

Federal Investment Policy Report for the CalPERS Board November 2015

I. Derivatives

1. **Brief Summary of Issue.** Policy developments related to derivatives, including reforms implemented by the Commodity Futures Trading Commission (CFTC) under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).
2. **Developments Since Last Report.**
 - **Automated Trading.** The CFTC unanimously approved proposed rules to revise the regulatory regime for algorithmic order origination and electronic trade execution on U.S. designated contract markets. The proposed rules would also require the registration of certain proprietary traders that are not currently registered with the CFTC. After publication in the Federal Register, the public will have 90 days to comment on the proposed rules.
 - **Registered Swap Dealers.** CFTC staff extended time-limited no-action relief to certain CFTC-registered swap dealers (SD) and major swap participants (MSP). Staff will not recommend that the CFTC take enforcement action against a non-United States SD or a non-U.S. MSP established in Australia, Canada, the European Union, Japan, or Switzerland, that is not part of an affiliated group in which the ultimate parent entity is a U.S. SD, U.S. MSP, U.S. bank, U.S. financial holding company, or U.S. bank holding company, for failure to comply with the swap data reporting requirements of certain CFTC regulations, with respect to its swaps with non-U.S. counterparties that are not guaranteed affiliates, or conduit affiliates, of a U.S. person.
 - **Swaps Execution Facilities.** CFTC staff extended time-limited no-action relief to Swap Execution Facilities (SEFs) from certain “block trade” requirements in CFTC regulations. Staff will not recommend CFTC enforcement action against a SEF that has rules and/or procedures which provide for the use of a SEF trading system or platform to facilitate the execution of block trades for swaps that are intended to be cleared, and thus not complying with the requirement that a swap block trade occur away from the trading system or platform under CFTC rules, provided that certain conditions are met.
 - **Un-cleared Swaps.** Senator Elizabeth Warren (D-MA) and Representative Elijah Cummings (D-MD) wrote Chairman Timothy Massad and Securities and Exchange Commission (SEC) Chair Mary Jo White requesting that, in finalizing new rules on swaps trades, the CFTC and SEC mitigate risks posed by un-cleared swap activities by imposing strong margin requirements for swaps between bank affiliates and other entities under their authority.
 - **CFTC Regulatory Agenda.** Chairman Massad said that, before the end of the year, the CFTC will consider proposals related to cybersecurity, margin for un-cleared swaps, and trade options. Among the CFTC’s ongoing efforts that Chairman Massad expects will lead to action in 2016 are clearinghouse resiliency, swap execution facility registrations, swaps trading rulemakings, position limits rulemakings, and the harmonization of domestic and

November 25, 2015

international regulations.

3. **Implications for CalPERS.** CFTC rulemaking will impact the ability of CalPERS to trade derivatives for the purpose of enhancing returns for shareowners and hedging portfolio risk.
4. **CalPERS/Federal Representative Actions.** Ongoing monitoring of relevant developments with respect to CFTC rulemakings and legislative developments.
5. **Recommendations for Next Steps.** We will continue to provide updates and recommend action by CalPERS as warranted, including comment on relevant rulemakings.

II. Housing Finance

1. **Brief Summary of Issue.** Policy developments related to housing finance including the market for asset-backed securities.
2. **Developments Since Last Report.**
 - **QM Safe Harbor.** The House passed H.R. 1210, which would amend the Truth in Lending Act provisions related to mortgage lending known as the “Qualified Mortgage” (QM) rule to create a safe harbor from lawsuit for depository institution lenders by requiring that their residential mortgage loans be treated as qualified mortgages provided the loans are held on such lender’s balance sheet. The President is expected to veto the bill if it is presented to him as a standalone measure. However, the prospects of H.R. 1210 or similar provisions could change if packaged as part of a larger, moving vehicle.
 - **FHA Reserve Ratio.** The Federal Housing Administration (FHA) released its independent actuarial analysis which indicates that the FHA’s required reserve ratio reached 2.07 percent. This marks the first time since the 2008 financial crisis that the FHA’s reserve ratio has exceeded the statutorily required 2 percent threshold. Observers note that this performance could put new pressure on the FHA and the Government Sponsored Enterprises (GSEs) to lower their fees.
 - **GSE Earnings Releases.** Freddie Mac reported its first net loss since going into conservatorship in 2008. This loss has renewed concerns that Freddie Mac will need to draw upon the remaining \$140 billion of its existing U.S. Treasury backstop. Fannie Mae reported earning \$2 billion in profit in the third quarter, which is significantly down from \$3.9 billion during the same period last year. Like Freddie Mac, Fannie Mae experienced accounting losses on its derivative holdings as interest rates fell during the quarter.
 - **GSE CEO Compensation.** The House passed S. 2036, the Equity in Government Compensation Act of 2015 by voice vote to cap the salaries of the chief executive officers of the GSEs at \$600,000 each as long as the GSEs remain under federal government control. The Senate passed the bill by unanimous consent on September 15, 2015. The President is expected to sign S. 2036 into law soon.
3. **Implications for CalPERS.** Changes to housing finance policy could impact market liquidity, mortgage interest rates and CalPERS investment returns.

