PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM
INVESTMENT OBJECTIVES AND GUIDELINES
SECURITIES LENDING PROGRAM

ADDENDUM Z

I. OBJECTIVES AND GOALS

A. Securities Lending

The Public School Employees' Retirement System (PSERS) securities lending program is designed to generate incremental income from lending securities to qualified borrowers who provide collateral in exchange for the right to use the securities. The investing of this collateral is expected to follow these investment guidelines with the principal objectives being liquidity and preservation of capital. Incremental income levels will be dictated by the market's demand for securities in our portfolio.

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The primary objectives of lending securities are to:

i. Safeguard securities through management of counterparty risk;
ii. Safeguard capital through receipt of sufficient collateral; and,
iii. Enhance portfolio earnings keeping the previous objectives in mind.

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B. Management of Cash Collateral

The primary objectives of the management of cash collateral supporting securities loans are to:

i. Safeguard principal;
ii. Endeavor to maintain a stable unit value of $1.00, similar to 2a-7 money market funds;
iii. Assure all cash collateral is invested in a timely manner;
iv. Maintain a diversified portfolio of investments;
v. Maintain adequate liquidity; and,
vi. Consistent with these objectives, to optimize the spread between the collateral earnings and the rebate rate paid to the borrower of securities.

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C. Management of Non-Cash Collateral

The primary objectives of non-cash collateral are to:

i. Maintain high quality collateral sufficient enough to protect our interest in loaned securities; and,
ii. Maintain non-cash collateral in a fashion to minimize risk.

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II. General Lending Guidelines

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A. The Contractor shall pay PSERS by the 10th business day of each month, in immediately available funds, via wire transfer, all income earned for the preceding month.

B. All transfer taxes, fees and necessary costs with respect to the transfer of the borrowed securities shall be paid by the Contractor or the borrower as they become due.

C. The Contractor must collateralize all loaned securities. The proper method of collateralization will be the market convention (market price times 102% for U.S., Euro Fixed Income debt issues where we are receiving Euros as collateral, and non-U.S. fixed income debt issues denominated in U.S. dollars; 105% for all other non-U.S. issues) plus accrued interest. All cash collateral will be in U.S. dollars with the exception of Euro fixed income debt issues where the collateral received can either be Euros or U.S. dollars.

D. The Contractor must mark to market daily all loaned securities. Loan collateral must be adjusted to limits discussed in section II.C. above within 24 hours and prior to the securities being re-loaned to the same borrowers. Notwithstanding the foregoing, with respect to collateral held in connection with loans of securities of non-U.S. issuers, certain standard industry practices may from time-to-time preclude the Contractor from obtaining additional collateral by the close of the next business day unless the market value of the collateral previously delivered by the Borrower is less than 100% of the market value of such loaned securities, including accrued interest, under no circumstances, however, will the collateral be permitted to remain below 100% of the value of the loaned securities.

E. In the event that any loan is terminated and the loaned securities, or any portion thereof, shall not have been returned for any reason (including, without limitation, the insolvency or bankruptcy of the Borrower) within the time specified by the applicable securities on loan agreement, the Contractor, at its expense, shall (i) promptly replace the loaned securities, or any portion thereof, not so returned with other securities of the same issuer, class, and denomination and with the same dividend rights and other economic benefits as such securities possessed at the close of business on the date as of which the loaned securities should have been returned, or (ii) if it is unable to purchase such securities on the open market, credit the account with the market value of such unreturned loaned securities, such market value to be determined as of the close of business on the date as of which such loaned securities should have been returned by the Borrower. Until such time as actions (i) or (ii) have been consummated, any dividends or interest which have accrued on the loaned securities, whether or not received from the Borrower, shall be credited to the account by the Contractor.

The Contractor shall indemnify, defend, hold and save harmless PSERS from any claims, actions, demands, losses, or lawsuits of any kind resulting from the negligence or willful misconduct of the Contractor, its agents or employees.

