

Federal Investments Report for CalPERS Board October 2017

I. Securities and Capital Markets

1. **Brief summary of issue.** Policy developments related to the Securities and Exchange Commission (“SEC”) and the securities and capital markets.
2. **Specific changes/developments since last report.**
 - **Rulemaking.** The SEC proposed rules that would modernize and simplify certain disclosure requirements in Regulation S-K, as required by the Fixing America’s Surface Transportation (“FAST”) Act. Among other things, the proposed rules would revise the SEC’s disclosure regime by “eliminating the risk factor examples listed in the disclosure requirement and revising the description of property requirement to emphasize the materiality threshold.” The proposed rules would update SEC rules “to account for developments since their adoption or last amendment by eliminating certain requirements for undertakings in registration statements.” Additionally, the proposed rules would “[s]implify disclosure or the disclosure process” through revisions “to exhibit filing requirements and the related process for confidential treatment requests.” The proposed rules would also require “data tagging for items on the cover page of certain filings and the use of hyperlinks for information that is incorporated by reference and available on [the] EDGAR [filing system]” to improve access to information. The proposed rules are based on the SEC staff’s FAST Act Report. If approved, the public will have 60 days to comment on the proposed rules.
 - **Treasury Report.** The U.S. Department of the Treasury released a report entitled “A Financial System That Creates Economic Opportunities: Capital Markets” (the “Report”), the second in a series of reports about possible ways to reform the U.S. financial system. President Trump’s February 3, 2017 Executive Order 13772 requires Treasury to release the reports. A fact sheet about the Report is available here. Notably, Treasury makes the following recommendations in the Report: “further study and evaluation of proxy advisory firms, including regulatory responses to promote free market principles if appropriate”; substantially revise “[t]he \$2,000 holding requirement for shareholder proposals”; substantially revise the resubmission thresholds for repeat proposals from the existing thresholds of 3 percent, 6 percent, and 10 percent; and repeal Section 1502 (conflict minerals), Section 1503 (mine safety), Section 1504 (resource extraction), and Section 953(b) (pay ratio) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The Report recommends that the SEC: “continue its efforts, when reviewing company offering documents, to comment on whether the documents provide adequate disclosure of dual class stock and its effects on shareholder voting”; and “proceed with a proposal to amend Regulation S-K in a manner consistent with its staff’s recent recommendations, as required by the FAST Act.”

- **SEC Oversight.** SEC Chairman Jay Clayton testified at an oversight hearing held by the House Financial Services Committee (“HFSC”). He indicated that the following four areas require his attention with respect to the SEC’s operations: (1) cybersecurity, (2) retail investor protection, (3) market integrity, and (4) capital formation. Chairman Clayton also testified at an oversight hearing held by the Senate Banking Committee (“SBC”). In response to a line of questioning from Sen. Joe Donnelly (D-IN), Chairman Clayton said that he is willing to consider issues in the “area of employment” and stock buybacks as part of the SEC’s review of Regulation S-K. Chairman Clayton informed Sen. Tim Scott (R-SC) that the SEC should continually examine the issue of shareholder proposal resubmissions. Chairman Clayton informed Sen. Richard Shelby (R-AL) that cost-benefit analysis is an important part of rulemaking and that an SEC rule on the issue is a focus for him.
- **Investor Advisory Committee.** The SEC’s Investor Advisory Committee (“IAC”) held a meeting. The IAC discussed the implications of blockchain and other Distributed Ledger Technology on the securities markets, law school clinic advocacy efforts on behalf of retail investors, and electronic delivery of certain information to retail investors.
- **Wells Fargo.** The SBC held a hearing entitled “Wells Fargo: One Year Later,” at which Wells Fargo Chief Executive Officer and President Timothy J. Sloan testified. The hearing explored efforts in response to Wells Fargo’s announcements that millions of unauthorized accounts had been opened. Additionally, the Committee sought to address recent disclosures about the auto insurance scandal. The focus of most questions involved the need for change at the managerial level, forced arbitration provisions, and executive compensation. SBC Chairman Mike Crapo (R-ID) acknowledged that Wells Fargo has made changes in the year since but new circumstances merit scrutiny. Ranking Member Sherrod Brown (D-OH) called for stronger rules to protect consumers, specifically with respect to forced arbitration and debt collection, and reinforcement of the Consumer Financial Protection Bureau (“CFPB”).
- **Legislation.** Congress passed and the President signed into law legislation (S. 327, the “Fair Access to Investment Research Act of 2017”) to direct the SEC to create a safe harbor for certain publications or distributions of research reports by brokers or dealers distributing securities. The bill states that, if a broker dealer participates in the registered offering of a “covered investment fund’s” securities, the investment fund research report shall not be deemed to constitute an offer for sale nor an offer to sell a security. S. 327 was introduced by Sen. Dean Heller (R-NV).

