I. GENERAL PROVISIONS

A. PRUDENT PERSON STANDARD

The selection of private debt investments will be guided by Section 8521 of the Public School Employees’ Retirement Code (“Code”), 24 Pa.C.S.

B. MAXIMUM LIMITATION

The Pennsylvania Public School Employees’ Retirement System (identified hereafter as “PSERS”, “Fund”, or “System”) Asset Allocation Policy limits the amount of the Fund’s assets allocated to private debt investments.

C. IMPLEMENTATION

1. PSERS Staff Requirements

Appropriate staff will be assigned as the workload is determined. The timing and types of investments will be determined by the availability of staff.

2. Legal Counsel

PSERS will use internal legal counsel. In addition, due to the complex structure of private debt partnerships, expert outside legal counsel may be retained.

3. Investment Process

If the investment meets PSERS’ criteria for investment recommendation, the proposed investment will be placed as an agenda item at the next possible Finance Committee meeting, then if approved, at the next Board meeting for Board approval. Documents relating to an investment approved under this process will be executed in accordance with PSERS’ standard policy; i.e., by any two of the individuals holding the positions of Executive Director, Chief Investment Officer, Deputy Executive Director,
4. Action Plan

On or before January 31st of each year, PSERS’ Partnership Consultant will provide the Chief Investment Officer and Managing Director of Private Markets and Real Estate with an Action Plan for the following calendar year. The purpose of the Action Plan is to provide PSERS with the Partnership Consultants’ outlook for the private investment markets as well as an overview of the Partnership Consultants’ specific investment objectives and goals for PSERS for the upcoming year. The Action Plan should address the following:

a. An overview of the Partnership Consultants’ outlook for the private and public investment market for the succeeding calendar year and for the following two years.

b. The Partnership Consultants’ recommended investment strategy for PSERS for the following calendar year. The investment strategy should specify investment types and structures, stages of investment, industry categories and other relevant investment characteristics.

c. An estimate of the number of partnerships the Partnership Consultant expects to recommend to PSERS for the following year and the amount of capital connected therewith.

5. Procedures

Any procedures in addition to those adopted by the Board will be developed by staff and the Partnership Consultant according to the manner of involvement the Board directs.

D. REVIEW AND MODIFICATION OF INVESTMENT POLICY STATEMENT, OBJECTIVES, AND GUIDELINES

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

The Board will review the Policy Statement from time to time to determine if modifications are necessary or desirable.

II. PRIVATE DEBT PARTNERSHIP INVESTMENT POLICY

A. BACKGROUND

1. Definition

   Private debt partnership investing includes, but is not limited to:
   
   a. **DISTRESSED DEBT** - Investments in the debt obligations of under-performing companies that are in need of operating or financial restructuring, and are either in or out of bankruptcy.

   b. **MEZZANINE** - Investments in unsecured or junior debt securities with equity enhancements such as warrants or nominally priced equity.

   c. **STRUCTURED PRODUCTS** - Investments in the debt tranche of a security that is generally leveraged and backed by a diversified pool of assets. Assets include bank debt, investment grade debt, non-investment grade debt, or mortgages.

2. Categorization of Funds

   For purposes of analysis, private debt funds will be categorized as follows:

   a. Preferred Investment Securities

      (i) Partnerships intending to invest in the senior debt, subordinated debt, or trade claims of private and/or public companies.

      (ii) Partnerships intending to invest primarily in the subordinated debt of private equity transactions.

      (iii) Partnerships intending to invest in collateralized debt securities.
b. Size Categories

(i) Large: Partnerships intending to purchase companies with revenues in excess of $700 million.

(ii) Medium: Partnerships intending to purchase companies with revenues between $200 million and $700 million.

(iii) Small: Partnerships intending to purchase companies with revenues below $200 million.

c. Industry Categories

(i) Partnerships intending to invest in a particular industry, or range of industries.

B. PHILOSOPHY

1. Fund Objectives

Private debt partnership investments provide an appropriate addition to the System's portfolio. Although considered an aggressive investment, viewed from a total portfolio perspective, the risk/return tradeoff as well as the diversification potential makes this a suitable choice for the Fund.

