

CFTC Proposes Amendments to Conditional Exemptions for Commodity Pool Operators and Commodity Trading Advisors

October 27, 2023

On October 2, 2023, the Commodity Futures Trading Commission (CFTC) published a notice of proposed rulemaking that would amend CFTC Rule 4.7, which provides limited exemptions for registered commodity pool operators (CPOs) and commodity trading advisors (CTAs) in respect of pools comprised solely of “Qualified Eligible Person” (QEP) participants, to:

- (i) Impose certain minimum disclosure requirements for 4.7 pools and trading programs (**4.7 Funds**) operated and offered by CPOs and CTAs (**Minimum Disclosure Proposal**);
- (ii) Increase the financial thresholds in the “Portfolio Requirement” which a QEP would be required to satisfy, to reflect inflation (**QEP Thresholds Proposal**); and
- (iii) Codify certain CFTC exemptive letters permitting CPOs of 4.7 Funds that are “fund of funds” to distribute monthly account statements within 45 days of the month-end, provided that the CPO notifies pool participants of this alternative distribution schedule (**FOF Relief Proposal**).¹

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¹ 88 Fed. Reg. 70852 (Oct. 12, 2023).

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I. BACKGROUND

The U.S. Commodity Exchange Act (CEA) defines “commodity pool” as any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests (i.e., swaps, futures and other derivatives regulated by the CFTC). The CEA and CFTC regulations do not regulate commodity pools directly; instead, they regulate operators of such pools which it defines as Commodity Pool Operators (CPOs²) and persons in the business of providing advice on trading in commodity interests to others, which it defines as Commodity Trading Advisers (CTAs³).

CPOs and CTAs are required to register with the CFTC, unless an exemption or exclusion from registration is available.⁴ Registered CPOs and CTAs are subject to extensive ongoing compliance obligations under Part 4 of the CFTC’s regulations, including proficiency requirements for associated persons (APs), disclosure, reporting, and recordkeeping requirements.

Rule 4.7 provides limited relief to registered CPOs and CTAs that do not meet the requirements for an exemption or exclusion from registration. Specifically, current Rule 4.7 exempts CPOs and CTAs from certain of the disclosure, reporting and recordkeeping requirements that would apply under Part 4 so long as their prospective and actual pool participants and advisory clients are restricted to QEPs. However, Rule 4.7 does not exempt APs of registered CPOs from the requirement to register as such with the National Futures Association and to satisfy the National Commodity Futures Examination, nor does it exempt registered CPOs from periodic financial reporting requirements under CFTC Rule 4.27. As a result, the utility of the exemption currently afforded to CPOs (in

particular CPOs of offshore funds) is limited, especially when compared to the CFTC Rule 4.13(a)(3) exemption which does not require AP registration or periodic financial reporting.

In order to qualify as a QEP, a person or institution must generally (i) be a professional financial intermediary or qualified purchaser, (ii) meet the requirements of an accredited investor⁵ and satisfy certain minimum investment thresholds (**Portfolio Requirement**), (iii) be closely affiliated with an exempt pool, CPO or CTA, or (iv) be an entity in which all of the unitholders or participants are QEPs.

Since the adoption of Rule 4.7 in August 1992, the CFTC has not sought to narrow the scope of exemptions under Rule 4.7. However, in the Proposal, the CFTC stated its “preliminary view that certain aspects of Regulation 4.7 no longer align with the Commission’s intentions,” and proposed three substantive amendments to Rule 4.7 discussed below, as well as technical amendments to Part 4.

II. PROPOSAL

1. New Minimum Disclosure Requirements

The most significant aspect of the CFTC’s proposed changes would be the Minimum Disclosure Proposal, which would require CPOs and CTAs relying on Rule 4.7 to provide and keep current certain mandatory disclosure.

In justifying the Minimum Disclosure Proposal, the CFTC highlighted:

- (i) QEPs, in particular natural person QEPs, are not able to receive adequate information about

² CPO is defined as “any person engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, with respect to that commodity pool, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests.” CEA section 1a(11).

³ CTA is defined as “any person who, for compensation or profit, engages in the business of advising others, either

directly or through publications, writing, or electronic media, as to the value of or the advisability of trading in commodity interests.” CEA section 1a(12).

⁴ For CPOs, common exemptions include those under CFTC Rule 4.13(a)(3) and related no-action relief under CFTC No-Action Letter 12-38. For CTAs, common exemptions include those under CEA Section 4m(3) and CFTC Rule 4.14(a)(5), (a)(8), and (a)(10).