In addition, the HFSC held a two-day markup of 22 bills, most of which are designed to try to provide regulatory relief to small banks, credit unions and emerging growth companies (“EGCs”). All of the bills were reported favorably to the full House. The Senate has not to date acted on the legislation. Of the 22 bills, the following are of particular note for CalPERS:

- H.R. 1585, the “Fair Investment Opportunities for Professional Experts Act.” Introduced by Rep. David Schweikert (R-AZ), the bill would amend the Securities Act of 1933 to modify the definition of accredited investor to include: (1) persons whose individual net worth, including their spouse’s, exceeds \$1 million (excluding the value of their primary residence); (2) persons with an individual income greater than \$200,000, or joint income with one’s spouse more than \$300,000; (3) persons with a current securities-related license; and (4) persons whom the SEC determines have demonstrable education or job experience to qualify as possessing professional subject-matter knowledge concerning a particular investment. The bill was approved 58-2.
- H.R. 1645, the “Fostering Innovation Act of 2017.” Introduced by Rep. Kyrsten Sinema (D-AZ), the bill would extend the exemption under Section 404(b) of the Sarbanes-Oxley Act to comply with the law for EGC that would otherwise lose their exempt status at the end of the five-year period that applies under current law. The bill would also extend the exemption until the earlier of ten years following the date the EGC went public, the end of the fiscal year in which the EGC’s average gross revenues surpassed \$50 million, or when the EGC qualifies with the SEC as a large accelerated filer (\$700 million public float - the number of shares that are able to trade freely between investors that are not controlled by corporate officers or promoters). The bill was approved 46-14.
- H.R. 3857, the “PASS Act of 2017.” Introduced by Rep. Ann Wagner (R-MO), the bill would repeal the Department of Labor’s conflict of interest - fiduciary duty rule. The bill would require broker-dealers to act in the retail customer’s best interest when providing a recommendation, which must reflect: (a) reasonable diligence and (b) the reasonable care, skill, and prudence that a broker-dealer would exercise based on the customer’s investment profile. The bill would require broker-dealers to provide increased disclosures to the customer before the broker-dealer may buy a securities product on behalf of that customer, including disclosures regarding the type and scope of services the broker-dealer provides, the standard of conduct that applies to the relationship, the types of compensation the broker-dealer receives, and any material conflict of interest. The bill was approved 34-26.
- H.R. 3903, the “Encouraging Public Offerings Act of 2017.” Introduced by Rep. Ted Budd (R-NC), the bill would amend the Securities Act of 1933 to expand to all public companies certain provisions of the JOBS Act that previously only applied to EGCs. In particular, the bill would allow issuers to submit to the SEC for confidential review (before publicly filing) draft registration statements for Initial Public Offerings (“IPOs”) and for follow-on offerings within one year of the IPO. The bill would allow all companies to “test the waters” prior to filing an IPO (e.g., meet with certain institutional buyers and other institutional accredited investors to determine investor interest in the offering). The bill was approved 60-0.

