

IV. 2. Private Equity Portfolio Policies & Procedures

ALTERNATIVE INVESTMENTS

The ERS Alternative Investments allocation incorporates two separate strategies: private equity (3.5% of the Total Fund) and timberland investments (1.5% of the Total Fund).

Private Equity

Private Equity involves the ownership of institutional limited partnerships or limited liability companies ("LLCs") that purchase primarily unlisted securities in private companies. Examples of investments would include venture capital, acquisitions, growth financings, workout situations, industry consolidations, and the purchase of other corporate finance-related securities. The program is currently implemented through an oversight manager who selects, on a discretionary basis, limited partnerships or LLCs that comply with the Private Equity Policies and Procedures adopted by the Board of Trustees. The board of trustees may also approve direct and co-investment private equity investment vehicles that are either managed by a retained, existing, or newly hired oversight manager, or by the ERS Investment Office staff ("Staff") and appropriate Private Equity ("PE") Consultant(s).

Timberland

This allocation involves ownership of timberland properties. Trees are planted, grown, harvested and sold employing sustainable forestry principles. The timberland properties are also purchased and sold with a view to maximize value. The program is implemented through a timberland investment manager who underwrites, purchases, manages, and disposes of a diversified portfolio of timberland holdings.

The Private Equity Portfolio Policies and Procedures and the Timberland Portfolio Policies and Procedures are attached.

IV. 2. Private Equity Portfolio Policies & Procedures

**PRIVATE EQUITY
PORTFOLIO
POLICIES & PROCEDURES**

Effective August 10, 2009

**EMPLOYEES' RETIREMENT SYSTEM OF
THE STATE OF HAWAII**

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EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

PRIVATE EQUITY PORTFOLIO POLICIES & PROCEDURES

**EFFECTIVE
August 10, 2009**

I. INVESTMENT OBJECTIVES

A. INVESTMENTS IN PRIVATE EQUITY ASSETS

The Employees' Retirement System of the State of Hawaii ("ERS") has determined that, over the long term, inclusion of private equity and debt investments (hereinafter referred to collectively as "private equity") would enhance the ERS' expected portfolio investment characteristics. Specifically, as a result of the possibility of enhanced rates of return over publicly traded securities and returns that have a low correlation with those associated with other major asset classes, the use of private equity investments tends to increase the portfolio's overall long-term expected real return, and reduce year to year portfolio volatility.

Private equity investments involve the purchase of unlisted, illiquid common and preferred stock, and to a lesser degree, subordinated and senior debt of companies which are in most instances privately held. Investments in company private securities are made primarily through institutional blind pool limited partnership or limited liability company vehicles, further described in Section I.D. The private equity strategies to be pursued are further described in Section II.A.

Private equity investments of the ERS shall be made in a manner consistent with the fiduciary standards of the prudent expert rule: (1) for the sole interest of the ERS' participants and their beneficiaries; and, (2) to safeguard and diversify the private equity portfolio. The selection and management of private equity assets will be guided to preserve investment capital and to maintain prudent diversification of assets and management responsibility. The diversification objective is required to manage overall market risk and the specific risks inherent in any single investment or management selection.

B. ASSET ALLOCATION

The allocation of ERS assets to private equity investments shall remain within the limits authorized by the Board of Trustees. The target allocation is 3.5% (within a range of 0% to 5%) of its portfolio (based on market invested net asset value). Allocated capital will be defined as invested capital (based on market value). The Board recognizes that it will be necessary to make capital commitments in excess of the target allocation in order to achieve and maintain a 3.5% net asset value.

The goal of the ERS is to spread out the timing of new commitments so as to avoid an undue concentration of commitments in any one fiscal year. Over the long-term, it is expected that approximately equal amounts of new funding will be committed each fiscal year to garner the benefits of time diversification.

C. PORTFOLIO PERFORMANCE

The ERS shall use the following rate of return tests to evaluate the performance of the private equity asset class:

1. Total Return (Realized and Unrealized Gain/Loss Plus Income)

Over rolling 10-year periods, the total private equity portfolio is expected to generate a minimum total dollar-weighted rate of return (internal rate of return or IRR) that exceeds an equivalent public equity return by 350 basis points ("bps") per year, net of all investment management fees and expenses. Any individual fund investment is expected to produce a commensurate return that contributes to the overall private equity portfolio return objectives. The ERS will also measure the portfolio employing a time-weighted rate of return calculation.

The primary investment strategies included in the allocation will provide the opportunity for long term capital gains. Additionally, over the long-term, the allocation will include investment strategies that will provide an element of predictable cash flow to the ERS that is not dependent on non-recurring events such as the permanent disposition of assets.

The portfolio and individual investments will be benchmarked against the universe contained in the Venture Economics Inc. *Investment Benchmark Report* database, published quarterly. Benchmarks are published for venture capital, buyouts and subordinated debt funds. For restructuring funds and other special situation private investments, returns should be competitive with buyout and subordinated debt funds, with the return falling between the two. In any event, the public equity-plus-350 bps/year minimum hurdle rate will apply for long-term core holdings.

