

PENNSYLVANIA TREASURY

ANNUAL INVESTMENT REPORT

For the Fiscal Year Ended June 30, 2010



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TREASURY DEPARTMENT
COMMONWEALTH OF PENNSYLVANIA
HARRISBURG, PA 17120

THE STATE TREASURER

November 30, 2010

The Honorable Edward G. Rendell
Governor
Commonwealth of Pennsylvania
Room 225 Main Capitol Building
Harrisburg, Pennsylvania 17120

RE: Pennsylvania Treasury Annual Investment Report

Dear Governor Rendell:

I am pleased to present the annual Pennsylvania Treasury Annual Investment Report pursuant to Act 53 of 2008.

If you have any questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "R M McCord".

Robert M. McCord
State Treasurer

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SCOPE OF REPORT



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SCOPE OF REPORT

The following report was prepared pursuant to Act 53 of 2008 (Act), which amended various provisions of the Act of April 9, 1929 (P.L. 343, No. 176), known as the Fiscal Code. Specifically, Section 301.3 of the Act requires the State Treasurer to submit an Annual Investment Report by November 30 to the Governor and to the Chair and Minority Chair of the Appropriations Committee of the Senate, the Chair and Minority Chair of the Finance Committee of the Senate, the Chairman and Minority Chairman of the Appropriations Committee of the House of Representatives, and the Chairman and Minority Chairman of the Finance Committee of the House of Representatives, for the most recently-ended fiscal year. Specific items required to be included in the annual report for the fiscal year ended June 30, 2010 are summarized below, along with their corresponding location in this report.

Additional information pertaining to the custodial and investment functions performed by the Pennsylvania Treasury, along with an overview of the Commonwealth Investment Program, are also included herein.

A glossary of terms used in this report is found at Exhibit 1

ANNUAL REPORTING REQUIREMENTS



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ANNUAL REPORTING REQUIREMENTS

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TREASURY OVERVIEW



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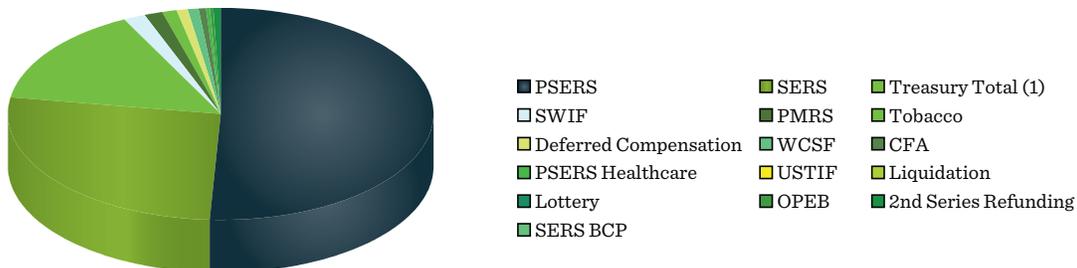
TREASURY OVERVIEW

The Pennsylvania Treasury is an independent executive office with the State Treasurer serving as chief executive. The State Treasurer is a statewide elected office created by the Pennsylvania Constitution. The powers and duties of the Treasurer and the Treasury are delineated for the most part in the Fiscal Code and generally involve the receipt and disbursement of funds by the Commonwealth, as well as the deposit, investment, and safekeeping of moneys and securities belonging to the Commonwealth. Treasury's mission is to provide effective stewardship over the financial assets obtained by and entrusted to the Commonwealth. As of June 30, 2010, the Treasury had a budget of approximately \$48 million and a staff of 418 employees.

Custodial Functions

The Treasurer serves as the statutory custodian of the funds of virtually all state agencies. As of June 30, 2010, such funds totaled approximately \$89 billion, as reflected in the chart below. As custodian, the Treasurer is responsible for monitoring and safeguarding money and securities, collecting interest and dividends, executing securities transactions, and handling daily trade settlements.

NET ASSET VALUE UNDER CUSTODY AS OF JUNE 30, 2010



| PROGRAMS | ACRONYM | NAV | % Under Custody |
|--|-------------------------------|--------------------------|-----------------|
| Public School Employees' Retirement System | PSERS | \$ 45,541,947,748 | 50.96% |
| State Employees' Retirement System | SERS | \$ 23,590,748,395 | 26.40% |
| Treasury Total ⁽¹⁾ | Treasury Total ⁽¹⁾ | \$ 13,425,061,690 | 15.02% |
| State Workers' Insurance Fund | SWIF | \$ 1,567,262,707 | 1.75% |
| Pennsylvania Municipal Retirement System | PMRS | \$ 1,301,575,980 | 1.46% |
| Tobacco | Tobacco | \$ 975,732,655 | 1.09% |
| Deferred Compensation | Deferred Compensation | \$ 792,545,848 | 0.89% |
| Workmen's Compensation Security Fund | WCSF | \$ 573,470,890 | 0.64% |
| Commonwealth Financing Authority | CFA | \$ 722,205,103 | 0.81% |
| Public School Employees' Retirement System Healthcare | PSERS Healthcare | \$ 140,938,035 | 0.16% |
| Underground Storage Tank Indemnification Fund | USTIF | \$ 91,761,930 | 0.10% |
| Insurance Liquidation Fund | Liquidation | \$ 5,929,261 | 0.01% |
| Lottery | Lottery | \$ 3,529,202 | 0.00% |
| Post Employment Benefits Other Than Pensions | OPEB | \$ 103,997,875 | 0.12% |
| 2nd Series Refunding | 2nd Series Refunding | \$ 519,130,146 | 0.58% |
| State Employees' Retirement System Benefit Completion Plan | SERS BCP | \$ 6,878,305 | 0.01% |
| | Total under Custody | \$ 89,362,715,768 | 100.00% |

