Alternative Investments – Due Diligence Procedures

GOALS AND ANTICIPATED OUTCOMES

These procedures are intended to reinforce accountability and memorialize transparent decision making throughout the entire initial alternative investment selection process, from sourcing to contract execution. These procedures are intended to supplement existing policies and procedures regarding alternative investments approved by the State Investment Council (SIC).

INVESTMENTS GOVERNED BY THESE PROCEDURES

These procedures will govern all initial and follow-on investments of any size in the following asset classes:

- Hedge Funds
- Private Equity
- Real Estate
- Commodities
- Infrastructure
- Bank Loans

SCOPE OF THESE PROCEDURES

These procedures only cover the initial investment selection process, from sourcing the deal to execution of the subscription agreement. These procedures do not encompass the ongoing monitoring of investments and the continuing due diligence process once capital has been committed.

STRATEGIC PLANNING

These steps describe the process by which the framework for fund selection is established.

1. The SIC shall establish an Investment Policy, setting forth asset allocation and policy guidelines for each asset class and subsector, consistent with statutory requirements and SIC regulations. The SIC shall update the Investment Policy annually or as needed.

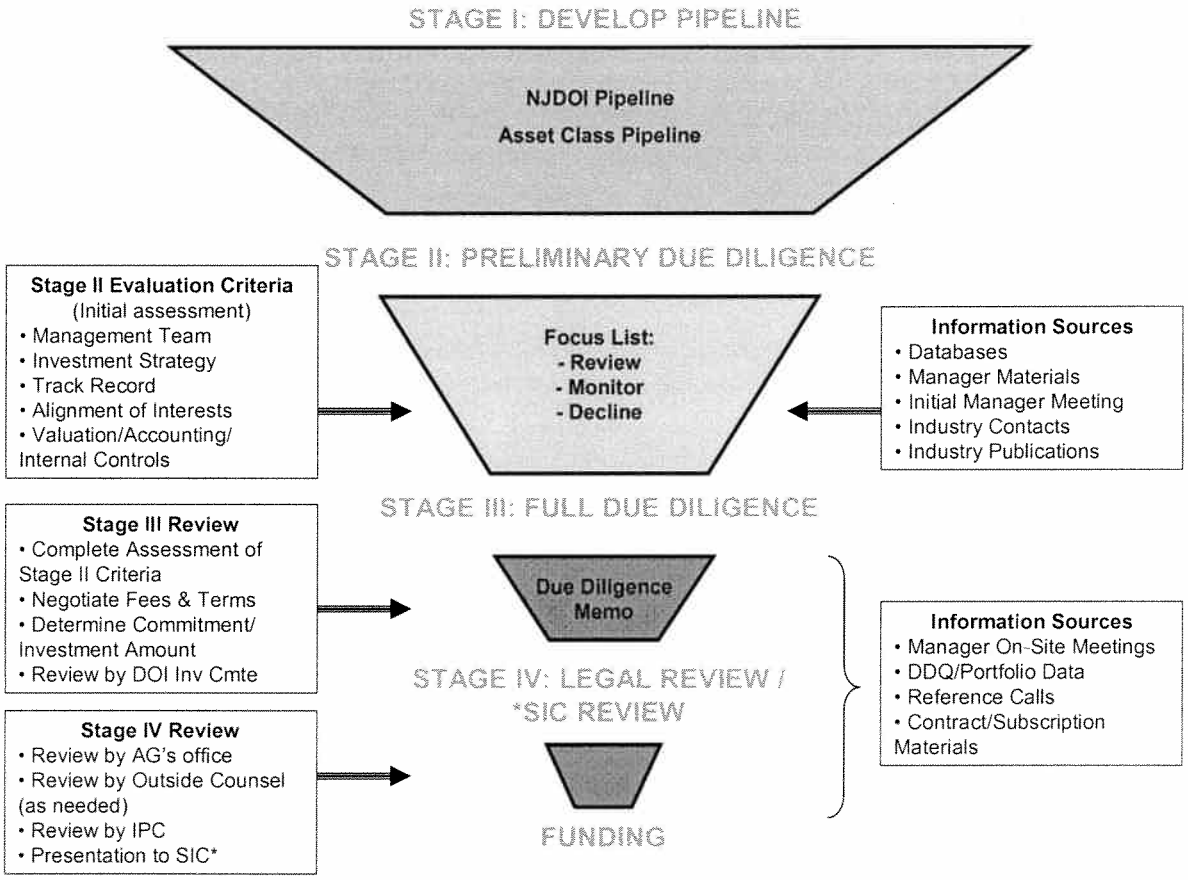
2. Based on the Investment Policy, the Division of Investment ("DOI") shall establish a detailed multi-year forward-looking schedule for each asset class (the "Investment Plan") to assess desired commitment goals over the next several fiscal years so as to assist the DOI to achieve long-term alternative investment objectives. The DOI shall update the Investment Plan at least annually, or more frequently as deemed necessary.