2. Risk with Regard to Individual Investments

In private equity investing there is the risk of sustaining a loss on any of the individual investments. It is the ERS' expectation that, while specific investments may incur losses of all or part of the capital invested, a diversified portfolio of holdings will produce a positive rate of return in the expected range set forth in Section I.C.1., above.

D. PROGRAM MANAGEMENT

The selection and management of assets in the private equity portfolio will be guided to generate a high level of risk adjusted return, to provide a moderate amount of current income, and to maintain prudent diversification of assets and specific investments.

With private equity investments, there is an inherent risk that the actual return of capital, gains and income will vary from the amounts expected. The ERS shall manage the investment risk associated with private equity investments in several ways:

1. Institutional Quality

All assets must be of institutional investment quality. Institutional quality will be defined as being of a quality whereby the investment would be considered acceptable by other prudent institutional investors (e.g. insurance company general accounts and separate accounts, commercial banks and savings institutions, public employee retirement systems, corporate employee benefit plans - domestic and foreign, and other tax-exempt institutions).

2. Diversification

The private equity portfolio shall be diversified as to investment strategy, timing of investment, size and life cycle of investment, industry sector, investment sponsor organization (e.g., general partner group), capital structure and geographical location. Diversification reduces the impact on the portfolio of any one investment or any single investment style to the extent that an adversity affecting any one particular area will not impact a disproportionate share of the total portfolio.

Investments will be made such that at full investment a maximum of 20% of the total private equity allocation can be invested at any point in time with any sole partnership/LLC sponsor. No single private equity investment strategy will comprise more than 50% of the total allocation. These limits are subject to waiver on a case-by-case basis by the Trustees. It is also recognized that during the portfolio development and wind-down stages the full investment parameters may not, of necessity, be met. The ERS is permitted to own up to 100% of any particular partnership/LLC subject to the partnership/LLC sponsor limitation above.

The scope and size of the ERS program is such that significant investments in fewer, more concentrated investments are preferred to smaller, more numerous investments. While ERS has not set a minimum dollar amount per partnership/LLC, the Oversight Manager will be charged with deploying the capital efficiently, such that funding targets are achieved with a minimal number of partnership/LLC holdings. Average investment size will be monitored according to the requirements established by the *Investment Projection Model*, which is a part of the *Annual Tactical Plan* (Appendix A).

Long-term diversification targets among eligible investment strategies will be set forth in the *Strategic Portfolio Structure* document, and reviewed annually or as necessary. The *Strategic Portfolio Structure* documents the private equity portfolio's long-term target mix of investment strategies and the rationale thereof. Interim investment goals for the implementation of the *Strategic Portfolio Structure* will be set forth in an annual *Tactical Plan* (Appendix A) as described herein.

3. Ownership Structure

Account and Investment Structure: The ERS will establish separate account relationships with one or more fiduciary oversight managers ("Oversight Managers") to manage the ERS private equity program portfolios. The ERS may also designate/retain one or more private equity consultant(s) (the "PE Consultant") to assist in implementing various aspects of the program. The Oversight Manager will in turn make commitments to private equity limited partnerships or LLCs, on behalf of ERS, on a discretionary basis. The investments will be subject to the portfolio diversification targets established in the *Strategic Portfolio Structure*, the approval of an annual *Tactical Plan* by the ERS, and with prior notification as to program compliance via an *Investment Disclosure Form* (Appendix B). Other commingled vehicles or separate account investments, which are not limited partnership/LLC units, may only be purchased by the Oversight Manager, subject to a structural compliance review by the PE Consultant, and approval by the Board of Trustees.

Co-Investments and Direct Investments: Certain fund-of-funds investment managers offer direct placement services on their clients' behalf. Suitable arrangements for co-investment and direct investment authorization may be incorporated in the investment management agreement. Co-investments entail providing additional funding to specific company investments being made by the limited partnerships/LLCs to which ERS has commitments. In specific instances, the general partner will invite the limited partners to provide additional capital when an investment is of a size that exceeds the partnerships/LLCs diversification parameters. Co-investments may be in the same class of security as the partnership/LLC investment or may consist of a combination of the same class of security as the partnership/LLC investment and a different class of security offered by the company. Co-investments may be sourced by the Oversight Manager, PE Consultant(s), or Staff, and must be approved by the Board of Trustees.

Direct Investments in Funds Structured as Limited Partnerships/LLCs: Commitments to direct fund investments in limited partnerships/LLCs (or other similar private investment legal structures suitable for public pension funds) may be sourced and recommended jointly by Staff and a retained PE Consultant for direct approval by the Trustees. Such direct fund investments collectively shall not exceed 25% of the ERS's overall private equity net asset value at time of commitment and shall not exceed 50% of the private equity net asset value overall after purchase based on market value unless approved by the Board of Trustees. Staff and/or an appropriate retained PE Consultant shall provide ongoing monitoring of such direct fund investments under equivalent standards as utilized by ERS's existing oversight manager(s).

