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TESTIMONY OF KARRIE MCMILLAN

GENERAL COUNSEL

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES

ON

"IMPLEMENTING DODD-FRANK: A REVIEW OF THE CFTC'S RULEMAKING PROCESS"

APRIL 13, 2011

EXECUTIVE SUMMARY

- Registered investment companies, or "funds," use swaps and other derivatives in a variety of ways. ICI and its members thus have a strong interest in ensuring that the new regulatory framework for the derivatives markets supports and fosters markets that are highly competitive, transparent, and liquid.

- ICI commends the CFTC and SEC for their diligence and dedication in the very difficult task of developing an appropriate regulatory framework and avoiding unintended consequences. We do, however, have concerns with the order in which rules have been published for public comment and the length of the respective comment periods. We also have urged the CFTC and SEC to phase-in application of new regulatory requirements over a reasonable period of time.

- ICI is particularly concerned with the CFTC's decision in late January to issue a sweeping proposal to revise or rescind several of its rules, including Rule 4.5, which currently provides an exclusion for funds and certain "otherwise regulated" entities from regulation as commodity pool operators. The proposal is *not* mandated or even contemplated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. And its issuance at this time is most unfortunate, because it has diverted attention away from the effort to implement the provisions of the Dodd-Frank Act.

- The proposed amendments to Rule 4.5 are premature and insufficiently developed. For example, the CFTC proposes a key trading restriction that would relate to margin levels on derivatives positions. ICI and its members cannot assess the full impact of this proposed restriction because it is not yet known which swaps will be subject to central clearing, what the margin requirements will be for cleared and uncleared swaps, and whether foreign exchange forwards and foreign exchange swaps will be exempted from the definition of "swap."

- If adopted in their current form, the proposed amendments to Rule 4.5 would subject funds – which are already subject to comprehensive regulation under all four of the major federal securities laws – to duplicative and fundamentally inconsistent regulatory requirements. The CFTC has failed to demonstrate the need for imposing a second layer of regulation on funds. Moreover, its cursory cost-benefit analysis is wholly inadequate to justify the costly and burdensome regulation contemplated by the proposed amendments.

- Even if the proposed amendments to Rule 4.5 are appropriately scaled back, there are likely to be some funds (and their investment advisers) that would become subject to CFTC regulation. It is essential that the CFTC work closely with the SEC to reconcile the duplicative and conflicting regulatory requirements to which these funds would become subject, and to re-propose the harmonized regulations for public comment.

I. INTRODUCTION

My name is Karrie McMillan. I am General Counsel of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). For ease of discussion, we refer in this testimony to all registered investment companies as "funds." Members of ICI manage total assets of $13.0 trillion and serve over 90 million shareholders.

ICI is pleased to offer its perspectives on rulemaking by the Commodity Futures Trading Commission (CFTC or Commission) to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). We also provide our views on the CFTC's recent decision to issue a sweeping proposal to modify or rescind several of its exemptive and exclusionary rules, a proposal that is not mandated (or even contemplated) by the Dodd-Frank Act. The proposed amendments to one of those rules – CFTC Rule 4.5 – are premature and insufficiently developed. If adopted in their current form, those amendments would subject a large segment of the fund industry – which is already subject to comprehensive regulation – to duplicative and fundamentally inconsistent regulatory requirements.

II. ICI VIEWS ON CFTC RULEMAKING TO IMPLEMENT THE DERIVATIVES REFORM PROVISIONS OF THE DODD-FRANK ACT

Like many financial institutions, funds use swaps and other derivatives in a variety of ways. They are a particularly useful portfolio management tool in that they offer funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, equitizing cash that a fund cannot immediately invest in direct equity holdings (*e.g.*, if the stock market has already closed for the day), managing the fund's cash positions more generally, adjusting the duration of the fund's portfolio (*e.g.*, by seeking to maintain a bond fund's stated duration of seven years as its holdings in fixed-income securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objectives stated in its prospectus.