- H.R. 3911, the “Risk-Based Credit Examination Act.” Introduced by Rep. Wagner, the bill would amend the Securities Exchange Act of 1934 to allow the SEC to conduct risk-based examinations of the Nationally Recognized Statistical Rating Organizations. The bill was approved 60-0.
- H.R. 3948, the “Protection of Source Code Act.” Introduced by Rep. Sean Duffy (R-WI), the bill would amend the Securities Act of 1933 to require the SEC to first issue a subpoena prior to compelling persons to produce or provide to the SEC algorithmic trading source code or related intellectual property. The bill was approved 46-14.
- H.R. 3973, the “Market Data Protection Act of 2017.” Introduced by Rep. Warren Davidson (R-OH), the bill would amend the Securities Exchange Act of 1934 to require that the SEC, Financial Industry Regulatory Authority, and the operator of the Consolidated Audit Trail (“CAT”), to develop internal risk control mechanisms to protect and govern the storage of market data, all market data sharing agreements, and all academic research using market data. The bill would end market data reporting to the CAT until the operator of the CAT puts in place these internal risk controls. The bill was approved 59-1.
- H.R. 3072, the “Bureau of Consumer Financial Protection Examination and Reporting Threshold Act of 2017.” Introduced by Rep. Wm. Lacy Clay (D-MO), the bill would increase the examination threshold that brings insured depository institutions or insured credit unions under supervision by the CFPB from assets of \$10 billion or more to assets of \$50 billion or more. The bill would increase from \$10 billion to \$50 billion the threshold at which insured depository institutions or insured credit unions are subject to CFPB reporting requirements. The bill was approved 39-21.
- H.R. 3312, the “Systemic Risk Designation Improvement Act of 2017.” Introduced by Rep. Blaine Luetkemeyer (R-MO), the bill would amend the Dodd-Frank Act to remove the \$50 billion asset threshold used to designate firms as “systemically important financial institutions.” The bill also would authorize the Financial Stability Oversight Council to subject bank holding companies to enhanced supervision and prudential standards by the Federal Reserve Board, if the institutions have been identified as global systemically important bank. The bill was approved 47-12.

3. Implications for CalPERS.

- The SEC’s rulemaking on Regulation S-K could further the goal of achieving an effective disclosure regime that furnishes CalPERS and other investors the information needed to make informed investment decisions;
- The Treasury report could impact the thinking of Senators who are currently working on a bipartisan basis to craft legislation to spur economic growth, which could have substantial implications for the securities markets and investors;

- Efforts to reform federal financial regulations through stand-alone legislation could impact the SEC’s ability to foster fair, orderly and efficient securities markets and the ability of CalPERS to protect shareowner rights; and
 - Chairman Clayton’s testimony could provide CalPERS and other capital market participants additional certainty about the SEC’s regulatory direction.
4. **CalPERS/Federal Representative Actions.**
 - Conducted ongoing monitoring of other regulatory and legislative developments related to the securities markets.
 5. **Recommendations for Next Steps.** We will continue to 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 the Commodity Futures Trading Commission (“CFTC”) and the derivatives markets.
2. **Specific changes/developments since last report.**
 - **Treasury Report.** As discussed above, the Report released by Treasury also contained a number of recommendations concerning the derivatives markets. Treasury recommends that: “[t]he CFTC and the SEC undertake and give high priority to a joint effort to review their respective rulemakings in each key Title VII [of the Dodd-Frank Act] reform area”; [t]he “CFTC and the SEC provide clarity around the cross-border scope of their regulations and make their rules compatible with non-U.S. jurisdictions where possible to avoid market fragmentation, redundancies, undue complexity, and conflicts of law”; “U.S. regulators take steps to harmonize their margin requirements for uncleared swaps domestically and cooperate with non-U.S. jurisdictions that have implemented the Basel Committee on Banking Supervision-International Organization of Securities Commissions framework to promote a level playing field for U.S. firms”; “[r]egulators properly balance the post-crisis goal of moving more derivatives into central clearing with appropriately tailored and targeted capital requirements”; “[t]he CFTC maintain the swap dealer *de minimis* registration threshold at \$8 billion, and establish that any future changes to the threshold will be subject to a formal rulemaking and public comment process”; and “[t]he CFTC complete its position limits rules, as contemplated by its statutory mandate, with a focus on detecting and deterring market manipulation and other fraudulent behavior.”
 - **Cross-border Harmonization.** CFTC Chairman J. Christopher Giancarlo announced that the CFTC has agreed with the European Commission (“EC”) on “a common approach regarding derivatives trading platform equivalence... [to] ensure that European firms and U.S. firms can trade on each other’s registered derivatives platforms.” He also announced that the EC “has adopted an equivalence decision for the CFTC’s margin framework for uncleared derivatives” and that the CFTC has concluded that “the [European Union (‘EU’)] margin rules are comparable to the CFTC rules.”