Private debt partnership investments are compatible with the general objectives of the Fund, which include:

a. Providing a means to pay benefits to the System's participants and their beneficiaries.

b. To produce a return on investment that is based on levels of liquidity and investment risk that are prudent and reasonable.

c. Attaining an adequate real return over the expected rate of inflation.

d. Earning a return over the assumed actuarial rate of interest.

e. Complying with all applicable laws and regulations concerning the investment of pension assets.

2. Conflicts of Interest
a. Corporate Governance

It does not appear that there are any basic conflicts of interest between private debt partnership investments and the corporate governance standards of one share, one vote.

b. Current Holdings

As a limited partner in a partnership in which PSERS has no discretion, a conflict would not appear to exist. As a sole limited partner or one in which PSERS exerts some influence, conflicts could be avoided at PSERS’ discretion.

3. Reasons to Invest in Private Debt Partnerships

a. High Rate of Return

Private debt partnership total rates of return are expected to be greater than those that are expected from conventional debt investments.

b. Diversification

Private debt partnership investing has a low correlation to other investment classes and will therefore contribute to the reduction of risk and the enhancement of returns on a portfolio basis.

C. OBJECTIVES

1. Portfolio Investment Performance Objective

The performance objective for private debt partnership investments is a total real return approximating 11%-14%.

2. Risk Management

a. Standard Deviation

The standard deviation of returns, one measure of the risk or volatility of private debt partnership investments, should be approximately 25% lower than that of private equity or venture capital due to its seniority in the capital structure.

b. Business/Economic Related Risks include:
(i) Incorrect underwriting assumptions resulting in the mispricing of assets.

(ii) Company has operational problems, reducing capital available for debt service.

(iii) If interest rates rise, poorly structured, highly leveraged deals may be strained.

(iv) A severe recession could cause a business which had been acquired recently to fail under its debt load.

(v) Foreign currency translation, if not adequately hedged, could compromise investment returns.

(vi) Failure to secure control of a transaction, when necessary, could result in the inability to fully execute the implied strategy.

c. Legislative/Tax

Legislative and/or regulatory bodies may amend the laws, policies, or guidelines that permit these types of strategies to be executed.

d. Lack of Liquidity

The time horizon for a private debt partnership is typically seven to twelve years. Private debt investments should therefore be considered an illiquid investment. PSERS is well structured for long-term investments due to the Fund's continuing cash flows and the nature of pension liabilities. Such investments also match PSERS' long-term liabilities for active employees.

e. Blind Pool

In partnership investments, control is vested with the general partners. Investments are generally unknown at the time the limited partners make their initial capital contributions. However, as sole limited partner, or in conjunction with other limited partners, PSERS could influence the direction the partnership takes should the general partner deviate from its intended strategy.
3. **Private Debt Partnership Portfolio Diversification**

In order to mitigate the risks associated with private debt partnership investments, a well-diversified portfolio is highly desirable. Each investment should be evaluated relative to the characteristics within the existing portfolio.

The following should be considered when addressing diversification needs:

a. **Preferred Investment**
   
   (i) Senior Debt of private and/or public equity transactions
   
   (ii) Subordinated debt of private and/or public equity transactions
   
   (iii) Equity of private and/or public equity transactions
   
   (iv) Warrants of private and/or public equity transactions

b. **Size of Restructured Companies**
   
   (i) Large companies with revenues in excess of $700 million
   
   (ii) Medium companies with revenues between $200 million and $700 million
   
   (iii) Small companies with revenues below $200 million

c. **Sectors** - investments diversification across a variety of industries.

d. **Maximum Investment** - an investment by PSERS will be limited to no more than 25% of the total amount of any commingled fund, and no more than 90.91% when PSERS is the only investor other than the general partner.

e. **Minimum Investment** - PSERS will make no investment less than $25 million.

f. **Time** - PSERS will endeavor to invest in a consistent manner over time, unless markets are extremely overvalued.
4. Total Portfolio Diversification

Correlation with the returns of many other asset classes is low; therefore the inclusion of private debt partnerships in the portfolio should provide an added means of diversification to the Fund.

