

III. 1. Investment Policy Statement

Investment Policy Statement

Employees'

Retirement System of the State of Hawaii

Effective July 2006

Executive Summary

Type of Plan	Defined Benefit
March 31, 2006	\$9.9 Billion
Investment Planning Time Horizon	5 years
Expected Annualized Return and Risk	Based on 2006 projections for 5 years, the target allocation is expected to achieve an average annualized return of 8.0% (5.25% real return with expected inflation of 2.75%). The annual nominal return over this five-year period is expected to fall within a range of (4.4%) and 20.4% two-thirds of the time.

Primary Goal

The preservation of capital is of primary concern. The Board seeks preservation of capital with a consistent, positive return for the Fund. Although pure speculation is to be avoided, the Board appreciates the fact that an above average return is associated with a certain degree of risk. Risk to be assumed must be considered appropriate for the return anticipated and consistent with the total diversification of the Fund.

Long-range Asset Allocation Target

The ERS will strategically invest in the following asset classes:

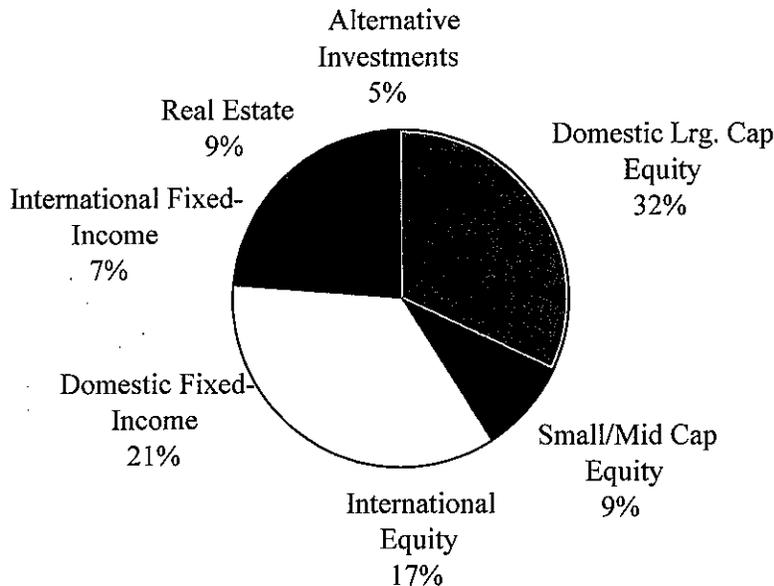
	<u>Lower Limit</u>	<u>Strategic Allocation</u>	<u>Upper Limit</u>
Domestic Equity	27%	32%	37%
Small/Mid Cap Equity	6%	9%	12%
International Equity	13%	17%	21%
Domestic Fixed-Income	19%	21%	23%
International Fixed-Income	5%	7%	9%
Mortgages	NA	0%***	NA
Equity Real Estate	0%	9%*	9%
Alternative Investments	0%	5%**	5%

*The real estate target will be the percentage actually invested up to 9% of the total fund. Changes in the real estate target will be offset by an equal percentage change in the large cap domestic equity target.

** The alternatives target will be the percentage actually invested up to 5% of the total fund. Changes in the alternatives target will be offset by an equal percentage change in the large cap domestic equity target.

***The mortgage target will be the percentage of the total fund actually invested. Changes in the mortgage target will be offset by an equal change in the domestic fixed-income target.

Adjustments in the above targets will take place annually in conjunction with the annual asset allocation review.



The target is to be pursued primarily by cash flow on a long-term basis and the actual allocation will be rebalanced no less frequently than annually back to the target range. This will primarily be accomplished by cash flow management, but actual asset transfers may be necessary in a period of diminished net cash flow activity. The target is to be reviewed annually for reasonableness relative to significant economic and market changes, or to changes in the ERS' long-term goals and objectives. A formal asset allocation study should be conducted at least every three years to verify or amend the targets.

Portfolio Evaluation Benchmark

To monitor the total fund result, a special target benchmark is constructed to measure the target mix. As the allocation to real estate and alternative investments changes, the target is adjusted. The latest target was created effective March 31, 2006. This serves as a minimum performance objective for the Fund. The target benchmark objective will be included in all quarterly evaluation reports of the ERS. As of March 31, 2006, the composition of the benchmark is:

- 34.9% of the Standard & Poor's 500 Stock Index
- 4.5% of the Standard & Poor's Mid Cap 400 Index
- 4.5% of the Russell 2000 Index
- 14.5% of the Morgan Stanley Capital International EAFE Index
- 2.5% MSCI Emerging Markets
- 21% of the Lehman Brothers Aggregate Bond Index
- 7% of the Citigroup(Unhedged) Non-U.S. Government Bond Index----
- 7.5% of the NCREIF Total Index
- 3.6% of Alternative Investment s

Individual investment managers will not be measured against this total fund objective. However, it is expected that the sum of their efforts will exceed the objective over time.

Guidelines for Manager Selection

The Board will select appropriate investment managers to manage the ERS' assets. This selection process shall include the establishment of specific search criteria, and documentation of analysis and due diligence on potential candidates. All manager candidates must meet the following minimum criteria:

- (1) Be a bank, insurance company, investment management company, or investment adviser as defined by the Registered Investment Advisers Act of 1940.
- (2) Provide historical quarterly performance numbers calculated on a time-weighted basis, based on a composite of all fully discretionary accounts of similar investment style, and reported net and gross of fees.
- (3) Within the manager selection process, performance evaluation reports prepared by an objective third party that illustrate the risk/return profile of the manager relative to other managers of like investment style shall be reviewed.
- (4) Provide detailed information on the history of the firm, key personnel, key clients, fee schedule, and support personnel and demonstrate financial and professional staff stability.
- (5) Clearly articulate the investment strategy that will be followed and document that the strategy has been successfully adhered to over time.
- (6) Have a reasonable and competitive fee structure.
- (7) Selected firms shall have no outstanding legal judgments or past judgments that reflect negatively upon the firm to the extent that in the Trustees judgement would impair the ability of the firm to provide expert investment management to the ERS
- (8) With respect to real estate advisors, the ERS shall enter into contractual arrangements only with organizations whose principal officers are engaged in the business of advising and evaluating commercial, industrial or residential real estate investments, mortgage banking, or property management, and which are duly licensed to perform real estate advisor services in the jurisdiction where the real property is located.

All investment manager candidates are expected to comply with all laws, regulations, and standards of ethical conduct.

Appendix A of this document provides more detailed selection factors that are recommended in the manager selection process.

Investment Practices

Investments will be prudent and consistent with the best investment practices, in accordance with the assigned investment mandate and in compliance with Chapter 88, HRS.

A. Domestic and International Equity Securities

Equity securities shall be diversified by industry and in number. No purchase should be made that causes an individual security to exceed 5% of the value of an individual manager's portfolio, where those securities constitute less than 3% of the current market capitalization of the appropriate benchmark. If those securities constitute more than 3% of the current market capitalization of the benchmark, then the Manager shall not hold more than the benchmark weight plus 2 percentage points.

Equity securities shall in general possess value and quality corroborated by accepted techniques and standards of fundamental and technical analysis.

Domestic equity managers are authorized to invest in foreign, dollar-denominated equity securities traded on US exchanges including ADR's and American Shares. Convertible equity securities and warrants are permissible investments for all domestic equity small cap managers.

Exchange Traded Funds (ETF's) and Preferred Stock are allowable investments on a limited basis for active domestic and international equity managers. The market value of ETF's or Preferred Stock may not exceed 10% of portfolio value. Rule 144a securities may be held by domestic and international equity managers up to 10% of portfolio value as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio.

Non-U.S. equity managers with an MSCI EAFE benchmark may hold up to 10% of the portfolio in emerging markets. Non-U.S. equity managers with an MSCI ACWI benchmark may hold up to 25% of the portfolio in emerging markets. Emerging Markets Equity managers may hold up to 10% of their portfolio in countries outside of the MSCI Emerging Markets Free Index. Within these benchmark constraints, investment managers shall be given full discretion to manage the assets under their supervision in terms of both security selection and country selection.

Currency hedging on the part of international equity managers will be permitted as part of a defensive strategy to protect the portfolio value. However, the overall benchmark for the ERS international equity asset class will be unhedged.

The Board recognizes that commingled funds' guidelines are established by their trust documents/prospectuses and that ERS guidelines have no bearing on the policies of commingled funds. However, the Board expects that any manager of a commingled fund and/or index funds would inform the Board if the investment policy of any such fund conflicts with this Investment Policy Statement.

B. Fixed-Income Securities

ERS has adopted the Lehman Brothers fixed-income index inclusion criteria for its fixed-income program. ERS utilizes two fixed income mandates: (i) a "Diversified Manager" whose benchmark will be the 85% Lehman Universal/15%Lehman Multiverse ex-USD Hedged Index and (ii) an "International Manager" whose benchmark will be the Lehman Multiverse ex-USD Hedged Index. ERS utilizes Fitch as a third rating agency alongside Moody's and Standard & Poors. The criteria are as follows:

-Securities rated by all three agencies are assigned the middle rating. So for example, for a security to be rated A it must be rated at least A by two of the three agencies.