Implementation of the Dodd-Frank Act will dramatically change financial regulation in the United States by, among other things, establishing a new regulatory framework for the derivatives markets and participants in those markets.[1] ICI and its members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent, and that the regulation governing them encourages liquidity, fairness and transparency. ICI has therefore been closely monitoring the work of the CFTC and the Securities and Exchange Commission (SEC) as the agencies seek to develop this framework, and we have provided comment on a number of their rule proposals.[2]

Developing the appropriate regulatory framework for derivatives and avoiding unintended consequences is a very difficult task. It is one that requires thoughtful and comprehensive analysis, a deliberative approach, coordination between the CFTC and SEC when possible and appropriate, and careful consideration of comments and recommendations from the public. From time to time,

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[1] ICI was an early supporter of federal legislation to close this regulatory gap. *See, e.g.*, Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf.

[2] *See, e.g.*, Letters from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated Sept. 20, 2010 and Feb. 22, 2011 (regarding the definition of key terms in the Dodd-Frank Act related to the regulation of swaps); Letters from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC, dated Jan. 18, 2011 and to David A. Stawick, Secretary, CFTC, dated Feb. 7, 2011 (regarding real-time reporting of swap transaction data); Letters from Karrie McMillan, General Counsel, ICI to David A. Stawick, Secretary, CFTC, dated Jan. 18, 2011 (regarding protection of customer collateral for cleared swaps) and Feb. 1, 2011 (regarding protection of customer collateral for uncleared swaps).

reproposals of certain rules may be necessary to ensure that they are workable and do not impose costs that are not justified by their benefits.

Getting the rules right is critical for protecting the swaps markets, market participants, and the broader financial system. And, in our view, the agencies have a much harder time getting the rules right if the public is limited in its ability to provide meaningful comment on proposed rules because of overly short comment periods or the order in which the rules are proposed.

Last December, ICI joined with nine other trade associations in sending a joint letter to the CFTC and SEC on their efforts to implement the derivatives provisions of the Dodd-Frank Act.[3] The letter began by commending the agencies "for their diligence and dedication with regard to this unprecedented rulemaking endeavor." It noted, in particular, that the Dodd-Frank Act imposes "short and strict deadlines" on each agency, and that many of the required rules "concern activities and products that are complex and new to regulatory oversight."

The joint letter did, however, raise concerns with aspects of the rulemaking process being followed by the two agencies and recommended certain changes. Among other issues, the letter expressed concern with the order in which the rules have been published for public comment. A prime example of this was the agencies' issuance of proposed requirements for "swap dealers" and "major swap participants" before they had proposed how these Dodd-Frank Act terms should be defined. Uncertainty regarding who might be covered by the proposed requirements made it very difficult for

[3] *See* Letter from American Bankers Ass'n, ABA Securities Ass'n, The Clearing House Ass'n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass'n, Investment Company Institute, Managed Funds Ass'n and Securities Industry and Financial Markets Ass'n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated Dec. 6, 2010.

firms to know whether and to what extent the requirements might apply to them, and thus whether and how to provide meaningful comment.

The joint letter also expressed concern that participants in the derivatives markets "would be asked to do too much in too short a time" in regard to implementing new rules. It cautioned that market participants might be forced to refrain from derivatives transactions for which compliance was not possible, which could in turn cause there to be little or no liquidity in certain segments of the market. The letter noted that the Dodd-Frank Act sets only a floor for the effective date for implementing rules (*i.e.*, "not less than 60 days after publication") and, accordingly, called on the CFTC and SEC to use their discretion in order to "phase-in the application of new regulatory requirements over a reasonable period of time, determined through discussions with the market participants that the agencies expect to be directly affected by those requirements." We are pleased that Chairman Gensler recently acknowledged that Congress "gave the CFTC broad latitude in determining when final rulemakings [under the Dodd-Frank Act] would become effective" and that the agency "may give market participants more time" to comply than the 60-day floor described above.[4]

As this Committee continues to oversee the CFTC's implementation of the Dodd-Frank Act, we urge you to encourage the agency to facilitate meaningful public comment on these important rule proposals, to consider those comments fully in their rulewriting effort and, once those rules are finalized, to allow the private sector sufficient time to come into compliance.

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[4] *See* Gary Gensler, Chairman, CFTC, Remarks, *Implementing the Dodd-Frank Act*, at the Futures Industry Association's Annual International Futures Industry Conference, Boca Raton, FL (March 16, 2011).