4. Reporting System

There shall be a comprehensive reporting and monitoring system for the entire portfolio, oversight manager(s), and individual investments. Situations of underperforming investments, portfolio diversification deficiencies from the *Policies & Procedures*, and conflicts of interest can then be identified, facilitating active portfolio management. Further definition of this reporting system is provided in Sections III.C.2.b. "Investment Management Ongoing Operations" and III.C.3. "Investment Management Portfolio Accounting and Financial Control."

5. Performance Measurement

The Oversight Manager will provide cash flow, valuation, and any other requested information to ERS Staff and the PE Consultant quarterly, and the ERS' custodian bank on a monthly basis. The oversight manager will notify the PE Consultant and Staff of any instances where the oversight manager is using different carrying values from those reported by the general partner.

Performance will be calculated on both a time-weighted and dollar-weighted (internal rate of return or IRR) basis, with primary emphasis being placed on the internal rate of return. The rate of return calculations will be net of all partnership/LLC fees and expenses, but gross of Oversight Manager fees and expenses. So that the performance numbers reported by the manager and the custodian bank are the same, the manager will be responsible for reviewing the custodian bank's figures as to timing, amount, value of in-kind securities at distribution and reported net asset value, and reconciling and explaining any discrepancies.

As highlighted above under Item 3, Staff and/or the appropriate designated retained PE Consultant will provide performance measurement information on all other Alternative Investments outside of the authority of Oversight Manager(s).

In-kind Distributions: Partnerships/LLCs will be valued on the distribution price of the in-kind security or other valuation method stipulated in the partnership/LLC membership agreement. Any change from distribution price to realized price of the in-kind distributions will then be monitored as a separate component of the total portfolio return. *Benchmarks:* For IRR calculations, the Vintage Year methodology developed by Venture Economics, Inc. will be used for purposes of performance comparisons to the industry. For time-weighted returns, comparable publicly traded market indicators (such as small cap indices) will be employed.

6. Evaluation of Potential Investments

All private equity investment proposals shall be referred for evaluation to: (1) Oversight Manager retained by, and with fiduciary responsibility to, the ERS or (2) Staff and PE Consultant(s) retained by, and with fiduciary responsibility to, the ERS.

E. CONFLICTS OF INTEREST

1. Manager Proprietary Products – In private equity investing, unlike other asset classes, there may be situations wherein the Oversight Manager may recommend its proprietary investment product(s) for investment. If considering placing ERS in a proprietary product, an analysis of why competing non-proprietary products are not suitable must be presented for the PE Consultant's review, and any investment must be approved by the Board of Trustees.
2. Allocation of Investments among Accounts – There may be instances where the manager will need to allocate an investment opportunity among a number of clients or a competing product (e.g., fund-of-funds). Suitable protective covenants or processes for resolving conflicts in allocation among accounts will be incorporated in the investment management agreement.
3. Personal Investments – The Oversight Manager's employees are permitted to invest personally or otherwise have beneficial interest in investments held on behalf of clients such as ERS, only upon the ERS first securing a full and appropriate allocation. Similarly, the investment manager's employees are permitted to sell an interest in investments which are also held by the ERS only after the ERS' holding has been first and fully liquidated. The Oversight Manager will provide the ERS with its policies for personal investments by employees as an attachment to the investment management agreement, and notify the PE Consultant and Staff in writing of any changes. In instances where the manager or its employees are securing an investment or beneficial interest, notice must be provided to ERS at least five business days prior to the closings for either party.
4. Other Conflicts of Interest – When and if other conflicts of interest become apparent, suitable protective covenants or processes for resolving conflicts will be incorporated into the investment management agreement.

F. UNRELATED BUSINESS INCOME TAX

The Oversight Manager will make a best efforts attempt to minimize UBIT incurrence by the ERS. This will include investing in partnerships/LLCs which do not intend to generate UBIT and when possible employing vehicles structured to shield the ERS from UBIT. It is required that any

investments structured to avoid UBIT be designed such that secondary sales or replacement of the oversight manager are not impeded.

II. INVESTMENT POLICIES

The private equity program will be guided by a long-term target *Strategic Portfolio Structure*. Each year the program will be further implemented and modified in accordance with an *Annual Tactical Plan* prepared by the Oversight Manager, reviewed by Staff and the PE Consultant, and approved by the Board.

A. ELIGIBLE INVESTMENTS

The following private equity strategies and investment types will be considered eligible for the ERS's portfolio:

1. **Venture Capital - Early-Stage:** Seed or start-up equity investments in private companies.
2. **Venture Capital - Middle-Stage:** Investments in companies which are beyond the start-up phase, but may not be generating revenues or profits.
3. **Venture Capital - Later-Stage:** Investments in more mature companies (e.g., with developed products, revenues, and in many instances profitable) to provide funding for growth and expansion.

Of note, some partnerships/LLCs invest in more than one stage of venture capital, however, the oversight manager will endeavor to select partnerships/LLCs that represent the strategies in the appropriate amounts and diversity.