-Securities rated by only two agencies are assigned the most conservative rating. Thus, if a security is rated A by one agency and BBB by another, it would be considered BBB.

-Securities rated by only one agency are assigned that rating.

The Fixed-Income portion of the Fund shall be invested in marketable, fixed-income securities. The following instruments are acceptable for fixed-income portfolios:

- Money Market Instruments
- Commercial Paper (must be rated A1/P1).
- Certificates of Deposit and Bankers Acceptances.
- United States Treasury Bonds, Notes, and Bills.
- Repurchase agreements with U.S. Treasury Securities and agencies of the U.S. Government as collateral.
- Debt instruments issued by agencies of/or guaranteed by the United States Government.
- Municipal Bonds
- Private Placements (including 144As)
- Bank loans
- Non-leveraged structured notes
- Convertible bonds
- Investment grade corporate debt issues.
- Emerging markets debt.
- Allowable countries for both Diversified Manager and International Manager mandates is the entire list of countries within the Custom 85% Lehman Universal/15% Lehman Multiverse ex-USD Hedged Index. Managers are allowed to invest in either local currency-based debt and/or U.S. Dollar-based debt and/or local currencies. Securities will be classified by the country/currency of issuance, not the origin or domicile of the issuer.
- CMO's and asset-backed securities. CMOs backed by pools of mortgages guaranteed by the full faith and credit of the U.S. Government or its agencies, or corporate issues rated AAA by at least one of the major rating agencies.
- Preferred stock.
- Sovereign debt instruments issued by agencies of, or guaranteed by, foreign governments, in addition to foreign corporate debt issues, foreign asset-backed securities, mortgages, CMO's, 144a Private Placements, convertibles, and supranational issues. Securities are classified by the country/currency of issuance, not the origin or domicile of the issuer.
- Minimum issuance size is \$150 million. Managers should be aware of minimum issuance size criteria used to create the benchmarks.

Fixed-Income investments shall be appropriately diversified although the investment manager may engage in "active" bond management. It is, therefore, anticipated that there may be turnover as shifts are made between and within countries, sectors, quality and maturity.

Summary of Concentration Limits:

Concentration limits should be determined exclusive of explicit currency and/or currency derivative positions. Sector, rating, and other allocations shall be compared to equivalent allocation levels of the appropriate *unhedged* benchmark. For example, if a manager holds a 5% position of debt issued in South Africa, holds a (2%) short position in the Rand, and the unhedged benchmark weighting of South Africa is 1%, then the 5% unhedged position counts against Emerging Markets limitation and the manager is 4% overweighted in South Africa. Separately, a 3% currency exposure (5% less 2%) counts against the absolute currency exposure constraint. Managers are required to segregate and summarize explicit currency exposures in the reporting process.

Specific Issue or Issuer	5%
Excludes supranationals, U.S. Treasuries, sovereign debt of OECD governments, U.S. agencies, and equivalently-rated agencies of OECD governments. Specific mortgage pools and trusts are considered separate issuers, and Each tranche within a CMO is considered a separate issue.	
Below Investment Grade	15%
Below B- Rating	2%
Non-U.S. Dollar Denominated (for Diversified Managers)	30%
Excludes money market securities and money market futures.	
U.S. Dollar Denominated (for International Manager)	25%
Excludes money market securities and money market futures.	
Emerging Markets (local currency and USD debt)	10% for Diversified Manager
Manager uses the World Bank's definition for emerging markets, which is based on a GNP per capita calculation.	
Emerging Markets (local currency and USD debt)	20% for International Manager
Manager uses the World Bank's definition for emerging markets, which is based on a GNP per capita calculation.	
Private Placements	10%
Including securities eligible for resale under Rule 144A.	
Convertible Securities	5%
Preferred Stocks	10%
Non-U.S. Agency CMOs	10%
Net Foreign Currency Exposure (Diversified Managers)	15%
Net Foreign Currency Exposure (International Managers)	100%
Net foreign currency exposure is the amount of offsetting currency exposure* versus a portfolio's or benchmark's cash market security positions. For example, a local-market sector amounting to a 5% portfolio weighting offset by a (5%) short position in the commensurate local currency would result in zero net foreign currency exposure. Net foreign currency exposure will be measured as the <u>absolute value</u> of all country-level net currency positions (long and short) versus the U.S.	

Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies.

**"exposure" meaning the net amount of a specific currency's outstanding long and short positions versus the U.S. Dollar.

Gross Foreign Currency Exposure (Diversified Managers)	15%
Gross Foreign Currency Exposure (International Managers)	100%

Gross foreign currency exposure will be measured as the absolute value of all country-level currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies.

Securities Prohibited: Mortgage Derivatives (IOs/POs/Inverse Floaters), Re-REMICs

C. Derivatives may be used in the ERS portfolio as a substitute for a cash market security, risk control, cost reduction or liquidity management. Derivatives are not permitted for purposes of speculation. **Any derivative investment not explicitly authorized by this Investment Policy Statement is prohibited.**

- Where derivatives are used as substitutes for specific a specific cash security or set of cash securities, the return volatility of the combination of the derivative and associated cash position shall be equivalent to the unleveraged cash security or securities underlying the derivative instrument.
- Managers shall mark-to-market their derivative positions daily
- Permitted Instruments:
 - Futures – stock index futures, stock and bond futures, and currency futures where the manager has the authority to invest in the underlying or deliverable cash market security
 - Options- options on stocks and bonds. Options on futures, swaps, and currency are allowed for those Managers who have permission to invest in the comparable cash instruments
 - Currency forwards – only those managers who have the authority to invest in the underlying cash market instrument
 - Swaps – for use in fixed income portfolios only and only on those securities that are currently permitted. Minimum counterparty rating: A-
- Futures contracts must be CTFC (Commodity Futures Trading Commission) approved and exchange traded.
- Options may be either exchange traded or over-the-counter (OTC) subject to counterparty guidelines as noted.
- Counterparties to OTC traded instruments (options and forwards) must be rated investment grade or better as determined by at least one major rating agency.
- Cross-hedging is not permitted by international equity managers; however, as it is a standard practice for non-U.S. bond managers, it is allowed for international fixed-income managers. International fixed-income managers may also use certain developed-market currencies as proxies for otherwise illiquid emerging-market currencies. In such cases, use of such proxies will be disclosed through the ongoing reporting process. The counterparties for foreign currency derivatives must be rated A- or equivalent.

- On an annual basis, all investment managers shall provide a summary of the derivatives used and the reasons for their use. This summary shall be the basis for verification that the investment managers are generally complying with the objectives and constraints of the investment policy. The investment consultant shall elicit responses on each manager's policy in the form of a letter.
 - On a daily basis the custodian bank shall examine all manager derivatives purchases for prohibited derivatives. Should any prohibited derivatives be found, the custodian bank should promptly notify staff and instruct the manager to sell the prohibited derivatives. The custodian bank will also value and monitor all derivatives and the trades from which they emanate.
- D. Real Estate Investment - A portion of the ERS Total Fund shall be invested in real estate of a nature consistent with the overall objectives of the Fund and the opportunities offered by the market conditions at the time of purchase. Complete real estate investment policy and procedures can be found beginning in Section III.7 of this document.
- E. Mortgages - A portion of the Fund shall be invested in mortgages of such a nature that they provide proper diversification for the Fund and yield a competitive return with other fixed-income alternatives of equivalent quality and maturity.
- F. Policies for other asset classes will be added as required.
- G. All investments will conform to Section 88-119, Hawaii Revised Statutes.

Manager Discretion

The investment managers shall be given full discretion to manage the assets under their supervision subject to the Investment Guidelines and their assigned mandate, the laws of the State of Hawaii, and the Investment Management Agreement. All transactions effected for the ERS Fund will be subject to best price and execution. If a manager utilized brokerage from the plan assets to effect commission recapture transaction, detailed records will be kept and communicated to ERS Staff.

The investment program will be managed by designated equity, fixed-income, international equity, international fixed-income, real estate, and/or alternative investment (private equity and timber) managers consistent with the asset allocation objectives set forth by the Board. Managers have no responsibility for the ERS Fund aggregate asset allocation.

Manager Evaluation

Individual domestic and international equity and bond managers will be measured against an appropriate index and peer group. Market indexes and peer group benchmarks are assigned to each manager and are intended as a guide for the investment manager to understand the risk/reward posture of their portfolio. Managers have full discretion to manage the risk posture of their portfolios relative to their designated market index and may, with conviction and appropriate expertise, execute security strategies not reflected by their market index as long as they conform to the investment guidelines and the laws of the State of Hawaii.

There shall be a continual review of the investments under management. The Board shall confer with the investment managers upon call to review ERS Fund investments and the current environment. Each investment manager shall report pertinent data relating to the ERS portfolio as stipulated in "Reporting Requirements for Investment Managers."