* Percentages may not sum to 100% due to rounding.

⁽¹⁾ Treasury includes Pool 98, Pool 99, Fund 65, Fund 196, HES, Invest, Float, TAP, Securities Lending, Safekeeping

INVESTMENT FUNCTIONS

In addition to its custodial functions, the Treasury has the duty to manage and invest moneys that exceed the ordinary operational needs of the Commonwealth when management of such funds is not explicitly under the control of any board, commission, or state official. Treasury also possesses investment authority for moneys derived from other specialized Treasury programs including, the Tuition Account Program Guaranteed Savings Plan (currently marketed by Treasury as the “PA 529 Guaranteed Savings Plan”) for postsecondary education savings and the INVEST program (for management of moneys from local government and charitable and nonprofit organizations).

The Treasurer’s investment authority was modified by Act 53 of 2008, which changed the language contained in Section 301.1 of the Fiscal Code (Investment of Moneys). Primarily, the standard was changed from “Prudent Person” to “Prudent Investor” with reference to specific investment criteria including accounting for economic conditions, liquidity, maintenance of principal, and other factors. Prior to July of 2008, when making investments, the Treasurer was charged with exercising that degree of judgment and care under the circumstances then prevailing which persons of prudence, discretion, and intelligence exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the funds, considering the probable income to be derived from them, as well as the probable safety of their capital.

The newer “Prudent Investor” investment standard requires that Treasury, when investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, shall act as a fiduciary with care, skill, prudence and diligence under the circumstances then prevailing, specifically including, but not limited to, the general economic conditions and the anticipated needs of the funds, that a prudent person acting in a like capacity, and with familiarity with those matters would use in the conduct of funds of a like character and with like objectives. Treasury must exercise careful judgment in determining those investments that are appropriate for each Commonwealth fund based upon distinct investment criteria such as income needs, cash flow requirements, investment time horizons, and risk tolerance. Investment judgments may also reflect the differing legal standards that authorize or limit the particular kinds of investments each fund could hold.

Consistent with its obligation to act as a Prudent Investor in carrying out its fiduciary responsibility, Treasury sought and continues to seek quality investments that maximize the likelihood that each pool will consistently satisfy its respective program requirements. Quality investments are those that are suitably conservative to safeguard principal while still projected to outperform relevant market benchmarks, net of all fees and expenses, over the appropriate time horizon. Finally, Treasury actively pursues certain investments offering a reasonable risk-adjusted rate of return appropriate to each pool, and equal or superior to comparable alternative investments available to each pool, that also provide a positive stimulus to strategic segments of Pennsylvania’s economic base, communities, and citizens.

OVERVIEW OF COMMONWEALTH INVESTMENT PROGRAM



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OVERVIEW OF COMMONWEALTH INVESTMENT PROGRAM

As previously stated, Treasury manages and invests moneys that have accumulated beyond the ordinary needs of Commonwealth agencies through the Commonwealth Investment Program. These moneys must also remain available to the Commonwealth to make payments for various operational expenses and other obligations.

The Commonwealth Investment Program consists of two separate pools, each with its own distinct investment strategies, goals, and holdings that reflect differing needs of Commonwealth funds for income, cash flow, and investment risk tolerance.

- **Pool 99** seeks to maintain a stable net asset value of \$1 per share, by investing exclusively in fixed-income securities, primarily of short duration. It is designed to generate income while minimizing investment volatility by protecting principal and maximizing availability of balances through ownership of very liquid investments.
- **Pool 98** is a variable net asset value per share investment vehicle that seeks to generate an enhanced investment return over time by investing assets in excess of liquidity needs in longer-term fixed income and equity securities. It is designed to generate both income and capital appreciation over long periods of time for funds that can sustain short-term price volatility.

Pool 99 includes investments in very short-term securities consisting of U.S. Treasury securities, Federal agency securities, certificates of deposit, commercial paper, money market funds, repurchase agreements, and similar short-term fixed-income instruments.

Pool 98 contains a combination of cash and cash equivalent investments for liquid assets to meet current expenses, and equities and intermediate to long-term investments to enhance the returns of fund balances which are either restricted or otherwise stable.