⁵ 17 CFR § 230.501(a).

the investment programs of 4.7 Funds as they do not have the requisite bargaining power;

- (ii) There has been a significant expansion and growth in the complexity and diversity of commodity interest products offered to QEPs via 4.7 Funds, as well as an expansion in the asset classes subject to the CFTC's jurisdiction and oversight, since Rule 4.7 was adopted. Specifically, the CFTC underscored the growth in the over-the-counter (OTC) swap market and the recent development of the digital assets market;
- (iii) Market structure developments have enabled investors to access the commodity interest market without intermediating futures commission merchants (FCMs), which traditionally serve as independent sources of information available to 4.7 Fund participants;
- (iv) Many CPOs and CTAs are already providing disclosures regarding 4.7 Funds to QEP investors that typically include much of the information the CFTC is proposing to require; and
- (v) The new disclosures and associated recordkeeping requirements would facilitate more effective oversight of registered CPOs and CTAs and their offerings by the CFTC and National Futures Association (NFA) by providing an increased level of transparency into registrants' activities for examination and enforcement purposes, thereby further deterring CPOs or CTAs from engaging in fraud or providing misleading representations.

Market participants who wish to comment on the Minimum Disclosure Proposal should consider the merits of each of the CFTC's stated justifications for imposing minimum disclosure requirement on CPOs and CTAs in respect of 4.7 Funds, including by providing data and insights regarding the current disclosure investors in 4.7 Funds commonly receive as well as the practical utility of such disclosure to QEPs. In this regard, Commissioner Summer K. Mersinger noted in her dissenting statement⁶ the limited evidence the CFTC included in support of its preliminary views on the need for the Minimum Disclosure Proposal.

The specific new requirements that would be introduced under the Minimum Disclosure Proposal are as follows:

Disclosure Requirements for CPOs Regarding Rule 4.7 Pools

The Proposal would require CPOs to deliver to their 4.7 Funds' prospective participants descriptions of the fund's principal risk factors, its investment program, use of proceeds, custodians, fees and expenses, conflicts of interest, and certain performance disclosures, including past performance. Specifically:

- **Principal risk factors**, including, without limitation, risks relating to volatility, leverage, liquidity, counterparty creditworthiness, as applicable to the types of trading programs to be followed, trading structures to be employed and investment activity (including retail forex and swap transactions) expected to be engaged in by the offered pool;⁷
- **Investment program and use of proceeds**, including the types of commodity interests and other interests which the pool will trade in (including, where applicable, the custodian or

⁶ See *Dissenting Statement of Commissioner Summer K. Mersinger On Proposal to Narrow Historical Exemptions for Qualified Eligible Persons in Rule 4.7*, COMMODITY FUTURES TRADING COMM'N (Oct. 2, 2023),

<https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement100223>.

⁷ CFTC Rule 4.24(g).

other entity that will hold such interests, and any non-U.S. jurisdiction in which such interests or assets will be held), a description of the trading and investment programs and policies, a summary description of the pool's major CTAs, a summary description of the pool's major investee pools or funds, and certain use of proceeds information (including the manner in which the pool will fulfill its margin requirements, the percentage of the pool's assets held in segregation pursuant to the CEA, and information regarding whom income from margin or security deposits will be paid);⁸

- **Fees and expenses**, including a complete description of each fee, commission, and other expense, which the CPO knows or should know has been incurred by the pool for its preceding fiscal year and is expected to be incurred by the pool in its current fiscal year;⁹
- **Potential or actual conflicts of interest**, including a full description of such conflicts regarding any aspect of the pool on the part of: (1) the CPO; (2) the pool's trading manager, if any; (3) any major CTA; (4) the CPO of any major investee pool; (5) any principal of the foregoing; and (6) any other person providing services to the pool, soliciting participants for the pool, acting as a counterparty to the pool's retail forex or swap transactions, acting as intermediary or acting as a swap dealer with respect to the pool, as well as any other material conflict involving the offered pool;¹⁰ and
- **Performance disclosures**, including certain information regarding past performance of the 4.7 Fund (but note that such information is not required regarding pools operated by the CPO other than the particular 4.7 Fund(s))¹¹.

The most burdensome aspects of the new disclosure requirements under the Minimum Disclosure Proposal—which are unlikely to be covered by existing offering materials of 4.7 Funds—include: (i) the break-even fee and expense analysis under CFTC Rule 4.24(i), which must be presented in a table format, and (ii) capsule performance disclosures under CFTC Rule 4.25, which requires past performance data.