Guidelines for Manager "Watch List" or Termination

The performance of the Board's investment managers will be monitored on an ongoing basis. The Board may place a manager on a "Watch List" or terminate a manager at any time.

Managers may be terminated or placed on a "Watch List" for a variety of reasons: personnel changes, violation of policy and investment guidelines, style deviations, underperformance, asset allocation changes and non-disclosure of material information. The ERS has two clearly stated fund performance objectives in the investment guidelines, the preservation of capital and consistent positive returns. These "Watch List"/termination guidelines were formulated with these objectives as a foundation. There are various factors that should be taken into account when considering placing a manager on a "Watch List" or the termination of a manager. These can be separated into two broad categories - qualitative and quantitative factors. The former focuses on personnel, organizational and legal issues while the latter addresses performance.

When possible, the Board will issue a warning letter to underperforming managers prior to placement on the "Watch List". However, the Board may place a manager on the "Watch List" at any time whether or not a warning letter has been issued. Placing a manager on the "Watch List" is an intermediate step towards either resolving the problem or terminating the manager. Managers may only be removed from the "Watch List" under these two conditions.

Watch List Guidelines - Qualitative Factors

Below are some of the *qualitative* factors that may be considered in determining whether an investment manager should be placed on the "Watch List" or terminated.

FACTOR	EVALUATION TECHNIQUE	ACTION STEPS
Violation of investment guidelines and/or the laws of the State of Hawaii	Review portfolio holdings vis-à-vis the investment guidelines <ul style="list-style-type: none"> - Individual securities - their percentage weight in the portfolio 	Correct violation. Review violations with manager to reestablish compliance with appropriate guidelines. Manager to compensate ERS for any losses that occurred from violation. Terminate or place on watch list - terminate on additional violation.
Deviation from stated investment style and philosophy	Style mapping- total fund analysis. Style attribution - manager specific style analysis.	Place on watch list. Monitor for on-going fit with asset allocation policy. Terminate if no longer consistent with asset allocation structure.
Changes in ownership	Require immediate notification of any pending changes in ownership	Place on watch list. Qualitatively determine if change may detrimentally effect asset performance. If so, terminate.
Turnover of key personnel	Require manager to establish a list of key personnel, and rank in level of importance, at the inception of the account. Manager updates on an as needed basis.	Place on watch list. Consider termination if there is key personnel turnover on the account (as specified in the manager provided list) or staffing is deemed insufficient to appropriately manage the ERS account.
Litigation	Require manager to notify ERS staff immediately if entity which manages the funds is involved in any litigation	Evaluate nature, seriousness and likely impact of charges on the investment process and take appropriate action.
Failure to disclose significant information which could impact manager evaluation	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time.	Review non-disclosure to determine if material to manager's ability to manage assets. If so, terminate.

Failure to disclose potential conflict of interest in managing assets	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time	Review non-disclosure to determine if conflict was material and should have been known by manager. If so, terminate.
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Watch List Guidelines - Quantitative Factors

Below are some of the *quantitative* factors to be considered in determining the appropriateness of terminating an investment manager or placing the investment manager on the "Watch List."

- Minimum of three years of performance preferred, but not required prior to termination.
- The Trustees may place the manager on the watch list at any time. Said manager may be terminated at any time if they continue to fail watchlist criteria.

PERFORMANCE TEST	BENCHMARK	FAIL CRITERIA
Test 1: Relative to Market Index, for trailing 3 and 5 years	Annualized performance relative to the agreed upon market index or appropriate benchmark	Equity managers fail if underperform index by 1% per annum over measurement period, gross of fees; fixed-income managers fail if underperform by 20 basis points over period, gross of fees.
Test 2: Peer group comparison, for trailing 3 and 5 years	Performance compared to that of an appropriate peer group	Fail if cumulative performance is at 65% percentile or lower over relevant time frame.

The quantitative guidelines above refer to a minimum time frame of three years. **In the interim, three quarters of consecutive underperformance relative to any or all of the above referenced benchmarks should trigger a review with the corresponding investment manager. All of the qualitative criteria should be reviewed along with an explanation of the underperformance from the manager.**

The following factors are important to monitor on an ongoing basis to understand and track the performance of the investment managers who have been placed on the Watch List:

FACTOR	EVALUATION TECHNIQUE
Consistency of returns	<ul style="list-style-type: none"> • Rolling 3 year returns relative to market index • Rolling 3 year returns relative to appropriate style group • Rolling correlations to market index

Risk adjusted performance	<ul style="list-style-type: none">• Rolling 3 year information ratio• Risk reward chart• Sharpe ratio• Treynor ratio
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Reporting Requirements for Equity and Fixed-Income Investment Managers

Monthly Reporting Requirements

A. Reporting Requirements

1. Statement of asset positions as of the end of the month on a trade date basis. Include the following information:
 - a. Number of shares or par value.
 - b. Book cost (both U.S. dollar and local currency if applicable) based on average cost basis.
 - c. Market value (both U.S. dollar and local currency if applicable) with disclosure of pricing source.
 - d. Unrealized gains/losses (both U.S. dollar and local currency, if applicable).
 - e. Classification of assets should include cash, cash equivalents, stocks (common, preferred), bonds (corporate, government, convertible), derivatives, etc.
 - f. Asset allocation percentages.
 - g. The percentage of individual securities position to the manager's portfolio.
 - h. In the case of derivatives, the percentage of the manager's portfolio represented by the notional amount of the derivatives position to the total fund.
 - i. Any combined derivatives position with a net exposure representing greater than 25% of the market value of the total fund.
2. Statement of liabilities (both U.S. dollar and local currency if applicable) as of the end of the month-end period with summary amount for open trades, contract options, etc.
3. Listing of all transactions for the period including unit price paid or received, quantity disposed or received, total value, gain/loss, bond rating on purchases. The transactions reported must be on an accrual basis and reported in both U.S. dollar and local currency, if applicable.
4. Detailed schedules for the following items must be made available upon request by ERS staff, but are not required on a regular basis.
 - a. Income receivable.
 - b. Realized and unrealized spot and forward foreign currency hedges.
 - c. Cash reconciliation.
 - d. Open or pending trades.
 - e. Interest collected or paid and/or dividend income.
5. One copy of the report is to be forwarded to the Custodian Bank; one copy is to be forwarded to the ERS.
6. Reports are to be stapled or bound and should have the manager's firm name on front.

- B. Within five business days of the occurrence of any of the following, submit a written explanation of the circumstances that resulted in:
1. Transactions that result in the Custodian Bank charging the ERS overdraft charges.
 2. Transactions that are extraordinary and warrant disclosure to ERS (also include items not reflected in the financial statements, e.g. significant changes in forward contracts, etc.).
- C. Reconciliation of Manager's Monthly Report with Custodian Bank's Monthly Report
1. To assist the Custodian Banks with the reconciliation of asset position for both the number of shares/par value and book value, income realized and gain/loss, and pricing, (in U.S. dollar and local currency for foreign managers), managers must provide the required information in a reasonable format (e.g. diskette, direct transmission, etc.). Contact the Custodian Bank for file format and layout.
 2. Each investment manager must reconcile its records to the Custodian Bank's reports. A copy of the manager's reconciliation report must be received within 30 days of the close of the reporting month.
- D. Fees
1. Investment Manager's fees are based on the Custodian Bank's reports. Fees are paid quarterly and after-the-fact. Invoices are sent to the ERS and processed for payment from the investment manager's portfolio.
 2. Failure to submit written explanations of charges (e.g. bank overdraft) listed in B.1. and B.2. above, may result in fees being adjusted at the discretion of the ERS.
 3. Fees may be adjusted if the market value of the portfolio presented in Custodian Bank's reports is subsequently revised for pricing errors or other adjustments.
 4. On an annual basis, the investment consultant shall write to the investment managers inquiring whether the ERS is receiving the lowest fee structure (favored nation clause).

Quarterly Performance Reporting Requirements

All of the information listed below shall be included in quarterly performance reporting. Performance results shall be placed at the beginning of the report.

1. A valuation report that includes a Statement of Assets.
2. Performance results for the quarter, calendar year to date, fiscal year to date, and preceding 1-year, 3-year and 5-year periods.
3. An analysis of the positive and negative aspects of the investment strategy during the quarter and how it affected the investment results.
4. A transaction report for the period, including the purchase or sale of securities, together with gains and/or losses from each sale.

5. An economic outlook and investment strategy for the next quarter and/or year.
6. Any other pertinent information that should be brought to the attention of the Board of Trustees.
7. One report is to be mailed to the ERS Chief Investment Officer and one report is to be sent to the ERS Chief Investment Officer in electronic format.

Organizational Changes

Important changes in the Investment Manager's organization, staff and investment strategy should be reported within 5 business days of their occurrence. Managers must also promptly report any involvement in litigation, claims, assessments, regulatory investigations, etc.

Registration Statement

Investment Managers must also send the ERS annually a copy of part II of their registration statement (Form ADV) on file with the Securities and Exchange Commission.

