the time of purchase, the in-the-money amount may be excluded in computing this 10%; and
- Will trade such commodity interests in a manner solely incidental to its securities trading activities.

In addition, the CPO must inform each pool participant and prospective participant in writing of the restrictions imposed by Rule 4.12(b) on the pool's trading of commodity interests. This information must be conveyed prior to the date the pool commences trading commodity interests and may be contained in the pool's Disclosure Document, account statement or a separate notice, including written communication delivered electronically. It must also make a statement on the cover page of the offering memorandum affirming that the pool is relying on the exemption under Rule 4.12(b). This exemption is effective only with respect to the pool for which a claim of exemption has been made. Once the claim for exemption is filed with the NFA, the CPO may solicit and accept subscriptions for the pool.

Pools meeting the requirements of Rule 4.12(b) may claim relief from the obligation to provide the Disclosure Document required by Rule 4.21 and, in lieu thereof, provide an offering memorandum prepared pursuant to the requirements of the Securities Act or an exemption from the Securities Act pursuant to which the pool is being offered and sold. This offering memorandum need not include either the cautionary statement or risk disclosure statement, or the performance disclosures as required by Rule 4.24. A Rule 4.12(b) pool is also

32. 17 C.F.R. § 4.12(b).

relieved of certain reporting and record-keeping requirements under Rules 4.22 and 4.23.

§ 5:4.2 Rule 4.7

A second source of disclosure relief available to registered CPOs can be found in Rule 4.7.³³ A registered commodity pool operator is afforded relief under Rule 4.7(b) from the disclosure requirements upon filing a notice of a claim for such relief with the NFA pursuant to Rule 4.7(d), provided that the registered CPO offers and sells participations in a commodity pool solely to “qualified eligible persons” (QEPs) in an offering that qualifies for exemption from the registration requirements of the Securities Act pursuant to section 4(a)(2) or pursuant to Regulation S.³⁴ In particular, exemption from the specific requirements of Rules 4.21, 4.24, 4.25, and 4.26 are applicable to each exempt pool. However, if an offering memorandum is distributed in connection with soliciting prospective participants in an exempt pool, the offering memorandum must include all disclosures necessary to make the information contained therein, in the context in which it is furnished, not misleading, and a legend must be prominently disclosed on the cover page of the offering memorandum, or if there is no offering memorandum, immediately above the signature line of the subscription agreement of the pool. The legend must state, in part, that the pool’s participants are limited to QEPs and that an offering memorandum is not required to be and has not been filed with the CFTC.³⁵ Where the CPO manages both QEP exempt pools and non-exempt pools, the non-exempt pools need not include in their Disclosure Documents the past performance of the exempt pool except to the extent that such past performance is material to the non-exempt pool’s offering and, if not so disclosed, the CPO must state in a footnote to the non-exempt pool’s performance disclosure that such exempt pool performance is not disclosed. A Rule 4.7 pool is also relieved of a number of the reporting and record-keeping requirements under Rules 4.22 and 4.23. The CPO must, however, within ninety days after the end of the exempt pool’s fiscal year, file electronically with the NFA and distribute to each pool participant an annual report that contains, at a minimum, a statement of financial condition as of the close of the exempt pool’s fiscal year, a statement of operations for that year, appropriate footnotes and further material information necessary to make the financial statements not misleading, a legend stating that a claim for exemption under Rule 4.7 has

33. 17 C.F.R. § 4.7.

34. 17 C.F.R. § 4.7(b).

35. 17 C.F.R. § 4.7(b)(1).

been made, and additional disclosures where the pool invests in other funds or is comprised of more than one ownership class or series.³⁶

[A] Qualified Eligible Persons

Central to the relief afforded by Rule 4.7(b) is the requirement that the pool be offered and sold exclusively to QEPs. Rule 4.7(a) sets forth two categories of QEPs. One category need not satisfy “portfolio requirements” set forth in the rule while the other category must do so.

[A][1] QEPs Who Need Not Satisfy Portfolio Requirements

QEPs that need not satisfy the portfolio requirements consist of the following persons acting for its own account or the account of a QEP,³⁷ who the CPO reasonably believes, at the time of sale, are:

- A futures commission merchant registered pursuant to section 4d of the CEA, or a principal thereof;
- A broker or dealer registered pursuant to section 15 of the Exchange Act, or a principal thereof;
- A CPO registered pursuant to section 4m of the CEA, or a principal thereof, provided that the CPO has been registered and active as such for two years or operates pools that, in the aggregate, have total assets in excess of \$5 million;
- A CTA registered pursuant to section 4m of the CEA, or a principal thereof, provided that the CTA has been registered and active as such for two years or provides commodity interest trading advice to commodity accounts that, in the aggregate, have total assets in excess of \$5 million deposited at one or more futures commission merchants;
- An investment adviser registered pursuant to section 203 of the Investment Advisers Act of 1940 (the “Advisers Act”) or pursuant to the laws of any state, or a principal thereof, provided that the investment adviser has been registered and active as such for two years or provides securities investment advice to securities accounts that, in the aggregate, have total assets in excess of \$5 million deposited at one or more registered securities brokers;

36. 17 C.F.R. § 4.7(b)(3); CFTC, Final Rules, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Feb. 8, 2012).