Disclosure Requirements for CTAs Regarding 4.7 Trading Programs

The Proposal would require CTAs to deliver to clients of their 4.7 Funds descriptions of certain persons to be identified, the principal risk factors of the investment, the CTA's trading program, fees, conflicts of interest, and performance disclosures. Specifically, the following would need to be provided:

- **Identities of Specified Persons**, including each principal of the CTA, the FCM and/or retail foreign exchange dealers (“**RFED**”) with which the CTA will require its client to introduce its account (or, if the client is free to choose which FCM, FRED, or introducing broker it uses, then a statement to that effect);¹²
- **Principal risk factors**, including, without limitation, risks due to volatility, leverage, liquidity, and counterparty creditworthiness, as applicable to the offered trading program and the types of transactions and investment activity expected to be engaged in pursuant to such program (including retail forex and swap transactions, if any);¹³
- **Trading program**, including (1) the method chosen by the CTA concerning how FCMs and/or RFEDs carrying accounts it manages treat offsetting positions (if other than a first-in,

⁸ CFTC Rule 4.24(h).

⁹ CFTC Rule 4.24(i).

¹⁰ CFTC Rule 4.24(j).

¹¹ CFTC Rule 4.25 (other than Rule 4.25(a)(3) or (c)(2)).

¹² CFTC Rule 4.34(e).

¹³ CFTC Rule 4.34(g).

first-out basis); and (2) the types of commodity interests and other interests the CTA intends to trade, with a description of any restrictions or limitations on such trading established by the CTA or otherwise;¹⁴

- **Description of fees**, including the dollar amount of each fee, wherever possible, and additional detail and explanation of certain fees, where the fees are dependent on specifically listed base amounts, or on any increase in a client's commodity interest account;¹⁵
- **Potential or actual conflicts of interest**, including a full description of any actual or potential conflicts of interest regarding any aspect of their trading programs on the part of: (1) the CTA; (2) any FCM and/or RFED with which the client will be required to maintain its commodity interest account; (3) any introducing broker through which the client will be required to introduce its account to an FCM and/or RFED; and (4) any principal of the foregoing, within their Disclosure Documents, as well as any other material conflicts involving any aspect of the offered trading programs and any certain specified direct or indirect arrangements where the CTA or any principal thereof may benefit;¹⁶ and
- **Performance disclosures**, including information on past performance for each relevant trading strategy.¹⁷

Disclosures regarding Non-4.7 Pools and Trading Programs

The Proposal would also remove the exemption for CPOs and CTAs from disclosing the past performance of 4.7 Funds in the disclosure documents of non-4.7 Funds.

¹⁴ CFTC Rule 4.34(h).

¹⁵ CFTC Rule 4.34(i).

¹⁶ CFTC Rule 4.34(j).

¹⁷ CFTC Rule 4.35.

The Proposal would not only require CPOs and CTAs relying on Rule 4.7 to create minimum disclosure in respect of 4.7 Funds, but also to update the disclosures in respect of non-4.7 Funds operated or advised by the same CPOs and CTAs to include past performance information regarding 4.7 Funds. For some CPOs and CTAs, reproducing historical trading information in the required format would result in significant cost.

Books and Records

The Proposal would require CPOs and CTAs to keep current the required disclosures regarding 4.7 Funds, maintain such disclosures as business records, and make them available to the CFTC, NFA, and the U.S. Department of Justice.

As a practical matter, the disclosure materials of 4.7 Fund would have to be updated at least every 12 months, and performance information could not be more than three months old as of the date the disclosure materials are made available.

The new disclosure requirements would also give rise to increased enforcement and litigation risk for CPOs/CTAs¹⁸ relying on 4.7. Given such risk, along with the detailed disclosure specifications and obligations to keep disclosures current, the Minimum Disclosure Proposal would further reduce the utility of exemptions under Rule 4.7 and may incentivize funds to reduce or eliminate commodity interest activity in order to seek exemptions from CPO/CTA registration.

2. QEP Portfolio Requirement Thresholds

¹⁸ The CEA creates private rights of actions for persons who purchased an interest or participation in a commodity pool or who received commodity trading advice in connection with a violation of the CEA by the relevant CPO/CTA. See 7 U.S.C. Section 25.

