

***Investment Policy Statement,
Objectives, and Guidelines***

of

***the Commonwealth of Pennsylvania
Public School Employees' Retirement Board***

**As adopted by
the Board of Trustees
on May 1, 2009**

**INVESTMENT POLICY STATEMENT, OBJECTIVES, AND GUIDELINES
FOR
THE PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT BOARD**

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I. Definitions

- A. **Asset Allocation:** the decision of selecting appropriate weights between broad asset class categories (Private Markets, bonds, cash, commodities, stocks, etc.) in order to produce the desired Risk and return profile for a total fund portfolio. The Asset Allocation decision is the most important investment strategy issue for an investment program.
- B. **Barclays Capital Aggregate Bond Index:** an index of U.S. government securities, mortgage-backed securities, asset-backed securities, and corporate securities to simulate the universe of bonds in the U.S. fixed income market. The maturity of the bonds in the index is over one year.
- C. **Barclays Capital Global Aggregate Bond Index:** an index of U.S. and non-U.S. government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the global fixed income market. The maturity of the bonds in the index is over one year.
- D. **Barclays Capital Global High Yield Index:** an index of U.S. and non-U.S. below investment grade fixed income securities.
- E. **Barclays Capital Multiverse Index:** a broad-based index that provides a measure of the global fixed income market. The index represents the union of the Lehman Brothers Global Aggregate Bond Index and the Lehman Brothers Global High Yield Index.
- F. **Barclays Capital U.S. High Yield Index:** an index of U.S. below investment grade fixed income securities.
- G. **Barclays Capital U.S. TIPS Index (Series-L):** an index of U.S. Treasury Inflation Protection Securities (TIPS) to simulate the universe of U.S. TIPS.
- H. **Barclays Capital U.S. Universal Index:** an index that covers U.S. dollar denominated, taxable fixed income securities that are rated either investment grade or below investment grade.
- I. **Benchmark:** a standard against which the performance of a security, index, or portfolio can be measured.
- J. **Board:** The Pennsylvania Public School Employees' Retirement Board.
- K. **CIO:** Chief Investment Officer.
- L. **Commingled Fund:** a type of fund consisting of assets from several accounts that are blended together. Sometimes called a pooled fund.

- M. **Commission Recapture Agent:** the party responsible for administering the Commission Recapture Program on behalf of a fund. See **Exhibit A** for the System's current Commission Recapture Agent.
- N. **Commission Recapture Program:** a program whereby a pension fund receives "credits" resulting from transactions incurred by the fund's investment managers on their behalf. These transactions may be from commissions (equities) or spreads (fixed income).
- O. **Correlation:** a statistical measure of how two securities or portfolios move in relation to each other. Correlations can range from negative 1 (perfect negative Correlation) to positive 1 (perfect positive Correlation). A Correlation of 0 indicates that the movements of securities or portfolios are completely random.
- P. **Counterparty:** the entity that is in the opposing position to a transaction.
- Q. **Commonwealth:** Commonwealth of Pennsylvania.
- R. **Custodian Bank:** an institution that keeps custody of stock certificates, fixed income securities, and other assets. The System's Custodian Bank has a contract with the State Treasurer, the legal custodian of the System's assets. See **Exhibit A** for the System's current Custodian Bank.
- S. **DEPM:** Director of External Public Markets, Risk & Compliance.
- T. **DJ/AIG Commodity Index:** a rolling commodities index composed of futures contracts on 19 physical commodities traded on U.S. exchanges. The index serves as a liquid and diversified benchmark for the commodities asset class.
- U. **DJ Wilshire Real Estate Securities Index:** a market capitalization-weighted index composed of publicly traded real estate securities, such as Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs).
- V. **Derivative:** a financial contract, such as a Forward, Futures, Option, or Swap Contract, whose value depends on the performance of any one or more underlying securities or assets (such as bonds, stocks, financial commodities, currencies, etc.), or index of securities or assets. Derivatives may be purchased through a national exchange or through a direct OTC arrangement with a Counterparty.
- W. **Diversification:** dividing investments among a variety of securities and/or funds with different Risk, reward, and Correlation statistics so as to minimize Unsystematic Risk.
- X. **EMPM:** Emerging Manager Program Manager.
- Y. **DPMRE:** Director of Private Markets & Real Estate.
- Z. **EPRA:** acronym for the European Public Real Estate Association. EPRA is a common interest group that promotes, develops, and represents the European public real estate sector.

- AA. **Exchange Traded Funds (ETFs):** trust-issued receipts that represent beneficial ownership of a specified group of stocks. ETFs allow the holder to benefit from the ownership of the stocks or bonds in a particular country, industry, sector, group, etc. ETFs include HOLDRS, iShares, SPDRs, etc.
- BB. **External Portfolio Manager:** an individual or firm with whom the Board has a contract to manage an investment portfolio.
- CC. **Forward Contract:** non-standardized contract between two Counterparties for a deliverable commodity or instrument which conveys the obligation to make or take delivery of that commodity or instrument at a future point in time at a specific price.
- DD. **Frictional Cash:** cash that is held by a portfolio that is not benchmarked to the asset allocation category of cash. For example, cash held in an S&P 500 index fund would create a performance variance vs. the S&P 500 index.
- EE. **FTSE:** a company co-owned by The Financial Times and the London Stock Exchange that specializes in index calculation.
- FF. **FTSE EPRA/NAREIT Global Real Estate Index:** a free-float index designed to track the performance of listed real estate companies and real estate investment trusts worldwide.
- GG. **Futures Contract:** a standardized contract for a deliverable commodity or instrument, which conveys the obligation to make or take delivery of that commodity or instrument at a future point in time at a specified price.
- HH. **Hard-dollar Fees:** fees or payments paid to brokerage firms in return for their services.
- II. **Hedge:** a transaction to reduce the Risk of adverse price movements in an asset. Normally, a Hedge consists of taking an offsetting position in a related security, such as a Futures Contract.
- JJ. **HOLDRS:** acronym for Holding Company Depositary Receipts. HOLDRS are EFTs issued by Merrill Lynch & Co., Inc.
- KK. **IAASP:** Investment Accounting Application Service Provider. This represents the outside service provider retained by the Board to provide investment accounting and technology services to the System. See **Exhibit A** for the System's current IAASP.
- LL. **IA:** Investment Accounting.
- MM. **Information Ratio:** a measure of Risk-adjusted excess return used to evaluate active management strategies. The information ratio is calculated by dividing a portfolio's excess return by excess Risk.
- NN. **Initial Margin:** the percentage of the purchase price of a security (that can be purchased on Margin) that the investor must pay for with his or her own cash or marginable securities.

- OO. **Internal Portfolio Manager:** an individual employed by the Board who manages an investment portfolio.
- PP. **Investment Consultant:** a third-party firm retained by the Board to provide advice on various investment issues ranging from general advice to advice on specialty asset classes (real estate or Private Markets). See **Exhibit A** for the System's current Investment Consultants. The System's real estate and Alternative Investment Investment Consultants are hereafter referred to as specialty Investment Consultants.
- QQ. **Investment Guidelines:** an outline of policy or conduct expected in the management of an investment portfolio.
- RR. **Investment Office Directors:** includes the Director of Private Markets & Real Estate, the Director of Equities, the Director of External Public Markets, Risk & Compliance, the Director of Fixed Income, and the Director of Trading.
- SS. **Investment Manager:** includes both Internal Portfolio Managers and External Portfolio Managers.
- TT. **IOS:** Investment Office Staff. IOS includes all individuals in the CIO's department.
- UU. **ISDA:** International Swaps and Derivatives Association. ISDA is an association created by the private negotiated derivatives market that represents participating parties. This association helps to improve the private negotiated derivatives market by identifying and reducing Risks in the market.
- VV. **iShares:** ETFs issued by Barclays Global Investors.
- WW. **Long-term:** in the context of the System, long-term represents perpetuity.
- XX. **Margin:** the amount of cash or securities deposited by a customer as a percentage of the current market value of the securities held in an account.
- YY. **Mark-to-Market:** the valuation of a security or other instrument, transaction, or portfolio of the same to current market prices.
- ZZ. **Market Risk:** The variability of returns that is due to macroeconomic factors that affect all risky assets. Because it affects all risky assets, it cannot be eliminated through Diversification. Market Risk is also called Systematic Risk.
- AAA. **Modern Portfolio Theory (MPT):** theory of trust investment and portfolio management that looks more toward the portfolio as a whole and less toward the prudence of a single investment in the portfolio. MPT assumes that investors: a. use a portfolio approach to evaluate investments; b. are Risk-adverse; c. behave rationally; and, d. make unbiased forecasts.
- BBB. **MSCI ACW Investable Market Index:** acronym for Morgan Stanley Capital International All-Country World Investable Market Index. It is an index of global equity securities used to simulate the universe of large cap, mid cap, and small cap stocks in the global equity market, including the U.S., developed and emerging markets.

- CCC. **NAREIT:** acronym for the National Association of Real Estate Investment Trusts. NAREIT is a trade association that represents U.S. Real Estate Investment Trusts (REITs) and publicly traded real estate companies worldwide.
- DDD. **NCREIF Index:** acronym for National Council of Real Estate Investment Fiduciaries Index. It is an index of real estate partnership portfolios used to simulate the universe of real estate partnerships.
- EEE. **Operational Risk:** risks for improper monitoring of positions, bad pricing, inadequate software, system failures or human error.
- FFF. **Option Contract:** an instrument that conveys the right to the buyer, but not the obligation, to buy or sell a deliverable instrument at a specific price.
- GGG. **OTC:** acronym for over-the-counter. OTC securities, derivatives, and other financial instruments are traded in some context other than on a formal or centralized exchange such as the New York Stock Exchange, Chicago Mercantile Exchange, etc.
- HHH. **Outside Service Providers:** External Portfolio Managers and Investment Consultants.
- III. **Policy Index:** a Benchmark used by the Board to measure the investment performance of the System.
- JJJ. **PMEIM Program:** acronym for the Public Market Emerging Investment Manager Program. This is a program established by the Board to assist emerging investment management firms with positive Risk adjusted returns grow and provide a source of potential managers for the main fund. The PMEIM Program is administered by the EMPM.
- KKK. **Private Markets (formerly Alternative Investments):** Investments in limited partnerships, limited liability companies, and other entities that invest in private debt, private equity, or venture capital.
- LLL. **Prudent Expert Standard:** the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are expert in such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital.
- MMM. **Prudent Investor Standard:** as articulated in the Board's enabling legislation, the Public School Employees' Retirement Code, "the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital." 24 Pa. C.S. §8521(a).

The Prudent Investor Standard requires a trustee to act prudently and with caution, discretion, loyalty, and care but does not restrict the assets in which the Board can invest. Under the Prudent Investor Standard, which recognizes Modern Portfolio

Theory, the Board's investment and management decisions respecting individual assets shall be considered in the context of the portfolio as a whole and as part of an overall investment strategy, and not in isolation. No specific investment or course of action, taken alone, shall be considered inherently prudent or imprudent. This standard recognizes the trade-off between Risk and return.

NNN. **PTRES:** acronym for publicly traded real estate securities.

OOO. **Risk:** the chance that an investment's actual return or market value will be different than expected. This includes the possibility of losing some or all of the original investment. Risk is usually measured by calculating the Standard Deviation of the historical returns or average returns of a specific investment. Risk can also represent the failure of a Counterparty to fulfill its obligations.