4. **Buyouts/Acquisition:** Partnerships/LLCs which provide funding to acquire majority or controlling interests in a business or product lines from either a public or private company.
5. **Restructuring/Recovery:** Investments made in distressed or poorly performing companies, with the intent of initiating a recovery via financial restructuring or the introduction of management expertise. Partnerships/LLCs investments may include debt and/or equity securities.
6. **Special Situations:** Partnerships/LLCs with investment strategies which have gained an institutional following, but where sporadic opportunities do not justify a separate long-term strategic allocation. Categories includes partnerships/LLCs which make strategic block investments, have very broad mandates (such as merchant banking funds), or focus on specific industries or which seek to exploit opportunities created by changing industry trends or governmental regulations.
7. **Subordinated Debt:** Partnerships/LLCs which invest in unsecured or junior obligations in financings. These generally take the form of subordinated debentures or preferred stock. They typically earn a current coupon or dividend and have warrants on common stock or conversion features.
8. **Privately Placed Debt:** Separate accounts or pooled funds which invest in investment grade and non-investment grade privately placed debt securities. Also included in this category are equipment lease partnerships.

9. **Project Finance:** Partnerships/LLCs which invest in industrial leveraged or unleveraged lease or project financings. These can include participation in equity, mezzanine, or senior debt investments. Investments should be made after the development phase, as part of the project's permanent financing, when projects are going operational.
10. **Global/International:** Partnerships/LLCs which make venture capital, later-stage, LBO or other private finance investments in companies based abroad. Some partnerships/LLCs in this category may make investments in companies based both domestically and abroad.
11. **Fund-of-Funds:** Blind pool partnerships/LLCs that evaluate, select and monitor investments in other limited partnership/LLC investments.
12. **Other:** Partnerships/LLCs which invest in publicly-traded securities or which employ strategies different from those cited above such as, hedge fund strategies, commodity trading, post-venture equities, investments in commercial leases, and other non-traditional strategies. The purchase of secondary partnership/LLC interests is also allowed.

B. GEOGRAPHICAL LOCATION DIVERSIFICATION

Although the priority of the portfolio should be to achieve diversification by investment strategy, another measure of diversification is by geographical location. Over the long-term, the ERS portfolio should seek portfolio diversification with regard to major regional areas both domestically (e.g., Northeast, Mid-Atlantic, Southeast, Midwest/Plains, Southwest/Rockies, West Coast, Pacific Northwest), and internationally (e.g., Europe, Pacific Basin, South and Latin America).

In line with the total ERS' international allocation, international private equity investments shall comprise no more than 30% of the private equity investment allocation, and shall be diversified in the context of the total private equity portfolio. The currency exposure to the ERS from the non-dollar aspect of the allocation is expected to be negligible.

C. INDUSTRY SECTOR DIVERSIFICATION

The ERS portfolio will seek to diversify by industry sector (e.g., Biotechnology, Computers, Financial Services, Healthcare, Medical, Media/Communications, Electronics, Software, Consumer/Retail, Basic Industry, Other, etc.) such that no one industry classification will represent more than 20% of the private equity portfolio.

The Staff and the PE Consultant will review the industry classification methodology employed by the oversight manager and will adopt the methodology if it is deemed sufficient, or work with the oversight manager to develop mutually satisfactory categories.

D. LIFE CYCLE DIVERSIFICATION

Commitments to partnership/LLC investments will be staged over time. It is the long-term goal of ERS to spread out investment timing such that new commitments will be made each fiscal year. This policy will have the effect of dollar cost averaging the ERS' portfolio over business cycles to help insulate the portfolio from event risk. Capacity to make commitments will be allotted to the oversight manager in accordance with the Investment Projection Model, which will be updated as part of the *Annual Tactical Plan*, described herein, or as necessary.

E. INVESTMENT SPONSOR DIVERSIFICATION

The ERS portfolio will seek to diversify by issuer of limited partnership/LLC securities, and other specific investments sponsors. No more than 20% of the ERS' private equity portfolio net asset value will be invested with any one investment sponsor organization.

It is the intention of ERS to keep the total holdings of the portfolio to a reasonable number (e.g., less than 100 partnership/LLC interests at any time). Given the significant total dollar size of the ERS's private equity net asset value target, large concentrated investments in fewer partnerships/LLCs, are preferred to smaller investments in more numerous partnership/LLC securities.

F. CAPITAL STRUCTURE DIVERSIFICATION

While the majority of investment opportunities in the private investment area are equity-oriented in nature, ERS will seek portfolio diversification such that both equity as well as more senior securities (e.g., those which are higher in a company's capital structure than common stock), are included in the portfolio. Senior securities should incorporate a current, predictable cash income component such as a regular dividend or interest coupon. These securities should also be senior to common and preferred equity, and can be in the form of preferred stock, subordinated debt, senior debt, or lease financing, etc.

The diversification limits for the above sections B, C, E and F may be waived on a case by case basis by the Board of Trustees.

III. PROCEDURES FOR INVESTMENT

A. RESPONSIBILITIES

The private equity program shall be implemented and monitored through the coordinated efforts of the ERS Board of Trustees; through the ERS' Staff (the "Staff"); the PE Consultant(s); and the Oversight Manager(s). Delegation of responsibilities for each participant is described in the following sections.