Presentations to the Board of Trustees

The Board of Trustees does not require investment managers to meet with the Board on a regular basis. However, the Board, at its discretion, may invite investment managers to discuss appropriate matters pertaining to the ERS account. Attendance by manager representatives at the Board's Annual Manager's Conference is required.

AIMR Investment Reporting Standards

Adopted November 29, 1993

WHEREAS: the Association for Investment Management Research (AIMR) has promulgated standards for calculating and reporting investment manager performance; and

WHEREAS: the Board has vital interest in consistent and fair reporting of investment performance by its current investment managers and by managers who present their historical investment performance in response to the Board's manager searches; and

WHEREAS: the whole investment industry benefits from the level playing field and the self-regulation represented by the AIMR reporting standards;

NOW THEREFORE BE IT RESOLVED: that the Board will require all of its current investment managers to report performance results in compliance with AIMR standards no later than December 31, 1993; and

BE IT RESOLVED: that effective immediately, all responses to the Board's manager searches shall include investment performance results presented in full compliance with Level 1 of the AIMR standards and to provide third party verification of their performance results in order to assure that managers are in full compliance with the reporting standards.

BE IT FURTHER RESOLVED: that certified copies of this Resolution be transmitted to all of the ERS' current investment managers and consultants.

CFA Institute Investment Reporting Standards

Adopted June 2006

WHEREAS: the CFA Institute has promulgated standards for calculating and reporting investment manager performance; and

WHEREAS: the Board has vital interest in consistent and fair reporting of investment performance by its current investment managers and by managers who present their historical investment performance in response to the Board's manager searches; and

WHEREAS: the whole investment industry benefits from the level playing field and the self-regulation represented by the CFA Institute reporting standards;

NOW THEREFORE BE IT RESOLVED: that the Board require all of its current investment managers to report performance results in compliance with the CFA Institute standards; and

BE IT RESOLVED: that effective immediately, all responses to the Board's manager searches shall include investment performance results presented in full compliance with Level 1 of the CFA Institute standards and to provide third party verification of their performance results in order to assure that managers are in full compliance with the reporting standards.

BE IT FURTHER RESOLVED: that certified copies of this Resolution be transmitted to all of ERS' current investment managers and consultants.

Employees' Retirement System Distribution Of Brokerage Commission

1. Each manager is charged with the responsibility of seeking the best execution and best price in the best interest of the ERS.
2. No trades of any manager shall be done through their own parent, subsidiary or otherwise related firm. Also, no trades should be done which benefits a manager unless prior approval has been given by the ERS for such actions.
3. At least thirty five percent of all brokerage transactions for domestic equity managers and international equity managers are required to be directed to brokers participating in the ERS' Commission Recapture Program and quarterly reports shall be made to the Chief Investment Officer regarding compliance with this requirement. Managers should still comply with their responsibility of seeking best execution and best price.

Managers will be forwarded brokers' transaction reports from the Custodian Bank and are expected to reconcile the broker's transaction reports to their in-house reports to confirm that all trades directed to the Commission Recapture Program are properly recognized and reported.

4. Annual reports prepared by the ERS staff summarizing the directed brokerage transactions will be submitted to the Board of Trustees.

Securities Lending Guidelines

The policies and guidelines governing securities lending shall be with the master custodian, unless contracted otherwise. A *separate contract*, distinct from a master custody relationship, detailing the type of securities lending relationship and program is both mandatory and essential in the treatment of securities lending as, foremost, an investment function with the associated risks and return implications, and fiduciary responsibility.

Objective

The securities lending provider has to exercise investment discretion within the overall objective of: preserving principal; providing a liquidity level consistent with market conditions and the lending and trading activities of the ERS; and maintaining full compliance with stated objectives and statutory provisions. The securities lending provider shall exercise prudence and expertise in managing the cash collateral reinvestment function.

Program Guidelines

Maintenance of the integrity and operational functionality of the securities lending program shall be pursued with utmost diligence. The securities lending provider shall have documented policies and procedures in place detailing the following if not stipulated in the securities lending contract for both domestic and international securities.

- Borrower Limits/Creditworthiness
- Acceptable Collateral
- Marking to Market
- Corporate Actions/Distributions
- Proxy Voting Limitations
- Recall of Loaned Securities
- Revenue Splits
- Valuation and Reporting of Loaned Securities and Cash Collateral Reinvestments
- Borrower Risk (Default)
- Cash Collateral Reinvestment Risk
- Operational Negligence
- Counterparty Indemnification
- Other relevant policies

The securities lending provider shall at all times exercise prudence and due care and shall comply at all times with HRS 88-121.5 and all laws, rules and regulations, including but not limited to banking and securities regulatory bodies, taxation authorities and the Department of Labor.

Collateral Management

The securities lending provider shall exercise prudence and reasonable care in discharging its discretion in the investment management of cash and non-cash collateral, including asset/liability (gap) management that is appropriate relative to the market environment or conditions that the securities lending provider is operating in.

Provided that the management of collateral, specifically cash, imposes the greater risk, the securities lending provider shall adhere to the overall investment objective of ERS. Policies regarding issuer, credit, exposure and rating limits utilized in the securities lending program per investment vehicle shall be under the full discretion of the provider, and appropriate and consistent with the stated general guideline. Issues such as exposure guidelines, prohibited securities for cash investment, duration strategies, and matched & mismatched book are both strategic and tactical investment functions and shall be consistent with the above objective.

Cash collateral reinvestment emanating from securities lending shall be in compliance with the stated investment policies and guidelines of the ERS for short term and/or fixed-income investments where applicable. The investment policies and guidelines governing securities lending shall not be any different, unless contracted or exempted otherwise.

Each securities lending provider shall provide documentation of their collateral reinvestment fund detailing the following:

Investment Management

Eligible Cash Market Instruments

Eligible Derivative Instruments

Credit Quality

Corporate Obligations

Instruments of U.S. and Foreign Banks

Sovereign Debt Obligations

Repurchase Agreement

Commingled Funds

Investment Restrictions and Concentration Limits

Liquidity and Investment Maturity

Policy Adjustments and Exceptions

Investment Limitations, Prohibited Transactions and Restrictions on Self Dealing

Prohibited Transactions and Securities

The following instruments and "exotic derivatives" are deemed inappropriate for the reinvestment of cash collateral and are prohibited in ERS accounts. Leverage is strictly prohibited.

- highly leveraged structured notes
- range floaters
- COFI floaters
- Dual Index Floaters
- Inverse floaters and leveraged floaters

CHAPTER 88:
HAWAII REVISED STATUTES AS AMENDED 2002

§88-119 Investments. Investments may be made in:

(1) Real estate loans and mortgages. Obligations (as defined in section 431:6-101) of any of the following classes:

(A) Obligations secured by mortgages of nonprofit corporations desiring to build multirental units (ten units or more) subject to control of the government for occupancy by families displaced as a result of government action;

(B) Obligations secured by mortgages insured by the Federal Housing Administration;

(C) Obligations for the repayment of home loans made under the Servicemen's Readjustment Act of 1944 or under Title II of the National Housing Act;

(D) Other obligations secured by first mortgages on unencumbered improved real estate owned in fee simple; provided that the amount of the obligation at the time investment is made therein shall not exceed eighty per cent of the value of the real estate and improvements mortgaged to secure it, and except that the amount of the obligation at the time investment is made therein may exceed eighty per cent but no more than ninety per cent of the value of the real estate and improvements mortgaged to secure it; provided further that the obligation is insured or guaranteed against default or loss under a mortgage insurance policy issued by a casualty insurance company licensed to do business in the State. The coverage provided by the insurer shall be sufficient to reduce the system's exposure to not more than eighty percent of the value of the real estate and improvements mortgaged to secure it. The insurance coverage shall remain in force until the principal amount of the obligation is reduced to eighty per cent of the market value of the real estate and improvements mortgaged to secure it, at which time the coverage shall be subject to cancellation solely at the option of the board of trustees. Real estate shall not be deemed to be encumbered within the meaning of this subparagraph by reason of the existence of any of the restrictions, charges, or claims described in section 431:6-308;

(E) Other obligations secured by first mortgages of leasehold interests in improved real estate; provided that:

(i) Each such leasehold interest at such time shall have a current term extending at least two years beyond the stated maturity of the obligation it secures; and

(ii) The amount of the obligation at the time investment is made therein shall not exceed eighty per cent of the value of the respective leasehold interest and improvements, and except that the amount of the obligation at the time investment is made therein may exceed eighty per cent but no more than ninety per cent of the value of the leasehold interest and improvements mortgaged to secure it; provided further that the obligation is insured or

guaranteed against default or loss under a mortgage insurance policy issued by a casualty insurance company licensed to do business in the State. The coverage provided by the insurer shall be sufficient to reduce the system's exposure to not more than eighty per cent of the value of the leasehold interest and improvements mortgaged to secure it. The insurance coverage shall remain in force until the principal amount of the obligation is reduced to eighty per cent of the market value of the leasehold interest and improvements mortgaged to secure it, at which time the coverage shall be subject to cancellation solely at the option of the board of trustees;

(F) Obligations for the repayment of home loans guaranteed by the department of Hawaiian home lands pursuant to section 214(b) of the Hawaiian Homes Commission Act, 1920; and

(G) Obligations secured by second mortgages on improved real estate for which the mortgagor procures a second mortgage on the improved real estate for the purpose of acquiring the leaseholder's fee simple interest in the improved real estate; provided that any prior mortgage does not contain provisions that might jeopardize the security position of the retirement system or the borrower's ability to repay the mortgage loan.