It is important to note that Pool 98 operates much like a mutual fund; participant withdrawals from the Pool can and will result in the realization of capital gains and losses. Purchases and redemptions of shares in Pool 98 are priced at the most current net asset value per share, which fluctuates daily. Consequently, if a participant's average cost per share, based on its own history of purchases and redemptions, is less than the share price on the day of redemption, the participant will realize a capital gain on the shares redeemed. Conversely, if a participant's average cost per share exceeds the share price on the day of redemption, the participant will realize a capital loss on the shares redeemed.

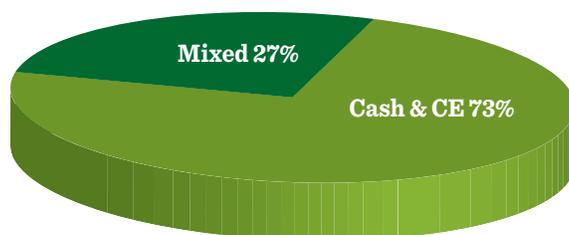
Prior to December 2008, Commonwealth entities maintained cash balances in only one of the above strategies. Effective December 1, 2008, Treasury modified its investment processes to permit Pool 98 participants with daily excess cash inflows to purchase shares of Pool 99. *(Since Pool 99 maintains a stable net asset value of \$1 per share, all purchases and redemptions from the Pool are made at \$1 per share, thus share redemptions do not incur a capital gain or loss.)* Daily participant outflows of cash were accomplished by first redeeming available shares in Pool 99; only after those shares were exhausted were redemptions made from Pool 98 to cover remaining expenditures. This modification greatly minimized the losses realized by Pool 98 participants.

Treasury continued this process throughout the remainder of the 2009-2010 fiscal year, resulting in a significant shift in balances from the mixed strategy to the cash and cash equivalent strategy. As illustrated on the following page, the balance in Pool 99 increased by approximately \$1.2 billion or 19%, from June 30, 2009 to June 30, 2010, while the balance in Pool 98 decreased by \$500 million or 14%, during the same time period. In addition, the Commonwealth Investment Program as a whole experienced a \$700 million or 8% growth in assets from June 30, 2009 to June 30, 2010.

OVERVIEW OF COMMONWEALTH INVESTMENT PROGRAM

(Continued)

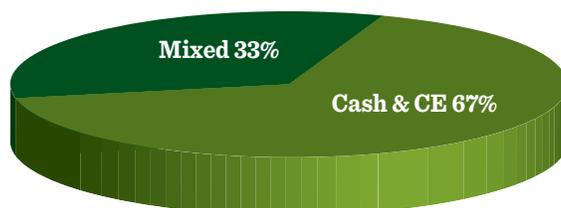
**Commonwealth Investment Program Summary
June 30, 2010**



■ Pool 99 ■ Pool 98

| Investment Pool | Net Asset Value | Program % | Strategy |
|-----------------|--------------------------|----------------|-----------|
| Pool 99 | \$ 7,650,871,002 | 73.50% | Cash & CE |
| Pool 98 | 2,758,522,126 | 26.50% | Mixed |
| | <u>\$ 10,409,393,128</u> | <u>100.00%</u> | |

**Commonwealth Investment Program Summary
June 30, 2009**



■ Pool 99 ■ Pool 98

| Investment Pool | Net Asset Value | Program % | Strategy |
|-----------------|-------------------------|----------------|-----------|
| Pool 99 | \$ 6,446,134,787 | 66.65% | Cash & CE |
| Pool 98 | 3,226,123,095 | 33.35% | Mixed |
| | <u>\$ 9,672,257,882</u> | <u>100.00%</u> | |

REPORTING REQUIREMENTS FOR ANNUAL INVESTMENT REPORT



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REPORTING REQUIREMENTS FOR ANNUAL INVESTMENT REPORT

Requirement 1 – An analysis of the status and performance of the current investments and transactions made over the last fiscal year.

On June 30, 2010, approximately \$7.651 billion of Commonwealth funds were invested in a “cash and cash equivalent strategy” in Pool 99. Pool 99’s one year return for the year ended June 30, 2010 was 0.29% versus its benchmark return of 0.16%. Investment earnings distributed to participants of Pool 99 for the fiscal year ended June 30, 2010, totaled \$16,380,841.

Approximately \$2.759 billion of Commonwealth funds were invested in a “mixed strategy” in Pool 98, as of June 30, 2010. The pool was comprised of 3% cash and cash equivalent investments, 4% alternative investments, 36% equity investments, and 57% fixed income investments. Pool 98’s one year return for the year ended June 30, 2010 was 10.52% versus its benchmark return of 11.35%. Investment earnings distributed to participants of Pool 98 for the fiscal year ended June 30, 2010, totaled \$27,370,721.

As a point of reference, the one year return for each of the Russell 3000 Index and the Barclay’s Capital U.S. Aggregate Bond Index was 15.72% and 9.50%, respectively, for the year ended June 30, 2010.

Requirement 2 – Targeted asset allocation and actual asset allocation on September 30, December 31, March 31, and June 30 of the previous fiscal year.