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F. The Contractor will present to PSERS on a periodic basis, but not less than monthly, a list of all potential borrowers. PSERS reserves the right to eliminate borrowers from the program.

G. The Contractor shall maintain PSERS' collateral so that it is separately identified from all other money, securities, and collateral held by the Contractor. The Contractor shall construct and maintain a "firewall" so that in the event of a bankruptcy by the Contractor, the PSERS' assets shall be immediately returned to PSERS.

H. PSERS may, at its discretion, have its auditors determine whether or not the segregation of assets described in paragraph G exists and is adequate. The auditors of PSERS' choice will perform "agreed upon procedures," and these auditors may be the Contractor's independent auditors, PSERS' independent auditors, the State Comptroller's Office, the State's Treasury Office, the State's Auditor General's Office, or any other PSERS authorized auditors. The Contractor will provide access and space, and will pay for the procedures contracted for by PSERS.

I. The Contractor will be required to warrant that the securities lending program meets the requirements of IRS Code Section 512(a)(5) and 512(b)(1) and other applicable provisions of the law, which excludes income earned by PSERS through participation in the securities lending program from possible unrelated business taxable income. The Contractor will be required to agree to indemnify PSERS from all unrelated business tax claims resulting from the program.

J. The Contractor shall comply with the responsibilities and reporting requirements in this Securities Lending Monitoring Policy.

K. The Contractor will use its best efforts to preserve PSERS' voting rights for all loaned securities to the extent requested to do so in a timely manner.

L. The Contractor shall warrant that it maintains errors and omissions insurance providing a prudent amount of coverage for negligent acts or omissions and that such coverage is applicable to the Contractor's actions under the contract.

M. The Contractor may annually be required to retain a third party to evaluate the collateral pool risk, at its own expense, with findings supplied to PSERS. The Contractor is required to provide the findings of any other evaluation of the collateral pool risk performed by third parties as long as providing those reports does not violate local, state, or federal laws or regulations.

N. The Contractor shall cooperate in PSERS' annual review of contract performance, providing all information and records to PSERS as we may, in our sole discretion, reasonably determine to be necessary for the determination as to the continuation of the contract term.

O. The Contractor shall supply PSERS with the completed, audited financial reports necessary to comply with the Governmental Accounting Standards Board Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*. Such financial reports should be provided on a quarterly basis as required.

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P. Security loan terms should not be greater than 14 days. All loan terms should include provisions for the immediate recall of securities at PSERS' discretion.

III. Cash Collateral Investment Guidelines

PSERS has established the following investment guidelines. The Contractor will invest cash collateral proceeds and shall follow these guidelines explicitly. If, at any time, the collateral portfolio is in violation of these guidelines (i.e. a credit rating downgrade), the Contractor shall notify Investment Office Staff promptly in writing the suggested course of action (i.e., continue to hold the security, sell the security, etc.). Unless, and to the extent otherwise specifically agreed to in writing, collateral for loaned non-U.S. securities may only be invested in instruments denominated in U.S. Dollars. To be eligible for cash collateral investment, a security must be rated by both Moody's Investor Service and Standard & Poor's ("Rating Agencies") at the required quality level. Split rated issues are considered to have the lower of the two ratings. For a credit-enhanced issue to be eligible for purchase, the provider of the enhancement must be an AAA-rated financial institution. When a security held in the portfolio is reclassified below the minimum acceptable credit ratings described below by either of the Rating Agencies, the portfolio manager must either, using its best reasonable efforts, sell the security within 60 days of the reclassification or contact PSERS Investment Office Staff in writing documenting the investment rational for continuing to hold the security as cash collateral in the portfolio. In addition, PSERS reserves the right, after consultation with the Contractor, to request that specific positions within the cash collateral pool be liquidated for any reason, including credit concerns, collateral concerns, etc.