PPP. **Securities Lending Program:** an investment program designed to generate incremental income from lending securities to qualified borrowers who provide collateral in exchange for the right to use the securities.

QQQ. **Soft-dollar Arrangements:** a means of paying brokerage firms for their services through commission revenue, as opposed to through normal payments (Hard-dollar fees).

RRR. **SPDRs:** acronym for Standard & Poor's Depository Receipts; also commonly known as "spiders." Each share of a spider contains one-tenth of the S&P 500 Index. SPDRs ETFs.

SSS. **Staff:** employees of the System.

TTT. **Standard Deviation:** a measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the standard deviation. Standard Deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility.

UUU. **State Treasurer:** the Treasurer of the Commonwealth of Pennsylvania.

VVV. **Swap Contract:** a contract where the parties agree to exchange the cash flows of the underlying assets in amounts and times specified in the contract.

WWW. **System:** The Pennsylvania Public School Employees' Retirement System.

XXX. **Systematic Risk:** see definition of Market Risk.

YYY. **Tracking Error:** a measure of relative Risk that compares a portfolio's returns to an alternative standard the investor has selected, such as a passive index. The tracking error measure incorporates the effects of all active investment decisions and is defined as the volatility or standard deviation of excess returns.

ZZZ. **Trading Desk:** represents the group of individuals employed by the Board that generally trades equity securities for investment managers managing U.S. equity

portfolios for the Board but can also trade non-U.S. equity securities, futures, options, forwards, etc.

AAAA. **Unit Investment Trust:** a registered trust in which a fixed portfolio of income-producing securities are purchased and held to maturity.

BBBB. **Unsystematic Risk:** Risk that is unique to an asset, derived from its particular characteristics. Unsystematic Risk can be eliminated in a diversified portfolio.

CCCC. **Variation Margin:** a variable payment that is made by clearing members to their respective clearing houses based upon the price movements of the futures contracts that these members hold. Variation Margin is paid by clearing members on a daily or intraday basis in order to reduce the Counterparty credit risk exposure created by carrying Future Contracts.

DDDD. **Venture Economics Median:** benchmark for Private Markets that represents the median performance of the venture capital/private equity industry listed in the Investment Benchmarks Reports on Venture Capital and Buy-outs produced by Venture Economics.

II. Investment Policy Statement

Purpose of Investment Policy Statement

The purpose of this Investment Policy Statement (the “Policy”) is to provide clear guidelines for the management of the assets by or on behalf of the Board. This Policy establishes policies and guidelines for the investment practices of the Board. The Board shall endeavor to review and revise the Policy annually and make changes as necessary. The Policy outlines objectives, goals, restrictions, and responsibilities to assure that:

1. The Board, Staff, Investment Consultants, Investment Managers, and the State Treasurer clearly understand the objectives and policies of the Board and the System;
2. The Investment Managers shall be given guidance and limitations on the investment of the System’s assets; and,
3. The Board has a meaningful basis for evaluating the investment performance of individual Investment Managers, as well as for evaluating overall success in meeting its objectives.

The System shall at all times be managed in accordance with all applicable state and federal laws, rules, and regulations.

The Board

The Board was established on July 18, 1917, under the provisions of Pamphlet Law 1043, No. 343. It was most recently established by state law as an independent administrative board of the Commonwealth, which acts as a board of trustees, exercising exclusive control and management of the System, including the investment of its assets. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania. The Board administers a governmental cost-share multiple-employer plan that provides retirement allowances and other benefits to members. As part of the Board’s function, it has the responsibility for the implementation of investment policy, Asset Allocation, retention of Investment Managers, and ongoing supervision of investment results. The Board is also responsible for establishing policies with respect to fees and commissions for all Investment Consultants, Investment Managers, and agents to the plan assets. The Board has fifteen members including the Commonwealth’s Secretary of Education, the State Treasurer, the Executive Director of the Pennsylvania School Boards Association, two members appointed by the Governor, six elected members (three from among the System’s certified members, one from among the System’s non-certified members, one from among the System’s annuitants, and one from among school board members in Pennsylvania), two members from the Senate, and two members from the House of Representatives.

Mission of Board

The Board and the employees of the System serve the members and stakeholders of the System by:

- Prudently investing the assets of the System;
- Maintaining a financially sound System;

- Providing timely and accurate payment of benefits;
- Clearly communicating members' and employers' rights and responsibilities; and
- Effectively managing the resources of the System.

Fiduciary Standard

As fiduciaries, the members of the Board and Staff must act solely in the interests of the members of the System and for the exclusive benefit of the System's members. In performance of their duties, the members of the Board and Staff delegated with investment authority shall be held to the Prudent Investor Standard.

Outside Service Providers shall be held to the Prudent Expert Standard. The Prudent Expert Standard shall be reflected in the System's contracts with Outside Service Providers.

Investment Objectives

The overall objective of the System is to provide benefits to its members through a carefully planned and well-executed investment program.

- A. **Return Objectives** – The overall return objective is to realize a return sufficient to achieve funding adequacy on an inflation-adjusted basis. Funding adequacy is achieved when the actuarial market value of assets is at least equal to the System's projected benefit obligations. The System has a return objective of meeting or exceeding the actuarial rate (currently 8.5%) over the long-term. In addition, the Board has the following broad objectives:

1. The assets of the System shall be invested to maximize the returns for the level of Risk taken; and,
2. The System shall strive to achieve a return that exceeds the Policy Index.

B. **Risk Objectives**

1. The assets of the System shall be diversified to minimize the Risk of losses within any one asset class, investment type, industry or sector exposure, maturity date, or geographic location. Failure to do so could seriously impair the System's ability to achieve its funding and long-term investment goals and objectives; and,
2. The System's assets shall be invested so that the probability of investment losses (as measured by the Policy Index) in excess of 12% in any one year is no greater than 2.5% (or two standard deviations below the expected return).

C. **Constraints**

1. The assets of the System shall maintain adequate liquidity to meet required benefit payments to the System's beneficiaries.
2. The System's assets shall be invested in a manner that is consistent with the System's long-term investment horizon.

3. As a tax-exempt investor, the System's assets may be invested without distinction between returns generated from income and returns generated from capital gains.

Identification of Duties and Investment Responsibilities

The Board relies on IOS, IA, and Outside Service Providers in executing its investment functions. Each entity's role as fiduciary are identified below to ensure clear lines of communication, operational efficiency, and accountability in all aspects of the System's operation.

- **The Board:** The Board has the responsibility of managing the investment process and setting the Asset Allocation. The Board, through the Finance Committee with the assistance of Staff, contracts with External Portfolio Managers and Investment Consultants, monitors the performance of investments; ensures funds are invested in accordance with Board policies; studies, recommends, and implements policy and operational procedures that will enhance the investment program of the System; and ensures that proper internal controls are developed to safeguard the assets of the System.
- **IOS:** IOS is responsible for the day-to-day administration of the investment operations of the System in accordance with Board policies as well as for reporting to the Board. Major items included in the day-to-day administration are working with and monitoring the performance of the outside service providers; developing, implementing, and monitoring the Asset Allocation plan; direct investment in and trading of securities; recommendation and oversight of Investment Managers; reporting of investment results, including both performance and assets held; oversight of the proxy voting process; and governmental and regulatory reporting.
- **IA:** IA is responsible for processing, monitoring, and recording all investment transactions as well as supporting the day-to-day administration of the investment operations of the System in accordance with Board policies. IA prepares daily, monthly and quarterly reports and analysis for IOS and the Board on cash management, the net asset value of the System, Asset Allocation, Investment Manager fees and securities class action recoveries. IA is also responsible for various regulatory and government reporting of investments, including the System's Comprehensive Annual Financial Report. In addition, IA is the primary liaison with the State Treasurer's office on daily cash movement and treasury operations, oversees the Custodian Bank and the IAASP and interfaces with the Investment Managers, brokers and Investment Consultants on investment accounting and operational issues.
- **Investment Consultants:** Investment Consultants shall have the responsibility of assisting the Board and Staff in managing the investment process. The Board shall determine their specific responsibilities, which shall be set forth in their respective contracts with the Board.
- **State Treasurer:** The State Treasurer is the legal custodian of not only the System's assets but also those of the entire Commonwealth. The State Treasurer has subcontracted the custodian function to the Custodian Bank for the Commonwealth, including the System. The Custodian Bank holds all cash and securities (except for those held in partnerships, commingled funds, mutual funds, etc.), and regularly accounts for these holdings to the System.
- **Investment Managers:** All External Investment Managers shall be retained pursuant to written contracts. Investment Managers shall construct and manage investment portfolios consistent with the investment philosophy and disciplines for which the Board retained them

and their specific investment guidelines, all of which shall be set forth in their Investment Objectives and Guidelines with the Board. They shall buy and sell securities and modify the asset mix within their stated guidelines. The guidelines shall be subject to periodic amendment at the discretion of the Board and IOS. The Board believes that investment decisions are best made when not restricted by excessive procedure. Therefore, full discretion shall be delegated to the Investment Managers to carry out investment policy within their stated guidelines, as amended. Investment Managers shall comply with the specific limitations, guidelines, and philosophies stated herein and within the Addendum(s) to the Investment Objectives and Guidelines assigned to them, or as expressed in written amendments thereto. Investment Managers are expected to communicate, in writing, any developments that may affect the System's portfolio to Staff within five business days of occurrence. Examples of such events include, but are not limited to, the following:

- A significant change in the Investment Manager's investment philosophy;
- A change in the ownership structure of the firm;
- A loss of one or more key portfolio management personnel; and/or,
- Any occurrence that might adversely impact the management, professionalism, integrity, or financial position of the firm.

Asset Allocation

The Board believes that the level of Risk assumed by the System is largely determined by the Board's strategic Asset Allocation plan. The Board, in determining its long-term Asset Allocation, shall take the following factors into consideration:

- The System's investment time horizon;
- The demographics of the plan participants and beneficiaries;
- The cash flow requirements of the System;
- The actuarial assumptions approved by the Board;
- The funded status of the System;
- The Board's willingness and ability to take Risk; and,
- The employers' (Commonwealth and school districts) financial strength.

In establishing the Asset Allocation for the System, the Board considers capital market expectations for expected return, volatility, and asset class correlations as prepared by its general Investment Consultant. The current long-term, top-down Asset Allocation targets of the Board, based on the market value of the System's assets, is attached at **Exhibit B**.

Monthly, IA will prepare the Moneyline Report of Investment Asset Values and post on the Board's secure intranet web site. The Moneyline Report will present the month-end Asset Allocation of the System as compared to the Asset Allocation plan targets approved by the Board.

Policy Index

The current Policy Index is attached at **Exhibit C**.

Asset Class Rebalancing

The Board is responsible for the System's Asset Allocation decisions and will meet to review target allocations at least annually or more frequently as needed based on market conditions.

Until such time as the Board changes allocations, it will be necessary to periodically rebalance the portfolio as a result of market value fluctuations. The Board delegates to the CIO the duty of implementing such rebalancing. IOS will review the Asset Allocation on a monthly basis. Any asset class that falls outside the policy ranges described in **Exhibit B** will be rebalanced to within the policy range within a reasonable and prudent period of time by the CIO. The CIO has the authority to tactically allocate between asset classes as long as the amount allocated to each asset class is within the policy ranges described in **Exhibit B**.