TARGET ASSET ALLOCATION FOR POOL 99 AND POOL 98

Pool 99 is designed to generate income while minimizing investment volatility; assets of the Pool may be invested in cash and cash equivalent securities including, certificates of deposit, commercial paper, Federal agency securities, money market funds, and repurchase agreements. Since this Pool is managed internally by Treasury’s investment staff, external management fees are not incurred on these investments.

Pool 98 is designed to generate both income and capital appreciation over long periods of time. Because the cash and cash equivalents portion of Pool 98 is driven by the liquidity needs of the participating Commonwealth funds, the balance attributable to this portion of the Pool fluctuates frequently over a short period of time. Accordingly, 100% of this balance may be invested in cash and cash equivalent securities including, certificates of deposit, commercial paper, Federal agency securities, money market funds, and repurchase agreements. Since this portion of the Pool is managed internally by Treasury’s investment staff, external management fees are not incurred on these investments.

Pool 98 is managed in both passive and active investment management styles. The passive portion of the Pool is managed internally by Treasury’s investment staff and includes exchange-traded funds (ETF) and mutual funds to obtain exposure to certain asset classes at a lower cost, as well as securities where a buy-and-hold strategy is employed. On June 30, 2010, passive investments accounted for 24% of Pool 98.

A portion of the Pool’s fixed income assets are comprised of Strategic Investment Opportunities (SIO), which are also passively managed by Treasury’s investment staff. SIOs consist of multiple purpose investments including the Agri-Link Program, the PHEAA HelpStart Program, the Hospital Enhancement Loan Program, the Keystone Home Energy Loan Program, the Better Choice Program, and State of Israel Bonds.

On January 27, 2010, Treasury revised the asset allocation plan for the Commonwealth Investment Program to combine Pool 99 and Pool 98, which together are now known as the Commonwealth Investment Pool (CIP). Until then, Pool 99 and Pool 98 each had its own distinct asset allocation plan. The tables below illustrate the target asset allocations under the previous and current asset allocation plans.

**Pool 99
Target Asset Allocation
Prior to January 27, 2010**

| Asset Class | Target Allocation |
|-------------------------|----------------------|
| Cash & Cash Equivalents | 100% of cash balance |

**Pool 98
Target Asset Allocation
Prior to January 27, 2010**

| Asset Class | Target Allocation |
|-------------------------|-------------------------|
| Cash & Cash Equivalents | 100% of cash balance |
| Equity | 38% of non-cash balance |
| Fixed Income | 62% of non-cash balance |

**Commonwealth Investment Pool (Pool 98 & Pool 99)
Target Asset Allocation
After January 27, 2010**

| Asset Class | Target Allocation |
|-----------------------------|-------------------|
| Cash & Cash Equivalents | 40% - 65% |
| Equity & Alternative Assets | 15% - 25% |
| Fixed Income | 20% - 35% |

ACTUAL ASSET ALLOCATIONS FOR POOL 99 AND POOL 98

The charts on the following page show the actual and target asset allocations for each of Pool 99 and Pool 98 for the quarters ended September 30, 2009 and December 31, 2009.

Pool 99
Actual Asset Allocation vs. Target Asset Allocation
September 30, 2009

| Asset Class | Target Allocation | Actual Allocation |
|-------------------------|----------------------|-------------------|
| Cash & Cash Equivalents | 100% of cash balance | 100% |

Pool 99
Actual Asset Allocation vs. Target Asset Allocation
December 31, 2009

| Asset Class | Target Allocation | Actual Allocation |
|-------------------------|----------------------|-------------------|
| Cash & Cash Equivalents | 100% of cash balance | 100% |

Pool 98
Actual Asset Allocation vs. Target Asset Allocation
September 30, 2009

| Asset Class | Target Allocation | Actual Allocation |
|-------------------------|-------------------------|-------------------|
| Cash & Cash Equivalents | 100% of cash balance | 100% |
| Equity | 38% of non-cash balance | 40% |
| Fixed Income | 62% of non-cash balance | 60% |

Pool 98
Actual Asset Allocation vs. Target Asset Allocation
December 31, 2009

| Asset Class | Target Allocation | Actual Allocation |
|-------------------------|-------------------------|-------------------|
| Cash & Cash Equivalents | 100% of cash balance | 100% |
| Equity | 38% of non-cash balance | 38% |
| Fixed Income | 62% of non-cash balance | 62% |

ACTUAL ASSET ALLOCATIONS FOR THE COMMONWEALTH INVESTMENT POOL

The tables on the following page show the CIP's actual and target asset allocations for the quarters ended March 31, 2010 and June 30, 2010. Treasury gradually implemented CIP's revised asset allocation plan throughout the remainder of the 2009-2010 fiscal year. This gradual implementation, coupled with market value fluctuations, explains the divergence between the actual allocations and the target allocations.