November 25, 2015

4. **CalPERS/Federal Representative Actions.** Ongoing monitoring of relevant developments, including the possibility that proposals related to credit risk transfer and the common securitization platform are included as “riders” in the expected omnibus appropriations bill.
5. **Recommendations for Next Steps.** We will provide updates and recommend action by CalPERS as warranted, including comment on relevant rulemaking and legislative proposals.

III. Securities

1. **Brief Summary of Issue.** Policy developments related to capital formation, investor protection and securities market structure.
2. **Developments Since Last Report.**
 - **Nominations.** SEC Commissioner Luis Aguilar announced that he will be departing from the SEC at the end of the year. The Senate Banking Committee is expected to hold the confirmation hearings of George Washington University Law Professor Lisa Fairfax (a Democrat) and George Mason University Researcher Hester Peirce (a Republican) to be SEC Commissioners in the near future. If confirmed, the nominees would replace Commissioner Aguilar and former Commissioner Daniel Gallagher.
 - **SEC Chair Testimony, Disclosure Requirements.** SEC Chair Mary Jo White testified before the House Financial Services Committee at a hearing on the SEC’s FY 2017 Budget Request. Chair White said that the SEC staff continues to review the SEC disclosure requirements, focusing first on certain business and financial disclosures and then on governance and compensation disclosures required in proxy statements. Chair White also indicated that the SEC would be responding to two Congressional letters on a possible political disclosure rulemaking in the near future.
 - **House Highway Bill.** House Financial Services Committee Chairman Jeb Hensarling (R-TX) successfully attached a package of 15 bipartisan bills to the House highway bill, including a bill (H.R. 1525) to alter companies’ annual SEC disclosures and require the SEC to revise certain filing requirements, and a bill (H.R. 1839) to allow owners of restricted securities to resell them to accredited investors so long as sufficient disclosures are made available and no “general solicitation” is used. House Speaker Paul Ryan (R-WI) appointed Chairman Hensarling to the Conference Committee that will reconcile the differences between the House and Senate versions of the highway bill, which increases the chances that Chairman Hensarling’s bills could be included in the final legislation.
 - **Hedge Fund Reporting.** Rep. Nydia Velázquez (D-NY), a senior member of the House Financial Services Committee, introduced legislation (H.R. 3921, the Hedge Fund Sunshine Act) that would require hedge funds to report to the SEC on any acquisition of more than a one percent equity in a class of equity securities, down from the current 5 percent threshold. H.R. 3921 would also require funds to report quarterly on 1 percent or larger ownership stakes in either equity or debt. It is not yet clear whether the House will consider the bill.
 - **Mutual Fund and ETF Rulemaking.** The SEC is considering rules that would impose greater restrictions on the ability of mutual funds and exchange-traded funds (ETFs) to use derivatives to gain leverage. Last year, SEC Chair White signaled that a key priority for the

November 25, 2015

SEC is to update its rules governing the mutual fund industry. The SEC is expected to take up the derivatives proposal on December 16, 2015.

- **SEC Regulatory Agenda: Universal Ballot and Incentive Compensation.** The White House released the fall 2015 regulatory agenda for the SEC that includes universal ballot and incentive compensation proposed rulemakings.
3. **Implications for CalPERS.** Ongoing SEC rulemaking and Congressional efforts to repeal or revise such rules, including the potential inclusion of regulatory reform measures in “must pass” legislative vehicles, could impact transparency necessary for informed allocation of capital by institutional investors, as well as corporate governance matters relevant to long term investment returns. Timely Senate confirmation of the two nominees to be SEC Commissioners will continue to be of interest because of the potential implications concerning the CalPERS SEC priorities.
 4. **CalPERS/Federal Representative Actions.** Ongoing monitoring of relevant developments including legislative proposals, and discussions with policymakers relating to the confirmation of the SEC nominees.
 5. **Recommendations for Next Steps.** We will continue to provide updates and recommend action by CalPERS as warranted, including preparing questions for the anticipated confirmation hearings of Lisa Fairfax and Hester Peirce.