1. Board of Trustees

The Board of Trustees shall approve the investment policies and objectives which the Trustees judge to be appropriate and prudent to implement its strategic plan for the investment of ERS' assets; review the performance criteria and policy guidelines for the measurement and evaluation of the investment managers of the ERS' assets; review the PE Consultant and Staff's recommendations to retain a qualified investment manager(s) and set discretionary investment limits; supervise the investment of ERS assets to ensure that the ERS' investment remains in accordance with the Board's strategic planning and the Employees' Retirement System of the State of Hawaii Objectives and Policies and the Private Equity Portfolio *Policies and Procedures* documents.

The Board of Trustees will guide the execution of the program by review and approval of a long term strategic plan (*Strategic Portfolio Structure*) prepared by the PE Consultant, and reviewed by Staff, which will be updated and revised periodically as appropriate; and a short term *Annual Tactical Plan* prepared by the Oversight Manager and PE Consultant, and

reviewed by Staff, which details goals and objectives for the ensuing twelve months. The Board will monitor the program's progress and results through a performance measurement report prepared quarterly by the Oversight Manager and reviewed and commented upon by the PE Consultant.

The Board of Trustees may approve direct investments in limited partnerships and LLCs subject to the Policy limitations and monitoring requirements of such investments as prescribed in Section I.D.31.

2. Staff

The Staff will review investment objectives and policy language developed by the PE Consultant. The Staff will guide the execution of the program by review and approval of a long term strategic plan prepared by the PE Consultant, which will be updated and revised periodically as appropriate. The Staff and the PE Consultant will oversee the Oversight Manager in preparing a short term annual *Tactical Plan*, which details goals and objectives for the next twelve months. The Staff and PE Consultant will also review the Oversight Manager's quarterly portfolio reports, review the Oversight Manager's proposed *Investment Disclosure Forms* (Appendix B) for compliance with the strategic plan and conflicts of interest, and review the Oversight Manager's and the portfolio's performance in relation to assigned responsibilities.

The Staff will coordinate program compliance among all participants and communicate the investment policies, objectives and performance criteria to the Oversight Manager(s) and the PE Consultant. The Staff will coordinate the receipt and distribution of capital.

The Staff and PE Consultant will identify qualified investment oversight manager(s) for implementation of private equity investment program, and will advise the Board of Trustees of any material changes in the Oversight Manager organization(s). Staff and the PE Consultant may identify and recommend private equity investments in accordance with this Policy.

Unless delegated to an Oversight Manager as prescribed by Policy, the Board of Trustees may direct Staff and the PE Consultant to provide the necessary and appropriate oversight management for direct investment, co-investment vehicles, and/or direct fund investments.

3. PE Consultant

In cooperation with the Staff, the PE Consultant shall advise on program compliance; assist in the implementation of the private equity program; review and comment on the *Annual Tactical Plan* submitted by the Oversight Manager and review and comment on the Oversight Manager's quarterly reports and proposed *Investment Disclosure Forms*; conduct performance measurement; review and periodically update all program documentation and review management relationships; conduct Oversight Manager searches when requested; and provide special project research pertaining to technical private equity and alternative investments issues as requested by the ERS. At the request of the Board, the PE Consultant shall assist in the evaluation of private equity investment proposals.

4. Oversight Manager(s)

The Oversight Manager(s) shall acquire and manage, on a discretionary basis, private equity investments on behalf of ERS and in accordance with the Investment Objectives as described

in Section I of the ERS' *Private Equity Policy and Procedures* document and the Investment Policies as described in Section II. The Board of Trustees may delegate oversight management and monitoring responsibilities to Staff and the PE Consultant(s) in accordance with this Policy.

The asset allocation executed by the Manager will be dictated by the *Strategic Portfolio Structure* and the *Annual Tactical Plans*.

B. INVESTMENT PROCEDURE

Private equity investments in compliance with the ERS' Policies (Section II) and the Investment Objectives (Section I) shall be acquired through the following process:

Strategic Portfolio Structure: Periodically, the Staff and the PE Consultant will prepare a long-term *Strategic Portfolio Structure* after a review of investment criteria, performance expectations, and other relevant program requirements for the ensuing period's investments. This document will recommend general capital allocations to each investment strategy and the rationale and expectations for inclusion. The *Strategic Portfolio Structure* will then be submitted to the Staff for review and Board of Trustees for final approval.

Annual Tactical Plan: Annually, the Oversight Manager will prepare a tactical plan which reviews the current status of the portfolio, recent historical and prospective market conditions, and proposes the steps to be taken over the next twelve month period to further implement the long-term strategic plan. The *Annual Tactical Plan* will be reviewed by the PE Consultant and approved by the Staff. The outline for the *Annual Tactical Plan* is provided in Appendix A.

Specific Investments: The Oversight Manager will identify and evaluate limited partnerships/LLCs and, as appropriate, other investment vehicles that are in compliance with Hawaii investment guidelines and current *Annual Tactical Plan*. The Oversight Manager will be responsible for all aspects of evaluation and closing, subject to prior notice via an *Investment Disclosure Form*, an example of which is provided in Appendix B.

