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Federal Investment Policy Report for the CalPERS Board
February 2016

I. Securities

1. **Brief Summary of Issue.** Policy developments related to the Securities and Exchange Commission's ("SEC") budget and agenda, nominations and appointments, corporate governance, and capital formation.

2. **Developments Since Last Report.**
   - **Board Diversity.** SEC Chair Mary Jo White said that she directed SEC staff to review the agency's existing corporate disclosure regime and guidance, and to provide recommendations about whether the SEC should require public companies to provide additional information as to the racial or gender composition of their boards of directors. It is not yet clear when SEC staff will complete its review and make recommendations. In the coming days, Rep. Carolyn Maloney (D-NY) is expected to release a discussion draft of a bill related to gender diversity on corporate boards.
   - **SEC Budget Request.** The Obama Administration released the President's Fiscal Year 2017 Budget proposal. The proposal includes a request to increase the SEC's budget by 11% to $1.8 billion. In addition, the Administration proposes to double the SEC's budget from FY2015 levels by FY2021. Although it is unlikely that Congress will pass the President's Budget, the proposal places a marker on where the Administration views its priorities.
   - **SEC Agenda.** SEC Chair White stated that the SEC would be focused in 2016 on the following areas:
     - *Disclosure Regime*. Chair White said that the SEC staff will continue its review of disclosure effectiveness. She noted that the SEC will take steps to review Regulation S-K and the agency's industry guides. Chair White indicated that these efforts will complement statutory mandates that require the SEC to simplify and modernize its disclosure regime for public companies;
     - *Security-based Swaps*. Chair White indicated that the SEC will be focused on finalizing its remaining security-based swaps rules required under the Dodd-Frank Wall Street Reform and Consumer Protection Act so that the broader regulatory regime can become operational;
     - *Equity Market Structure*. Chair White expressed her expectation that the SEC will finalize a rule to enhance the oversight of active proprietary traders, including high-frequency traders. She said that the SEC will finalize a rule to substantially update regulations for alternative trading systems. Chair White expects the SEC to consider rules to improve order routing disclosures and risk controls on trading algorithms. Chair White also said that the SEC will advance a notice for comment related to the Consolidated Audit Trail; and
     - *Asset Management*. Chair White stated that the SEC will work to finalize rules proposed last year requiring open-end funds to monitor and manage derivatives-related risks and to impose limits on their use. She signaled that an SEC priority in this area would also be to advance proposals for transition planning and stress testing.

- **Nominations.** The Democratic members of the Senate Banking Committee sent a letter to Chairman Richard Shelby (R-AL) urging him to act quickly on the 16 nominations pending before the Committee, which include Lisa Fairfax (a Democrat) and Hester Peirce (a Republican) to be SEC Commissioners. Chairman Shelby had previously reiterated his position that the Committee will likely not consider any nominations before his March 1, 2016 primary election. Additionally, Committee Majority staff have indicated that a number of issues will likely play into any future nominations process, including the political dynamics surrounding the expected nomination of a replacement for Supreme Court Justice Antonin Scalia and concerns about how the SEC is allocating resources that have already been appropriated by Congress. Majority staff stated that Chairman Shelby's concerns about Obama Administration inaction on the nomination of a Federal Reserve Vice Chairman for Supervision could also impact the nominations process.
- **Appointments.** SEC Chair White said that the SEC should wait until it has a full panel of Commissioners before appointing someone to a five-year term to head of the Public Company Accounting Oversight Board ("PCAOB"). James Doty, whose term as Chairman expired in October 2015, continues to lead the PCAOB and has expressed interest in reappointment.
- **SEC-related Legislation.** The House passed the SEC-related bills below. No action to date has occurred in the Senate on the legislation.
  - H.R. 2187, the "Fair Investment Opportunities for Professional Experts Act." Introduced by Rep. David Schweikert (R-AZ), the bill would direct the SEC to modify its rules under Regulation D to consider a "natural person" an accredited investor, regardless of specified income and net worth requirements, so long as the person makes certain certifications to the issuer prior to the sale of securities. H.R. 2187 passed the House on February 1 by a vote of 347-8;
  - H.R. 4168, the "Small Business Capital Formation Enhancement Act." Introduced by Rep. Bruce Poliquin (R-ME), the bill would require the SEC to respond to findings and recommendations from the SEC's annual Government-Business Forum on Small Business Capital Formation. H.R. 4168 passed the House on February 1 by a vote of 390-1;
  - H.R. 3784, the "SEC Small Business Advocate Act of 2015." Introduced by Rep. John Carney (D-DE), the bill would create the "Office for Small Business Capital Formation" within the SEC to assist small businesses and investors and to facilitate capital formation. H.R. 3784 passed the House on February 1 by voice vote; and
  - H.R. 1675, the "Capital Markets Improvement Act of 2016." Introduced by Rep. Randy Hultgren (R-IL), the bill would direct the SEC to modify its rules to increase the threshold amount for requiring issuers to provide certain risk-related and financial disclosures related to compensatory benefit plans. The bill provides that the threshold would be increased from $5 million to $10 million and would thereafter adjust for inflation every five years. H.R. 1675 passed the House on February 3 by a vote of 265-159.

