Commonwealth of Pennsylvania
Public School Employees' Retirement System

DATE: July 31, 2009

SUBJECT: Proposed Revisions to the Investment Policy Statement, Objectives and Guidelines

TO: Members of the Finance Committee

FROM: James H. Grossman, Jr., CPA, CFA
Managing Director of External Public Markets, Risk & Compliance

---

At the August Finance Committee meeting, staff will recommend that the Finance Committee adopt the proposed changes to the Investment Policy Statement, Objectives, and Guidelines (hereafter referred to as the Investment Policy Statement), including Addenda.

The more substantive changes to the Investment Policy Statement and Addenda have been black lined for your convenience in reviewing the changes. Substantive changes to the Addenda are based on suggestions made by Investment Office Staff and Wilshire. If you have any questions or comments regarding these changes, please contact me at 717-720-4703.

Investment Policy Statement, Objectives and Guidelines

Definitions (pages 1-7)

Added a definition for Placement Agent.

Use of Placement Agents by External Portfolio Managers (pages 16-18)

As we indicated at the June Finance Committee meeting, we are proposing a System-wide Policy to the Investment Policy Statement to address the use of Placement Agents by the External Portfolio Managers. This issue has come up due to transgressions related to the use of Placement Agents in soliciting business from the New York pension funds. The proposed policy will continue to permit the use of Placement Agents with a significant increase in disclosure and transparency for the Board and Staff in evaluating the retention of managers. This is consistent with policies adopted by a number of retirement systems throughout the country, including CalPERS, MassPRIM, and the New Jersey Division of Investment.

On July 22, 2009, the SEC proposed a rule prohibiting investment advisers from paying a third party, such as a solicitor or placement agent, to solicit government clients on behalf of the investment adviser and restricts political contributions among other provisions. These proposed SEC regulations will enter the 60-day comment period shortly. The proposed SEC regulations are consistent with the policies adopted by three large New York public pension plans. The proposed policy is only relevant if the proposed SEC regulations are not adopted. Should the SEC regulations be adopted, then the policy will not be relevant as the SEC regulations prohibiting the use of Placement Agents would supersede our policy. In essence, all External Portfolio Managers would be required to disclose that they have not retained a Placement Agent.

The key components to this proposed policy include:

Scope

This policy will apply to all External Portfolio Managers that the Board is considering for retention or has already retained. The purpose of the policy is to obtain disclosure of Placement Agent relationships, compensation, and fees paid by all External Portfolio Managers in an effort to prevent improprieties or the appearance of improprieties and to provide transparency in the investment process.

Policy

External Portfolio Managers shall not directly or indirectly charge or pass on any Placement Agent fee or expense, finder's fee, or any similar fee to the Board, regardless of whether or not the Board receives a credit or offset for such payments against other fees or expenses chargeable to the Board.

Disclosures

Prior to being considered by the Board for retention (or after being retained for all current managers), each External Portfolio Manager shall provide certain disclosures related to Placement Agents, including:

- Whether or not the External Portfolio Manager has retained a Placement Agent;
- Resumes of the Placement Agent;
- A description of the arrangement with the Placement Agent, including any compensation or other considerations;
- A description of the services performed;
- Whether or not the Placement Agent was utilized for all prospective clients or only a subset of clients;
- A copy of any an all agreements;
- Names of any parties related to PSERS who suggested the retention of the Placement Agent;
- A statement of whether the Placement Agent is registered and, if not, why;

- A statement of whether the Placement Agent is registered as a lobbyist with any state; and
- Any other information deemed pertinent by the Board or Staff.

Contracts

PSERS shall not pay directly or indirectly any fees, compensation, or expenses for any Placement Agent used by the External Portfolio Manager. If the External Portfolio Manager represents that a Placement Agent was not used, a written statement to that effect must be provided to PSERS.

Changes

The External Portfolio Manager is required to provide an update of any changes to the information previously provided to PSERS within five business days.

Remedies

Any material omission or inaccuracy in information submitted by the External Portfolio Manager shall result in the following:

- Reimbursement or payment of the greater of the prior two years of management fees or an amount equal to the amounts paid or promised to be paid to the Placement Agent by the External Portfolio Manager; and
- PSERS will retain the right to terminate the manager without penalty, to withdraw without penalty from any partnership, and to cease making further capital contributions (and paying fees on uncalled commitments).

Exhibit B (pages 32)

Adjusted the private market target based on the actual allocation at the end of June (decrease of 1%) with a corresponding increase to the non-U.S. equities target of 1%.

Exhibit C (page 33)

Adjusted the policy index weight for private markets based on the actual allocation at the end of June (decrease of 1%) with a corresponding increase in the global equity policy index weight of 1%.