C. MANAGER RESPONSIBILITIES

1. General Responsibilities

An Oversight Manager is an Investment Manager and, without limiting the responsibilities described in this section, shall have the responsibilities, described in the section of this manual entitled ERS Plan Structure, of an "Investment Manager."

2. Funding Procedures

The Oversight Manager shall provide the ERS, on a best efforts basis, with 5 days written notice of drawdowns. ERS shall also be provided with documented wiring instructions in advance.

3. Investment Management

Oversight Managers are directly accountable for the following investment management responsibilities. This section designates certain investment responsibilities which the

Oversight Manager will perform or cause to be performed. Fees and expense reimbursements for these duties are outlined in the Oversight Manager's contract.

- a. Investment Selection – The Oversight Manager will be responsible for evaluating investment opportunities and selecting, on a discretionary basis with fiduciary responsibility, private equity investments to be made on behalf of ERS.

The screening and selection will be made with a view to maximize ERS' risk adjusted rate of return, within the parameters and allocations of each private equity strategy as set by the Board of Trustees in the *Strategic Portfolio Structure*. A discussion of private equity risk and return with respect to the ERS' portfolio is incorporated in the *Strategic Portfolio Structure* document.

An *Annual Tactical Planning* process will be used in determining the number and types of investments within each strategy. The manager will also take into consideration relevant overall portfolio diversification considerations as set forth in the Objectives and Policies statement and Program Management (Section I.B.) of this document. The process will include, but not be limited to, the following services:

- (1) *Annual Tactical Plan* preparation. This report outlines the steps the investment manager will take during the next ERS fiscal year to further implement the ERS' strategic plan as set forth in the *Strategic Portfolio Structure*.

The *Annual Tactical Plan* will include a review of the current status of the portfolio, perceived investment environment, the types and number of partnerships/LLCs to be sought and underlying rationale, and goals for other management responsibilities such as situations being monitored and adding value.

- (2) Review and maintain a log of all opportunities available in the market over time, as well as investments directed to the manager by the ERS.
- (3) Screen and evaluate all opportunities to identify investments which will provide the most attractive risk and return characteristics and are a fit with the long-term and short-term objectives of ERS.
- (4) Conduct full and proper due diligence, fully documenting the process. Due diligence will be conducted to a standard of completeness attributable to a prudent expert. The Oversight Manager will make available for review by ERS, or its agents, the Manager policies, procedures, and standards for conducting due diligence, and the due diligence documentation performed on any investment made on the ERS' behalf. Onsite visits at the General Partners' main office will be a mandatory part of investment due diligence.

The Oversight Manager may also be called upon to periodically provide the Staff with oral or written evaluations and recommendations on specific investment opportunities, as requested by the Staff.

- (5) The Oversight Manager will submit an *Investment Disclosure Form* to Staff and the appropriate PE Consultant at least 5 business days prior to making a commitment on behalf of ERS.

- (6) Negotiate investment terms and conditions, partnership and LLC membership agreements and other closing documents on behalf of ERS, with a view to maximize returns, minimize expenses, safeguard the ERS' assets, and secure investor rights; and make investments on the ERS' behalf.
 - (7) The Oversight Manager shall deploy capital efficiently, such that funding targets are achieved with a minimal number of partnership/LLC holdings. Due to the scope and size of the ERS program, significant, concentrated investments in fewer partnership/LLC investments are preferred to smaller, more numerous investments. The manager will include discussions of the number and size of planned investments in the periodic portfolio planning and reporting documents.
- b. Ongoing Operations – The Oversight Manager shall manage or cause to be managed, each investment made such as to enhance the ERS' value in the investment. The Oversight Manager shall be responsible for conducting or supervising the following services with respect to each investment:
- (1) Monitoring and Voting – Maintaining close communication with the General Partners of the investments, maintaining an awareness of, and documenting the progress and level of performance of each investment. This will include attendance at annual partnership/LLC meetings and, as appropriate, sitting on limited partner advisory boards. It will also involve voting on partnership/LLC, and other portfolio securities matters on behalf of ERS as need arises.
 - (2) Adding Value – The Oversight Manager shall take all necessary or appropriate steps consistent with applicable capital and operating budgets to assure the ERS' investment is managed to or above its anticipated performance level.
 - (3) Disbursement, Receipt and Cash Management – Develop procedures for funding commitments on a timely basis and coordinating the receipt of cash distribution from the partnership/LLC investments, including a policy for the orderly treatment of in-kind distributions (e.g., securities distributions) received from partnerships/LLCs.
 - (4) Books and Records – The Oversight Manager shall maintain books of account with correct entries of all receipts and expenditures incident to the management of the investment. These books, together with all records, correspondence, files and other documents, shall at all times be open to the inspection of the ERS. The Oversight Manager shall maintain complete and accurate records of all transactions related to the managed investment, including receipts and all correspondence relating thereto on such forms as the ERS' auditors may reasonably require and make such records available for inspection and copying by ERS at all reasonable times. The Oversight Manager shall bear the costs associated with the retention of such records and if ERS shall request copies of such records, the Oversight Manager shall bear the cost of duplicating and sending such records to the ERS.
 - (5) On-Going Review – The Oversight Manager shall keep itself informed of the overall market conditions relative to the managed investments and the managed investments' competitive position in the applicable investment strategies. The Oversight Manager will also be responsible for ensuring compliance with partnership and/or LLC membership agreements, attending to amendments, resolutions, voting proxies, and

other investment related matters. All such activities will be undertaken with a view toward maximizing value to ERS.