The board of trustees may retain such real estate, including leasehold interests therein, as it may acquire by foreclosure of mortgages or in enforcement of security, or as may be conveyed to it in satisfaction of debts previously contracted; provided that all such real estate, other than leasehold interests, shall be sold within five years after acquiring the same, subject to extension by the governor for additional periods not exceeding five years each, and that all such leasehold interests shall be sold within one year after acquiring the same, subject to extension by the governor for additional periods not exceeding one year each;

(2) Government obligations, etc. Obligations of any of the following classes:

(A) Obligations issued or guaranteed as to principal and interest by the United States or by any state thereof, or by any municipal or political subdivision or school district of any of the foregoing; provided that principal of and interest on such obligations are payable in currency of the United States; or sovereign debt instruments issued by agencies of, or guaranteed by foreign governments;

(B) Revenue bonds, whether or not permitted by any other provision hereof, of the State or any municipal or political subdivision thereof, including the board of water supply of the city and county of Honolulu, and street or improvement district bonds of any district or project in the State; and

(C) Obligations issued or guaranteed by any federal home loan bank including consolidated federal home loan bank obligations, the Home Owner's Loan Corporation, the Federal National Mortgage Association, or the Small Business Administration;

(3) Corporate obligations. Below investment grade or nonrated debt instruments, foreign or domestic, in accordance with investment guidelines adopted by the board of trustees;

- (4) Preferred and common stocks. Shares of preferred or common stock of any corporation created or existing under the laws of the United States or of any state or district thereof or of any country;
- (5) Obligations eligible by law for purchase in the open market by federal reserve banks;
- (6) Obligations issued or guaranteed by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, or the African Development Bank;
- (7) Obligations secured by collateral consisting of any of the securities or stock listed above and worth at the time the investment is made at least fifteen per cent more than the amount of the respective obligations;
- (8) Insurance company obligations. Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in Hawaii, including its separate accounts, and whether the investments allocated thereto are comprised of stocks or other securities or of real or personal property or interests therein;
- (9) Interests in real property. Interests in improved or productive real property in which, in the informed opinion of the board of trustees, it is prudent to invest funds of the system. For purposes of this paragraph, "real property" includes any property treated as real property either by local law or for federal income tax purposes. Investments in improved or productive real property may be made directly or through pooled funds, including common or collective trust funds of banks and trust companies, group or unit trusts, limited partnerships, limited liability companies, investment trusts, title-holding corporations recognized under section 501(c) of the Internal Revenue Code of 1986, as amended, similar entities that would protect the system's interest, and other pooled funds invested on behalf of the system by investment managers retained by the system;
- (10) Other securities and futures contracts. Securities and futures contracts in which in the informed opinion of the board of trustees it is prudent to invest funds of the system, including currency, interest rate, bond, and stock index futures contracts and options on such contracts to hedge against anticipated changes in currencies, interest rates, and bond and stock prices that might otherwise have an adverse effect upon the value of the system's securities portfolios; covered put and call options on securities; and stock; whether or not the securities, stock, futures contracts, or options on futures are expressly authorized by or qualify under the foregoing paragraphs, and notwithstanding any limitation of any of the foregoing paragraphs (including paragraph (4)); and
- (11) Private placements. Investments in institutional blind pool limited partnerships or direct investments that make private debt and equity investments in privately held companies, including but not limited to investments in Hawaii high technology businesses or venture capital investments that, in the informed opinion of the board of trustees, are appropriate to invest funds of the system. In evaluating venture capital investments, the board of trustees shall consider, among other things, the impact an investment may have on job creation in Hawaii and on the state economy. [L 1925, c 55, pt of §7; RL 1935, pt of §7926; am L 1935, c 156, §1; am L 1939, c 5, pt of §1; am L 1941, c 50, §1 and c 61, §1; RL 1945, §710, subs 2; am L 1947, c 233, §1; am L 1949, c 297, §1; am L Sp 1949, c 27, §1; am L 1951, c 56, §1; am L 1955, c 270, §§1, 2; RL 1955, §6-75; am L 1959, c 81, §1, c 144, §1, and c 175, §1; am

L 1961, c 111, §1; am L 1965, c 222, §11; am L 1967, c 166, §§1, 2; HRS §88-110; am L 1969, c 107, §1, c 110, pt of §1, and c 159, §1; am L 1970, c 89, §§1 to 3; am L 1974, c 177, §1; am L 1977, c 83, §1; am L 1978, c 11, §2; am L 1981, c 129, §1; am L 1983, c 105, §1; am L 1986, c 71, §1 and c 77, §2; am L 1987, c 114, §1; am L 1990, c 34, §8; am L 1991, c 17, §1; am L 1998, c 151, §21; am L 1999, c 168, §1; am L 2000, c 297, §12]

§88-119.5 Investment guidelines.

Notwithstanding any other law to the contrary, real estate loans and mortgages made pursuant to section 88-119(1)(D) and (E) shall be in accordance with conditions and restrictions set forth by the board of trustees; provided that the board may establish the minimum and maximum loan amounts and interest rates for these real estate loans and mortgages by motion, at any duly noticed meeting of the board. The board of trustees, subject to chapter 91, shall adopt, amend, and repeal rules having the force of and effect of law to implement all provisions of this section other than those relating to loan amounts and interest rates for its real estate loans and mortgages. [L 1982, c 165, §3; am L 1991, c 17, §2; am L 1998, c 151, §22]

§88-121.5. Power to enter into security loan agreements.

Anything in this part to the contrary notwithstanding, the board of trustees may enter into an agreement or agreements with a financially responsible stock or bond brokerage firm, bank, or similar financial institution ("borrower") authorized to do business under the laws of any state or the United States, for the purpose of lending to the borrower securities held by the system, subject to the following conditions:

- 1) The securities shall be loaned to the borrower for a period not to exceed one year;
- 2) At the termination of the loan period, the borrower shall deliver to the board of trustees certificates for identical securities which are of the same class and issue as the loaned securities;
- 3) For the protection of the system, the borrower shall deliver to the board of trustees or its agent, collateral in the form of cash, letters of credit, bonds, or other interest-bearing notes and obligations of the United States or federal instrumentalities which are eligible for investment by the board of trustees, in an amount not less than one hundred two percent of the market value of the loaned securities, as determined by the board of trustees. The system shall have a security interest in the collateral to secure borrower's obligations under the agreement. The board of trustees shall not be obligated to return the collateral or any part thereof to the borrower, except upon borrower's delivery to the board or its agent of securities identical to the loaned securities, as provided in paragraph (2). The board of trustees or its designated agent shall monitor the market value of the loaned securities daily, and if, on any business day, the amount of the collateral deposited by the borrower is less than one hundred two percent of the market value of the loaned securities on that day, the borrower shall immediately deposit with the board or its agent additional collateral in the form of cash, letters of credit, bonds, or other interest-bearing notes and obligations of the United States or federal instrumentalities which are eligible for investment by the board of trustees. Such additional collateral, together with the collateral previously on deposit, shall be in an amount not less than one hundred two percent of the market value of the loaned securities at the time of such deposit;
- 4) The board of trustees, at its election, may use or invest any collateral delivered by a borrower to the board or its agent pursuant to the agreement, and any income and profits earned on the collateral shall be retained for the benefit of the system. Any investment of the collateral shall be subject to section 88-119;

- 5) Until the termination of the loan, the borrower may exercise all the incidents of ownership of loaned securities, including the right to transfer the loaned securities to others and vote or otherwise consent as a holder of such securities; provided that the borrower shall be obligated to the board of trustees for all dividends and distributions made with respect to the loaned securities during the period of the agreement, including, without limitation, cash, stock or property dividends or distributions, interest payments, and subscription rights;
- 6) In the event that the borrower, at the termination of the loan period, fails to deliver to the board of trustees certificates for identical securities which are of the same class and issue as the loaned securities, the borrowers shall forfeit to the system the collateral deposited. (L 1981, c 212, §1)

III. 2. Asset Allocation Rebalancing Guidelines

Rebalancing Assets within the Strategic Asset Allocation

One essential component of a strategic asset allocation policy is the development and use of rebalancing ranges for the target allocation. According to a Callan Associates study, systematic rebalancing reduces portfolio volatility and increases portfolio return. Using ERS' long-range target allocation, the greatest enhancement to investment performance (i.e., enhancing the annualized return while lowering the risk) is achieved by the rebalancing range shown below.