**Commonwealth Investment Pool (Pool 98 & Pool 99)
Actual Asset Allocation vs. Target Asset Allocation
March 31, 2010**

| Asset Class | Target Allocation | Actual Allocation |
|-----------------------------|-------------------|-------------------|
| Cash & Cash Equivalents | 40% - 65% | 67% |
| Equity & Alternative Assets | 15% - 25% | 14% |
| Fixed Income | 20% - 35% | 17% |

**Commonwealth Investment Pool (Pool 98 & Pool 99)
Actual Asset Allocation vs. Target Asset Allocation
June 30, 2010**

| Asset Class | Target Allocation | Actual Allocation |
|-----------------------------|-------------------|-------------------|
| Cash & Cash Equivalents | 40% - 65% | 74% |
| Equity & Alternative Assets | 15% - 25% | 11% |
| Fixed Income | 20% - 35% | 15% |

| Pool 98 Strategic Investment Opportunities June 30, 2010 | | | |
|---|-------------------------|-----------------------|-----------------|
| <u>Program Investment</u> | <u>Security Type</u> | <u>06/30/10 NAV</u> | <u>% of SIO</u> |
| PHEAA (Line of Credit & Note) | Municipal Securities | \$ 144,121,964 | 60.67% |
| Agri-Link, Better Choice, Hospital Help | Certificates of Deposit | 50,698,230 | 21.34% |
| Keystone HELP, Keystone HELP DEP | Whole Loans | 24,969,381 | 10.51% |
| State of Israel Bonds | International Bonds | 16,758,552 | 7.05% |
| Agri-Link | Federal Agencies | 1,000,000 | 0.42% |
| | | \$ 237,548,128 | 100.00% |

Approximately 15% of Pool 98's fixed income assets were invested in Strategic Investment Opportunities (SIO) on June 30, 2010. The following table summarizes those investments.

Requirement 3 – The standards and measures of investment performance, including benchmarks for each asset class.

A summary of the Commonwealth Investment Program’s performance benchmarks and risk measures is shown below.

**Commonwealth Investment Program
Performance and Risk Measures**

| Pool/Asset Class | Benchmark | Risk Measure |
|--------------------------------------|--|---|
| (Pool 99) Cash & Cash Equivalents | Merrill Lynch 3-Month U.S. Treasury Bill Index | 130 day Weighted Average Maturity (WAM) |
| (Pool 98) Cash & Cash Equivalents | Merrill Lynch 3-Month U.S. Treasury Bill Index | 130 day Weighted Average Maturity (WAM) |
| (Pool 98) Equity | 75% Standard & Poor's 500 Index 25% MSCI ACWI ex U.S. Index | 5.0 Standard Deviation |
| (Pool 98) Fixed Income | 83% Barclays Capital U.S. Aggregate Bond Index 17% Merrill Lynch 6-Month U.S. Treasury Bill Index | |

Requirement 4 – Return for each asset class including a breakdown of the return versus the targeted benchmark calculated net of fees.

The following tables reflect the fiscal year returns for each asset class versus their assigned benchmarks as of June 30, 2010.

**Pool 99
Asset Class Returns (Net of Fees)**

| Asset Class | Benchmark | FY 09-10 Return | Benchmark Return | Over/Under Performance vs. Benchmark |
|---------------------------|--|-----------------|------------------|--------------------------------------|
| Cash and Cash Equivalents | Merrill Lynch 3-Month U.S. Treasury Bill Index | 0.29 | 0.16 | 0.13 |

**Pool 98
Asset Class Returns (Net of Fees)**

| Asset Class | Benchmark | FY 09-10 Return | Benchmark Return | Over/Under Performance vs. Benchmark |
|---------------------------|---|-----------------|------------------|--------------------------------------|
| Cash and Cash Equivalents | Merrill Lynch 3-Month U.S. Treasury Bill Index | 2.81 | 0.16 | 2.65 |
| Equity | 75% Standard & Poor's 500 Index, 25% MSCI ACWI ex-U.S. Index | 15.95 | 13.48 | 2.47 |
| Fixed Income | 83% Barclays Capital U.S. Aggregate Bond Index, 17% Merrill Lynch 6-Month U.S. Treasury Bill Index | 10.07 | 7.92 | 2.15 |
| Alternative | No Assigned Benchmarks | -1.66 | N/A | N/A |

Requirement 5 – A list of external managers including whether the manager was selected through competitive bid or as a sole source selection, the principals and key staff of the manager, the date of the manager’s hire, the amount of fees received by the manager in the previous fiscal year, and the return on the manager’s portfolio versus his targeted benchmark.

SUMMARY OF EXTERNAL INVESTMENT MANAGERS, FEES, AND PERFORMANCE

A summary of Pool 98’s external investment managers as of June 30, 2010 is shown below. Management fees and performance information applicable to all investment managers employed during the 2009-2010 fiscal year is included on page 16 of this report.