(6) Disposition Review – The Oversight Manager shall review the managed investments with respect to continued timely return of capital, income and gains. The manager will be responsible for managing to cash any in-kind (e.g., security) distributions received from the partnership/LLC investments.

(7) Notice – The Oversight Manager shall notify the Staff and the PE Consultant as soon as practicable in writing of any investigation, examination or other proceeding involving the investments or investment sponsors commenced by any regulatory agency or of any action, suit or proceeding commenced against or by the Oversight Manager or an investment sponsor.

4. Portfolio Accounting and Financial Control

The Oversight Manager's accounting, reporting and financial control, and administration system shall meet the following objectives:

a. Financial Control – The Oversight Manager will provide control systems to protect assets, detect errors and insure the reliability of information generated by the accounting system.

c. Investments' Financial Statements – On a quarterly basis, the Oversight Manager will receive from investee partnerships/LLCs unaudited financial statements, and annually, audited financial statements.

d. Accounting Policies – Accounting policies for ERS are outlined below:

(1) Current Value Reporting – Accounting data shall be computed using current values provided by the General Partners and Investment Sponsors of the investments. The Oversight Manager will make note of instances where performance presentation standards are not in compliance with those of the CFA Institute. The Oversight Manager will be held to a standard of reasonable care in verifying that the General Partners valuations reasonably reflect the underlying value of the investments. The Oversight Manager will make special note of investments which may be impaired in relation to the General Partners carrying value, and will notify the Staff and the PE Consultant of such investments, as soon as practicable, and in no instance later than in the next quarterly performance measurement report.

5. Reporting Requirements

a. Manager Quarterly Report – On a quarterly basis, within 45 days of quarter-end, the Oversight Manager(s) shall submit a written report to the Staff and Consultant on the portfolio which will address activities occurring during the quarter, an updated list of holdings, cash flows, valuations, IRR, and any and all other items of which ERS should be appraised.

b. Custodian Bank Monthly Statement – On a monthly basis, the Oversight Manager(s) shall provide the Custodian a report of ERS' account cash flows and valuations, and any other information reasonably requested.

- c. Annual Tactical Plan – Within 60 days of calendar year end, the Oversight Manager will submit an *Annual Tactical Plan* for review by the Staff and the PE Consultant, and approval of the Staff. The *Annual Tactical Plan* will include a review of the current status of the portfolio and outline the steps anticipated toward portfolio development over the course of the coming fiscal year.
- d. Investment Disclosure Form – At least five (5) business days prior to making a commitment on behalf of ERS, the Oversight Manager will provide to the Staff and the PE Consultant an *Investment Disclosure* form. The investment disclosure form will be reviewed by the Staff and the PE Consultant regarding an investment's fit within the *Strategic Portfolio Structure, Annual Tactical Plan*, and any possible conflicts of interest.

Any questions or discussion items with regard to an investment's fit within the portfolio structure can then be reviewed prior to the oversight manager executing the subscription documents.

- e. Other Information – The Oversight Manager will also provide any other reasonable information requested by the Staff, or the ERS' Custodian Bank, the PE Consultant or other agent of ERS.

D. PE CONSULTANT RESPONSIBILITIES

The PE Consultant shall review and submit to Staff comments on the Oversight Manager's quarterly reports of the ERS' private equity investments. The PE Consultant shall also be responsible for reviewing the *Annual Tactical Plan*, and *Investment Disclosure Forms* and submitting comments to Staff. The PE Consultant will incorporate quarterly performance measurement information received from the Custodian Bank in the investment measurement report for the total portfolio.

The PE Consultant will also be responsible for the initial development and ongoing review and recommendation of revisions to ERS Policies and Objectives, *Private Equity Policies and Procedures*, and *Strategic Portfolio Structure*, when requested by the Staff. The PE Consultant may also be requested to perform special projects as requested by the Staff, including the evaluation of private equity investment proposals.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII ANNUAL TACTICAL PLAN GUIDELINES

Annual Tactical Plan: The Tactical Plan is a report which outlines the steps to be taken in the next 12 month period to further implement the private equity portfolio, and any other actions or considerations germane to the active management and success of the portfolio. It also documents the reasons for the particular courses of action to be taken, and importance of items under consideration.