Target Mix With Rebalancing Ranges

Domestic Large Cap Equity	32%	+/- 5%
Domestic Small/Mid Cap Equity	9	+/- 3%
International Equity	17	+/- 4%
Domestic Fixed-Income	21	+/- 2%
International Fixed-Income	7	+/- 2%
Mortgages	0***	NA
Equity Real Estate	9*	NA
Alternative Investments	5**	NA

- * The real estate target will be the percentage actually invested up to 9% of the total fund. Changes in the real estate target will be offset by an equal percentage change in the large cap domestic equity target
- ** The alternatives target will be the percentage actually invested up to 5% of the total fund. Changes in the alternatives target will be an equal percentage change in the large cap domestic equity target.
- *** The mortgage target will be the percentage of the total fund actually invested. Changes in the mortgage target will be offset by an equal change in the domestic fixed-income target. Adjustments in the above targets will take place annually in conjunction with the annual asset allocation review.

If the Fund has positive cash flow (i.e., contributions exceeding disbursements), ERS staff has the discretion to rebalance by directing new moneys to the under allocated asset classes on a pro-rata basis. If the Fund has negative cash flow, ERS staff has the discretion to withdraw moneys to be disbursed from over allocated asset classes. In each case, the Chief Investment Officer shall keep the Board of Trustees

apprised of current asset movements. Managing asset allocations in this manner shall not incur any additional transaction cost beyond what would have been normally incurred to liquidate or invest assets.

If external cash flows are not deemed to be sufficient to manage the asset allocation, ERS staff shall rebalance the fund allocations to their targets when the allocations are beyond the ranges indicated above. This shall be done only with prior Board approval. In no case shall fund allocations be left outside their target ranges for beyond twelve months.

Because of the unusual valuation characteristics of real estate and mortgages, these asset classes have broader rebalancing ranges relative to their target allocation. Concerns of liquidity and the long-term horizon for these investments suggest a more infrequent rebalancing schedule. Accordingly, other more qualitative considerations (e.g., transaction costs, liquidity needs, investment time horizons, etc.) regarding the timing of rebalancing real estate and mortgage investments will be important to consider with the guidelines shown above.

Rebalancing Investment Style Allocations Within Asset Classes

Rebalancing ranges among equity investment styles in risk/reward trade-off is not necessary, particularly if transaction costs are incurred to implement rebalancing. Style weightings need to be addressed only during normal funding, extraordinary manager restructuring (i.e., when hiring or firing managers), asset class rebalancing, or upon recommendation by the investment consultant.

III. 3. Policy on Local Managers

The Board of Trustees wishes to utilize qualified local firms in the management of a portion of the Retirement System's assets. Due to the size of the ERS' portfolio and the fiduciary responsibility of the board members to select qualified firms in accordance with overall Board investment strategy, the following guidelines have been established for the identification, selection and evaluation of Hawaii-based investment management firms.

1. It shall be the policy of the Board to allocate assets to local investment managers in accordance with the Board's strategic asset allocation and long term investment policies.
2. The asset mix of the combined local investment managers' portfolios shall not exceed more than 10% of the asset mix of total ERS assets for the broad asset classes in which local managers invest.
3. Staff will maintain files and data on Hawaii-based firms that they are made aware of through known contacts, conferences, consultants, etc.
4. Whenever the Board initiates a search for an investment manager, the ERS staff and investment consultant will determine if any local firm meets the specific search criteria designated by the Board.
5. As a guide for inclusion of a local investment manager in a Board-initiated search, staff/consultant may use some of the following qualifications in the screening of local firms:
 - a) One year of operation as an SEC registered investment management firm.
 - b) The portfolio manager handling the account must have a minimum of seven years of experience in investment management.
 - c) The firm must have a minimum of \$50 million in total assets under management and at least \$25 million in the style/product designated for the search.
 - d) The firm must have at least three tax-exempt client(s).

- e) The senior principal must have at least two years experience in running an investment management operation, either at the present or a predecessor firm.
- f) An acceptable and verifiable historical track record of at least three years (a prior firm's record is acceptable), which could have been reasonably achieved by the manager's current staff and resources. Local managers are not required to be in conformance with CFA Institute Standards.
- g) Ownership or an equivalent stake in the firm by the active investment management professionals.
- h) A sound and convincing investment management process.
- i) An adequate staff to support the investment, administrative and regulatory functions.

Evaluation of Local Firms

All local firms retained by the Board of Trustees shall be evaluated based upon the Investment Objective and Guidelines adopted by the Board for all investment managers.

III. 4. New Investment Proposals

All new investment proposals presented to the ERS are initially reviewed and analyzed by the Chief Investment Officer. The Chief Investment Officer shall: (1) categorize the proposal as a "Core Investment Proposal" or a "Hawaii Investment Proposal,"; and (2) decide if the investment proposal should be brought to the attention of the Investment Committee.

If the investment proposal is to be brought to the attention of the Investment Committee, the Chief Investment Officer shall conduct a due diligence process to review the investment proposal as follows:

- "Core Investment Proposal" – the Chief Investment Officer shall utilize the services of the investment consultant and/or investment managers to assist in the due diligence process; or
- "Hawaii Investment Proposal" – the Chief Investment Officer shall utilize the services of a firm with relevant market knowledge, expertise and qualifications to assist in the due diligence process.

After completion of the due diligence process the Chief Investment Officer will take his findings to the Investment Committee.

Upon review, the Investment Committee will direct the Chief Investment Officer to do one of three things: (1) decline the investment offer; (2) investigate the investment proposal further; or (3) present the investment proposal to the Board of Trustees for approval.

Upon review, the Board of Trustees will decide one of the following: (1) decline the investment offer; (2) direct the Chief Investment Officer to investigate the investment proposal further; or (3) approve the investment proposal.

The Board of Trustees makes the final decision on all new investment proposals.

III. 5. Asset Transition Guidelines

From time to time the ERS will have a need to restructure its portfolios as a result of manager performance or asset allocation changes. The Board of Trustees, acting on recommendations and suggestions of the staff and investment consultants, will undertake actions based upon the following considerations.

1. A determination will be made about the importance of maintaining the ERS' strategic asset allocation throughout the restructuring. If maintaining the strategic asset allocation is desired, this can be accomplished through the simultaneous purchase and sale of assets, through the use of futures, or other means.
2. The ERS may select a vendor(s) to manage and implement the portfolio restructuring. The vendor(s) should be chosen for its ability to minimize transaction costs, including, without limitation, commissions, market impact, and opportunity cost. Furthermore, the vendor(s) should be able to demonstrate depth of experience and commitment of resources to the portfolio restructuring business.

A trading cost analysis should be obtained in order to evaluate the results of the restructuring and to satisfy the ERS' fiduciary obligation to monitor best execution.

III. 6. Securities Litigation Guidelines

Securities litigation has become increasingly prevalent among public pension plans. ERS is of the opinion that securities litigation tends to be a distraction to the staff and Trustees of a pension plan and a tax on limited fund resources. Additionally, most litigation is directed at companies in which plan sponsors still own stock. In these cases sponsors are, in essence, suing themselves for the benefit of a questionable long-term payoff. Furthermore, because of the diversity of the ERS' investment portfolio, and the ERS' investment policy guidelines, it is likely that other institutional investors will have a larger financial interest in the relief sought and would therefore be more appropriate lead or co-lead plaintiffs than the ERS.

The ERS believes that a passive approach is the best way to make use of limited staff resources while fulfilling its fiduciary duty to monitor the companies that it invests in and recover all that is entitled. Therefore, it is the general policy of the ERS that it will not seek or accept designation as lead or co-lead plaintiff, but will work diligently with the fund custodian to ensure that it collects all that it is entitled to as the result of class action litigation. It is important to note that lead plaintiffs are not entitled to more of a settlement than class members of a lawsuit are.

ERS will utilize the services of its custodial bank to monitor and manage the timely filing of proofs of claim in class action lawsuits with respect to investments held by ERS. The ERS has adopted the following process:

1. The custodial bank will have a team that is dedicated to monitoring class action lawsuits.
2. The team creates and manages a database of all class action lawsuits which is accessed by service teams.
3. The ERS service team downloads class action notices and uses a tracking system based on CUSIP. The custodial bank has access to this information because they handle custody for all the assets of ERS.
4. If it is determined that the ERS held a security during the defined class period – according to the class action notice – the custodial bank will file a claim on behalf of the ERS as a member of the class. (Standing Instructions)
5. The custodial bank will not file for ERS to become lead plaintiff unless specifically instructed to do so.
6. The custodial bank will obtain a claim number and track the class action right up through settlement.
7. The custodial bank will prepare and provide ERS with an Excel spreadsheet report listing class action filings and settlements that ERS is involved in.

The ERS does recognize, however, that there may be situations when it could benefit from active participation in a lawsuit. The Attorney General is therefore authorized to retain up to two law firms to identify, monitor and review securities litigation in which the ERS may be a class member and to make recommendations as to whether active participation in such litigation should be considered by the ERS. The law firm or firms retained for this purpose ("monitoring counsel") shall perform their services free of charge. ERS shall participate in the selection of monitoring counsel.