A. Acceptable cash collateral investment instruments include:

i. Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations when rated AAA;

ii. Repurchase agreements should be collateralized by debt obligations of the U.S. Government or its agencies, marked-to-market daily, and collateralized according to the table below. The table recognizes that longer-dated securities posted as collateral carry additional risk, and accordingly, demand higher collateral to compensate for that risk:

	0 to 5 Yrs	6 to 10 Yrs	11 to 30 Yrs
U.S. Treasury	102%	106%	110%
Agency	103%	108%	115%

iii. Obligations of U.S. and non-U.S. banks, including banker's acceptances, certificates of deposit, U.S. and off-shore bank time deposits, bonds (Euro), floating rate notes (Euro) and other debt instruments subject to the maturity limitations described below. The banks must be rated at least A2/A;

iv. Instruments issued by U.S. corporations including corporate notes and floating rate notes with a short-term rating of A-1/P-1 or better. If no short-term rating exists, the long-term rating must be A2/A or

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Deleted: Repurchase agreements collateralized at 105% by A3/A- or higher rated corporate debt or Aa3/AA- or better asset-backed securities or commercial paper with a minimum P-1/A-1 rating. Collateral must be rated by both Rating Agencies. Split rated issues are considered to have the lower of the two ratings. The Participating Funds understand that for tri-party repurchase agreements, the collateral may, at times, be rated by only one Rating Agency or may have a split rating with the second rating being lower than A3/A-. The tri-party repurchase agreements collateralized by corporate debt will be considered in conformity with these guidelines as long as at least one Rating Agency has a rating of A3/A- or higher;

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better. Commercial paper and other short-term paper of U.S. corporations must be rated A-1/P-1 or better. Floating rate notes must reprice daily, weekly, monthly or quarterly and utilize a standard repricing index such as LIBOR, Treasury Bills, commercial paper or Federal funds;

v. U.S. dollar-denominated instruments issued by sovereigns, sovereign supported credits, and instruments of foreign banks and corporations. The foreign banks and corporations must be rated at least A2/A. Commercial paper and other short-term paper of foreign banks and corporations must be rated A-1/P-1 or better;

vi. Yankee Securities must be rated A2/A or better;

vii. Insurance company funding agreements, guaranteed investment contracts (GICs) and bank investment contracts (BICs) are acceptable if the issuer has a long-term debt rating or claims paying ability rating of at least A1/A+ and an A.M. Best rating of at least A-. In addition, GIC/BIC investments must contain an unconditional put feature that can be exercised within 90 days at par value;

viii. Money market funds as defined under SEC Regulation 270.2a-7. Any investment management or similar type fees paid by any money market, commingled fund, or mutual fund to BNY Mellon or any of its affiliates shall be rebated to PSERS; and

ix. Agency asset-backed securities rated AAA in the most senior tranches only. Direct exposure to sub-prime or Alt A collateral is prohibited.

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Unless specifically identified in these guidelines, investment in derivative securities, unsecured obligations of institutions whose primary business is to function as a broker/dealer, interest only and principal only stripped mortgages, swap transactions, auction rate securities, Collateralized Debt Obligations (CDO's), Collateralized Loan Obligations (CLO's), structured investment vehicles (SIV's) and repurchase agreements collateralized by whole loan mortgage-backed securities is prohibited.

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B. The cash collateral investment portfolio can invest in adjustable rate securities tied to LIBOR, Fed Funds, Treasury Bills, and Commercial Paper indices. To limit exposure of the cash collateral investment portfolio to interest rate risk, the following adjustable rate securities are specifically prohibited:

i. any securities whose interest rate reset provisions are based on a formula that magnifies changes in interest rates, such as "inverse floaters" and "leveraged floaters";

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ii. securities whose interest rate reset provisions are tied to long-term interest rates so that a change in the slope of the yield curve could result in the value of the instrument falling below par, such as "Constant Maturity Treasury (CMT) floaters";

iii. securities on which interest is not paid above a certain level, such as "capped floaters" or that cease to pay any interest when a certain level is reached, such as "range floaters";

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iv. securities whose interest rate reset provisions are tied to more than one index so that a change in the relationship between these indices may result in the value of the instrument falling below par, such as "dual index floaters"; and,

v. securities whose interest rate reset provisions are tied to an index that materially lags short-term interest rates, such as "Cost of Funds Index (COFI) floaters" or Prime floaters.