The Staff and PE Consultant review the Annual Tactical Plan, submit comments, and recommend Board of Trustees approval of the finalized plan. All sections should be as brief as possible using a format as follows:

I. FUNDING LEVEL

Annual Tactical Plan Period: 1/1/xx through 12/31/xx

A. Funding Tables:

1. Current Funding Position (As of x/xx/xx)

Total Fund Market Value	\$xx billion
% Target for Private Equity	3%
Total Private Equity Allocation	\$xx million
Current Net Asset Value Deficit/(Surplus)	\$(xx) million

2. Projected Funding Position⁽¹⁾

Five Year Projected Market Value	\$xx billion
% Target For Private Equity	\$xx million
Total Private Equity Allocation	\$xx million
Amount Available for Investment in Current Tactical Plan Period:	\$xx million

Annual Tactical Plan Guidelines

3. Funding by Strategy Analysis Table - Portfolio 2 - As of Month xx, 19xx⁽²⁾

PORTFOLIO 2				Five Year Target:		155,000,000
STRATEGY	# Funds	% Target	\$ Target	Undrawn Commitments	Invested Value	NAV Target Variance (3)
Venture Capital	10	25.0%	38,750,000	0	0	38,750,000
Early	4	10.0%	38,085,000	0	0	38,085,000
Multi	4	10.0%	25,390,000	0	0	25,390,000
Late	2	5.0%	47,606,250	0	0	47,606,250
Buyouts	8	40.0%	88,865,000	0	0	88,865,000
Special Situations	3	15.0%	6,347,500	0	0	6,347,500
Restructuring	2	10.0%	47,606,250	0	0	47,606,250
Sub. Debt	2	10.0%	47,606,250	0	0	47,606,250
Project Fin/Other CF	1	5.0%	15,868,750	0	0	15,868,750
TOTAL	25	100.0%	155,000,000	0	0	155,000,000

- (1) Per Funding Projection Model attached Appendix A
- (2) Reflects commitments made through Month xx, xxxx
- (3) NAV Target Variance = Target - Invested Value

II. DIVERSIFICATION

- A. Strategy: (Commentary)
- B. Industry Diversification: (Table and Commentary)
- C. Geographic Diversification (Table and Commentary)
- C. Stage of Investment: (Table and Commentary)
- D. Current Portfolio Risk and Return: (Commentary)

III. MARKET CONDITIONS

- A. Market Conditions: Discussion of Private Equity Market.
 - 1. Past 12 months
 - 2. Next 12 months
 - 3. Conclusion

IV. PROSPECTIVE INVESTMENT

A. Investment Objectives:

1. Types – Strategies to receive the foremost attention or priority:
 - a. Venture Capital
 - b. Buyouts
 - c. Restructuring
 - d. Special Situations
 - e. Subordinated Debt
2. Expected impact on the portfolio regarding:
 - a. Return
 - b. Risk
 - c. Diversification

B. Candidates the Oversight Manager is aware of and/or planning to pursue.

C. Timing of investments.

D. Dollar amount to be invested

E. Impact on the portfolio.

F. Diversification considerations: Strategy, Geographic, Industry, Capital Structure, and any other relevant considerations.

V. MONITORING

A. Specific situations being monitored, underperforming investments.

B. Actions to be initiated or in progress with existing investments.

C. Other specific goals related to the monitoring of ERS investments.

V. EXITING

A. Pending distributions or liquidations.

B. Any other relevant considerations relating to existing ERS investments.

Annual Tactical Plan Guidelines

VI. OTHER

A. Other items relevant to ERS portfolio.

SUMMARY

Investment Objectives: Summary of basic goal for the portfolio for the next 12 months.

APPENDIX:

Projected Funding Schedule and any other attachments the Oversight Manager would like to submit.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
Prospective Private Equity Investment Disclosure Form

Please provide the following information in hard copy to PE Consultant at least 5 business days prior to legally committing to any investment on behalf of the ERS, as follows:

Jeremy Thiessen, PCA, Inc., 514 NW 11th Avenue, Suite 203, Portland, OR 97209
Ph: 503-226-1050, Fax: 503-226-7702 Email: jeremythiessen@pensionconsulting.com.

1. General Information:

Name of Partnership/LLC: _____

GP/Investment Advisor: _____

Address: _____

Contact Person: _____ Title: _____

Phone: _____ Fax: _____

2. Investment Size:

Anticipated Total Partnership/LLC Size: \$ _____

Anticipated Commitment by the ERS \$ _____

% ERS Commitment of Total Partnership/LLC: _____ %

of other clients placed in investment _____

Total Ownership of Advisor's Clients \$ _____ (excluding Hawaii)

3. Proposed Category:

- | | |
|--|--|
| _____ VC Early | _____ Special Situations - Hybrid |
| _____ VC Multi | _____ Special Situations - Strategic Block |
| _____ VC Late | _____ Subordinated Debt |
| _____ Buyouts - Large | _____ Restructuring |
| _____ Buyouts - Small/Medium | _____ Project Finance/Other Cash Flow |
| _____ Buyouts - Industry Consolidation | |

4. Provide Brief Description of Investment Objective:

6. Description of Fit with the ERS' Annual Tactical Plan:

7. Disclosure/Other Comments:

- Describe any prior investment history with the general partner group and of any existing holdings affiliated with the general partner group.
- Are there any items associated with the investment of which the ERS or the PE Consultant should be aware?
- Are there any other comments the Oversight Manager would like to mention?

8. Attachments:

- Include Offering Memorandum and any other relevant materials.