

Federal Investments Report for CalPERS Board October 2016

I. Securities and Capital Markets

1. **Brief summary of issue.** Policy developments related to Securities and Exchange Commission (“SEC”) rulemakings, board diversity and “clawbacks” of executive compensation.
2. **Specific changes/developments since last report.**
 - **Board Diversity.** SEC Chair Mary Jo White authored an op-ed in the *American Banker* entitled “Board Diversity Is the Right Thing to Do.” In the op-ed, Chair White cited a number of studies and “mounting evidence” which indicate “that diversity in the boardroom is linked to better financial results for companies.” She also stated that, at her direction, the SEC staff is currently working on a recommendation to the SEC to amend the agency’s existing diversity disclosure rule to “require more specificity, including information on the race, gender and ethnicity of board members and nominees.”
 - **Clawbacks.** House Financial Services Committee Ranking Member Maxine Waters (D-CA) and 10 Committee Democrats sent a letter to the SEC and five other federal financial services regulatory agencies requesting them to strengthen their jointly issued Notice of Proposed Rulemaking related to incentive-based compensation arrangements at financial institutions. The letter expresses concerns about “the excessive level of discretion granted to covered institutions in terms of when the institution must exercise a ‘clawback’ provision - or a contractual clause that would trigger when the institution would withhold, reduce or recoup senior executive bonus pay.”
 - **Rulemakings.**
 - *Universal Proxies.* The SEC proposed a rule to require the use of universal proxy cards in all contested director elections. Chair White stated that the proposed rule would eliminate the “disparity” between voting by proxy and voting in person by requiring proxy contestants to provide shareowners with a universal proxy card that includes the names of both registrant and dissident nominees. After publication in the Federal Register, the public will have 60 days to comment on the proposed rule.
 - *Disclosure Effectiveness.* The SEC extended the public comment period from October 3, 2016 to November 2, 2016 for its Disclosure Update and Simplification proposed rule, which would amend certain SEC disclosure requirements “that have become redundant, duplicative, overlapping, outdated, or superseded,” given other SEC disclosure requirements.
 - *Fund Reporting and Risk Management.* The SEC adopted final rules on reporting and disclosure of information by registered investment companies and liquidity risk management by open-end funds, including mutual funds and exchange-traded funds. The rules will also allow mutual funds to utilize “swing pricing,” which is the process of adjusting the net asset value of fund shares so that purchasing or redeeming investors bear

part of the costs of entering or exiting the fund under certain circumstances. The rules will become effective on June 1, 2018 for fund complexes with \$1 billion or more in net assets, while fund complexes with less than \$1 billion in net assets will be required to comply with the rules on June 1, 2019.

- *Securities Clearing Agencies.* The SEC adopted a final rule to create additional standards for the operation and governance of securities clearing agencies that are systemically important or are involved in security-based swaps and other complex transactions. The rule will become effective on December 12, 2016, though affected securities clearing agencies will not be required to comply with the rule until April 11, 2017.
- *Settling Securities Transactions.* The SEC proposed a rule to reduce the standard settlement cycle for most broker-dealer securities transactions from three business days after the trade date to two business days after the trade date. The public will have until December 5, 2016 to comment on the proposed rule.

3. **Implications for CalPERS.**

- The SEC's efforts regarding board diversity could help CalPERS and other investors to determine whether corporate boards have the appropriate combination of qualities to manage risk, guard against "group-think" and achieve long-term sustainable returns for investors;
- A final rule on incentive-based compensation which assures that unearned compensation for executives at covered financial institutions is appropriately returned to shareowners could help to better align the interests of executive officers and shareowners;
- The SEC rulemaking on universal proxies could provide shareowners an efficient and cost-effective way to exercise their right to vote for any combination of director candidates in contested elections;
- The SEC's extension of the public comment period for the Disclosure Update and Simplification proposed rule provided CalPERS and other interested parties additional time to prepare and submit comments to help inform the SEC's efforts to ensure that disclosures furnish investors useful information to make informed investment and voting decisions; and
- The SEC's other rulemaking activity could improve protections for CalPERS and other investors by addressing certain risks in the securities markets.

4. **CalPERS/Federal Representative Actions.**

- Continued regulatory engagement efforts by facilitating follow up meetings for Anne Simpson at the SEC and by Ms. Simpson's attendance at a Public Company Accounting Oversight Board advisory group meeting;
- Worked on comment letter regarding the SEC's Disclosure Update and Simplification proposed rule; and
- Continued to monitor the pending nominations of Lisa Fairfax and Hester Peirce to be SEC Commissioners.