III. CFTC PROPOSAL TO MODIFY OR RESCIND SEVERAL EXEMPTIVE AND EXCLUSIONARY RULES, INCLUDING RULE 4.5

A. ICI Views on the Proposal Generally

In late January, the CFTC voted to issue a sweeping proposal to revise or rescind several of its exemptive and exclusionary rules, as well as adopt new disclosure requirements, in an effort to "more effectively oversee its market participants and manage the risks that such participants pose to the markets."[5] In particular, the proposal would rescind the exemptions from regulation as a commodity pool operator (CPO) on which sponsors of private investment funds typically rely, significantly narrow the exclusion from CPO regulation in Rule 4.5 under the Commodity Exchange Act as it relates to funds (discussed in detail below), and impose new periodic reporting requirements on all CPOs and commodity trading advisors registered with the CFTC.

Not surprisingly, a proposal of this nature and scope, if adopted, would have significant implications for many asset management firms – and this would be *in addition* to the many new obligations imposed on these firms by the Dodd-Frank Act. Because of this, ICI and other stakeholders have spent considerable time analyzing the proposal and in particular, the amendments to Rule 4.5, and have developed some recommendations for how it might be appropriately amended.

For many reasons, the timing of this proposal is most unfortunate. The proposal is not mandated by the Dodd-Frank Act, although the CFTC attempts to describe it as being "consistent with the tenor" of that Act.[6] Its publication for comment has required ICI and other stakeholders to

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[5] *See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations,* 76 Fed. Reg. 7976 (Feb. 11, 2011) ("Release").

[6] *Id.* At 7977.

divert attention away from analyzing and commenting on the many proposals from the CFTC, SEC and other agencies to implement the Dodd-Frank Act.[7] The proposal has likewise been a diversion for the CFTC and its staff.

It is also important to note that any adoption of the proposal in its current form would have considerable long-term implications for the CFTC. A host of new registrants would increase the agency's workload, and regulatory oversight of these new registrants would strain its limited resources, at a time when the agency acknowledges that it does not have the staffing or budget to meet new responsibilities under the Dodd-Frank Act.[8] It likewise would strain the resources of the National Futures Association (NFA), which serves as the frontline regulator for CPOs.

B. ICI Views on the Proposed Amendments to CFTC Rule 4.5

Rule 4.5 currently provides an exclusion for certain "otherwise regulated entities," including funds, from regulation as CPOs. The proposed amendments would condition eligibility for the Rule 4.5 exclusion on compliance with certain trading and marketing restrictions.[9] Funds unable to satisfy these conditions would be subject to regulation and oversight by the CFTC and the NFA. This would impose a second layer of regulation on such funds, which already must comply with comprehensive

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[7] The CFTC first published a petition for rulemaking from the National Futures Association on September 17, 2010. *See Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5*, 75 Fed. Reg. 56997. ICI and others commented extensively on that petition. On February 11, 2011, the CFTC published the proposal in question, seemingly without taking into account the commenters' myriad concerns raised during the first comment period.

[8] *See* Testimony of Gary Gensler, Chairman, CFTC, Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, United States House of Representatives, on the CFTC's budget request for FY2012 (March 17, 2011) (stating that the Commission's current funding level is "simply not sufficient for the CFTC's expanded mission to oversee both the futures and swaps markets.").

[9] The topics covered in this section are discussed in extensive detail in ICI's comment letter on the proposal. This letter was filed with the CFTC on April 12, 2011, and we will submit a copy of this letter to the Committee for inclusion in the hearing record.

regulatory requirements under the Investment Company Act of 1940 (Investment Company Act) and other federal securities laws.

1. The CFTC Has Not Justified the Broad Scope of the Proposed Amendments

The Release states that the amendments to Rule 4.5 are intended to "stop the practice of registered investment companies offering futures-only investment products without Commission oversight . . ."[10] The Release fails to explain, however, why the proposed amendments are troublingly broader in reach. Specifically, the sweeping language of the proposed trading and marketing conditions would implicate a large number of funds that use futures, options and swaps simply as a means to efficiently manage their portfolios, rather than as part of operating a "futures-only" fund. It is difficult to justify this result at a time when, as noted above, the CFTC Chairman has stated that current funding levels for the agency are "simply not sufficient" and is requesting substantial additional resources from Congress.[11]

2. The CFTC Has Not Demonstrated the Need for Imposing a Second Layer of Regulation on Funds

In its Release, the CFTC provides no evidence that a "futures-only" fund – not to mention a fund using futures, options or swaps for reasons *other than* providing exposure to the commodities markets – is currently subject to inadequate regulation, or that investors or the commodity markets generally have been harmed by their practices.