D. CONSTRAINTS AND GUIDELINES

1. Minimum Requirements

a. The Fund will not invest in any domestic or international fund-of-fund structures.

b. Private debt dollars under management by the general partners of the partnership should be or have been substantial.

c. The general partners must have demonstrated investor acceptance by retention of other institutional clients.

d. The general partner(s) must have displayed a track record of investments transacted under a similar investment strategy to the one being considered.

e. The returns realized or projected by the general partner for previous investments must be or have been at a level consistent with a private debt investment strategy for the period of time referenced.

f. General partners must commit at least 5% of the total aggregate capital to the partnership or 10% of PSERS’ commitment in a parallel fund structure.

g. The partnership should provide PSERS with a preferred return of at least eight- percent (8%), compounded annually.

h. The general partner must be in a first loss position to PSERS’ limited partner position. This first loss position can be achieved through either through 1) a distribution schedule where the full 5% general partner contribution is subordinated to all of the limited partners, 2) the establishment of an escrow account that totals 10% of PSERS’ contribution for the benefit of PSERS, or 3) the issuance of a guarantee in an amount equal to 10% of PSERS’ contribution, provided the firm’s financial resources are substantial.
i. The fund must agree to operate under a prudent expert standard of indemnification.

j. If the fund’s general partner is a partnership, the general partner of that partnership must commit an amount equal to one-half of the required 5% capital commitment.

k. PSERS requires a seat on any limited partner Advisory/Valuation Committee.

l. PSERS requires expense reimbursements for attending Advisory/Valuation Committee meetings and the fund’s Annual Meetings.

m. PSERS requires a Key Person provision, if it is deemed applicable, that gives the limited partners the option to discontinue capital contributions.

n. PSERS requires a No Fault Divorce provision.

2. Evaluation Criteria

a. The primary emphasis will be on the quality and experience of the general partners.

b. Additional factors include, but are not limited to, the following:

   (i) The majority of the individuals comprising the general partner must have significant and complementary private debt and related experience, as well as a high quality, identifiable track record.

   (ii) The general partners should have worked together previously to ensure compatibility.

   (iii) There are a variety of skills investment managers need to be successful. They should possess the appropriate combination of operating, technical, financial, and private debt experience, as well as enthusiasm and the ability to motivate.

   (iv) Investment managers often have special relationships that can enhance operations, deal flow, or existing strategies. These could include relationships with
investment banks, industry specialists, lending institutions, or legal professionals.

(v) The partnership’s investment process is important. This includes due-diligence on potential investments, analysis of the financial structure of potential investments, and the degree of participation by the general partners in the direction of portfolio companies.

(vi) The amount of time the general partners commit to the current partnership is important.

(vii) References should be generally positive and include those not provided by the general partners.

(viii) All partnership agreement materials require a legal and logical audit. This should include a review of distribution policies, fees, profit and loss allocations, and partnership term extensions.

(ix) The willingness of the general partners to negotiate terms will be viewed favorably.

(x) The agreement should include adequate provisions to assure the original general partners continue to manage the partnership. In the event the original general partners leave, PSERS, as a limited partner, should be given the option to withdraw.

(xi) Potential for co-investments.

c. A due diligence review by the staff and/or the Partnership Consultant comprising the following, when applicable:

(i) Review of whether the proposed investment falls within PSERS’ investment plan, constraints and guidelines, and if it complies with applicable investment policies.

(ii) Background check of principals.

(iii) Discussions with principals of the proposed investment.
(iv) Review and analysis of all pertinent offering documents including: (1) offering memoranda, (2) subscription agreements, (3) private placement memoranda, and (4) operative investment agreements.

(v) Consideration of potential conflicts of interest, if any, posed by the proposed investment and prior investments and activities of the principals.

(vi) Review and analysis of investment:
- Concept - including entry and exit strategies
- Terms - including fees, principal participation, structure

(vii) Review of news articles regarding principals, prior investments, and concepts.