Asset Allocation rebalancing may be accomplished by using the cash markets or through the use of Derivative securities. Derivative securities may only be used to implement asset allocation adjustments. When feasible, index funds will be used to facilitate rebalancing to minimize the transition time frame and costs to implement. Any account may be increased or decreased to achieve the rebalancing objective based on the judgment of the CIO. When a rebalancing is required, consideration will be given to the unique characteristics of each asset class, the degree of over/underweight, liquidity characteristics, current market conditions, and any other relevant considerations to ensure prudence and care.

The purpose of this structured rebalancing policy is to provide a disciplined approach to Asset Allocation. All rebalancings shall be reported to the Board at its next scheduled meeting.

Investment Structure

Annually, the general Investment Consultant shall provide the Board with the investment structure of the System. The investment structure includes, among other things, the Investment Managers approved by the Board as well as the pro forma targets as a percentage of the total fund by Investment Manager. These target percentages represent the portion of the total fund allocated to each Investment Manager for investment management. IOS shall, when able and within a reasonable period of time, implement the investment structure within the target ranges noted in **Exhibit D**. The CIO shall have discretion in the timing of such implementation and have discretion in implementing changes, taking into account transactions costs and liquidity.

IOS shall endeavor to invest any underweight in private real estate in public market real estate securities until such a time as the money is allocated to and invested by a private real estate fund. In addition, IOS shall invest any underweight in private markets (private debt, private equity, and venture capital), in public market equities until the money is allocated to and invested by an alternative investment fund. Should either private real estate or private markets be overweight versus target, then IOS shall reduce the allocation to the public market real estate securities/public market equities allocation.

Index Portfolio Rebalancing

Throughout the year, the index portfolios need to rebalance positions to minimize the tracking error of the portfolios. At times, rebalancing may lead to inefficient buying and selling of securities. To minimize the costs associated with rebalancing the portfolios, the CIO shall have discretion to fund the internally managed index accounts, as necessary, with additional cash consistent with the Asset Allocation.

Cash

The System currently has cash outflows (primarily benefit payments) in excess of cash inflows (primarily contributions and investment income received). In addition, Frictional Cash is minimized in the System through the commingling of the cash in various investment portfolios and reallocation of excess cash through the Asset Allocation plan. Therefore, there will be various points in time where the CIO will need to increase cash through allocation reductions to meet the liquidity needs of the System. As such, the CIO shall have the discretion to raise cash from any of the public market equity or fixed income portfolios as he considers prudent. The CIO shall consider the current positioning of the Asset Allocation, liquidity, cost, etc. in determining where to raise cash.

Allocation Approval Process

For internal control purposes, all Investment Manager fundings, including but not limited to those for new Investment Managers, private market investment managers' capital calls, index portfolio rebalancing, termination of Investment Managers, and cash flow related activities initiated by the CIO, will be reviewed, audited for compliance with the Investment Policy Statement, Objectives, and Guidelines, and approved by IA. Once approved, IA will process and execute all allocations with the State Treasurer and its Custodian Bank. Monthly, the IA will prepare and post on the Board's secure intranet web site a report of allocation changes that will detail each allocation increase and decrease.

Selection of Investment Managers

The Board delegates to IOS the authority to conduct Investment Manager searches with the assistance of the appropriate Investment Consultant. All Investment Managers, excluding PMEIM Program Investment Managers, shall be approved by the Board prior to execution of a contract. The following are the selection procedures for public market Investment Managers, private market Investment Managers (partnerships), and PMEIM Program Investment Managers.

Public Markets excluding the PMEIM Program

A search for a public market equity, fixed income, commodity, real estate, or other Investment Manager is not conducted until there is a need for an Investment Manager. The following are potential reasons for an Investment Manager search:

- Termination of an existing Investment Manager due to organizational/personnel changes, change in investment process/philosophy, and/or poor performance;
- Expansion of an allocation to an asset class or,
- Addition of a new asset class.

The following are the steps taken to conduct the search:

- The DEPM shall be responsible for public market Investment Manager searches.
- IOS shall leverage the appropriate Investment Consultant's research to develop a list of potential Investment Managers to interview for potential inclusion in the System in those areas where sufficient data exists. At times, IOS and the appropriate Investment Consultant will use other means of searching for Investment Managers to meet the needs of the System because a comprehensive database of Investment Managers may not exist (i.e., portable alpha Investment Managers, commodity Investment Managers, etc.).

- IOS and the appropriate Investment Consultant shall review an initial list of Investment Managers. The list shall be narrowed to a manageable number based on the number of Investment Managers needed (short list).
- The Investment Consultant shall prepare a presentation book including a profile of each Investment Manager on the short list, historical performance, the appropriate Investment Consultant's ranking or score, if any, assets under management of the Firm and product, inception date of the firm and product, style/size comparison (if applicable), and correlations of excess returns vs. other potential Investment Managers and existing Investment Managers in the specific mandate.
- Investment Managers on the short list shall be interviewed by IOS (CIO, DEPM, Senior and/or Mid Level Investment Analyst, and normally at least one of the other Investment Office Directors based on the mandate) and the appropriate Investment Consultant. Based on the qualitative and quantitative information gathered prior to and during the interview, IOS and the appropriate Investment Consultant come to a consensus as to which Investment Manager(s) best compliments the System's investment program. The factors which may be considered include, but not be limited to:
 - Organizational stability
 - Investment approach and process
 - Competence of staff
 - Expected returns and correlations
 - Integrity
 - Quality of reporting
- The DEPM shall enter into fee and contract negotiations with each selected Investment Manager. If DEPM is unable to negotiate an acceptable contract, the next best choice is selected, and this process continues until the Investment Manager and the System come to an agreement on the terms. Once an agreement is reached, the selected Investment Manager(s) is recommended to the Finance Committee and Board for approval within the investment structure.

Private Markets, including Private Debt, Private Equity, Venture Capital and Real Estate

IOS monitors new private market funds coming to the market. The following steps are taken to hire a new Private Market Investment Manager:

- IOS is contacted regarding new fund or receives a referral from the specialty Investment Consultant.
- IOS will perform an initial screening to evaluate the investment opportunity, including:
 - Size of fund
 - Strategy of fund
 - Fund's deal terms
- If IOS or the specialty Investment Consultant wishes to continue the evaluation, IOS shall arrange to meet with the general partner of the fund under consideration.
- If IOS wants to move forward with more in-depth due diligence, the general partner may be required to sign a Model Letter of Understanding (**Exhibit E**) that outlines the following:
 - Specific deal terms required by the Finance Committee;
 - Indemnification contract language; and,
 - Sample side letter language.
- The prospective general partner shall also complete an investment questionnaire for IOS and the specialty Investment Consultant that includes:
 - Performance history of the organization and partners

- Fund strategy
- History of the organization and partners
- References
- The prospective general partner shall also meet with the appropriate specialty Investment Consultant.
- Following both meetings, IOS and the specialty Investment Consultant shall make a determination about whether to proceed.
- If it is decided to proceed, then (1) the specialty Investment Consultant shall perform detailed due diligence into the prospective fund, (2) IOS may have a follow-up meeting with the general partner, and (3) IOS will complete its due diligence, including a meeting at the general partner's office.
- The goal of the due diligence process is to determine whether to recommend that the System invest in the prospective fund based on the composition of the investment team (including ethical evaluation), verification of past performance, analysis of the process, style, strategy, etc. All factors evaluated will be used in assessing the potential strengths and weaknesses of the prospective fund.
- If IOS decides to invest in the prospective fund, then DPMRE enters contract negotiations with the general partner.
- Assuming acceptable terms are agreed upon, DPMRE will make a presentation to the Finance Committee. The Finance Committee and the Board are required to approve the investment prior executing a contract with the prospective fund.

PMEIM Program

The PMEIM Program is administered internally by the EMPM. The PMEIM Program Policy has been approved by the Board in a separate document entitled "Public Market Emerging Investment Manager Program Policy of The Commonwealth of Pennsylvania Public School Employees' Retirement System" (**Exhibit F**).

Prospective firms are brought to the attention of the EMPM through other institutional investors, financial publications, word-of-mouth, contact directly by the Investment Manager, or the results of screening a database. The EMPM will start the due diligence process on firms that meet the System's required characteristics and qualifications as follows:

- Contact the Investment Manager to have it give a presentation of its product;
- Evaluate prospective Investment Manager based on philosophy, methodology, past performance, ethical standards; and,
- Perform an on-site visit at the Investment Manager's place of business.

The administration of this Program is more fully documented in Exhibit F.

Termination of Investment Managers

The CIO, after receiving concurrence from the Executive Director and the Chair of the Finance Committee and notifying the Board, has authority to terminate an Investment Manager, except a PMEIM Program Investment Manager, for any reason, including, but not limited to, poor performance, personnel changes, organizational changes, deviation from their investment style, compliance violations, and the need for liquidity. Notwithstanding the preceding, any individual Board member has the right to request to have the termination decision listed on the

agenda of the next scheduled Finance Committee meeting. Pending said Finance Committee meeting, no action shall be taken by the CIO to terminate the Investment Manager. The CIO shall inform the Board of the status of the termination at the next scheduled Board meeting. Upon the termination of any Investment Manager, the CIO has the authority to reinvest the proceeds from the terminated Investment Manager with any remaining Investment Manager(s) previously approved by the Board and/or keep the proceeds in the System's cash management account consistent with the Asset Allocation.

PMEIM Program Investment Managers may be terminated for any reason, including, but not limited to, poor performance, personnel changes, organizational changes, deviation from their investment style, and compliance violations. In addition, PMEIM Program Investment Managers whose assets under management exceed \$3 billion are no longer eligible for participation in the PMEIM Program and must either be terminated or, with the approval of the DEPM, CIO, Finance Committee, Board, and General Investment Consultant may be transferred out of the PMEIM Program to the main investment program. The EMPM must receive approval to terminate a PMEIM Program Investment Manager from the DPMRE, the CIO, and the Executive Director.

Securities Lending Program

The State Treasurer has entered into a contract with the Custodian Bank to manage a Securities Lending Program on behalf of the Commonwealth. The Board approves participation in the Custodian Bank's Securities Lending Program subject to the Board approved portfolio specific guidelines, Addendum Z - Securities Lending Objectives and Guidelines.

Derivatives Policy

Objective and Investment Standards

The Board's objectives for using derivatives are to manage and/or reduce the Risk of the overall investment portfolio in an efficient manner. Through the use of derivatives, the complex Risks that are bound together in traditional cash market investments can be separated and managed independently. If used appropriately, derivative contracts can be a productive component of an investor's portfolio by reducing Risk and/or providing a cheaper, more efficient way to obtain market exposure or to expand the opportunity set in which qualified investment managers seek to add value.

Permitted Uses of Derivatives

Consistent with the objectives set out in this Policy, derivative applications may be used by Investment Managers engaged to manage the asset allocation and/or separate account portfolios to:

- Implement investment strategies in a lower cost and more efficient manner;
- Implement overlay strategies in search of alpha (i.e. excess return);
- Replicate the return of a passive benchmark (i.e. market return);
- Efficiently manage the Asset Allocation by altering the System's market exposure (Systematic or Market Risk) in lieu of trading the underlying cash market securities through purchases or short sales, or both, of appropriate derivatives;
- Construct portfolios with Risk and return characteristics that could not be created with cash market securities consistent with the objectives in this Policy;

- Hedge and control Risks so that the System's Risk-return profile is more closely aligned with the System's targeted Risk-return profile through purchases or short sales, or both, of appropriate derivatives; or,
- Facilitate transition trading when holdings must be rebalanced or reallocated among permissible investments as a result of changes to applicable benchmark indexes or policy changes.