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[10] Release, *supra* note 5, at 7984.

[11] *See supra* note 8.

In fact, funds are already extensively regulated. They are the only financial institutions that are subject to all of the four major federal securities laws. The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the public offering of shares and ongoing reporting requirements, respectively. Funds must provide comprehensive disclosure to investors in plain English, including with regard to fees and expenses, the fund's investment objectives, and the risks of investing in the fund. The Investment Company Act regulates a fund's structure and operations, and addresses fund capital structures (including limits on use of leverage), custody of assets, investment activities (particularly with respect to transactions with affiliates and other transactions involving potential conflicts of interest), and the composition and duties of fund boards. A fund's investment adviser must register with the SEC and comply with the provisions of the Investment Advisers Act of 1940. Funds and their advisers are subject to antifraud standards. Finally, the federal securities laws provide the SEC with inspection authority over funds and their investment advisers, principal underwriters, distributing broker-dealers and transfer agents. The Financial Industry Regulatory Authority (FINRA) also has oversight authority with regard to funds' principal underwriters and distributing broker-dealers.

As a result, ICI questions why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily regulated entities.

3. Because the Regulatory Regime for Swaps is Still Being Developed, the Fund Industry and Other Interested Parties Cannot Adequately Assess the Impact of This Proposal

It is difficult at this time to assess the full impact of, and meaningfully comment on, the proposed amendments to Rule 4.5. This is because one of the key conditions would relate to margin levels on derivative positions held by funds, and the regulators have not yet made critical determinations that relate to swap margin levels. Specifically, the CFTC and SEC have not finalized rules regarding which swaps will be subject to central clearing requirements. In addition, margin requirements have not been established for cleared or uncleared swaps (which could end up varying significantly based on the type of swap). Finally, we do not yet know whether the Department of the Treasury will exempt foreign exchange forwards and foreign exchange swaps from the definition of "swap" and, if no exemption is granted, what the margin requirements would be for these instruments.

It is our strongly held view that the new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* the Commission can propose any amendments to Rule 4.5 that implicate the use of swaps.

4. The CFTC Has Not Adequately Analyzed the Potential Costs and Benefits of Its Proposal

We believe that the CFTC's cursory analysis of the costs and benefits of the proposed amendments to Rule 4.5 is wholly inadequate to justify the costly and burdensome regulation they would impose on a large portion of the fund industry. The CFTC does identify a few costs, which it does not detail or quantify, but it fails to identify many of the major costs the proposal would impose on funds, some of which would inevitably get passed on to shareholders. The CFTC's analysis of benefits is even more abstract and does not appear to be focused on the proposed amendments to Rule 4.5. Importantly, the Commission fails to acknowledge in its analysis that any benefits that fund shareholders may receive as a result of these amendments would largely duplicate many protections they currently enjoy as a result of the Investment Company Act and other federal securities laws.

We have deep concerns whether the CFTC's cost-benefit analysis would satisfy the applicable requirements of the Commodity Exchange Act,[12] and we believe that the agency should not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis. We further question whether it is even possible for the CFTC to conduct an adequate analysis until the status and margin issues regarding swaps, mentioned above, have been resolved, as the resolution of those issues could vastly impact the number of funds that may be swept into the CFTC's jurisdiction.

ICI is not alone in its concerns. The Chairman of this Subcommittee, together with the Committee Chair, recently raised very similar concerns in requesting that the CFTC's inspector general undertake an investigation of the adequacy of the Commission's cost-benefit analysis.[13] We particularly agree with their observations that:

> the CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . [p]articularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.

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[12] Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

[13] *See* Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC dated Mar. 11, 2011.

Even members of the Commission have raised concerns about the manner in which the agency conducts its cost-benefit analysis. Commissioner Sommers, for example, has observed that:

> the proposals we have voted on over the last several months [ ] contain very short, boilerplate 'Cost-Benefit Analysis' sections. . . . how can we appropriately consider costs and benefits if we make no attempt to quantify what the costs are? . . . Clearly, when it comes to cost-benefit analysis the Commission is merely complying with the absolute minimum requirements of the Commodity Exchange Act. That is not in keeping with the spirit of the President's recent Executive Order on 'Improving Regulation and Regulatory Review.' We owe the American public more than the absolute minimum.[14]