5. **Recommendations for Next Steps.** We will continue to:

- Monitor possible House Floor consideration of H.R. 5983, “Financial CHOICE Act,” which contains H.R. 5424, the “Investment Advisers Modernization Act of 2016;” H.R. 5311, the “Corporate Governance Reform and Transparency Act of 2016;” and H.R. 5429, the “SEC Regulatory Accountability Act;”
- Monitor and continue to engage on H.R. 4718, the “Gender Diversity in Corporate Leadership Act of 2016;”
- Monitor the SEC nominations process; and
- Provide updates on other legislative and regulatory issues and recommend action by CalPERS, as warranted.

II. *Derivatives Reform*

1. **Brief summary of issue.** Policy developments related to Commodity Futures Trading Commission (“CFTC”) nominations and rulemakings.

2. **Specific changes/developments since last report.**

- **Nominations.** The Senate Agriculture Committee approved by voice vote the nominations of Democrat Chris Brummer and Republican Brian Quintenz to be CFTC Commissioners to fill the two vacancies on the five-member board. The timing of full Senate consideration remains unclear, though it is possible that the nominations could be bundled together with the pending SEC nominees and considered *en bloc* on the Senate Floor before the end of the year.
- **Swaps.**
 - *Interest Rate Swaps.* The CFTC adopted a final rule related to the clearing of additional interest rate swaps subject to the CFTC’s jurisdiction. The requirements apply to nine currencies for fixed-to-floating swaps, and various subsets of those nine currencies in the other classes. The rule will become effective on December 13, 2016, though compliance with the new requirements will be “phased-in according to an implementation schedule based on when analogous clearing requirements have taken, or will take, effect in non-U.S. jurisdictions.”
 - *Swap Dealers.* The CFTC proposed a rule to define certain terms for purposes of applying the Commodity Exchange Act’s swap provisions on a cross-border basis. The proposed rule would establish a standard for determining when swap dealing transactions should be included as part of an entity’s calculation of whether to register as a swap dealer. The proposed rule would also require non-U.S. swap dealers and foreign branches of U.S. swap dealers to comply with applicable external business conduct standards. The proposed rule would apply the definitions to future CFTC cross-border rulemakings. The public will have until December 19, 2016 to comment on the proposed rule.
 - *De Minimis Exception.* The CFTC approved an order to maintain the *de minimis* threshold that requires swap dealers to register with the CFTC at \$8 billion until December 31, 2018. The threshold was scheduled to

decrease automatically from \$8 billion to \$3 billion in 2017 if the CFTC had not acted.

3. **Implications for CalPERS.**

- Advancement of the CFTC nominees could provide CalPERS and other derivatives market participants greater certainty regarding the CFTC's direction and regulatory agenda; and
- The CFTC's rulemaking activity could improve derivatives market stability and further efforts to harmonize international swaps regulations, which could benefit CalPERS and other market participants. In addition, the CFTC's decision to maintain the *de minimis* threshold will allow time for further consideration of a CFTC staff report on the *de minimis* threshold thereby providing greater certainty to market participants.

4. **CalPERS/Federal Representative Actions.** Ongoing monitoring of the CFTC nominations process as well as relevant regulatory and legislative developments related to the derivatives markets.

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. GSE Reform

1. **Brief summary of issue.** Policy developments related to Fannie Mae and Freddie Mac (the "GSEs").

2. **Specific changes/developments since last report.**

- **GSEs.** The Congressional Budget Office ("CBO") issued a report entitled "The Effects of Increasing Fannie Mae's and Freddie Mac's Capital." The report summarizes the budgetary effect of allowing the GSEs to each retain \$5 billion of profits annually over a ten year period. The report concludes that the retention of profits would lower the probability of a small draw on the Treasury and would create greater confidence in the mortgage market. Additionally, the report indicates that the CBO views the GSEs as federal entities and views the retention of profits as an intragovernmental transfer that would have no impact on the deficit. According to the CBO, under the Obama Administration's "budgetary treatment," the retention of profits would have a budgetary cost of \$85 billion over ten years.

3. **Implications for CalPERS.** The CBO's report provides CalPERS and other investors in mortgage-backed securities ("MSB") additional information about the potential impact of increasing the GSEs' capital on the prospective long-term value of MSB investments and on financial market stability broadly.

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

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