**Pool 98
External Investment Manager Listing
June 30, 2010**

| Investment Managers | Principals/Key Staff | Title | Funding Date | Selection Method ⁽¹⁾ |
|-----------------------------------|---|---|--------------|---------------------------------|
| Attalus Capital | Patrick C. Egan Michelle C. Egan Daniel S. Kim | President & CEO Deputy Chief Investment Officer Chief Compliance Officer | 11/09 | Negotiated |
| Blackrock Financial Management | Laurence D. Fink Robert S. Kapito | Chairman & CEO President | 05/06 | Negotiated |
| Bluecrest Capital Management LLP | David DeRosa Linburgh Martin William Reeves Keith Walton | Director Director Director Director | 11/09 | Negotiated |
| Blue Hill Investment Partners, LP | Joyce Ferris Scott Herrin Peter Williams | Managing Partner Partner Principal | 11/06 | Negotiated |
| Brevan Howard | Nagi Kawkabani James Vernon | CEO COO | 05/10 | Negotiated |
| Cameron Capital Management | Denean R. Williams Christopher J. Martin | President, Chief Compliance Officer Portfolio Manager | 11/09 | Negotiated |
| Chartwell Investment Partners | Michael J. McCloskey Timothy J. Riddle G. Gregory Hagar Joseph A. Barilotti, Jr. | Director, Client Svcs & Mkting CEO CFO, Compliance Officer Principal, VP, Client Svcs & Mkting | 09/03 | Negotiated |
| Community Capital Mgmt, Inc. | Barbara VanScoy Alyssa Greenspan Stefanie Little Todd Cohen David Downes Joseph Hastings | Board Chair & Sr. Portfolio Mgr COO & Portfolio Mgr Chief Compliance Officer President & CIO Chief Executive Officer CFO | 08/06 | Negotiated |
| Credit Suisse | George R. Hornig Timothy Barnes Edward A. Poletti Michael J. Bessel David Lerner | Chairman, CEO, Director COO CFO Chief Compliance Officer Managing Director | 12/09 | Negotiated |
| Delaware Structured | Patrick P. Coyne See Yeng Quek Brian L. Murray | Chairman, President Executive VP, CIO Chief Compliance Officer | 09/09 | Negotiated |
| Emerald TALF | Kenneth G. Mertz Stacey L. Sears Daniel W. Moyer James A. Meehan Anthony J. Basile | CEO, President, Director Sr. VP, Director Executive VP Chief Compliance Officer CIO Fixed Income | 09/09 | Negotiated |
| EnTrust Capital | Jill Zelenko Bruce J. Kahne Mark S. Fife Gregg S. Hymowitz | Managing Director, CFO Chief Compliance Officer Managing Member Managing Member | 11/09 | Negotiated |

| Investment Managers | Principals/Key Staff | Title | Funding Date | Selection Method ⁽¹⁾ |
|--|--|--|--------------|---------------------------------|
| Estabrook Capital Mgmt, LLC | Charles T. Foley Lewis S. Lee William C. McClean III William C. Petty III Virginia W. Sheerin Henry A. Wilmerding III | Chairman President Director/Portfolio Manager Director/Portfolio Manager Director/Portfolio Manager Director/Portfolio Manager | 09/04 | Negotiated |
| Federated Investors, Inc. | John C. Donahue John B. Fisher Brian P. Bouda | Chairman President & CEO VP & Chief Compliance Officer | 08/01 | Negotiated |
| Haverford | Joseph J. McLaughlin Henry B. Smith Paul S. Rovner Marieelena V. Ness | Chairman, CEO, President CIO CFO Chief Compliance Officer | 12/09 | Negotiated |
| Mesirow Financial Management | James Tyree Richard Price Kristie P. Paskvan | Chairman & CEO President & COO Chief Financial Officer | 03/06 | Negotiated |
| Philadelphia Trust Company | Michael G. Crofton George J. Marlin Richard I. Sichel Mary McCreesh | President & CEO Chairman & COO Chief Investment Officer Senior Vice President | 08/01 | Negotiated |
| PNC Capital Advisors, LLC ⁽²⁾ | Kevin McCreadie Andrew Harding Timothy McDonough | President, CEO CIO, Fixed Income Senior Director: Client Service | 08/01 | Negotiated |
| Robeco Investment Management | John T. Moore Thomas J. Modzelewski Jerry S. Lettieri | Manager COO Chief Compliance Officer | 11/09 | Negotiated |
| Ryan Labs, Inc. | Harlan Batrus Sean McShea | Chairman | 12/00 | Negotiated |
| Selene | Frank J. Jaeger Lewis S. Ranieri David E. Creamer Scott A. Shay Yale E. Stark | VP Principal Principal Principal Principal | 09/09 | Negotiated |
| The Swarthmore Group | Paula R. Mandle Glenn E. Becker | CEO, Chief Compliance Officer | 12/00 | Negotiated |
| Titanium TALF | Jack Walsh Brian Gevry Robert Siefert Donald Ross | Chief Compliance Officer Managing Director Managing Director Executive VP | 10/09 | Negotiated |
| Turner Investment Partners | Thomas R. Trala Robert E. Turner Mark D. Turner Scott J. Kearney Christopher K. McHugh Brian F. McNally | COO, CFO Chairman, CIO Vice Chairman, President Managing Director, Principal Director Chief Compliance Officer | 11/09 | Negotiated |
| Valley Forge Asset Management | Bernard A. Francis, Jr. James E. Gibson William J. Reuter Michael F. Swallow | Director, President, CEO Director, CIO & COO Chairman CFO, Chief Compliance Officer | 12/00 | Negotiated |
| Waterloo Partners | David Schroll Guy Judkowski | Manager Manager | 11/09 | Negotiated |
| Weaver C. Barksdale & Assoc, Inc. | Weaver C. Barksdale John E. McDowell J. Dewey Daane Frank G. Puryear Marshall E. Cox, Jr. Timothy A. Carpenter S. Guerry Simmons Ann Loden Roberts Kathy E. Carpenter Deborah K. Slocum | Founding Principal, Chairman President & CEO Principal Principal Principal Principal Principal Principal Principal Chief Compliance Officer | 07/01 | Negotiated |