3. DOI staff shall meet periodically with the general and asset class consultants to review and recommend changes to the Investment Policy, the Investment Plan and these Due Diligence procedures.

SCREENING PROCESS

The screening process used to identify qualified alternative investments from the broad available universe of opportunities is described below:

ALTERNATIVE INVESTMENT SCREENING PROCESS



STAGE I: MAINTAIN PIPELINE

DOI staff, in conjunction with the asset class consultant, will maintain a database (the "Pipeline") of investment opportunities within each asset class to be able to track the available opportunity set on a forward-looking basis. The Pipeline shall be maintained by DOI staff using data received from various sources, including but not limited to asset class and general consultants, fund of funds managers and other general partner relationships, marketing firms and publications. Maintenance of the Pipeline is the responsibility of DOI staff; the Pipeline shall be updated 2-4 times per year, or as needed.

The Pipeline shall include the following categories of information:

- Fund name and/or manager
- Current Fund Size
- Prior Fund Size
- Prior Fund Vintage Year
- Fund Type
- Geographic Focus
- Source of Investment
- Materials received such as Private Placement Memoranda, Term Sheets, etc.

STAGE II: PRELIMINARY DUE DILIGENCE

Creation of Focus List

DOI staff will, on a regular basis, review those funds in the Pipeline that are consistent with the current investment goals set forth in the Investment Policy and the Investment Plan. DOI staff, in conjunction with the Asset Class Consultant, will initially review each fund's reputation and track record. If the fund is of interest after such review, the fund will be added to the Focus List. DOI staff, in conjunction with the Asset Class Consultant, may then schedule one or more meetings with the fund manager of each fund on the Focus List and/or may review due diligence materials provided by the fund.

Initial Fund Evaluation Memo

After a meeting with a fund manager or upon review of due diligence materials (PPM, presentation book, etc.), DOI staff, in conjunction with the Asset Class Consultant, will complete an Initial Fund Evaluation Memo. This memo should be broad in scope and should focus on the following topics (please note that this list is not exhaustive and may vary among asset classes):

- **Management Team**
  - How is the leadership structured for the fund and parent organization?
    - Size
    - Composition
    - Cumulative experience together
  - What is the fund manager's level of experience in this particular area or investment strategy, both on this team and with other entities? Are they operating this fund outside of their particular niche or normal strategy area?
  - What is the fund manager's overall level of resources? What is its succession plan? What is its current business plan?
- **Investment Strategy**
  - What is the fund's investment strategy?
  - Is the current management team experienced in this type of strategy?
  - How unique is the fund's strategy? How does it fit with the DOI's existing portfolio of funds?
  - What is the fund manager's perspective on adhering to this strategy, even in times of prolonged economic downturn or negative performance?