C. Maturity and duration constraints are as follows:

i. Not withstanding the following, the weighted average life of the collateral investment portfolio shall not exceed 45 days. The average life of floating rate instruments will be calculated to the reset date. In addition, these guidelines are intended to eliminate any negative convexity risk (i.e. contraction or extension risk), and the Contractor is expected to invest the collateral portfolio in the full spirit of this intention;

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ii. Fixed-rate notes, bonds, and debentures may not exceed a term of 13 months fixed from date of purchase to final stated maturity or unconventional put date. Fixed-rate asset-backed securities will have a projected maximum average life of nine months and a final stated maturity that does not exceed three years;

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iii. Floating rate and variable rate securities may not exceed a term of two years fixed from date of purchase to final stated maturity. The interest rate reset on each of these securities must occur no less frequently than quarterly;

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iv. Repurchase agreements, excluding U.S. Treasuries or agencies, will have a maximum term of 33 days. U.S. Treasuries or agencies will have a maximum term of 94 days;

v. Money market mutual funds will be considered to have a maturity of one day; and,

vi. Normal settlement period practices are to be used for all security purchases and sales (i.e., no extended settlement periods are allowed).

D. Diversification standards are as follows:

i. No more than the greater of $100 million or 4 percent of the collateral pool may be invested in the obligations of any one issuer, except for those of the U.S. Treasury and agencies carrying an explicit federal government guarantee;

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ii. No more than the greater of $200 million or 10 percent of the collateral pool may be invested in the obligations of U.S. Treasury sponsored agencies (Fannie Mae, Freddie Mac, etc.);

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iii. No more than 20 percent of the portfolio may be invested in the securities issued by participants in any one corporate sector, except for the financial and banking sectors, which are each limited to 30 percent of the portfolio;

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iv. Investment in securities issued by broker-dealers is specifically prohibited;

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v. No more than 15 percent of the portfolio may be invested in zero-coupon U.S. government issues. All other zero-coupon issues are specifically prohibited. U.S. Treasury Bills, commercial paper, and U.S. agency discount notes are not considered zero-coupon issues;

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vi. No more than 50 percent of the portfolio may be invested in floating rate or variable rate securities;

vii. No more than 25 percent of the portfolio may be invested in asset-backed securities;

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viii. No more than 40 percent of the portfolio may be invested in commercial paper;

ix. The portfolio may not be invested in illiquid securities. For purposes herein, an illiquid security is defined to be an issue that is not salable without the sale proceeds being materially impacted due to a lack of other trading activity in the security. The Participating Funds, therefore, expects the Contractor to invest only in liquid short-term securities. Bank time deposits are considered liquid herein as long as the maturity of such instruments is less than 94 days; and,

x. No more than the greater of $500 million or 25 percent of the aggregate prior days collateral pool balance may be invested in repurchase agreements with a single counterparty.

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xi. The minimum overnight (next business day) liquidity will be 20%.

IV. Non-Cash Collateral Guidelines

To be eligible as non-cash collateral, a security must be rated at the required quality level by the two Rating Agencies. Split rated issues are considered to have the lower of the ratings. When a security provided as non-cash collateral subsequently becomes unacceptable relative to the approved forms noted below, the lending agent will cause prompt substitution of such collateral with a security that qualifies under the schedule that follows.

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A. Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations rated AAA.