⁽¹⁾ The Commonwealth Procurement Code (62 Pa.C.S.A. § 515 (9)) permits contracts to be awarded for a supply, service or construction item without competition if the contracting officer first determines in writing that the contract is for financial or investment experts to be used and selected by the Treasury Department.

⁽²⁾ Former investment manager Allegiant Asset Management Co. Management firm is a result of the merger of The PNC Financial Services Group, Inc. and National City Corporation, in September 2009.

Pool 98
External Investment Manager Fee and Performance Summary ⁽¹⁾
FY 2009-2010

| Investment Manager | Investment | FY '09-'10 | Return (Net of Fees) | FY '09-'10 Benchmark Return | Over/Under Performance vs. Benchmark | | |
|---|--------------|------------------------|----------------------|---|--------------------------------------|-------|-------|
| BlackRock Financial Mgmt, Inc. | Fixed Income | Core | \$ 158,030 | Barclays Capital U.S. Aggregate Bond Index | 10.18 | 9.50 | 0.68 |
| Blue Hill Investment Partners, LP | Equity | Venture Capital | \$ 125,000 | No Assigned Benchmark | 0.38 | N/A | N/A |
| Chartwell Investment Partners | Fixed Income | High Yield | \$ 619,821 | Merrill Lynch U.S. High Yield Cash BB-B Index | 16.67 | 21.78 | -5.11 |
| Community Capital Mgmt, Inc. | Fixed Income | Intermediate | \$ 144,610 | Barclays Capital U.S. Aggregate Bond Index | 8.28 | 9.50 | -1.22 |
| (2) Credit Suisse | Fixed Income | Senior Secured Debt | \$ 228,118 | Barclays Capital U.S. Aggregate Bond Index | 5.40 | 3.69 | 1.71 |
| (3) Davis Hamilton Jackson & Associates | Fixed Income | Short-Term | \$ 67,391 | Merrill Lynch 1-3 Year U.S. Treasury & Agency Index | 7.20 | 2.52 | 4.68 |
| (4) Delaware | Fixed Income | TALF | \$ 350,126 | No Assigned Benchmark | 25.61 | N/A | N/A |
| (3) Dix Hills Partners, LLC | Fixed Income | Enhanced Cash | \$ 129,554 | Merrill Lynch 1-3 Year U.S. Treasury & Agency Index | -0.02 | 2.52 | -2.54 |
| (5) Emerald TALF | Fixed Income | TALF | \$ 846,314 | No Assigned Benchmark | 4.89 | N/A | N/A |
| (6) EnTrust | Alternative | Absolute Return | \$ 233,160 | No Assigned Benchmark | 6.43 | N/A | N/A |
| Estabrook Capital Mgmt, LLC | Equity | Large Cap Value | \$ 209,748 | Russell 1000 Value Index | 16.45 | 16.92 | -0.47 |
| Federated Investment Counseling | Fixed Income | High Yield | \$ 211,918 | Merrill Lynch U.S. High Yield Index | 23.15 | 27.55 | -4.40 |
| (7) Haverford Financial Services | Fixed Income | Senior Secured Debt | \$ 48,160 | Barclays Capital U.S. Aggregate Bond Index | -0.06 | 3.69 | -3.75 |
| Mesirow Financial Investment Mgmt, Inc. | Fixed Income | Core | \$ 112,988 | Barclays Capital U.S. Aggregate Bond Index | 10.63 | 9.50 | 1.13 |
| PNC Capital Advisors | Fixed Income | Intermediate | \$ 298,774 | Barclays Capital U.S. Intermediate Government/Credit Bond Index | 8.29 | 8.29 | 0.00 |
| Ryan Labs, Inc. | Fixed Income | Intermediate | \$ 358,047 | Barclays Capital U.S. Intermediate Government/Credit Bond Index | 8.87 | 8.29 | 0.58 |
| (3) Ryan Labs, Inc. | Fixed Income | Short-Term | \$ 231,423 | Merrill Lynch 1-3 Year U.S. Treasury & Agency Index | 4.61 | 2.52 | 2.09 |
| (8) Ryan Labs, Inc. | Fixed Income | TALF | \$ 147,383 | No Assigned Benchmark | -9.88 | N/A | N/A |
| (9) Selene | Fixed Income | Opportunistic Mortgage | \$ 1,500,001 | No Assigned Benchmark | -56.95 | N/A | N/A |
| The Philadelphia Trust Company | Equity | Large Cap Value | \$ 416,479 | S&P 500 Index | 14.75 | 14.43 | 0.32 |
| The Swarthmore Group | Equity | Large Cap Core | \$ 895,620 | S&P 500 Index | 12.06 | 14.43 | -2.37 |
| (10) Titanium TALF | Fixed Income | TALF | \$ 137,450 | No Assigned Benchmark | 5.28 | N/A | N/A |
| Valley Forge Asset Mgmt | Equity | Large Cap Core | \$ 902,622 | S&P 500 Index | 9.25 | 14.43 | -5.18 |
| Weaver C. Barksdale & Associates | Fixed Income | Intermediate | \$ 250,914 | Barclays Capital U.S. Intermediate Government/Credit Bond Index | 9.20 | 8.29 | 0.91 |