Rule 4.7 requires certain persons to be subject to a “Portfolio Requirement” to be a QEP. Currently, a person can satisfy the Portfolio Requirement by:

- (i) owning securities (including pool participations) of issuers not affiliated with such person and other investments with an aggregate market value of at least \$2 million (**Securities Portfolio Threshold**);
- (ii) Having on deposit with an FCM, for its own account at any time during the six months preceding either the date of sale to that person of a pool participation in the 4.7 Fund or the date the person opens an exempt account with the CTA, at least \$200,000 in exchange-specified initial margin and option premiums, together with required minimum security deposit for retail forex transactions for commodity interest transactions (**Initial Margin and Premium Threshold**); or
- (iii) Owning a portfolio comprised of a combination of the funds or property specified in the Securities Portfolio Test and the Initial Margin and Premium Test, which, when expressed as percentages of the required amounts, meet or exceed 100%.

The QEP Thresholds Proposal would double the Securities Portfolio Threshold from \$2 million to \$4 million, and the Initial Margin and Premium Threshold from \$200,000 to \$400,000.¹⁹ A person could still meet the Portfolio Requirement through a combination of the two tests.

The CFTC clarified that CPOs and CTAs would not be forced to effect mandatory redemptions or terminations of advisory relationships for investors that would cease to be QEPs due to the increase of thresholds, because under Rule 4.7(a)(3), QEP status is assessed at the time of sale of any pool participation units or when a person opens an exempt account. However, as Commissioner Mersinger noted, the CFTC did not clarify whether formerly eligible QEPs would be able to make additional investments in exempt pools in which they are currently participating.

3. Codifying Exemptive Relief for Fund-of-Funds

Rule 4.7(b)(3) currently exempts CPOs relying on it from providing monthly account statements to pool participants, but instead requires CPOs to provide account statements at least quarterly within 30 days of the end of each quarter. Operators of “fund of funds” have obtained no-action relief in the past to follow an alternative account statement schedule because they cannot control the timing of when they receive information from the investee funds, which often results in the investor fund CPO not receiving the requisite information for its own 4.7 pool reporting until close to the quarterly reporting deadline.

The FOF Relief Proposal would codify existing no-action letters and allow CPOs of fund of funds to send monthly account statements within 45 days of the end of each month, provided that that the CPO notifies pool participants of such alternative distribution schedule.

III. REQUESTS FOR COMMENTS

The CFTC has invited comment on a number of questions related to the Proposal. The questions, reproduced in Appendix A, touch on a number of issues identified in the Proposal, including: (i) how to measure

¹⁹ The CFTC justified doubling the thresholds data from two inflation indices over the past 30 years (specifically, the Consumer Price Index for All Urban Consumers and the

Consumer Price Index for Urban Wage Earners and Clerical Workers, each as published by the United States Bureau of Labor Statistics).

the increase to the Portfolio Requirement; (ii) the impact of the increased Portfolio Requirement; (iii) how current CPOs and CTAs relying on Rule 4.7 disclose information to participants and clients; (iv) current and anticipated costs for compliance with Rule 4.7; (v) commenter proposals for alternative approaches to Rule 4.7; (vi) the operation of CPOs of fund of funds; and (vii) antitrust considerations.

In her dissenting statement, Commissioner Mersinger criticized the questions posed in the Proposal. She noted that the list of questions does not address whether universal disclosures to QEPs should even be required, whether QEPs below the increased Portfolio Requirement thresholds would be permitted to make additional investments in a Rule 4.7 exempt commodity pool, and whether the CFTC should utilize its resources to review mandatory disclosures to QEPs. Commissioner Mersinger requested comment on her own list of questions regarding the Proposal addressing these and other issues. These questions, reproduced in Appendix B, are open for comment by all market participants, but are especially directed at QEPs.

Comments on the Proposal must be received on or before December 11, 2023.

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Appendix A

The CFTC has requested comments regarding the Proposal, generally. The specific questions in the Proposal on which the CFTC requested comment are reproduced below.