The only authorized uses of derivative transactions are:

- to support efficient portfolio management and/or reduction of Risk in portfolios; or,
- to implement investment strategies authorized by this Policy more effectively and at a lower cost than would be possible in the cash market.

Investment Managers may not engage in derivative applications that are inconsistent with their general and portfolio specific guidelines, as amended.

Prohibited Uses of Derivatives

Derivatives may not be used for any activity whose primary purpose is speculation while materially increasing the Risk to the System. Derivatives are considered speculative if their uses have no material relation to the general and portfolio specific guidelines, as amended, and their use is not reasonably and substantially intended to produce efficiency in portfolio management and/or reduce market, credit, or liquidity Risks applicable to the portfolio. Derivatives may not be used for circumventing limitations or restrictions imposed by this Policy or applicable regulatory requirements.

The term of an OTC derivative instrument may not exceed two years unless otherwise specified below.

Risks Associated with Derivatives

The following are some of the major Risks associated with Derivatives and the controls the System uses to mitigate those Risks:

a) Counterparty Risk

⇒ Controls – will vary by whether the contract is exchange traded or OTC as follows:

- Exchange Traded Derivatives (Futures and Options) – the counterparty Risk of a listed Futures/Options Contract lies with the futures clearing merchant and the clearinghouse of the exchange where the contract is traded. Each clearinghouse is guaranteed by its members. A default would require a number of back-to-back bankruptcies by a number of the members of the exchange.
 - Controls – upon entering into a Futures Contract, collateral is deposited with the broker, in the System's name, in accordance with the Initial Margin requirements of the broker. Futures Contracts are Marked-to-Market daily by the board of trade or exchange on which they are traded. The resulting gain/loss is received/paid the following day until the contract expires or is closed out (this daily process is referred to as Variation Margin). Additionally, the System trades only on highly reputable exchanges.

- OTC Derivatives – the Counterparty Risk of an OTC derivative lies directly with the Counterparty. OTC Derivatives consist primarily of Swap and Forward Contracts but can also include Option Contracts. Swap Contracts are primarily used by the System to gain exposure to the equity markets. Forward Contracts primarily entered into by the System include currency forward agreements and mortgage-backed securities forward agreements also known as TBAs (to-be-announced mortgage pools issued by Freddie Mac, Fannie Mae, and Ginnie Mae).
 - Controls for Swap Contracts:
 - ✓ All OTC derivative swap transactions will be governed by an ISDA Master Agreement and any other appropriate agreements signed by the System and the Counterparty.
 - ✓ The System requires that all ISDA Master Agreements and any other appropriate agreements entered into by or on behalf of the System be negotiated and signed by authorized System staff as approved by the Board.
 - ✓ All transactions must be subject to established ISDA Master Agreements and have full documentation of all legal obligations of the System under each transaction.
 - ✓ Each Counterparty used by the System must have credit ratings of at least A-/A3 or better.
 - ✓ All ISDA Master Agreements entered into by the System shall provide for netting of positions at the portfolio level.
 - ✓ All obligations created by Swap Contracts shall be limited to the portfolio where the obligation was created and shall not exceed the Investment Manager's authority.
 - ✓ To mitigate Counterparty credit Risk, the System will require the use of collateral arrangements with the following terms at the portfolio level:
 - ❖ Each contract is required to be Marked-to-Market daily;
 - ❖ Thresholds (maximum uncollateralized dollar exposure) shall be no greater than \$1 million per Counterparty;
 - ❖ Minimum transfer amounts shall be no greater than \$1 million per Counterparty; and
 - ❖ Custody of collateral backing swap agreements shall be held at the System's custodian bank or at a prime broker designated by the System.
 - Controls for other than Swap Contracts:
 - ✓ Each Counterparty used by the System must have credit ratings of at least A-/A3 or better.
 - ✓ All Forward Contracts will have a term of no greater than six months.

b) Market Risk

⇒ Control: only permit the use of derivatives consistent with the objectives defined in the Policy.

c) Operational Risk

⇒ Control: the System will hire qualified individuals, adequately staff the investment operations, including the front office, middle office, and back office, and procure the appropriate technology in order to minimize the controllable Operational Risks. Areas encompassed by this Risk include the Investment Office, the Investment Accounting Division, and the Legal Office. Investment Managers shall have sufficient internal controls prior to being permitted to enter into derivative contracts.

Scope of Policy

Except where specifically noted, this Policy applies to all derivatives transactions executed by IOS and Investment Managers. This Policy does not apply to registered or private investment funds, including commingled funds.

III. Investment Manager Objectives and Guidelines

The following represent general portfolio guidelines that are applicable to all Investment Manager separate account portfolios.

Adherence to Investment Style

Each Investment Manager is expected to adhere to the investment philosophy and style that was presented to the Board, IOS, and Investment Consultant at the time of its hiring and as set forth in its contract with the Board.

Measurement Process

Passive Investment Managers

Each portfolio shall be measured on a total return basis (yield plus appreciation). On a one-year and three-year annualized rolling return basis, results will be judged, net of all manager fees and transaction costs, versus a pre-established performance band based on the liquidity, volatility, and difficulty in replicating of the benchmark assigned.

Active Investment Managers

Each portfolio shall be measured on a total return basis (yield plus appreciation). On a one-year and three-year annualized rolling return basis, results will be judged as follows, net of all manager fees and transaction costs:

- A. Relative performance versus a relevant peer Investment Manager universe selected by IOS:
 - 1. Median and above Acceptable
 - 2. Below median Unacceptable; Watch Closely

- B. Information Ratio (excess return/excess Risk vs. the Benchmark assigned to the Investment Manager) as follows:
 - 1. Information Ratio \geq assigned level¹ Acceptable
 - 2. Information Ratio $<$ assigned level¹ Unacceptable; Watch Closely

Quarterly performance shall be evaluated to monitor progress toward attainment of these goals. It is understood that there are likely to be short-term periods during which performance deviates from market indexes. During such times, greater emphasis shall be placed on performance comparisons with Investment Managers employing similar styles. The IOS, the CIO, and the Investment Consultant shall monitor firms experiencing poor short-term performance or disruption at the organizational level. These include changes of ownership, significant personnel changes and substantial deviation from their investment style.

Interest, Dividend, and Other Miscellaneous Income Earned

¹ The assigned level will be provided in the addendum to the guidelines for each mandate.

Interest, dividend, and other miscellaneous income earned each month by the Investment Manager will be swept (“Income Sweep”) from each account one month and one business day after the month in which it was earned (for example, income earned in December will be swept from the accounts on the first business day in February). The amount to be swept as determined by the Custodian Bank monthly through the reconciliation process between the Custodian Bank and/or the System is reviewed and approved by IA. The Investment Managers shall be responsible for having sufficient cash available to meet the Income Sweep requirements. The CIO has discretion to waive this provision for any Investment Manager.

Investment Management Fees

Investment management fees shall be submitted to the System on a quarterly basis. Fees will be paid directly out of the Investment Manager’s account as administered by IA. Investment Managers are responsible for having sufficient cash available to cover the amount of the quarterly investment management fee. The CIO shall have discretion to waive this provision for any Investment Manager. On a quarterly basis, IA will prepare a report of investment management fees to be posted on the Board’s secure intranet web site.

Brokerage Commissions

Equity Investment Managers

Brokerage commissions are a plan asset and, as such, shall be monitored by the System. The Investment Managers are obligated to seek best execution on all trades.

Investment Managers trading U.S. equities shall be required to execute trades through the System’s Trading Desk unless otherwise approved by the CIO.

U.S. equity Investment Managers not trading through the System’s Trading Desk and non-U.S. equity Investment Managers shall be required to participate in the System’s commission recapture program. The System has retained a Commission Recapture Agent to manage this program and the Investment Managers are required to send monthly reports to the Commission Recapture Agent indicating the commissions directed to each broker, including non-designated brokers. Best efforts must be made to execute trades through commission recapture brokers for initial and subsequent fundings and partial liquidations. **All commissions generated through the System’s approved commission recapture brokers are considered to be directed trades and should be so communicated by the Investment Manager to the broker.**

Commissions recaptured by the System shall be remitted to the restricted revenue account held by the State Treasurer on behalf of the System. The monies in this account shall be used to support the investment operations of the System. All expenditures from the account shall follow the rules established for any other expenditure of the System.

The Investment Managers are permitted to enter into Soft-dollar Arrangements for commissions not executed through the System’s Trading Desk or through the System’s approved commission recapture brokers provided that:

- Such arrangements are consistent with applicable law and best execution obligations;

- All amounts paid for brokerage and related services are reasonable; and,
- The Investment Manager submits an annual report to the System within six weeks of the end of each calendar year that contains:
 1. A list of each soft dollar broker with which the Investment Manager executes trades on behalf of the System and, for each such broker, the amount of soft dollars that have accrued to the Investment Manager as a result of trading activity on behalf of the System;
 2. An item-by-item listing of the expenditure of said soft dollars, with the cost associated with each expenditure;
 3. A description of the manner in which the cost of each such expenditure was allocated to the System; and,
 4. An explanation of how the System benefited for each such expenditure.

Fixed Income Investment Managers

Fixed income Investment Managers shall use their best efforts to execute trades and all new issue designations with the System's Commission Recapture Agent. National Association of Securities Dealers' rule 2740, "Selling Concessions, Discounts, and Other Allowances," regarding new issue designations preclude the remittance of selling concessions recaptured to be remitted to the System. Those selling concessions, however, may be used to pay for qualified investment research.

Proxies

All proxies shall be voted by the System in accordance with the Board's U.S. and Non-U.S. Proxy Voting Guidelines. Should the Investment Manager have a strongly held position on specific proxy issues as they relate to holdings in the portfolio managed by it, the Investment Manager should state its positions in writing to the CIO for consideration.

The Board, through the Corporate Governance Committee of the Board, has adopted a separate U.S. Proxy Voting Policy and a separate Non-U.S. Proxy Voting Policy. These policies are carried out by a third-party proxy-voting agent that has been retained by the Board and are located at the following web link: www.psers.state.pa.us/invest/invest.htm.

Class Actions

The Board or its appointed delegate shall be responsible for the filing of all necessary papers or documentation regarding class action settlements proposed or received as a result of holdings in the System. Investment Managers shall promptly forward any papers or documentation received by it to the Board regarding class actions.

Mutual/Commingled Funds and Unit Investment Trusts

Mutual funds (both closed and open-ended), Commingled Funds, Unit Investment Trusts, ETFs, or any equivalent fund type funds are prohibited investment vehicles without the written permission of the CIO.

Market-Driven Breaches

The System recognizes that the portfolio will always be subject to fluctuations in market value. Market-driven breaches of the guidelines (breaches that occur due to market fluctuations) shall not be considered a violation of the guidelines as long as the Investment Manager corrects these breaches within 10 business days of the breach (unless an extended period of time is granted elsewhere in the guidelines and/or written permission is received from the CIO providing an extended period of time). Active breaches (breaches that occur due to purchase and sale activity) shall be considered a violation of the guidelines and must be corrected as soon as prudently possible. Consistent patterns of active breaches may be cause for termination.