  - What is the proposed fund size in dollars or other currency? How does this compare with previous funds? How does the manager justify this targeted fund size? What is their intended universe of investors/Limited Partners and how does the DOI fit within this universe?
- **Track Record**
  - How many funds has the fund manager managed in the past? How many funds or products is the fund manager currently responsible for?
  - What is the fund manager's historical performance on an absolute and risk-adjusted basis? Are there any trends in performance? What has been the realization record?
  - What has been the strategy's risk profile? Have the returns been consistent over time?
  - How might macro events outside the fund manager's control affect performance going forward (for example, the effects of rising or falling energy prices or federal government regulation)?
- **Alignment of Interests**
  - What is the fund manager's (and its affiliates') anticipated commitment to the fund? How will it be funded?
  - Does the Limited Partnership Agreement allow the fund manager some latitude in changing its commitment size? If so, what is the timeframe and method of communicating such change to clients?
  - What is the fund manager's stance on indemnification/exculpation?
  - Does the Limited Partnership Agreement provide for an Advisory Board to review conflicts? Would the Division be invited to serve on the Advisory Board, should one exist?
- **Valuation, Accounting and Internal Controls**
  - Does the fund employ formal valuation policies and methodologies?
  - What are the valuation policies and procedures which will be followed for this opportunity?
  - Are there formal policies and procedures governing key areas of internal control?
  - How frequently is valuation of the underlying investments performed (e.g. daily, monthly, quarterly or annually)? Are different procedures performed at different intervals?
  - Will the investments be valued in accordance with FAS 157?
  - Who does the fund use as its auditing firm? If appropriate, how is fund administration handled (third-party administrator/in-house/etc.)?
  - Is the manager a '40 Act Registered Investment Advisor?

Note: For some asset classes and investment strategies, certain of the aforementioned evaluation questions may not be applicable.

Classification of Funds

At the conclusion of this initial due diligence, DOI staff will classify the fund according to the following classifications:

- Review: If a fund is of interest and has begun, or will soon begin fundraising, a DOI staff member will be assigned to proceed with further due diligence in concert with the asset class consultant.
- Monitor: If a fund is of interest but is not currently being considered for investment, a DOI staff member will be assigned to maintain contact with the fund manager.
- Decline: If a fund is deemed to not be of interest after initial due diligence, or is deemed to be no longer of interest at any time during the due diligence process, due diligence will be discontinued.

DOI staff and the Asset Class Consultants shall monitor the initial due diligence progress on an ongoing basis; ensure due diligence is completed on a timely basis prior to the closing of a fund; and make changes to Focus List classifications based on information gathered throughout the due diligence process.

END OF STAGE 2 DUE DILIGENCE – A process flow sign off sheet should be completed and signed the members of the DOI Investment Committee (Director, Deputy Director and asset class senior staff member) prior to beginning Stage III (Full Due Diligence).

STAGE III: FULL DUE DILIGENCE

For funds classified on the Focus List as Review, DOI staff will conduct comprehensive due diligence with the assistance of the Asset Class Consultant.

- Campaign contribution disclosure forms must be completed to comply with Subchapter 4 of the SIC regulations and P.L. 2005, c.271. The forms will be completed at the outset of Stage III.
- DOI staff will hold additional meetings with the fund's senior leadership and investment staff. A reasonable effort will also be made to conduct at least one meeting on-site. For fund managers with multiple locations, a reasonable effort will be made to visit as many key offices involved in the fund's investment process as possible.
- DOI staff will conduct a further detailed assessment of the following points as enumerated above:
    i. Management Team;
    ii. Investment Strategy;
    iii. Track Record;

iv. Alignment of Interests;
v. Valuation, Accounting and Internal Controls; and
vi. Any other relevant considerations or concerns.

Reference Calls

DOI staff, in concert with the Asset Class Consultant, will attempt to conduct and document at least three (3) reference calls with industry contacts, existing clients/investors, other potential investors, and/or references provided by the fund manager. When possible, DOI staff and the Asset Class Consultant should seek to find references other than those provided by the fund manager.

Note that reference calls will often continue into Stage IV (Legal Review/Council Review) as it can often take a long time to schedule calls with industry contacts.