3. **Implications for CalPERS.**
   - Efforts by Rep. Maloney and the SEC to promote greater diversity on corporate boards allow publicly traded companies to benefit from a broader range of perspectives thereby adding value to corporations and shareowners;

- The SEC's FY2017 budget request and 2016 agenda provides CalPERS and other investors a better sense of the SEC's priorities and possible future activity which could impact investment returns; and
- The delayed consideration of key nominations and appointments could impact the ability of the SEC and PCAOB to advance their agendas.

4. **CalPERS/Federal Representative Actions.**
    - Spoke with Rep. Maloney's staff about her expected bill about gender diversity on corporate boards. We inquired about whether there would be interest in expanding the scope of the bill slightly beyond women to also include the phrase "and women of color." The staff said that Rep. Maloney is focused on gender diversity, but understands that others may want to add additional facets as the proposal moves forward;
    - Spoke with Financial Accounting Standards Board Chairman Russ Golden about CalPERS' interest in having a representative on the Financial Accounting Standards Advisory Council ("FASAC");
    - Provided substantive and technical input to the CalPERS letter in response to the Solicitation of Comments by Nasdaq about Shareholder Approval Rules;
    - Monitored closely the Fairfax and Peirce nomination process;
    - Monitored developments related to climate change following the U.S. Supreme Court's stay of the Obama Administration's Clean Power Plan ("CPP"); and
    - Monitored and reported on other relevant regulatory and legislative developments.

5. **Recommendations for Next Steps.** We will continue to:
    - Develop a strategy for continued engagement with Rep. Maloney's office on her gender diversity bill and to monitor closely the legislation's progress. We will work with her office and CalPERS staff to provide input, which Rep. Maloney's office welcomes, once a draft bill is released. In addition, we will simultaneously monitor SEC developments on board diversity;
    - Push for consideration of a CalPERS representative to serve on the FASAC;
    - Monitor the Senate Banking Committee's possible consideration of the pending nominees to be SEC Commissioners following Chairman Shelby's March 1 primary election;
    - Monitor possible responses to the Supreme Court's stay of the CPP; and
    - Provide updates on other legislative and regulatory issues and recommend action by CalPERS, as warranted.

II. Derivatives

1. **Brief Summary of Issue.** Policy developments related to the Commodity Futures Trading Commission's ("CFTC") budget, regulatory agenda and activities.

2. **Developments Since Last Report.**
    - **CFTC Budget Request.** The President's Fiscal Year 2017 Budget proposal includes a request to increase the CFTC's budget by 32 percent to $330 million. Additionally, the Administration proposes doubling the CFTC's budget from FY2015 levels by FY2021.
    - **CFTC Agenda.** CFTC Chairman Timothy Massad testified before the House Agriculture Committee about the CFTC's 2016 agenda. Below are highlights from the hearing.

  - *Relief for Commercial End-Users*. Chairman Massad detailed a number of CFTC rulemakings designed to provide relief to commercial end-users, including simplified recordkeeping requirements, determination of when volumetric optionality provisions are forward contracts, and relief for small banks and community development financial institutions;
  - *Position Limits*. Chairman Massad noted that the CFTC continues to work to finalize rules related to position limits, noting the particular concern about bona fide hedging. He also discussed the possibility of granting exchanges greater latitude with respect to allowing exemptions for non-enumerated hedges;
  - *U.S.-EC Clearing Equivalence*. Chairman Massad said that the much-anticipated agreement to harmonize European Union and U.S. regulations on central clearing counterparties ("CCPs") will not reduce safeguards for U.S. markets. He also stressed the strong need for cross-border regulatory oversight of CCPs;
  - *Harmonization with Regulations in Asia*. In noting the importance of Asian markets, Chairman Massad indicated that the CFTC is committed to working with regulators in Asia on regulatory harmonization; and
  - *Supplementary Leverage Ratio*. Chairman Massad said that the CFTC is closely watching the issue of large derivatives participants spinning off their swap desks as a result of Basel III supplementary leverage ratio requirements.
- **BHC Commodity Activities.** Senate Banking Committee Ranking Member Sherrod Brown (D-OH) sent a letter urging Federal Reserve Board Chair Janet Yellen to quickly take up rules to address the commodities activities of bank holding companies ("BHCs"). Ranking Member Brown indicated that senior Fed officials have previously signaled that the Fed would issue proposed rules on the matter in 2015, but it has not yet taken up the rulemaking.

3. **Implications for CalPERS.** Most notably**,** the CFTC's FY2017 budget request and 2016 agenda provides CalPERS and other derivatives market participants additional details about whether the CFTC will have the resources it needs to appropriately regulate the derivatives markets, which directly impacts market users who trade derivatives to increase shareowner value and mitigate investment risk.