ERS will provide monitoring counsel with direct access to custodial bank electronic transaction database. Recommendations by monitoring counsel shall be evaluated by the Attorney General, who shall be the primary contact with monitoring counsel.

Monitoring counsel shall report to the Attorney General all claims or potential claims and shall provide their recommendation as to the appropriate action by the ERS with respect to any claims or potential claims of \$2,000,000 or more. Balancing the potential for a significant increase in the ERS' recovery against the burden on scarce resources, the ERS does not anticipate that it will accept or seek lead or co-lead plaintiff status in a class action or take independent action with respect to a potential claim unless the potential claim is substantial and there are other special circumstances, such as the extent of the ERS' interest or the nature of the alleged wrongful acts or omissions, that make it in the best interests of the ERS to participate actively in a lawsuit to recover a claim. A potential claim is "substantial" if it is expected to be \$10,000,000 or more.

When evaluating a recommendation from monitoring counsel that the ERS become actively involved in securities litigation, the Attorney General will consider the following factors:

1. The size of the claim and the likely degree of recovery versus the time and costs involved in pursuing the matter actively.
2. The investment manager's evaluation of the business merits of the claim (i.e., the extent to which the manager believes there was wrongdoing and would be support the ERS' position in the case).
3. Staffing constraints that might make it difficult to effectively pursue the case actively (i.e., as a lead plaintiff or through an independent lawsuit).
4. The legal analysis of the merits of the case and the availability of assets from which to collect a significant recovery.
5. The investment manager's opinion on whether the stock should be actively traded and the potential impact on the portfolio of possible trading restrictions arising from the acquisition of inside information in the litigation.
6. The legal analysis of the ERS' or investment manager's files and any related materials for any unique issues or defenses to which ERS might be subject in the particular case.
7. The effectiveness and availability of potential witnesses.
8. The willingness of the investment manager to respond to requested discovery.
9. The effectiveness of potential alternatives for recovering the value of the claim, such as corporate governance actions or less costly methods of monitoring the litigation.
10. Whether the active involvement of ERS will add value to the potential resolution or management of the case.
11. Whether any other institutional investors are in the class, and whether they are likely to become actively involved.

If the Attorney General concurs with monitoring counsel's recommendation that the ERS become actively involved in litigation to pursue recovery of a claim or potential claim, the Attorney General will present

the Attorney General's recommendation of a proposed course of action to the Board of Trustees for approval.

The ERS shall participate in the selection of counsel to represent the ERS in any litigation instituted to pursue recovery of a claim or potential claim.

The Attorney General will provide a semi-annual report to the Board of Trustees summarizing the reports and recommendations received from monitoring counsel and the action taken with respect to the recommendations.

III. 7. Proxy Voting Guidelines

ERS has a fiduciary responsibility to act solely in the best interest of its members and beneficiaries. Therefore, investment managers voting proxies on behalf of the board will do so with the primary objective of maintaining and advancing the economic value and interests of ERS members. ERS also requests investment managers, as part of their investment discretion and fiduciary responsibility, to take into consideration the importance of the Corporate Governance Policies promulgated by the Council of Institutional Investors, adherence to CFA Institute Proxy Voting Guidelines and the Global Sullivan Principles.

Additionally, ERS requires investment managers to adhere to CFA Institute proxy voting standards. ERS staff, with the assistance of their investment consultant, shall poll managers annually as to their proxy voting policies and whether they comply with the CFA Institute standards, specifically the basic element of a proxy voting policy listed below. The spirit and substance of these standards amended for Hawaii ERS' use are reprinted in their entirety from the CFA Institute Standards of Practice Handbook Below. A letter affirming compliance with the proxy voting guidelines will be requested from each manager on an annual basis. ERS will engage the services of a third party provider to review the votes cast on behalf of ERS and provide a comprehensive report.

Corporate Governance Policies Council of Institutional Investors (reprinted from www.cii.org)

The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

The Council believes every company should also have written disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its web site (www.cii.org); it hopes corporate boards will meet or exceed these standards and adopt similarly appropriate additional policies to best protect shareholders' interests.

In general, the Council believes that corporate governance structures and practices should protect and enhance accountability to, and ensure equal financial treatment of, shareholders. An action should not be taken if its purpose is to reduce accountability to shareholders.

The Council also believes shareholders should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

The Council believes good governance practices should be followed by publicly traded companies, private companies and companies in the process of going public. As such, the Council believes that, consistent with their fiduciary obligations to their limited partners, the general members of venture capital, buyout and other private equity funds should use appropriate efforts to encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

The Council believes that U.S. companies should not reincorporate offshore because corporate governance structures there are weaker and therefore reduce management accountability to shareholders.

Council policies neither bind members nor corporations. They are designed to provide guidelines that the Council has found to be appropriate in most situations.

CFA Institute Proxy Voting Standards

To meet their fiduciary duty with regard to corporate governance, ERS managers must follow adequate procedures concerning the voting of proxies. Since ERS managers are given the responsibility to vote proxies, they must adopt procedures to ensure that issues are noted, analyzed, and considered before voting. Investment managers must be thoroughly familiar with the issues that arise in proxies. Proxies have economic value and must be voted in the interest of the ultimate shareholder or plan beneficiary. ERS investment managers cannot simply vote without adequate examination of the underlying issues. These guidelines list the issues that arise in proxy voting and recommend ways of approaching and analyzing a number of these issues. Although each manager must establish policies and procedures appropriate to its own circumstances, the methods and approaches outlined should be followed in establishing a formal, written proxy policy. The skills and experience of the professional investment community, particularly the research and analytic skills, can be used effectively in corporate governance issues, which will ultimately benefit corporations and shareholders alike and enhance the competitiveness of business in global markets. Good corporate governance and good investment decisions go hand in hand.

Basic Elements of a Proxy Voting Policy

I. Creation of a Proxy Policy

A. Designate a policy-making body (the board, managing directors, or a committee) or an individual to recommend proxy policy and to monitor implementation. The same body or individual should:

1. Develop initial, specific guidelines and institute a regular review process, including review of new or controversial proxy issues.
2. Verify that any decision about how to vote is in accord with the investment interests, stated objectives, and particular preferences, if stated or known, of the ERS, its participants and beneficiaries.
3. Discuss the issues involved with those who do the voting and decide whether additional action is necessary (i.e., to initiate and/or cosign shareholder proposals).

4. Provide a review mechanism for any unusual proposals, such as an opposition slate of directors, corporate restructuring related to hostile takeovers, or any proposals that appear not to be in the best interests of shareholders.
5. Consider applying to proxy decisions internal financial ratios or other criteria for evaluating corporate performance. Such applications, for instance, might show such outstanding economic performance over a business cycle that investor confidence in a board and management would outweigh a proposal to classify the board.
6. Provide a process for deciding whether a vote against management should be preceded or followed by a letter, telephone call, in-person discussion with corporate personnel, and/or action to be taken with other concerned firms and organizations.
7. Decide under what conditions those who hold a concentration of stock in their own names or have other vested interest in the corporations in which stock is held should be excluded from participating in the voting.
8. Decide how and when to report to the ERS on the positions taken during the proxy season, notify ERS staff accordingly and provide a comprehensive report.

B. Identify major proxy issues for the ERS. Note should be taken of preferences stated by the ERS Board and staff. A manager of a pooled account that maintains ERISA assets may be subject to conflicting proxy voting guidelines from the plans contained in the account. In that instance, the manager must reconcile, to the extent possible, the proxy voting policies of the various plans. To the extent that reconciliation is not possible, the manager should consider voting the securities in proportion to the plan's respective interests in the pooled account. The major proxy-related issues generally fall within five categories: corporate governance, takeover defenses, compensation plans, capital structure, and social responsibility. These categories may include the following:

1. Corporate governance.

- Confidentiality of voting.
- Annual election of directors.
- Composition of board.
- Equal access to proxy statements.
- Indemnification of management or directors or both against negligent, imprudent, or unreasonable action.
- Removal of directors from office only for cause or by a supermajority vote.
- Cumulative voting.
- "Sweeteners" to attract support for proposals.
- Unequal voting rights proposals (superstock).
- Supermajority proposals.
- Limitation of shareholder rights to remove directors, amend bylaws, fill board vacancies, call special meetings, nominate directors, and act by written consent—or other actions to limit or abolish shareholder rights to act independently.
- Proposals to permit management discretion to issue "blank check" stock without prior shareholder approval.
- Proposals to vote unmarked proxies in favor of management
- Pre-emptive rights.