Insurance

External Investment Managers managing separate accounts are required to carry both errors and omissions (E&O) insurance and fidelity bond coverage. The insurer from which the Investment Manager obtains coverage must have a financial strength rating of A- or better and a financial size category rating of VII or higher, both by A.M. Best. The fidelity bond must name the Board as either a loss-payee or additional insured party. Both the E&O coverage and fidelity bond must provide that the Board be given at least 30 days notice prior to any cancellation or policy change. Insurance coverage may be in the name of the Investment Manager's parent organization as long as the Investment Manager is named in that policy or bond as an insured party.

The Investment Manager is required to maintain E&O coverage amounting to at least 1 percent of assets under management for the System. The Investment Manager must maintain a fidelity bond coverage amounting to at least 0.5 percent of cumulative assets under management for the System. The minimum amount of E&O and fidelity bond coverage shall be \$500,000. The maximum deductible on both the Errors and Omissions coverage and the Fidelity Bond must be either: (a) no greater than \$500,000 if the Investment Manager has less than \$1 billion in assets under management and no greater than \$1 million if the Investment Manager has \$1 billion or more in assets under management, or (b) no greater than 10 percent of the Investment Manager's retained earnings (equity) as disclosed in the Investment Manager's annual audited balance sheet which must be provided to the Board annually in a timely fashion.

Derivatives

Unless written permission is obtained from the CIO or unless otherwise specified in the portfolio specific guidelines, derivative investments, including but not limited to, forwards, futures, interest only and principal only strips, options, structured notes, swaps, etc. are prohibited.

Communications

Written and/or oral reports must be supplied by the Investment Manager, in sufficient detail and with supporting commentary, so the CIO and DEPM are apprised of status and any changes in philosophy or investment strategy. Periodic meetings shall be held with the Investment Manager to discuss performance results, economic outlook, investment strategy, organizational changes and other pertinent matters.

The Board requires continual awareness of the System's activity and position, both absolute and relative. To accomplish this, the following shall be provided by the public market Investment Managers:

A. Promptly -

1. When requested by the Staff - a complete listing of all holdings, pending trades, transaction history and any additional related information.
2. Notification to the CIO, the DEPM, and the Compliance Officer of any compliance exceptions as they relate to these policies and applicable amendments.
3. Notification to the CIO, DEPM, and the Compliance Officer of any material personnel or organizational changes that could affect the management of the System's portfolio.

B. Daily - To the Custodian Bank, IA, and the IAASP:

1. On a daily basis all trades, including foreign currency exchange transactions, must be sent via e-mail to IA and IAASP in a Microsoft Excel-readable formatted file. The trade file should include, but not be limited to, the following: Custodian Account Number, Buy/Sell indicator, Broker Identification Code, Broker Name, Trade Date, Settle Date, Ticker, CUSIP, Security Description, Shares, Price, Principal, Commission, Fees, and Net Amount (all monetary amounts to be provided in base and local currency).

C. On an as needed basis - information for the State Treasurer's staff to perform their pre-audit function.

D. Monthly - To the Investment Consultant, CIO, DEPM, Compliance Officer, and IA:

1. End of month valuations in accordance with the System's requested format or, if PSERS does not request a specific format, the Investment Manager's usual format, containing cost and market valuations by security (including FX forward and spot positions), holdings by sector segmentation, transaction summary register (purchases, sales, dividends/interest, other distributions/receipts), and holdings by country, with cost and market valuation in local currency and in U.S. dollar terms. These reports shall be in electronic form (i.e. Microsoft Excel, Adobe Acrobat files, etc.) and shall be sent via e-mail to the System and the System's general or designated Investment Consultant unless written permission is received from the CIO to send reports other than by e-mail.

E. Monthly - To the DEPM, Compliance Officer, and IA:

1. Total commissions incurred by broker, and segregated by those in the Commission Recapture Program and those not in the Commission Recapture Program.
2. Performance reports for the month, quarter-to-date, year-to-date, rolling one-year, rolling three-year, and portfolio-to-date (since inception) as well as the

benchmark performance figures for each of those periods. Information is to be sent via e-mail to a designated Internet address within five business days from the end of each month.

F. Monthly - To Custodian Bank, IA, and IAASP:

1. Each Investment Manager is required to complete a month-end reconciliation of its account balance to the balance per the Custodian Bank. A reconciliation template in the form of a Microsoft Excel spreadsheet shall be sent via e-mail from the Custodian Bank not later than the seventh business day of the following month. The Investment Manager is required to transmit its reconciliation via e-mail to the Custodian Bank and IA by the third business day (not later than the tenth business day of the following month) following receipt of the reconciliation template. The Custodian Bank in those cases where there are variances between the Investment Manager and the Custodian Bank above a certain threshold and the Custodian Bank is deemed to be incorrect will issue a letter restating the month-end net asset value of the account. Restated net asset values will be used for performance and billing purposes.
2. The final or closed account holdings and amounts, including cash and pending trades, must be sent via e-mail to IA and IAASP in a Microsoft Excel-readable formatted file. The holdings spreadsheet should include at least the following headings and information: custodian account number, CUSIP, security description, shares, base cost, local cost, base market value, and local market value.

G. Quarterly - To the DEPM and Compliance Officer:

1. Provide written confirmation of adherence to these Investment Objectives and Guidelines in the format provided by the System within 30 days after the end of each calendar quarter. Consistent patterns of failing to complete the compliance certifications within 30 days after the end of each calendar quarter may be cause for termination.
2. Provide a detailed attribution of returns for the portfolio for the previous quarter and year versus the established benchmark for the portfolio within 30 days after the end of each calendar quarter.
3. Provide a quarterly report showing the dispersion of the System's returns versus a representative composite return for the quarter, rolling one-year, rolling three-year, and since inception in a format provided by the DEPM within 45 days after the end of each calendar quarter.

H. Annually - The Investment Manager is expected to visit IOS in Harrisburg to provide an update on the firm, provide a portfolio overview, staff changes, etc.

I. Other - To the Investment Consultant, CIO, and DEPM:

Immediate telephone and/or letter advice should be forthcoming from the Investment Manager when information of an important nature, such as a change in ownership of the advisor, a change in the portfolio manager(s) managing the

System's portfolio, or unusual market activity (oil embargo, monetary crisis, etc.) that is causing, or may cause, material impact on the System.

Portfolio Specific Guidelines

The portfolio specific guidelines are included as an addendum to this document. The following are the various addendums (by letter and by name), one of which will be assigned to each separate account portfolio or program:

U.S. Equity Guidelines

- A U.S. STYLE-ORIENTED LARGE CAP EQUITIES
- B U.S. MASTER LIMITED PARTNERSHIP INDEX PORTFOLIOS
- C U.S. STYLE-ORIENTED SMALL CAP EQUITIES
- C1 U.S. MICRO CAP EQUITIES
- D ** not used **
- E INTERNALLY MANAGED INDEXED EQUITY PORTFOLIOS
- E1 INTERNALLY MANAGED ALPHA GENERATION PROGRAM
- E2 EQUITY REBALANCING PROGRAM
- F EQUITY OPTION PROGRAM – INCREMENTAL RETURN
- G ** not used **

Commodity Guidelines

- H FULL DISCRETION COMMODITY PROGRAM
- H1 ENHANCED COMMODITY INDEX PROGRAM

U.S. Fixed Income Guidelines

- I U.S. CORE PLUS FIXED INCOME PORTFOLIOS
- J FIXED INCOME REBALANCING PROGRAM
- K U.S. HIGH YIELD FIXED INCOME PORTFOLIOS
- K1 MORTGAGE AND ASSET BACKED SECURITIES PORTFOLIO
- L TREASURY INFLATION PROTECTION SECURITIES PORTFOLIOS

Non-U.S. Equity Guidelines

- M NON-U.S. EQUITIES
- N NON-U.S. SMALL CAP EQUITIES
- O EMERGING MARKETS EQUITIES
- O1 EMERGING MARKETS SMALL CAP EQUITIES

Currency Guidelines

- P ACTIVE CURRENCY HEDGING OVERLAY PROGRAM
- P1 ACTIVE CURRENCY PROGRAM

Global Fixed Income Guidelines

- Q GLOBAL CORE PLUS FIXED INCOME PORTFOLIOS
- Q1 ABSOLUTE RETURN EMERGING MARKETS FIXED INCOME

Q2 EMERGING MARKETS FIXED INCOME

Pennsylvania Mortgage Program Guidelines

R PENNSYLVANIA MORTGAGE PROGRAM GUIDELINES & PROCEDURES

Real Estate Guidelines – Private and Public

S OPEN-END REAL ESTATE FUND INVESTMENTS
T U.S. PUBLICLY TRADED REAL ESTATE SECURITIES
T1 NON-U.S. PUBLICLY TRADED REAL ESTATE SECURITIES
T2 GLOBAL PUBLICLY TRADED REAL ESTATE SECURITIES
U CLOSED-END OPPORTUNISTIC AND VALUE-ADDED REAL ESTATE INVESTMENTS
V REAL ESTATE PROGRAM
W FARMLAND INVESTMENT PROGRAM

Alternative Investment Guidelines

X PRIVATE INVESTMENT AND VENTURE CAPITAL POLICY
X1 PRIVATE DEBT POLICY

Short-Term Investment Pool Guidelines

Y SHORT-TERM INVESTMENT POOL PORTFOLIOS
Y1 LIBOR-PLUS SHORT TERM INVESTMENT POOL PORTFOLIOS

Securities Lending Guidelines

Z SECURITIES LENDING

Investment Policies Deviations

This Policy is intended to state the position of the Board concerning investments in the various approved asset classes. While a prudent investor could adopt policies that would subject the fund to more Risk, the policies adopted herein are statements of the level of Risk that the Board is currently willing to accept consistent with its fiduciary obligation to support the present and future pension obligations of the System.

The following procedures should be employed when there is a variation between adopted policies and actual practice:

1. When an Investment Manager is given permission to invest in a particular manner pursuant to an exception to the policies granted by the CIO as explicitly permitted in the guidelines, that permission shall be given in writing to the Investment Manager and reported to the Finance Committee monthly by way of posting on the Board's secure intranet web site. Notification is provided monthly to the Board regarding the availability of these reports.
2. When an Investment Manager violates a policy, the CIO (in the interest of preserving capital) may give the Investment Manager reasonable time to

liquidate the position that is violative of the policy or the CIO may allow an exception to the policy. When appropriate, the Investment Manager shall be notified in writing of its liability in the event of a loss. In all cases, the Finance Committee shall be notified at its next meeting of any material violation and the action taken by the CIO. Exceptions to the guidelines permitted by the CIO shall be reported to the Finance Committee monthly via posting on the Board's secure intranet web site. Notification is provided monthly to the Board regarding the availability of these reports.

3. When an Investment Manager wishes (a) to invest in a manner inconsistent with specific Board policies, (b) the investment is not covered by paragraph (1) and (c) the CIO believes that under the circumstances the proposed investment is appropriate notwithstanding the Board policies, the CIO shall grant a waiver of Board policy and report material waivers to the Finance Committee at its next meeting. All waivers granted shall be reported to the Finance Committee monthly via posting on the Board's secure intranet web site. Notification is provided monthly to the Board regarding the availability of these reports.
4. The Board may waive any of its limitations on any investments if the need for a waiver is specifically referred to in the materials presented to the Finance Committee and the Board and a discussion of that waiver is included in the minutes of the Finance Committee and the Board.