Follow-on Investments

Follow-on investments related to an already-approved fund on which full due diligence has already been performed will be subject to a streamlined version of the above due diligence process.

Commitment/Investment Amount

DOI staff, with the DOI Investment Committee, will decide on a desired commitment or investment amount (this can be done at any time during the due diligence process), which will depend on several factors. These factors may include: the DOI's needs as identified in the Investment Policy and the Investment Plan for the asset class and subsector; the overall attractiveness of the fund individually and relative to other funds within the asset class and subsector; the size of the fund; SIC regulation limitations; and capacity to the DOI as negotiated with the fund manager. This amount can be changed at any time during the due diligence process prior to the execution of the Limited Partnership Agreement.

Due Diligence Memo

DOI staff, in consultation with the Asset Class Consultant, will complete a Due Diligence Memo which describes the investment opportunity in detail, including: the proposed commitment/investment amount; key terms and conditions; the fund manager's organization structure and investment team; the rationale for investment relating to the DOI's decision to proceed with the investment; and any issues of concern and factors mitigating these concerns. This Due Diligence Memo will be distributed to and reviewed by the DOI Investment Committee. The DOI Investment Committee will make the determination whether to present the opportunity to the SIC Investment Policy Committee ("IPC"). Investment opportunities will be presented to IPC prior to making any commitment to the fund.

END OF STAGE III DUE DILIGENCE – A process flow sign off sheet should be completed and signed by the Director, Deputy Director and the asset class senior staff member prior to presentation to the IPC.

STAGE IV: LEGAL REVIEW AND COUNCIL REVIEW

Note that the two components of Stage IV are generally done concurrently. Given the extensive time involved in completing legal review, this step, as well as completion of reference calls, is frequently still in process after review by the IPC and/or SIC. In these cases, investments are presented to the IPC and SIC "pending final completion of due diligence and legal review".

Legal Review and Appropriate Resolution of Legal Issues

DOI staff will conduct a conference call with internal and/or external counsel and a majority of the DOI Investment Committee members to discuss and vet any outstanding legal issues and their potential resolution. The DOI's legal counsel will then work with the fund manager's legal counsel to reach appropriate compromise and report back to the DOI staff with the outcome of such negotiations. Documentation from counsel should be placed in the file which outlines the issues considered, the impact of such issues if left unresolved and the outcome or compromise reached.

IPC/SIC Review

The potential investment will be presented to the IPC prior to presentation to the entire SIC. IPC members will be provided with a copy of the Due Diligence Memo and DOI staff and/or the Asset Class Consultant will discuss the potential investment with IPC members. If the investment is less than $50 million, execution of the legal documents can be done before presentation to the SIC; however, notification shall be posted on the DOI's public website; this option will only be utilized in those cases where timely action is warranted. If the investment is $50 million or more, it will be presented to the SIC at a scheduled meeting. Prior to the execution of any documents, members of the DOI Investment Committee will hold a final call with counsel to ensure that all legal matters have been appropriately and favorably resolved and that all material information has been disclosed. The dates of these calls will be recorded on a sign-off sheet and a majority of the DOI Investment Committee must sign off on the investment prior to execution. Executed legal documents shall be forwarded from counsel and placed in the file.

ONGOING COMMUNICATION

It is expected the DOI will engage in informal discussions with the Asset Class Consultant, General Consultant, and fund managers on a regular basis and as needed to discuss any issues relevant for managing the Alternative Investment Program.

For each Alternative Investment asset class, the DOI, including if possible the Director and/or Deputy Director, shall conduct regularly scheduled bi-weekly calls with the Asset Class Consultant and General Consultant, schedules permitting.

Discussion topics may include, but are not limited to:

- Updates to the Pipeline and Focus List
- Updates to the Investment Plan
- Review of Initial Fund Evaluation Memos, if any
- Identification of attractive investment opportunities
- Upcoming fund manager meetings, including annual meetings
- Planning for upcoming SIC/IPC meetings
- Progress towards completing any outstanding projects
- Review of market environment, news, etc.
- Performance updates, if any