4. **CalPERS/Federal Representative Actions.** Ongoing monitoring of relevant legislative and regulatory developments related to the CFTC.

5. **Recommendations for Next Steps.** We will provide updates and recommend action by CalPERS, as warranted, including commenting on relevant rulemakings and legislative proposals.

III. Housing Finance

1. **Brief Summary of Issue.** Policy developments related to housing finance, particularly issues regarding the secondary mortgage market.

2. **Developments Since Last Report.**

- **FY2017 Budget Proposal.** The President's Fiscal Year 2017 Budget proposal calls for a wind-down of Fannie Mae and Freddie Mac ("the GSEs") through comprehensive legislation such as the proposals introduced by Senators Bob Corker (R-TN) and Mark Warner (D-VA). However, the proposal does not anticipate changes to the existing sweep of GSE profits to the Treasury Department. The proposal estimates that the GSEs will provide the Treasury with roughly $151.5 billion of dividends over the next 10 years, which differs significantly from Congressional Budget Office estimate which is $20 billion in net payments to the Treasury in 2016 ($3 billion less than what the GSEs sent to Treasury in 2015). In addition, the proposal estimates $136 million will be provided to the Housing Trust Fund in FY 2017. The proposal is silent on the new Home Affordable Refinance Program or the Home Affordable Modification Program to replace the expiring authority.
- **FHFA Director Speech.** Federal Housing Finance Agency ("FHFA") Director Melvin Watt delivered a speech and took questions from the audience at the Bipartisan Policy Center, a Washington DC-based think-tank. His remarks were notable because, for the first time, he noted the specific risks associated with a future Fannie Mae or Freddie Mac draw on their remaining backstop authority at Treasury. At present time, Fannie Mae has $118 billion and Freddie Mac has $141 billion remaining available to them without further Congressional action. Director Watt's speech noted that future draws erode investor confidence in the ability of the GSEs to meet future obligations which could prompt a wholescale retreat from the market. Additionally, future draws could prompt a hasty Congressional response that could result in significant threats to the stability housing finance system. According to Director Watt, the solution is to enact comprehensive housing finance reform before the GSEs exhaust or approach exhaustion of their Treasury backstop. During the question and answer portion, Director Watt also expressed concerns about whether there is sufficient private investor capital to sustain the GSEs' current credit risk transfer levels and whether such capital will be available during an economic downturn. This statement captures the general view of the FHFA on the need for improvements to the existing credit risk transfer programs in order to attract new sources of durable investment.
- **CBO Outlook.** The Congressional Budget Office ("CBO") released its 10-year budget and economic outlook, which includes an estimate of the ongoing taxpayer costs of the GSEs. The CBO projects that the GSEs will need to draw an estimated $11 billion from the Treasury Department over the next 10 years, provided the conservatorship (which includes the remaining $258 billion Treasury bailout authority) remains in place. This is $7 billion less than the CBO previously forecast in its August 2015 budget projection. However, the estimated reduction does not appear to be a function of improving conditions at the GSEs. According to the CBO, the reduction is instead based on the CBO's expectation that the GSEs will "guarantee fewer mortgages over the next decade and that those mortgages will have lower associated fair-value costs." The CBO does not estimate that the GSEs will be sweeping additional profits into the Treasury past the end of this calendar year. As such, the CBO estimates that after the $20 billion the GSEs contribute this year, no further "profits" will be declared by the GSEs. The impact of the CBO study since its release has been measured. The forecast is expected to be used frequently as part of arguments in favor of ending conservatorship, as it is one of the few quantifiable estimates of the ongoing risks to taxpayers that the GSEs pose in their current state.

- **Alternative Dispute Resolution.** The FHFA announced that the GSEs have completed work on the long anticipated independent dispute resolution ("IDR") process to govern mortgage buyback disputes with lenders. This project was undertaken as part of a FHFA Scorecard requirement for the GSEs and fits within the work stream on improving the Representation and Warranty framework for the government guaranteed securities. Improvements to the Representation and Warranty Framework are expected to facilitate the growth of the GSE market by encouraging lenders to expand the credit box, remove unnecessary friction and expense caused by the uncertainty in the repurchase process, and eventually restore investor confidence in the value of the securities. Specific details about the process and procedures governing the IDR will be published in the GSEs' selling guides in the coming months. The process will be available for all loans acquired by the GSEs on or after January 1, 2016.

3. **Implications for CalPERS.** Changes to housing finance policy could affect market liquidity and stability thus impacting CalPERS investment returns.

4. **CalPERS/Federal Representative Actions.** Ongoing monitoring of relevant regulatory and legislative developments, including possible inclusion of provisions in appropriations legislation to mandate greater credit risk sharing between the GSEs and the private sector.

5. **Recommendations for Next Steps.** We will provide updates and recommend action by CalPERS, as warranted, including commenting on relevant rulemakings and legislative proposals.