Monthly, the CIO shall notify the Finance Committee and the Board of the waivers currently in effect and the waivers issued since the previous update through a posting on the Board's secure intranet web site.

Review and Amendments

The Board shall review Investment Manager compliance with this Policy and any addendum related to the Investment Manager's mandate plus any amendments thereto.

In the application and implementation of the Investment Policy Statement, Objectives, and Guidelines, the CIO has the authority to interpret the guidelines to meet individual portfolio needs and to determine the appropriateness of any investment. On material policy issues and amounts, the CIO and/or the Executive Director, in conjunction with the Chair of the Finance Committee and/or Chair of the Board, will evaluate and determine the appropriateness of any investment. All interpretations of material policy issues and dollar amounts will be reported to the Finance Committee at the next regularly scheduled meeting.

If at any time the Investment Manager believes that the objectives cannot be met, or the guidelines constrict performance, the CIO should be notified in writing. The Investment Manager shall be encouraged to suggest changes in these guidelines as necessary. By signature the Investment Manager shall agree to these Investment Policy Statement, Objectives, and Guidelines and shall perform in accordance therewith.

Exhibit A – Current Professional Service Providers

The following is a list of current professional service providers to the System.

Private Markets, Real Estate, and External Portfolio Managers	see www.psers.state.pa.us/invest/invest.htm for “Roster of Investment Managers, Advisors, and Partnerships”
Private Markets Investment Consultant	Portfolio Advisors, LLC
Commission Recapture Agent	LJR Recapture Services
Custodian Bank	BNY Mellon Asset Servicing
IAASP	Financial Control Systems, Inc.
General Investment Consultant	Wilshire Associates Inc.
Proxy Voting Agent	Glass, Lewis & Co., LLC
Real Estate Investment Consultant	Courtland Partners, Ltd.

Exhibit B – Asset Allocation

The current long-term, top-down Asset Allocation targets of the Board, based on the market value of the System's assets as of April 1, 2009:

<u>ASSET CLASS</u>	<u>SUB-CLASS OBJECTIVE</u>	<u>OBJECTIVE</u>	<u>POLICY RANGE</u>
Public Market U.S. Equity Exposure			
Large Cap	10.80%		± 5.0%
SMID Cap	2.43%		± 2.5%
Micro Cap	<u>0.27%</u>		± 0.3%
Total Public Market U.S. Equity Exposure		13.50%	± 5.0%
Public Market Non-U.S. Equity Exposure			
Non-U.S. Large Cap	12.38%		± 5.0%
Non-U.S. Small Cap	2.47%		± 2.5%
Emerging Markets	<u>1.65%</u>		± 1.7%
Total Public Market Non-U.S. Equity Exposure		<u>16.50%</u>	± 5.0%
Total Public Market Equity Exposure (excluding PTRES)		30.00%	± 10.0%
Private Markets		18.00%	
Real Estate (including PTRES)			
PTRES Portfolios	1.50%		± 1.5%
Private Real Estate	<u>9.50%</u>		
Real Estate (including PTRES)		<u>11.00%</u>	
Total Equity Exposure		59.00%	± 10.0%
Fixed Income Exposure			
TIPS	5.00%		± 4.0%
U.S. Fixed Income	7.50%		± 4.0%
Global Fixed Income	3.00%		± 3.0%
High Yield and Opportunistic	9.00%		± 4.0%
Cash	<u>5.00%</u>		± 5.0%
Total Fixed Income Exposure		29.50%	± 10.0%
Absolute Return Exposure		7.50%	± 4.0%
Commodity Exposure		<u>4.00%</u>	± 4.0%
		<u>100.00%</u>	

The total equity exposure, total fixed income exposure, and commodity exposure targets established above are long-term targets.

As the private real estate and private markets allocations are funded (or distributions received) and/or the allocation increases/decreases due to the total market value of the Fund changing, the public market U.S. and non-U.S. equity objectives will be revised to reflect these changes. For example, if the allocation to Private Markets increases by 100 basis points due to a change in the market value of the total Fund in the fourth quarter, then starting with the first quarter the objective in private markets will increase by 100 basis points and the objective in public market U.S. equity and non-U.S. equity exposure will each be reduced by 50 basis points with proportional adjustments to the sub-class objectives. Adjustments to the private real estate and private markets objectives will be completed in 50 basis point increments (adjustment will be made to the nearest 0.50%) on a quarterly basis. The ultimate objective of these adjustments is to maintain the total equity exposure around the long-term targets.

The policy ranges for the Asset Allocation represent rebalancing triggers around the objectives.

For purposes of this analysis, cash and cash equivalents held in each Investment Manager's portfolio will be considered fully invested based on that advisor's objectives (i.e. cash in a U.S. equity Investment Manager's account will be considered as part of the U.S. equities in the table above). For classification purposes, cash equivalents include fixed income securities maturing in less than one year.

Exhibit C – Policy Index

Based on the Asset Allocation in **Exhibit B**, the Board adopts the following weighted policy benchmarks to measure the performance of the System beginning April 1, 2009:

Public Market Equity Exposure	
MSCI ACW Investable Market Index (net dividends)	30.00% ¹
U.S. Fixed Income	
Barclays Capital U.S. Universal Index	7.50%
High Yield and Opportunistic	
Barclays Capital U.S. High Yield Index	9.00%
TIPS	
Barclays Capital U.S. TIPS Index (Series-L)	5.00%
Global Fixed Income	
Barclays Capital Multiverse Index	3.00%
Cash	
Merrill Lynch U.S. Treasury Bill 0 – 3 Months	5.00%
PTRES Portfolios	
FTSE EPRA/NAREIT Global Real Estate Index	1.50%
Private Real Estate	
NCREIF Index, one-quarter lagged	9.50% ¹
Private Markets	
Venture Economics Median, one-quarter lagged ²	18.00% ¹
Absolute Return	
8% Annualized Return	7.50%
Commodities	
DJ/AIG Commodity Index	4.00%
<hr/>	
Total	<u>100.00%</u>

¹ As the private real estate and private markets allocations are funded (or distributions received) and/or the allocation increases/decreases due to the total market value of the Fund changing, the public market equity benchmark will be revised to reflect these changes. For example, if the allocation to Private Markets increases by 100 basis points due to a change in the market value of the total Fund in the fourth quarter, then starting with the first quarter the Policy Index will include this 1.0% increase in the Private Markets benchmark and the MSCI ACW U.S. Investable Market Index (net dividends), benchmark will also be reduced by 100 basis points. Adjustments to the private real estate and private market benchmarks will be completed in 50 basis point increments (adjustment will be made to the nearest 0.50%) on a quarterly basis.

² The Venture Economics Median returns will be calculated on a weighted vintage year basis that will account for the timing of commitments made by the System.

Exhibit D – Public Market Investment Manager Target Ranges

All allocations to individual Investment Manager portfolios shall be subject to the limits established by the Board through the Asset Allocation in **Exhibit B**. IOS is permitted to manage the allocation of capital to each Investment Manager portfolio within the target ranges to public market Investment Manager portfolios of the total fund noted below. The CIO shall have discretion on the timing of reducing any Investment Manager portfolio exceeding the maximum ranges approved below. However, the CIO is not permitted to allocate additional capital to those portfolios currently above the target ranges.

	Target Ranges as a Percentage of the Total Fund
Public Market U.S. Equity Portfolios	
Internally Managed S&P 500 Index	0.0% - 20.0%
Global Macro, including Overlay	0.0% - 2.0%
Internally Managed Enhanced S&P 500 Index	0.0% - 1.5%
Portable Alpha - Active Currency and Equity Option Program	0.0% - 0.5% ¹
Other Portable Alpha Strategies (including Absolute Return Emerging Markets Fixed Income)	0.0% - 1.0%
Internally Managed S&P 400 Index	0.0% - 2.5%
Internally Managed S&P 600 Index	0.0% - 2.5%
U.S. Style-Oriented Small Cap Equity	0.0% - 1.0%
U.S. Micro Cap Equity	0.0% - 0.5%
Internally Managed Synthetic Beta Replication ³	0.0% - 5.0%
Public Market Non-U.S. Equity Portfolios	
Internally Managed MSCI ACW Index ex. U.S. Non-U.S. Equity	0.0% - 15.0%
Non-U.S. Small Cap Equity	0.0% - 2.5%
Non-U.S. Small Cap Equity	0.0% - 1.0%
Emerging Markets Equity	0.0% - 1.0%
Internally Managed Synthetic Beta Replication ³	0.0% - 5.0%
U.S. Fixed Income and High Yield Portfolios	
Internally Managed U.S. Core Fixed Income	0.0% - 5.0%
U.S. Core Plus Fixed Income	0.0% - 2.0%
U.S. High Yield and Opportunistic Fixed Income	0.0% - 2.0%
Internally Managed Synthetic Beta Replication ³	0.0% - 5.0%
TIPS Portfolios²	
Internally Managed U.S. TIPS	0.0% - 5.0%
U.S. and Non-U.S. TIPS	0.0% - 2.5%
Internally Managed Synthetic Beta Replication ³	0.0% - 2.0%

¹ Portable Alpha – Currency portfolios without capital requirements will be subject to a maximum of \$1 billion notional at 4.0% tracking error.

² The total TIPS portfolios may be leveraged up to 2.2 times in aggregate.

³ The maximum amount of internally managed synthetic beta replication will be 5% of the total fund (excludes beta synthetically replicated within the actively managed and indexed separate account portfolio).

Target Ranges
as a percentage
of the Total Fund

Global Fixed Income Portfolios

Global Core Plus Fixed Income	0.0% - 2.0%
Emerging Market Fixed Income	0.0% - 1.5%
Internally Managed Synthetic Beta Replication ³	0.0% - 2.0%

Cash Portfolios

Internally Managed LIBOR-Plus Short-Term Investment Pool	0.0% - 6.0%
Externally Managed LIBOR-Plus Short-Term Investment Pool	0.0% - 2.0%
Internally Managed Short-Term Investment Pool	No limit

PTRES Portfolios

U.S., Non-U.S., and Global PTRES	0.0% - 1.0%
Internally Managed Synthetic Beta Replication ³	0.0% - 2.0%

Absolute Return Portfolios

Active Currency	0.0% - 0.5% ¹
Global Macro	0.0% - 2.0%
Other Absolute Return Strategies (including Absolute Return Emerging Markets Fixed Income)	0.0% - 1.0%

Commodities Portfolios

Full Discretion and Enhanced Index Commodity	0.0% - 2.0%
Internally Managed Synthetic Beta Replication ³	0.0% - 2.0%

PMEIM Program Portfolios

0.0% - 0.3%

Internally Managed Synthetic Beta Replication represents market exposures in the various asset classes achieved through Derivative exposures such as futures, options, swaps, etc. IOS will synthetically achieve beta exposures to either assist in a transition from one actively managed portfolio to another or to generate alpha. It excludes synthetic beta replication within the actively managed and indexed separate account portfolios.

¹ Currency portfolios without capital requirements will be subject to a maximum of \$1 billion notional at 4.0% tracking error.