37. 17 C.F.R. § 4.7(a)(2).

- A “qualified purchaser” as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (the “Investment Company Act”);³⁸
- A “knowledgeable employee” as defined in section 270.3c-5 of the Investment Company Act;³⁹
- Certain parties related to the exempt pool including:
 - The CPO, CTA or investment adviser of the exempt pool, or an affiliate of any of them;
 - The principal of the exempt pool, its CPO, CTA or investment adviser, or an affiliate of them;
 - An employee of the exempt pool, its CPO, CTA or investment adviser, or an affiliate of them (other than an employee performing solely clerical, secretarial, or administrative functions with regard to such person or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of the exempt pool, other commodity pools operated by the CPO of the exempt pool, or other accounts advised by the CTA or investment adviser of the exempt pool, or by the affiliate of the CPO, CTA or investment adviser; provided that the employee has been performing such functions and duties for or on behalf of the exempt pool, CPO, CTA, investment adviser, or affiliate, or substantially similar functions or duties for or on behalf of another person engaged in providing commodity interest, securities, or other financial services for at least twelve months;
 - Any other employee of, or an agent engaged to perform legal, accounting, auditing, or other financial services for the exempt pool, or its CPO, CTA, or investment adviser or their affiliates (other than an employee or agent performing solely clerical, secretarial, or administrative functions) provided that such employee or agent is an accredited investor under the net worth or income tests of Rule 501(a)(5) or (6) of Regulation D and has been so employed for at least twenty-four months;
 - The spouse, child, sibling or parent of these related parties, provided that an investment in the exempt pool by such

38. See *infra* section 10:3.1.

39. See *infra* section 10:2.2.

family members is made with the knowledge and at the direction of the related party;

- A person who acquires a participation in an exempt pool by gift, bequest, or legal separation or divorce, or from the estate of any of these related parties or eligible family members of the related parties;
- A company established by any related party or eligible family members of a related party exclusively for the benefit of, or owned exclusively by, that person or any person acquiring an interest by gift, bequest, legal separation, or divorce or from the estate of any of these related parties or eligible family members of the related parties;
- A trust that was not formed for the specific purpose of participating in the exempt pool, and whose trustee or other person authorized to make investment decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a QEP;
- A charitable organization under section 501(c)(3) of the Internal Revenue Code where the trustee or other person authorized to make investment decisions with respect to the organization and the person who established the organization is a QEP;
- A non-U.S. person, as defined in Rule 4.7; and
- An entity in which all of the unit owners or participants are QEPs, exempt QEP pools or an entity operating under Rule 4.5 in which all of its unit holders or participants are QEPs.

[A][2] QEPs Who Must Satisfy Portfolio Requirements

QEPs also include the following persons, which the CPO reasonably believes, at the time of sale of an interest in an exempt pool, satisfy the “Portfolio Requirement” set forth in Rule 4.7:⁴⁰

- An investment company registered under the Investment Company Act or a business company as defined in section 2(a)(48) of the Investment Company Act not formed for the specific purpose of investing in the exempt QEP pool;
- A bank as defined in section 3(a)(2) of the Securities Act or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Securities Act acting for its own account or for the account of a QEP;

40. 17 C.F.R. § 4.7(a)(3).

- An insurance company as defined in section 2(13) of the Securities Act acting for its own account or for the account of a QEP;
- An employee benefit plan established by a state or its political subdivision, or one of their agencies or instrumentalities, if the plan has total assets exceeding \$5 million;
- An employee benefit plan under ERISA, provided that the investment decision is made by a plan fiduciary, as defined in section 3(21) of ERISA, which is a bank, savings and loan association, insurance company or registered investment adviser; or that has total plan assets in excess of \$5 million or, if the plan is self-directed, has its investment decisions made solely by persons that are QEPs;
- A private business development company as defined in section 202(a)(22) of the Advisers Act;
- A not-for-profit organization described in section 501(c)(3) of the Internal Revenue Code with total assets exceeding \$5 million;
- A corporation, Massachusetts or similar business trust, or partnership, limited liability company or similar business venture, other than a commodity pool, which has total assets in excess of \$5 million and is not formed for the specific purpose of participating in the exempt pool;
- A natural person whose individual net worth, or joint net worth with that person's spouse, at the time of either his purchase in the exempt pool or his opening of an exempt account would qualify him as an accredited investor as defined in Rule 501(a)(5) of Regulation D (the individual net worth test);⁴¹
- A natural person who would qualify as an accredited investor as defined in Rule 501(a)(6) of Regulation D (the individual income test);
- A pool, trust, insurance company separate account, or bank collective trust, with total assets in excess of \$5 million, not formed for the specific purpose of participating in the exempt pool and whose participation in the exempt pool is directed by a QEP; or

41. 17 C.F.R. § 4.7(a)(3)(ix).