2. Takeover defense and related actions.
 - Proposals involving tender offers and mergers.
 - Fair price provisions.
 - Some increases in authorized shares and/or creation of new classes of common or preferred stock.
 - Proposals to introduce or eliminate greenmail provisions.
 - Proposals to reevaluate in-place "shark repellents."
 - Shareholder rights plans (poison pills).
3. Compensation plans.
 - Stock option plans and/or stock-appreciation plans.
 - Profit incentive plans and employee stock purchase plans.
 - Extension of stock option grants to outside directors.
 - Stock option plans and other stock bonus plans, including plans permitting issuance of loans to management or selected employees with authority to sell stock purchased by the loan without immediate repayment, or plans that are overly generous (below market price or with appreciation rights paying the difference between option price and the stock, or allowing the directors to lower the purchase price of outstanding options).
 - Incentive plans that become effective in the event of hostile takeovers or mergers (golden and tin parachutes).
 - Proposals that create an unusually favorable compensation structure in advance of sale of the company.
 - Proposals that fail to link executive compensation to management performance (including golden handcuffs).
4. Capital structure, classes of stock, and recapitalizations.
 - Dual class recapitalizations.
 - Proposals to reincorporate or reorganize into a holding company.
 - Proposals designed to discourage mergers and acquisitions in advance.
 - Proposals to change state of incorporation to a state less favorable to shareholder interests.
5. Social responsibility.
 - Human rights.
 - Environment, such as endorsing the CERES principles.
 - Nuclear weapons and energy-generating facilities.
 - McBride Principles (Northern Ireland).
 - Equal employment and diversity.
 - Community-related economic growth.
 - Anti-addiction (such as alcohol or gambling).

C. A useful proxy policy format is to (1) state the pros and cons of issues and (2) evaluate specific proxy proposals against the history and productivity of current management as well as the conceptual reasons for or against the proposal.

II. Administration

- A. Responsibility for proxy voting.
 1. Externally. ERS managers have the sole responsibility for voting proxies in accordance with these guidelines.

2. Internally. Determine the responsibilities of staff and/or committees for following voting guidelines.
- B. Develop a system to monitor any delegation of proxy voting responsibility to others.
- C. Provide for recordkeeping.
1. Maintain a record of stock held.
 2. Reconcile proxies received with the stock held on the record date.
 3. Develop a system to trace missing proxies expeditiously.
 4. Keep a record of how proxies are voted and why:
 - Note any deviations from any stated policy relating to specific issues.
 - Note any contacts from plan sponsors or issuers with staff related to the proxy voting function and the actions taken.
 - Note any apparent conflicts of interest and how they are handled.
- D. Provide for a process to monitor performance of a custodian, or its agent, to ensure timely receipt of proxies; the process should include delegation of responsibility to an individual staff member.
- E. Avoid or minimize conflicts of interest. Parties vulnerable to conflicts of interest include corporate directors and managers who may also serve on the boards of public and private funds, plan sponsors, analysts and investment management staff who may invest in stock also held in management accounts, and others with direct interest in the outcome of voting (investment banking, credit or loan obligations, corporate finance). When possible, consider implementing “Fire Wall” techniques similar to those used to prevent the flow of material nonpublic information to portfolio managers and analysts.
- F. Educate and train staff.
1. Provide opportunities for staff members to understand the firm’s proxy voting policy. Each person related to voting proxies should have a copy of the policy and/or guidelines and an opportunity to discuss them with supervisory staff.
 2. Designate specific staff members to receive all proxies, reconcile receipt with holdings list, distribute proxies to those who do the actual voting, and trace missing proxies in a timely fashion. Make certain all staff members know who does what.
 3. Train staff to separate non-routine proxies—that is, those involving shareholder rights and the economics of a corporation—from those that are routine, as the firm guidelines define the categories.
 4. Train staff to vote non-controversial proxies under supervision of a compliance officer, committee, or other designated persons.
 5. Provide periodic review sessions at least annually to
 - reacquaint staff handling or voting proxies with the overall policy,
 - reevaluate any previous decisions that deviate from guidelines,
 - discuss current proxy issues, and
 - recommend action on any current “hot issues” or unusual proposals.

The Global Sullivan Principles

Preamble

The objectives of the Global Sullivan Principles are to support economic, social and political justice by companies where they do business; to support human rights and to encourage equal opportunity at all levels of employment, including racial and gender diversity on decision making committees and boards;

to train and advance disadvantaged workers for technical, supervisory and management opportunities; and to assist with greater tolerance and understanding among peoples; thereby, helping to improve the quality of life for communities, workers and children with dignity and equality. I urge companies large and small in every part of the world to support and follow the Global Sullivan Principles of corporate social responsibility wherever they have operations.

Feb. 1, 1999
The Rev. Leon H. Sullivan

Principles

As a company which endorses the Global Sullivan Principles we will respect the law, and as a responsible member of society we will apply these Principles with integrity consistent with the legitimate role of business. We will develop and implement company policies, procedures, training and internal reporting structures to ensure commitment to these principles throughout our organization. We believe the application of these Principles will achieve greater tolerance and better understanding among peoples, and advance the culture of peace.

Accordingly, we will:

- Express our support for universal human rights and, particularly, those of our employees, the communities within which we operate, and parties with whom we do business.
- Promote equal opportunity for our employees at all levels of the company with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- Respect our employees' voluntary freedom of association.
- Compensate our employees to enable them to meet at least their basic needs and provide the opportunity to improve their skill and capability in order to raise their social and economic opportunities.
- Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- Work with governments and communities in which we do business to improve the quality of life in those communities – their educational, cultural, economic and social well-being – and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- Promote the application of these principles by those with whom we do business.

We will be transparent in our implementation of these principles and provide information which demonstrates publicly our commitment to them.

5/26/99

Source of Global Sullivan Principles: [mallenbaker.net](http://www.mallenbaker.net),
<http://www.mallenbaker.net/csr/CSRfiles/gsprinciples.html>, 11/05/03

ERS has a fiduciary responsibility to act solely in the interest of its members and beneficiaries. Therefore investment managers voting proxies for the board will do so with the primary goal of maintaining or increasing the economic interests of ERS.

III. 8. Anti Terrorism Policy

Introduction

Since 9/11, attention has been focused on the potential security threats certain countries and specific companies pose to the United States of America. The ERS Board of Trustees recognize the heightened awareness of security risks and the fact that public pension funds have come under increased pressure from the general public to divest from companies that do business in countries that support terrorism. On the surface this issue may appear simple and straightforward, but in reality it is very complex and requires information that is not currently available to public pension funds. A policy as simple as requiring divestiture from all companies that do business in certain countries may actually work to the detriment of US foreign policy objectives and needlessly damage US companies and jobs. The Board maintains its fiduciary obligations to the members of the System as its top priority. This requires the Board to act prudently and in the exclusive interest of participants in the management of System assets. In an effort to balance their fiduciary obligations with their moral and ethical responsibility as citizens of the United States of America, the Board of Trustees is hereby establishing this Anti-Terrorism Investment Policy.

Background on US Foreign Policy Related to Countries Supporting Terrorism

In the area of foreign policy, regulations and sanctions are complex and continually changing to address the needs of US national security. The US State Department maintains an official list of countries that the US deems to be supporting international terrorism. The countries included on this list and the regulations and sanctions that apply in these countries change frequently. Unfortunately, a list of companies that are deemed to be supporting terrorism is not publicly available at this time. The fact that a company may have a business link to a listed country does not mean that the US government believes the company is supporting terrorism. In many cases, the US government allows business relationships because they believe they further US policy goals via the contracts and leverage that trade and other business connections create. Placing investment restrictions that would discourage business relationships in these countries could actually run counter to US anti-terrorism initiatives in some instances. As a result of the complexities and lack of public information in this area, ERS must rely upon federal agencies such as the Securities and Exchange Commission and the State, Commerce, Justice and Treasury Departments to provide factual information regarding companies that are supporting terrorism. To date, this information has not been available to ERS or any other public pension fund. Quite simply, factual information that ERS would need to prudently divest from these companies is not available.

ERS' Actions Related to an Anti-Terrorism Policy

Given the importance of this issue, on an annual basis, the Chief Investment Officer will contact the Department of Homeland Security, the State Department, the Commerce Department, the Justice Department, the Treasury Department, the Securities and Exchange Commission, and any other federal agency deemed to have useful information in accurately identifying companies that are supporting terrorism. Specifically, the CIO will request guidance from these agencies on countries and more

specifically companies that are believed to be supporting terrorism. Once the information is received, ERS staff will compare the list of companies with current holdings. In the event that ERS is a holder of one of these companies, the CIO will immediately contact the manager of the specific investment account to bring the situation to their attention and discuss appropriate actions for divesting from the company. In addition, the CIO will forward all information received from any of these federal government agencies to our investment managers so they can avoid making initial investments or divest of existing investments in companies that are identified as supporting terrorist activities. Finally, the CIO will provide a report to the Board on an annual basis that identifies any investment actions taken due to links to terrorist activities.

This policy is intended to avoid 1) discriminating against companies whose activities abroad are supported by the US government; 2) discriminating against companies whose activities abroad do not further terrorism; 3) unnecessarily harming US companies and jobs; and 4) compromising the Board's fiduciary duties to the beneficiaries of the System. Recognizing the dynamic nature of the issue, annually staff will evaluate this policy to determine if changes need to be made to reflect recent developments in this area. In the event that staff believes changes to this policy are warranted, they will bring the issue to the attention of the Board of Trustees for consideration.