³ The maximum amount of internally managed synthetic beta replication will be 5% of the total fund (excludes beta synthetically replicated within the actively managed and indexed separate account portfolio).

Exhibit E – Letter of Understanding

Model Letter of Understanding

Thank you for your interest in the Pennsylvania Public School Employees' Retirement System's (PSERS) Private Equity Program. PSERS has adopted several requirements to which a prospective general partner must agree prior to our staff performing due diligence on a potential private equity partnership investment.

We are requesting the general partner's acknowledgement of and consent to the basic terms enumerated below. To promote an understanding of the applicable concepts, we have attached a form of indemnification provision and form of side letter agreement. Other terms should be self-explanatory. PSERS' terms may be incorporated into the main partnership agreement, a separate partnership agreement between the general partner and PSERS, or a letter agreement.

- The general partner must contribute 5 percent of the aggregate committed capital as a general partner and must subordinate 10 percent of PSERS' contribution in terms of the distribution schedule, which puts the general partner in a first loss position with respect to PSERS. The subordination can be accomplished through the distribution schedule, an escrow account or a parent company guarantee.
- The partnership must provide a preferred return to all limited partners of no less than 8 percent.
- The partnership must make available contractual co-investment rights to investors on a pro rata basis.
- Management fees and any other payment obligations undertaken by PSERS must be payable from (*not* in addition to) and reduce PSERS' capital commitment. PSERS' liability cannot exceed its capital commitment.
- Indemnifications by the partnership must be controlled by the standard and process set forth in the attached Model Provision.
- PSERS requires a "no fault divorce" provision that gives us the option to discontinue capital contributions if the Partnership has at least two instances of indemnification of \$500,000 or more.
- PSERS requires a seat on limited partner advisory and valuation committees, along with the right to appoint a successor to its member. The committees should possess rights to act on certain matters.
- The partnership must reimburse PSERS for the expenses incurred in attending advisory/valuation committee meetings and partnership annual meetings.
- PSERS may, in its discretion, require a key person provision in the event that one or more designated persons is no longer involved in the partnership at the prescribed levels.

- PSERS requires the partnership to issue financial statements on a Generally Accepted Accounting Principles (GAAP) basis.
- The general partner must execute the attached form of Model Side Letter Agreement or incorporate its terms and conditions into the partnership agreement.
- The Partnership shall not knowingly make investments in portfolio companies that outsource or privatize the jobs of active members of the Pennsylvania Public School Employees' Retirement System.

If these requirements are acceptable to your firm, please execute and return a copy of this letter to my office. This letter sets forth the understanding between PSERS and the undersigned general partner.

Sincerely,

Director of Private Markets & Real Estate

The undersigned General Partner hereby agrees to the above terms.

General Partner

By: _____
Name: _____
Title: _____

Model Provision

Liability to Partners; Indemnification.

(a) Neither the General Partner or any partner of the General Partner (each a “Covered Party” and collectively the “Covered Parties”) shall be liable to any Partner for any action taken or omitted to be taken by such Covered Party or for any action taken or omitted to be taken by any other Partner or other person with respect to the Partnership, except in any of the following cases (and with respect to any member of the Advisory Committee, except only in the case of clause (iv) below):

(i) the case of such Covered Party’s own failure to exercise the care, skill, prudence and diligence under the circumstances then prevailing which persons of prudence, discretion, and intelligence who are experts in such matters exercise in the conduct of a venture capital enterprise with similar purposes;

(ii) the case of the Covered Party’s material violation of any law, including but not limited to, violation of any federal or state securities laws;

(iii) the case of such Covered Party’s material breach of this Agreement, the Investment Management Agreement, or any other agreement between the Partnership and the General Partner, the Investment Manager, or their Affiliates; or

(iv) the case of such Covered Party’s self dealing, bad faith or willful misconduct.

(b) The Partnership shall indemnify and hold harmless the Covered Parties, to the extent permitted by applicable law, from any and all reasonable costs and expenses and any and all damages and claims that may be incurred or asserted against such persons or entities by reason of any action taken or omitted to be taken on behalf of the Partnership unless such cost, expense, damage, or claim arises out of a case described in (a)(i) to (iv), above, or in the case of such Covered Party’s claim for indemnification arising out of any claim brought by an Affiliate of the General Partner (other than a Portfolio Company, prior Portfolio Company or Affiliate thereof).

(c) If any Covered Party seeks indemnification from the Partnership pursuant to this section, it shall so notify the Partnership and the Valuation Committee and shall present to the Valuation Committee any proposed settlement arrangement giving rise to the indemnification obligation under this section for the approval of the Valuation Committee, which approval shall not be unreasonably withheld. No Covered Party shall enter into any settlement agreement without the approval of the Valuation Committee. If the Valuation Committee shall determine that such Covered Party shall be entitled to indemnification under this section, such determination shall be binding on the Partners and the Partnership.

(d) Subject to Subsection (e) below, expenses incurred by any person or entity entitled to indemnification in respect of any costs, expenses, damages and claims up to a maximum in the aggregate of \$_____ may be paid by the Partnership in advance of the final disposition of any such claim or action in the discretion of the General Partner upon the receipt of an undertaking by or on behalf of such person to repay the amount if it shall ultimately be determined that such person is not entitled to be indemnified by the Partnership as authorized by this section. Requests for advance payments in excess of \$_____ shall be submitted to and approved by the Valuation Committee in its discretion.

(e) Notwithstanding anything contained in this section to the contrary, no advance payment pursuant to Subsection (d) shall be made with respect to any action brought by a Limited Partner or any action brought by a Majority-in-Interest of the Limited Partners during the pendency of such a suit brought by such Limited Partner(s) and no payment shall be made if such Limited Partner(s) substantially prevails on the merits in such suit.

(f) The General Partner shall use commercially reasonable efforts to obtain the funds needed to satisfy the Partnership's indemnification obligations under this Section ___ from Persons other than the Partners or the Partnership (for example, pursuant to insurance policies that provide primary coverage or Portfolio Company indemnification arrangements) before causing the Partnership to make payments pursuant to this Section ___. The General Partner shall not be permitted to purchase insurance at the expense of the Partnership that would provide coverage for liabilities and expenses for which the General Partner or any other indemnified parties would not be entitled to indemnification under this Section ___ (for example, errors and omissions coverage for liabilities and expenses resulting from the negligence of the indemnified party).

(g) The Partnership shall not make any capital call for the purpose of making an investment in any Portfolio Company if the General Partner has actual knowledge or reason to believe that such Portfolio Company intends to use the proceeds from such investment to indemnify any Covered Party.

(h) If a Limited Partner shall default in respect of its obligation to contribute capital to the Partnership, the Partnership shall not make a call for capital to be contributed by the non-defaulting Limited Partners to satisfy a claim for indemnification under this section in excess of the amount that such non-defaulting Limited Partners would have contributed to the Partnership had the defaulting Limited Partners made its capital contribution.

Model Side Letter Agreement

_____, L.P.

_____, 200_

Commonwealth of Pennsylvania
Public School Employees' Retirement System
Five North Fifth Street
Harrisburg, Pennsylvania 17101

Attention:

Chief Investment Officer

Re: _____, L.P.

Dear Mr. Van Noord:

This letter is being written and delivered to confirm certain agreements with regard to the investment made by the Public School Employees' Retirement System ("PSERS") in _____, L.P., a [NAME OF STATE] limited partnership (the "Partnership"), pursuant to the Limited Partnership Agreement dated as of _____, 20__ (the "Agreement") of the Partnership and the Subscription Agreement among the Partnership, the General Partner and PSERS dated as of _____, 20__. Capitalized terms used herein and not otherwise defined shall have the meanings given to them in the Agreement.

The General Partner, on behalf of the Partnership, and PSERS agree that the terms of this letter agreement shall be applicable to the investment by PSERS in the Partnership, notwithstanding anything to the contrary contained in the Partnership Agreement or the Subscription Agreement. The terms of this letter agreement supersedes any conflicting term(s) in the Partnership Agreement or the Subscription Agreement.

1. The General Partner understands that PSERS reserves all immunities, defenses, rights or actions arising out of its status as a sovereign entity, including those under the Eleventh Amendment to the United States Constitution. No provision of the Agreement or the Subscription Agreement shall be construed as a waiver or limitation of such immunities, defenses, rights or actions.

2. The General Partner hereby agrees and acknowledges that any legal proceeding involving any contract claim asserted against PSERS arising out of the Agreement or the Subscription Agreement may only be brought before and subject to the exclusive jurisdiction of the Board of Claims of the Commonwealth of Pennsylvania pursuant to 62 Pa. C.S. §§1721-1726, and that such proceeding shall be governed by the procedural rules and laws of the Commonwealth of Pennsylvania, without regard to the principles of conflicts of law.

3. The General Partner hereby confirms that the Agreement and the Subscription Agreement do not impose any personal indemnification obligations on PSERS and shall not be applied or construed to require PSERS to provide indemnification directly to any person or entity thereunder. PSERS, however, acknowledges that it is obligated as a Limited Partner to make capital contributions as called pursuant to the terms of the Agreement.

4. In compliance with PSERS' enabling legislation, 24 Pa. C.S. §8521(i), the liability of PSERS shall be limited to the amount of its capital commitment.

5. The General Partner agrees to appoint one representative designated by PSERS on the limited partner advisory/valuation committee and to accept a successor appointee designated by PSERS in the event such representative is removed or is no longer able to serve. The Partnership shall reimburse PSERS the travel and related expenses for attending advisory/valuation committee meetings and annual or special partnership meetings.

6. If upon the liquidation of the Partnership there shall be any Securities that are non-marketable, then in lieu of distributing to PSERS its share of such Securities, the General Partner shall use its reasonable best efforts to dispose of such Securities. In the event the General Partner is unable to dispose of such Securities within a reasonable period of time, the General Partner shall give PSERS at least ten business days prior written notice of its intention to make a distribution in kind of such Securities to PSERS. PSERS may within such notice period elect, by written notice to the General Partner or liquidating trustee, as applicable, to decline the receipt of such distribution in kind. In the event that PSERS elects to decline the receipt of the proposed in kind distribution, the General Partner or liquidating trustee, as the case may be, shall hold such

Securities for the benefit of PSERS until such Securities are liquidated. The General Partner shall liquidate such Securities at the same time and on the same terms as the General Partner's liquidation of its own holdings of such Securities. PSERS shall bear only its pro rata share of the out of pocket expenses of such liquidating trust. The General Partner shall not allocate any non Publicly Traded Securities to PSERS relating to an investment from which PSERS was excused or excluded under the terms of the Agreement.

7. The General Partner hereby agrees to preserve all financial and accounting records pertaining to the Partnership Agreement during the term of the Agreement and for four years thereafter, and during such period, PSERS or any other department or representatives of the Commonwealth of Pennsylvania, upon reasonable notice, shall have the right to audit such records in regard thereto to the fullest extent permitted by law. The General Partner shall have the right to preserve all records and accounts in original form or on microfilm, magnetic tape, or any similar process.

8. The General Partner agrees that it shall not knowingly and willfully take or fail to take any action that would cause the auditor's report on the annual financial statements provided by the General Partner pursuant to Section _____ of the Agreement to include any qualification due to scope limitation, lack of sufficient competent evidential matter, or a departure from Generally Accepted Accounting Principles.