5. The CFTC's Proposal Would Impose Inconsistent and Duplicative Regulation on Funds

Finally, even if the restrictions in the proposed amendments to Rule 4.5 are appropriately scaled back, there are likely to be cases in which funds and their advisers would be unable to rely on the amended rule and thus would become subject to regulation by both the CFTC and the SEC. The Release specifically acknowledges that funds may have difficulty complying with some of the CFTC's regulations, yet it does not propose any solutions. As part of our analysis of the Commission's proposal, ICI and its outside counsel have compared the CFTC and SEC regulatory regimes under the Investment Company Act and the Commodity Exchange Act, respectively. This analysis is summarized in a detailed appendix to our April 12 comment letter.[15] As this appendix demonstrates,

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[14] *See* Jill E. Sommers, Commissioner, CFTC, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011).

[15] *See supra* note 9.

many of the CFTC's requirements would be duplicative of the requirements to which funds and their advisers are already subject under the Investment Company Act or other federal securities laws. Other of the CFTC's requirements would be fundamentally inconsistent with the requirements to which funds and their advisers are subject.

For example, the SEC significantly limits the ability of a fund to include in its prospectus performance information about other funds or accounts managed by the fund's adviser.[16] The CFTC rules, by contrast, *require* disclosure of such information in certain circumstances. A fund could not comply with the CFTC's requirements without likely violating the SEC's (and FINRA's) requirements. As another example, the CFTC rules regarding delivery and receipt of a commodity pool disclosure document are fundamentally different than the model under the federal securities laws, and would not be practicable for funds, which generally offer their shares publicly on a daily basis though broker-dealers and other intermediaries.

The examples above illustrate why we believe it is absolutely critical that the CFTC, before imposing an *additional* regulatory requirement on funds, evaluate its regulatory purpose in doing so and consider whether a regulation to which funds and their advisers are *already* subject would be sufficient to satisfy that purpose.

More broadly, it is essential that the CFTC work closely with the SEC before amending Rule 4.5 in order to reconcile the many duplicative and conflicting regulations to which a fund and its adviser could become subject. The harmonized regulations then should be re-proposed for public comment.

[16] FINRA, which has oversight over fund advertising, similarly prohibits funds from advertising the adviser's other fund or account performance.

IV. CONCLUSION

We appreciate this opportunity to testify before the Committee. The regulatory proposals discussed in our testimony have important implications for funds and the over 90 million shareholders who rely on funds to meet their retirement and investment goals. Continued Congressional oversight of the CFTC's work on these proposals is critical to ensuring that the regulatory scheme for the derivatives markets is appropriately established and that funds are not made subject to duplicative and fundamentally inconsistent regulatory requirements.

Karrie McMillan

Karrie McMillan is General Counsel of the Investment Company Institute, the national association of the U.S. investment company industry. In her role as General Counsel, Karrie is responsible for legal and regulatory initiatives affecting the Institute's member firms, which represent over 93 million individual shareholders and manage approximately $11.3 trillion in investor assets.

Karrie joined the ICI's legal staff in September 2007. Previously, she was a partner in the Asset Management Groups at Willkie Farr & Gallagher LLP and Shearman & Sterling LLP. She also served at the SEC's Division of Investment Management from 1991 – 1998, rising to the position of Assistant Chief Counsel in the Division's office of Chief Counsel.

Karrie's practice at Willkie Farr & Gallagher and Shearman & Sterling included developing compliance policies and procedures for mutual funds and investment advisers and conducting compliance reviews; structuring innovative investment products; analyzing distribution methods; providing advice concerning corporate governance practices; and assessing trading practices. While at the SEC, Karrie was involved with various no-action letters, including those addressing trade allocation; assignments of advisory contracts; the use of the Internet by hedge funds and unregistered advisers; and interpretive releases addressing the cross-border use of the Internet and principal and cross trades under the Advisers Act. Karrie also was an active participant in IOSCO.

Karrie is a member of the District of Columbia and Texas bars and has spoken at numerous conferences. She is a graduate of the College of William and Mary and the University of Virginia School of Law

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: Karen H. McMillan

Organization you represent (if any): Investment Company Institute

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: None **Amount:** ______

Source: ______ **Amount:** ______

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:**

Source: None **Amount:** ______

Source: ______ **Amount:** ______

Please check here if this form is NOT applicable to you: X

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