1. Are the CPI-U and the CPI-W indexes the most appropriate for considering the impact of inflation on the thresholds within the Portfolio Requirement, and if they are not, what other suggested indexes or methods should the Commission consider using to assess inflationary effects?
2. The Commission is also seeking any data or information, from CPOs and CTAs that utilize Regulation 4.7, on the estimated number of advisory clients and pool participants that currently qualify as QEPs via the existing Portfolio Requirement, but would not so qualify if the increased monetary thresholds in the Portfolio Requirement described above are adopted.
3. How much time would CPOs and CTAs need to determine that their existing QEP pool participants and clients would continue to satisfy the increased Securities Portfolio or Initial Margin and Premium Tests, if adopted as proposed?
4. How many QEPs would intermediaries expect to no longer be considered QEPs, if the Portfolio Requirement threshold increases are adopted?
5. How many CPOs and CTAs that currently offer pools and trading programs exclusively to QEPs have participants and clients that would no longer be QEPs under the new thresholds?
6. If the increased thresholds are adopted, will registered CPOs and CTAs form and begin offering new pools and trading programs designed for non-QEPs?
7. Should the Commission increase or decrease the types of information included in Proposed Regulations 4.7(b)(2) and (c)(1)? In particular, should additional disclosure requirements listed in Regulations 4.24 and 4.34 be included for CPOs and CTAs, respectively? If so, what disclosures?
8. The Commission is seeking specific data or information regarding: (i) the current number of CPOs and CTAs utilizing Regulation 4.7 that provide the proposed minimum disclosures to their QEP participants and clients; (ii) the level of disclosure currently provided by CPOs and CTAs to their QEP participants and clients; (iii) if disclosures are provided, the general format, tenor, and manner used in both structuring and delivering the disclosures; and (iv) the context and timing of when any such disclosures are provided (e.g., whether during solicitation or otherwise during the course of the investment relationship).
9. What specific challenges would CPOs and CTAs face in complying with the disclosure requirements in Proposed Regulations 4.7(b)(2) and (c)(1)? Should the Commission consider an implementation period for the proposed amendments, and if so, how much time should the Commission allow for CPOs and CTAs to develop and prepare QEP Disclosures that would comply with the proposed amendments?
10. To what extent is the information necessary to provide past performance and fees already gathered in order to provide account information under Regulations 4.7 and 4.22? What additional steps would be required to process and disseminate that information in QEP Disclosures, as required under the Proposal?
11. To what extent would CPOs' and CTAs' trading strategies be revealed in QEP Disclosures? How would such proposed

- disclosure requirements impact the development of such trading strategies and/or directly affect the behaviors of CPOs and CTAs utilizing Regulation 4.7?
12. The Commission welcomes comments on [current costs for compliance with Rule 4.7 and future estimated costs under the Proposal], particularly from existing CPOs and CTAs utilizing Regulation 4.7 exemptions.
 13. What are the costs of gathering and disseminating the other types of information required to be included in QEP Disclosures?
 14. How will the fees and expenses charged by CPOs and CTAs for pools and trading programs operated under Regulation 4.7 be affected by the proposed disclosure requirements?
 15. How many CPOs operate their 4.7 pools as Funds of Funds, meaning such pools invest in other 4.7 pools, other commodity pools, or other collective investment vehicles?
 16. How many CPOs operating 4.7 pools provide sufficiently timely account statements to their participants that are other 4.7 commodity pools, so as to allow their CPOs to also produce their own account statements within 30 days of the quarter-end?
 17. How many 4.7 Fund of Funds pools are currently able to provide quarterly account statements within 30 days of the end of the quarter, without the alternative monthly schedule currently provided exemptive relief?
 18. [Do the proposed changes to funds of funds quarterly account statements requirements] effectively [create] a mechanism in Regulation 4.7(b)(3) that is equivalent to the exemptive letters currently issued by the [CFTC]?
 19. [Are] the alternate account statement distribution schedule and notice requirements clear?
 20. The Commission requests comment on whether the Proposal implicates any other specific public interest to be protected by the antitrust laws.
 21. The Commission requests comment on whether the NPRM is anticompetitive and, if it is, what the anticompetitive effects are.
 22. The Commission requests comment on whether there are less anticompetitive means of achieving the relevant purposes of the CEA that would otherwise be served by adopting the amendments proposed in this NPRM.
 23. [Are there] any other technical amendments that [the CFTC] should consider for ease of use?
 24. [Are there] any other cross-references within Regulation 4.7 not addressed by the Proposal that should also be corrected?
 25. Commenters may also suggest other alternative(s) to the proposed approach that would be expected to further the Commission's stated policy and regulatory goals as described in this NPRM.

Appendix B

Commissioner Mersinger separately requested comment on the questions reproduced below.²⁰

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?

²⁰ See *Dissenting Statement of Commissioner Summer K. Mersinger On Proposal to Narrow Historical Exemptions for Qualified Eligible Persons in Rule 4.7*, COMMODITY

FUTURES TRADING COMM'N (Oct. 2, 2023), <https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement100223>.