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B. General obligation issues of foreign countries as long as sovereign debt ratings for those countries are AA/Aa or better.

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C. Multinational Development Debt of Supranational Issues (i.e. International Bank for Reconstruction and Development) as long as the issuer rating is AAA/Aaa.

Deleted: D. Equity index basket collateral from the following indices: AEX 25, CAC 40, DAX 30, Euro 50, FTSE 100, Nikkei 225, SMI 23, and the S&P 500. Stocks with a beta of greater than 1.00 compared to their representative index will not be considered acceptable collateral under these guidelines except for the case of equity securities included in the FTSE 100.¶
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V. Market-Driven Breaches of Guidelines

PSERS 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 or the breach (unless an extended period of time is granted elsewhere in the guidelines and/or written

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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.

VI. Grandfather Clause

At the Contractor's discretion, positions in the securities lending cash collateral portfolio at the time of approval of these guidelines are permitted to remain in the portfolio as long as those positions were in compliance with the guidelines previously in place. This includes the Mellon GSL Euro Fund which is expected to be liquidated via the transfer of PSERS' pro-rata share of positions into a separate, segregated portfolio no later than January 1, 2009. Any new purchases must be in compliance with the latest set of guidelines approved by the Board.

VII. Monitoring Policy

A. Purpose

The purpose of this Securities Lending Monitoring Policy is to define the process for management and oversight of the securities lending program.

B. Responsibilities

The Securities Lending Monitoring Policy is disseminated below through the assignment of responsibilities within the securities lending program to PSERS' Board of Trustees and Finance Committee, Investment Office Staff, and Contractors.

i. Board of Trustees and Finance Committee:

- Approve Securities Lending Objectives and Guidelines.
- Review securities lending program performance annually with Staff.
- Upon recommendation from the Staff, approve which portions of the portfolio may be lent.

ii. Investment Office Staff:

- Report to the Finance Committee annually on the performance and compliance of the securities lending program.
- Monitor Contractors' compliance with program guidelines on an ongoing basis and notify the Finance Committee of any violation.
- Review the Securities Lending Objectives and Guidelines annually and recommend changes to the Finance Committee.

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- Review and evaluate the quarterly reports, as defined below, from the Contractors. Design and request changes to the quarterly report format as needed.
- Oversee the resolution of the sell-fail disagreements between Contractors and investment managers.
- Review approved broker/borrower list.
- Make recommendations on which portion of the portfolio should be lent.

iii. Contractors:

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- The Contractor will notify Staff immediately if there is a violation of the Securities Lending Guidelines.

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- The Contractor will provide a quarterly report (summarizing monthly information) including, but not limited to, the following:
  - the daily lending activity and income earned, and an average volume of securities loaned by broker, asset category, and manager account, summarized for each month over the quarter (including year-to-date statistics);
  - listing of portfolio holdings, with portfolio level statistics, for each month end, including market values, cost, maturity, date to reset, yield-to-maturity, and credit quality;
  - the monthly net income earned as a percentage of average loan balances, designed to measure the return earned on loans by asset category;
  - the net income earned as a percentage of the lending asset base (defined below) in each category;
  - the average monthly gross spread in each asset category (the gross spread will be calculated as the yield earned on the collateral portfolio plus the fee paid on non-cash collateral minus the rebate paid to the broker-dealer, and represents the earnings available to split between the Contractor and PSERS);
  - the average market value of the assets available for lending each month (lending asset base) by asset category;
  - the average monthly loan balances as a percentage of the average monthly lending asset base in each category;
  - the monthly average maturity of the collateral portfolio and the broker loan portfolio;

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- a review of the loan spreads and volume available in the market segments in which each PSERS lends; and,
- completed, audited financial reports necessary to comply with the Governmental Accounting Standards Board Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions.*

- The Contractor will provide written confirmation of adherence to these objectives and guidelines in the format provided by the Fund within 30 days from the end of each calendar quarter.

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