(viii) Discussions with other investors, peers, and industry associates (reference checks).

(ix) Review and analysis of performance for prior and current investments.

(x) Consideration of the percentage of capital commitment available to PSERS.

(xi) Investigation of special terms and side letter agreements with past, present, or future investors.

d. A focused review by the staff and/or the Partnership Consultant comprising, when appropriate, the following:

(i) Identification of key issues stemming from certain criteria or other concerns relating to particular proposed investments, including non-standard opportunities, prior to a full due diligence review.

(ii) Highlighting such issues and concerns, along with suggestions as to how they may be addressed, resolved or mitigated (through negotiation or otherwise).

(iii) Where a further review of such an opportunity is authorized and upon completion of a focused due diligence review, identification of the attractive
attributes as well as the concerns relating to the proposed opportunity and possible mitigation of such concerns.

(iv) For new general partner relationships, PSERS staff will perform an on-site visit of the general partner's office as part of the due diligence process.

At each stage of such a focused review, the Managing Director of Private Markets and Real Estate will be furnished information regarding relevant issues early in the review process to permit flexibility in considering and deciding on such proposed opportunities.

3. Legal Constraints

   a. Unrelated Business Taxable Income (UBTI) - Partnerships should be structured to minimize UBTI.

   b. Plan Assets - Many partnership documents contain language that addresses ERISA's rules concerning "Plan Assets." While these regulations do not apply to PSERS, it may be affected by such ERISA-related language.

4. Guidelines

   a. Method of Participation

   PSERS will generally participate as a limited partner in professionally managed funds.

   b. Types of Authorized Investments

   Domestic and foreign private debt partnerships involved in:

   (1) Distressed Debt
   (2) Defaulted Debt
   (3) Mezzanine Debt
   (4) Debt Obligations, such as Collateralized Bank or Debt Obligations ("CBO" or "CDO").
   (5) Other High-yield asset-backed securities, such as Collateralized Mortgage-backed Securities ("CMBS")

   c. Fees

   Fees should be negotiated where prudent and without creating offsetting adverse effects.
E. STRATEGY

1. **Allocation** - PSERS should endeavor to invest on a consistent basis. Annual commitments should not be budgeted, but rather meet and be responsive to the opportunities and market dynamics of the private debt industry.

2. **Method of Participation** - PSERS should secure a core holding in this asset class attained through investments in large, well established private debt funds, with participation in smaller partnerships or direct investments to follow.

3. **Size of Partnerships** - In accordance with this Policy Statement, all types of private debt partnerships should be considered, including smaller partnerships, though diversity in size is recommended overall.

F. MONITORING

1. **Performance**

   Performance will be assessed relative to:

   a. Objectives established by the partnership or the principals managing the investment.

   b. Risks undertaken.

   c. Other similar partnership performance.

   d. The general private debt market.

   e. An internal rate of return ("IRR") and compared to cohort year peer groups.

2. **Adherence to Strategy**

   The actual strategy employed by the partnership or the investment will be judged relative to the stated objectives and strategies.

3. **Frequency and Types of Monitoring Reports**

   Reports required from private debt partnership investments will be negotiated by staff.
4. Board Reports

Semi-annual reports will be provided to the Board, with a more detailed report submitted annually.

III. AMENDMENTS AND ACCEPTANCE

It is the Board’s intention that the investment staff, with the support of the Consultant, reviews manager compliance with this document on a quarterly basis. Should these guidelines change in any way, the foregoing will be modified.

If at any time the Consultants believe that the objectives of this program cannot be met, or that these guidelines constrict performance, the Chief Investment Officer should be notified in writing. The Consultants are encouraged to suggest changes to these guidelines at any time. By signature, the Consultant agrees to these Investment Objectives and Guidelines and shall perform in accordance herewith.

_____________________________ Pennsylvania Public School Employees’
Company Name Retirement System

_____________________________ __________________________________
Managing Director Signature Chief Investment Officer

_____________________________
Managing Director Name

_____________________________ ________________________________
Date Accepted Date Proposed

Approved March 13, 2009