- **Chairman Giancarlo Testimony.** The House Agriculture Committee held a hearing about the CFTC’s agenda for 2017, at which Chairman Giancarlo testified. In his testimony, Chairman Giancarlo said that he and Chairman Clayton have set up a “Chairman to Chairman working group that meets regularly” to discuss harmonization of their respective agency rules. He said that the CFTC’s Project Keep It Simple Stupid (or “KISS”) is not “about identifying rules for repeal,” but rather it is about “taking our existing rules and applying them in ways that are simpler, less costly and less burdensome.” He said that he remains a “supporter” of the swaps reforms contained in Title VII of the Dodd-Frank Act. He indicated that he looks forward to resolving such “outstanding regulatory issues” as the *de minimis* exception and a position limits rule.
 - **De Minimis Threshold.** In Chairman Giancarlo’s testimony described above, he also indicated that the CFTC’s swap dealer *de minimis* registration threshold will remain at \$8 billion through 2019, instead of falling to \$3 billion at the end of 2018 as scheduled. Further, he indicated that he intends to work to resolve the issue with his fellow CFTC Commissioners during the first half of 2018. In a statement, Commissioner Rostin (“Russ”) Behnam stated, “[i]nstead of kicking this critical issue into the future again, the [CFTC] should take further action now or let the current rule take effect.” Commissioner Brian Quintenz indicated in a statement that “it is well past time to address this issue head-on, finalize a rational and effective threshold, and provide the market with clarity.”
3. **Implications for CalPERS.**
 - Chairman Giancarlo’s Congressional testimony and announcement about the *de minimis* registration threshold could provide CalPERS and other derivatives market participants greater certainty about the CFTC’s regulatory direction; and
 - Cross-border harmonization of derivatives rules will allow EU firms to rely on substituted compliance with EU margin rules to satisfy CFTC requirements thereby facilitating more consistent regulatory treatment of derivatives market activities.
 4. **CalPERS/Federal Representative Actions.**
 - Conducted ongoing monitoring of other 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 concerning the Department of Housing and Urban Development (“HUD”), Federal Housing Administration (“FHA”), Federal Housing Finance Agency (“FHFA”), Fannie Mae and Freddie Mac (the “GSEs”) and the secondary mortgage market.
2. **Specific changes/developments since last report.**

- **Nominations.** The SBC held a hearing to consider the nomination of Brian Montgomery to be an Assistant Secretary at HUD and Commissioner of the FHA. Mr. Montgomery is currently Vice Chairman of The Collingwood Group, a company focused on business consulting, risk management and compliance in the financial services industry. He was previously Assistant Secretary/FHA Commissioner and Acting Secretary of HUD.
 - **GSE Reform Working Group.** Rep. Emanuel Cleaver (D-MO) signaled that he and Rep. Sean Duffy (R-WI) will form a bipartisan working group on GSE reform. Reps. Duffy and Cleaver are Chairman and Ranking Member of the House Financial Services Housing and Insurance Subcommittee, respectively. Chairman Crapo, Ranking Member Brown and Sens. Bob Corker (R-TN) and Mark Warner (D-VA) are currently crafting bipartisan GSE reform legislation in the Senate. Sens. Corker and Warner authored bipartisan reform legislation in a prior term of Congress. Following Sen. Corker’s announcement that he will not run for re-election in 2018, Rep. Cleaver expressed his opinion that “[w]e’ve got to do something before [Sen. Corker] leaves.”
 - **Congressional Testimony.** FHFA Director Melvin L. Watt testified at a hearing held by the HFSC. During the hearing, HFSC Chairman Jeb Hensarling (R-TX) said, “[c]learly it is time – in fact it is well past time – for Congress to enact sustainable housing finance reform with private capital at its center.” In response to a line of questioning from Rep. Mike Capuano (D-MA), Director Watt said that the FHFA has been having “constructive conversations” with Treasury to help prevent another draw by the GSEs on the Treasury line of credit. In addition, HUD Secretary Ben Carson testified at a different hearing held by the HFSC. In his testimony, Secretary Carson stated that “housing finance reform should be built on shared goals of ensuring a well-functioning housing finance system that provides access for creditworthy borrowers that are ready to own a home, expands the role of the private sector, and reduces overall taxpayer exposure.”
3. **Implications for CalPERS.**
 - Senate confirmation of Mr. Montgomery could provide further certainty about the direction of the FHA and on the future of housing finance reform, given his expected role in the discussions on the issue; and
 - Efforts to reform the GSEs could affect market liquidity, mortgage interest rates and long-term investment returns for CalPERS shareowners.
 4. **CalPERS/Federal Representative Actions.**
 - Conducted ongoing monitoring of other regulatory and legislative developments related to housing finance reform, the GSEs and other secondary mortgage market activities.
 5. **Recommendations for Next Steps.** We will provide updates and recommend action by CalPERS, as warranted, including commenting on relevant rulemakings and legislative proposals.