- Except as provided for the state and local governmental entities referenced above, if otherwise authorized by law to engage in such transactions, a governmental entity (including the United States, a state, or a foreign government) or political subdivision thereof, or a multinational or supranational entity or an instrumentality, agency or department of any of them.

[A][3] Portfolio Requirements

Each of the foregoing investors must meet one of three available categories of “portfolio requirements” in order to be a QEP. This requires that the investor must:

- Own securities (including pool participations) of issuers not affiliated with such person and other investments with an aggregate market value of at least \$2 million;⁴²
- Have had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date of sale to that person of a pool participation in the QEP exempt pool, at least \$200,000 in futures exchange-specified initial margin and option premiums, together with required minimum security deposits for retail forex transactions for commodity interest transactions;⁴³ or
- Own a portfolio of a combination of funds or property specified in the preceding two categories in which the sum of the funds or property includable under the first category, expressed as a percentage of the minimum amount required thereunder, and the amount of futures margin and option premiums includable under the second category, expressed as a percentage of the minimum amount required thereunder, equals at least 100%.⁴⁴

§ 5:4.3 Offshore Commodity Pools

A registered CPO who operates an offshore commodity pool may claim relief from the disclosure and reporting requirements and certain record-keeping obligations contained in CEA regulations by filing a notice of a claim for exemption in duplicate with the CFTC Division of Trading and Markets and the NFA that sets forth the following representations:

42. 17 C.F.R. § 4.7(a)(1)(v)(A).

43. 17 C.F.R. § 4.7(a)(1)(v)(B).

44. 17 C.F.R. § 4.7(a)(1)(v)(C). An example of a composite portfolio acceptable under this third category of portfolio requirement would consist of \$1 million in securities and other property (50% of the first category) and \$100,000 in exchange-specified initial margin and option premiums (50% of the second category).

- The CPO is registered with the CFTC;
- The commodity pool is, and will remain, organized and operated outside the United States;
- The commodity pool will not hold meetings or conduct administrative activities within the United States;
- No shareholder or other participant in the commodity pool is or will be a U.S. person;
- The commodity pool will not receive, hold or invest any capital directly or indirectly contributed from sources within the United States; and
- The CPO, the commodity pool, and any person affiliated with them will not undertake any marketing activity for the purpose, or that could reasonably be expected to have the effect, of soliciting participation from U.S. persons.⁴⁵

For purposes of this exemption, the participants in the commodity pool will not be considered U.S. persons if they fall within the definition of “non-United States person” in Rule 4.7(a)(1)(iv), which includes:

- A natural person who is not a resident of the United States;
- A partnership, corporation or other entity, other than an entity organized principally for passive investment, organized under the laws of a foreign jurisdiction and that has its principal place of business in a foreign jurisdiction;
- An estate or trust, the income of which is not subject to U.S. income tax regardless of source;
- An entity organized principally for passive investment such as a commodity pool, investment company, or other similar entity; provided that units of participation in the entity held by U.S. persons represent in the aggregate less than 10% of the beneficial interest in the entity, and such entity was not formed principally for the purpose of facilitating investment by persons who are U.S. persons in a pool with respect to which the operator is exempt from the disclosure requirements of Part 4 of the CFTC’s regulations by virtue of its participants being non-U.S. persons; and

45. CFTC Advisory Number 18-96 (Apr. 11, 1996).

- A pension plan for the employees, officers or principals of an entity organized and with its principal place of business outside the United States.⁴⁶

§ 5:4.4 *Electronic Filing*

CPOs and CTAs are required to electronically file with the NFA all notices of exclusion or exemption from Part 4 requirements required by Regulations 4.7 and 4.12(b).⁴⁷ Persons or entities seeking an exemption under CFTC Advisory 18-96 should file hardcopy notices.⁴⁸

46. *Id.* at n.7. It should be noted that the definition of who is or is not a U.S. person under the CEA differs from that set forth in Regulation S.

47. 17 C.F.R. §§ 4.7(d)(vii), 4.12(d)(1). It should be noted that the definition of who is or is not a U.S. person under the CEA differs from that set forth in Regulation S.

48. NFA Notices to Members 1-07-07 (Feb. 2, 2007); NFA Notices to Members 1-12-12 (June 27, 2012).