9. The Partnership and General Partner represent and warrant that none of the Partnership, the General Partner or the individual partners of the General Partner has entered or will enter into any side letter or similar agreement on or prior to the date hereof with any investor or Partner in the Partnership or with any investor in the Parallel Funds or side by side funds in connection with the admission of such investor or Partner to the Partnership, Parallel Funds or side by side funds except as disclosed to PSERS in writing on or prior to the date hereof. If the Partnership, the General Partner or the individual partners of the General Partner shall enter into a side letter or similar agreement with an existing or future investor, PSERS shall promptly be given a copy of such agreement and the opportunity to obtain the same rights and benefits of such side letter or similar agreement by written notice thereof to the General Partner delivered within 30 days of receipt by PSERS of copies of such side letters or similar agreements.

10. The General Partner (i) understands and acknowledges that it is subject to the reporting requirements set forth in 25 P.S. § 3260a., (ii) if required to file a report, confirms that it has submitted to PSERS' Executive Director a copy of its current report to the Secretary of the Commonwealth of Pennsylvania, and (iii) if required to file successive reports, hereby agrees to submit a copy of each successive report to PSERS' Executive Director by February 15 of each year during the term of this Agreement.

11. For as long as PSERS is a Limited Partner, the General Partner agrees that it will not obtain, at the expense of the Partnership or any Limited Partner, any insurance that would provide for indemnification of any Covered Person for any liability with respect to which a Covered Person would not be entitled to indemnification pursuant to the Partnership Agreement.

12. The General Partner acknowledges that PSERS is an administrative agency of the Commonwealth of Pennsylvania and may be required by law to disclose to the public certain information that may be considered confidential under this Agreement ("Disclosure Obligations"). Therefore, notwithstanding anything to the contrary in the Agreement, the

General Partner hereby agrees that PSERS, without prior notice to or approval of the General Partner, may disclose to the public the following information regarding the Partnership to satisfy such Disclosure Obligations:

- i. The name, address, and vintage year of each alternative investment vehicle;
- ii. The identity of the manager of each alternative investment vehicle;
- iii. The dollar amount of the commitment made by the System to each alternative investment vehicle;
- iv. The dollar amount of cash contributions made by the System to each alternative investment vehicle since inception;
- v. The dollar amount of cash distributions received by the System from each alternative investment vehicle since inception;
- vi. The net internal rate of return of each alternative investment vehicle since inception, provided that the System shall not be required to disclose the net internal rate of return under circumstances which, because of the limited number of portfolio assets remaining in an alternative investment vehicle, such disclosure could reveal the values of specifically identifiable remaining portfolio assets to the detriment of the alternative investment;
- vii. The aggregate value of the remaining portfolio assets attributable to the System's investment in each alternative investment vehicle, provided that the System shall not be required to disclose said value under circumstances in which, because of the limited number of portfolio assets remaining in an alternative investment vehicle, such disclosure could reveal the values of specifically identifiable remaining portfolio assets to the detriment of the alternative investment; and,
- viii. The dollar amount of total management fees and costs paid to each alternative investment vehicle by the System on an annual fiscal year-end basis.

The General Partner further acknowledges that the types of information identified in (i) through (vi) above are not inclusive of all the information that PSERS may be required to disclose.

PSERS will not, however, without the prior written consent of the General Partner, disclose any information regarding the identity, performance, or value of any portfolio company, proprietary business information relating to the services or products of any portfolio company, or the Partnership's pending acquisition or pending disposition of a portfolio company or proposed investment in a portfolio company ("Trade Secrets"). In the event that PSERS is required by law (any statute, governmental rule or regulation, or judicial or governmental order, judgment or decree) to disclose Trade Secrets, the General Partner has the right not to disclose further to PSERS the types of Trade Secrets that PSERS is required by law to disclose, provided, that the General Partner agrees not to withhold from PSERS (w) such information as is reasonably necessary for PSERS to determine the items set forth in (i) through (vi) above, (x) balance sheets, statements of portfolio investments (including cost and value), income statements and statements of cash flow of the Partnership, (y) the capital account balance of PSERS (prepared in the Partnership's quarterly and annual financial statements and in PSERS' Capital

Account Summary delivered to PSERS pursuant to this Agreement), and (z) federal and state tax information statements (including Federal Form K-1).

Sincerely yours,

_____, L.P.

By: _____

By: _____

Agreed to and Acknowledged:

COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT
SYSTEM

By: _____

Name:

Title:

By: _____

Name:

Title:

Approved for form and legality:

Chief Counsel
Public School Employees'
Retirement System

Chief Deputy Attorney General
Office of Attorney General

Deputy General Counsel
Office of General Counsel

***Public Market Emerging Investment
Manager Program Policy
Of
The Commonwealth of Pennsylvania
Public School Employees' Retirement Board***

As adopted by
the Board of Trustees
on January 25, 2008

Effective
January 25, 2008

PUBLIC SCHOOL EMPLOYEES' RETIREMENT BOARD
PUBLIC MARKET EMERGING INVESTMENT MANAGER PROGRAM POLICY

I. OBJECTIVES AND GOALS

Consistent with the Board's fiduciary responsibilities, the Pennsylvania Public School Employees' Retirement System (PSERS, System, or Fund) has established the Public Market Emerging Investment Manager Program (PMEIM Program) to:

1. Locate and fund managers with successful histories of generating positive alpha with Risk commensurate with the alpha generated (positive Risk adjusted returns);
2. Provide a source of potential managers for the main fund; and,
3. Assist public market emerging investment management firms with positive Risk adjusted returns grow through use of the System's name in the manager's marketing efforts.

The Board has allocated up to \$1.0 billion to the PMEIM Program. Funding for each investment manager will come from assets allocated within the main fund similar to or most closely related to the investment manager's mandate. The maximum number of investment managers in the program at any one time shall not exceed 25. The program may run with less than 25 investment managers.

II. PUBLIC MARKET EMERGING INVESTMENT MANAGER PROGRAM CRITERIA

Investment Manager desiring to participate in the program must meet the following required criteria:

- ◆ Firms must be registered under the Investment Advisors Act of 1940 or be exempt therefrom (and will maintain such registration or exemption);
- ◆ Firms must provide transparency of positions and transactions;
- ◆ Firms must provide at least quarterly liquidity;
- ◆ Firms, the portfolio manager, or any combination thereof must have a three-year historical, performance record verified by at least one consultant or accounting firm in accordance with Global Investment Performance Standards (GIPS);
- ◆ Firms must have no more than \$1.5 billion of total assets under management when hired (existing investment managers will be terminated within a reasonable period of time from the PMEIM Program when the total assets under management exceeds \$3.0 billion);
- ◆ For performance-based fee accounts, the managers must exceed both a hurdle rate and a high water mark before they can earn the performance-based fee.

Preference will be given to investment managers deemed by Investment Office Staff (IOS) as able to meet the objectives, goals, and required criteria noted above plus having one or more of the following characteristics:

- ◆ Pennsylvania investment management firms headquartered or incorporated within the Commonwealth; and/or,

- ◆ Minority- or women-owned investment management firms approved by the Office of Minority and Women Business Enterprise in accordance with the criteria established by Executive Order No. 1987-18 and 4 Pennsylvania Code, Section 68.204.

Please note: *Firms applying for participation under the status of a Women and/or Minority Owned Business must contact the Office of Minority & Women Business Enterprise at (717) 787-7380 to obtain the proper certification material.*

III. ADMINISTRATION OF THE PUBLIC MARKET EMERGING INVESTMENT MANAGER PROGRAM

IOS has the authority to hire and fund any investment manager meeting the objectives, goals, and criteria set forth above as long as capacity exists within the PMEIM Program. IOS has authority to invest in any type of business organization or investment fund (including, without limitation, separate accounts and limited partnerships) that meets the liquidity and transparency guidelines set forth in this Policy. The PMEIM Program is prohibited from investing in investment vehicles that primarily include private equity, private debt, venture capital or private real estate instruments.

The Emerging Manager Portfolio Manager (EMPM) is responsible for administering the PMEIM Program. The EMPM will meet with managers that appear to meet the objectives, goals, and criteria of the Program. Any investment manager considered for hiring into the PMEIM Program will meet with the Internal Review Committee (IRC). The IRC will consist of the Chief Investment Officer, the EMPM, the five Investment Office Directors (External Public Markets, Risk & Compliance, Equity, Fixed Income, Trading, and Private Markets), and any other IOS deemed necessary. The purpose of the IRC is to review each manager considered for inclusion in the Program and provide feedback to the EMPM. IOS approval required to hire any manager include the EMPM, the EMPM's supervising Director, and the CIO.

IOS is required to obtain Board approval in instances when the CIO, EMPM's supervising Director, and EMPM locate (or have retained) an exceptional investment manager that does not meet one or more of the above required criteria. In these cases, IOS shall present the specific reasons for hiring the investment manager to the Board. Upon approval of the Board, IOS shall have the authority to fund the investment manager according to VI. Fundings, which is described later.

The EMPM's responsibilities also include either recommending the investment manager for inclusion in the main fund or terminating the investment manager. Investment managers hired into the PMEIM Program will continue in the program for generally three- to five-years. If the investment manager generates strong Risk adjusted returns, IOS will use best efforts, in conjunction with the General Investment Consultant and the Board, to make a place in the main fund for that investment manager. IOS and the General Investment Consultant will consider things such as the investment manager's assets under management and projected ability to continue generating strong Risk adjusted returns in the future. An investment manager may be terminated by the EMPM, with approval from the EMPM's supervising Director and the CIO, if that investment manager is underperforming, not generating strong Risk adjusted returns, not meeting the criteria to move into the main fund, changes their investment process, has personnel turnover, or any other reason which is deemed by IOS to be in the best interests of the System.

IV. INVESTMENT GUIDELINES

Each investment manager shall manage its portfolio within the constraints of the Investment Policy Statement, Objectives and Guidelines, any applicable addendum, and any applicable amendments thereto or within the constraints of the Offering Memorandum if the System will be entering into a commingled fund structure with the investment manager. IOS shall have authority to negotiate the investment contract with the investment manager, including the investment guidelines.

V. INSURANCE

All of the standard insurance provisions set forth in the Investment Policy Statement, Objectives and Guidelines, except for the maximum deductibles, will apply to the investment manager until the investment manager is either managing over \$100 million for the Emerging Manager Program or is moved out of the Emerging Manager Program into the main fund. The maximum deductible for both the Error and Omissions Insurance and the Fidelity Bond is the greater of 10% of audited retained earnings or:

<u>Asset Size</u>	<u>Maximum Deductible</u>
\$0 - \$50 million	\$50,000
\$50 - \$75 million	\$100,000
\$75 – 100 million	\$200,000

VI. FUNDINGS

Total capital allocated to any individual investment manager may not exceed \$75 million during their participation in the PMEIM Program. The EMPM, the EMPM's supervising Director, and the CIO will determine the amount of the initial allocation and each subsequent allocation to each investment manager.

Acknowledgement

We acknowledge the receipt of and agree to be bound by the Investment Policy Statement, Objectives, and Guidelines for the Pennsylvania Public School Employees' Retirement Board approved May 1, 2009, the applicable portfolio specific addendum approved _____, and any amendments thereto.

Investment Manager Firm Name

**Pennsylvania Public School
Employees' Retirement System**

Portfolio Manager Signature

Chief Investment Officer

Portfolio Manager Name

Portfolio Specific Addendum

Date Accepted

Date Proposed