Below we detail the proposed changes to the various addenda. The only material changes to discuss relate to the cash management guidelines for portfolios that hold derivative positions that are backed by cash equivalent holdings. Cash used to back derivative positions is generally managed against a 3-month LIBOR benchmark as this represents the financing rate embedded in the derivative pricing. Three addenda (H, H1, and Y1) have fixed income guidelines for LIBOR portfolio management. However, the guidelines were inconsistent. We had Wilshire review these guidelines and numerous changes that they recommended were incorporated into the three addenda. Now, the proposed guidelines are consistent. The proposed changes will reduce the cash management risk of these portfolios on a prospective basis.

Addendum E / Internally Managed Indexed Equity Portfolios

No material changes.

Addendum E1 / Internally Managed Alpha Generation Program

No material changes.

Addendum E2 / Equity Rebalancing Program

No material changes.

Addendum F / Equity Option Program – Incremental Return

No material changes.

Addendum H / Full Discretion Commodity Program

1. Reduced the risk of the general stock guidelines by:
   a. Limiting the sector exposure to the greater of 150% of the DJ/UBS Commodity Index weighting or 25% of the portfolio (previously limited sector exposure to 50% of the portfolio);
2. Reduced the risk of the general fixed income guidelines by:
   a. Incorporated a minimum rating for commercial paper of P-2 or better;
   b. Reducing the maximum amount that can be invested in any corporation from 7% to 3%;
   c. Increasing the minimum rating for asset backed securities from Baa3/BBB- to Aa3/AA-;
   d. Increasing the minimum rating for 144A securities without registration rights from Baa3/BBB- to Aa3/AA-;
   e. Imposed a 20% limit on non-U.S. exposure;
   f. Reducing the maturity limits from 40 years to no more than 5 years (depending on the security) and limiting the maximum average maturity of the portfolio to 180 days;
   g. Reducing the maximum duration limit of the portfolio from 1 year to 180 days;

   h. Increasing the minimum weighted-average credit rating of the portfolio from A2/A to A1/A+;
   i. Reducing the maximum amount that can be invested in single issue cash and cash equivalent securities from 7% to 3%; and
   j. Increasing the minimum credit rating for REMICs and CMOs from Baa3/BBB- to Aa3/AA-.
   k. Prohibited the investment in fixed income securities denominated in foreign currencies.
3. Clarified the permitted strategies.
4. Permitted the manager to invest up to 10% of the portfolio in taxable municipal securities rated Aaa/AAA.

Addendum H1 / Enhanced Commodity Index Program

1. Reduced the risk of the general fixed income guidelines by:
   a. Incorporated a minimum rating for commercial paper of P-2 or better;
   b. Reducing the maximum amount that can be invested in any corporation from 7% to 3%;
   c. Increasing the minimum rating for asset backed securities from Baa3/BBB- to Aa3/AA-;
   d. Increasing the minimum rating for 144A securities without registration rights from Baa3/BBB- to Aa3/AA-;
   e. Imposed a 20% limit on non-U.S. exposure;
   f. Reducing the maturity limits from 40 years to no more than 5 years (depending on the security) and limiting the maximum average maturity of the portfolio to 180 days;
   g. Reducing the maximum duration limit of the portfolio from 1 year to 180 days;
   h. Increasing the minimum weighted-average credit rating of the portfolio from A2/A to A1/A+;
   i. Reducing the maximum amount that can be invested in single issue cash and cash equivalent securities from 7% to 3%; and
   j. Increasing the minimum credit rating for REMICs and CMOs from Baa3/BBB- to Aa3/AA-.
   k. Prohibited the investment in fixed income securities denominated in foreign currencies.
2. Eliminated the hedging section (previous II. D.) since investment in foreign denominated securities is prohibited.
3. Permitted the manager to invest up to 10% of the portfolio in taxable municipal securities rated Aaa/AAA.

Addendum P / Active Currency Hedging Overlay Program

No material changes.

Addendum P1 / Active Currency Program

No material changes.

Addendum Y1 / LIBOR-Plus Short Term Investment Pool Portfolios

1. Reduced the risk of the general fixed income guidelines by:
   a. Reducing the maximum amount that can be invested in any corporation from 7% to 3%;
   b. Reducing the maximum amount that can be invested in asset backed securities from 50% to 25%;
   c. Increasing the minimum rating for asset backed securities from Baa3/BBB- to Aa3/AA-;
   d. Imposing a minimum rating of Aa3/AA- for 144A securities without registration rights;
   e. Reducing the maximum average maturity of the portfolio from 270 days to 180 days;
   f. Reducing the maximum duration limit of the portfolio from 270 days to 180 days;
   g. Imposing a maximum amount that can be invested in single issue cash and cash equivalent security to no more than 3%; and
   h. Increasing the minimum credit rating for REMICs and CMOs from A3/A- to Aa3/AA-.