Total Fees Paid \$ 8,623,652

(1) Performance information obtained from VTL Associates' June 30, 2010, Investment Performance Reports.
(2) Portfolio inception date is 12/1/09. Performance figures reflect since inception returns through June 30, 2010.
(3) Manager was terminated on 2/5/10. Performance figures reflect since inception returns through February 28, 2010.
(4) Portfolio inception date is 9/8/09. Performance figures reflect since inception returns through June 30, 2010.
(5) Portfolio inception date is 9/1/09. Performance figures reflect since inception returns through June 30, 2010.
(6) Portfolio inception date is 11/27/09. Performance figures reflect since inception returns through June 30, 2010.
(7) Portfolio inception date is 12/2/09. Performance figures reflect since inception returns through June 30, 2010.
(8) Portfolio inception date is 9/9/09. Performance figures reflect since inception returns through June 30, 2010.
(9) Portfolio inception date is 9/28/09. Performance figures reflect since inception returns through June 30, 2010.
(10) Portfolio inception date is 10/2/09. Performance figures reflect since inception returns through June 30, 2010.

SUMMARY OF EXTERNAL INVESTMENT MANAGERS, FEES, AND PERFORMANCE – (Continued)

Due to the unique nature of alternative investments, many investment management fees are paid differently. Rather than incur a separate, distinct charge, the management fees associated with the alternative investments are deducted from the fund value and may not be reported concurrently with the end of each quarter. Annual fees for Treasury’s alternative managers range from 0.75% to 2%. Fees are incurred monthly or quarterly and are based on month- or quarter-end net asset value of the fund. To this point there has not been sufficient history to report actual fees for the new alternative managers.

Requirement 6 - Brokerage fees.

When placing portfolio transaction orders on behalf of Treasury’s investment programs, investment managers are required to obtain execution orders through responsible brokerage firms at competitive prices and at reasonable commission rates. For the period July 1, 2009 through June 30, 2010, 767 equity trades were placed through 26 brokers, resulting in gross commissions of \$805,303 for Pool 98. The average gross commission price was \$.03632 per share. A summary of commissions paid to those brokers for Pool 98 is reflected below.

Pool 98
Broker Commissions
Fiscal Year 2009-2010

| Broker | Commission | Broker | Commission |
|--|------------|--|------------|
| ASSENT LLC, HOBOKEN | 0.05 | LEERINK SWANN & CO, JERSEY CITY Total | 1,586.00 |
| BARCLAYS CAPITAL LE, JERSEY CITY | 5,684.00 | MELLON FINANCIAL MRKTS LLC, JERSEY CITY Total | 74,238.76 |
| BROADCOURT CAP CORP/SUB OF MLPF&S,NY | 4,626.00 | MERRILL LYNCH PIERCE FENNER SMITH INC NY Total | 1,994.00 |
| CITATION GROUP/BCC CLRG, NEW YORK | 4,572.16 | MORGAN J P SECS INC, NEW YORK Total | 8.96 |
| CITIGROUP GBL MKTS INC, NEW YORK | 630.00 | NATIONAL FINL SVCS CORP, NEW YORK Total | 4,409.96 |
| DEUTSCHE BK SECS INC, NY (NWSCUS33) | 182,418.48 | PERSHING LLC, JERSEY CITY Total | 1,260.00 |
| FIRST SOUTHWEST CO, DALLAS | 709.50 | ROCHDALE SECURITIES CORP Total | 216.00 |
| GOLDMAN SACHS & CO, NY | 12.60 | SEI FINANCIAL SERVICES CO, NEW YORK Total | 82,573.56 |
| HIBERNIA SOUTHCOAST CAP INC, JERSEY CITY | 530.00 | SEI FUNDS EVALUATION Total | 41,525.44 |
| INSTINET CORP, NY | 100.89 | SEI INVESTMENTS DIST, JERSEY CITY Total | 213,871.32 |
| INVESTMENT TECHNOLOGY GROUP, NEW YORK | 9.56 | UNIVERSAL NETWORK EXCHANGE INC, NEW YORK Total | 160,580.00 |
| ISI GROUP INC, NY | 21,680.00 | WILLIAMS CAPITAL GROUP LP, JERSEY CITY Total | 620.00 |
| JOHNSON RICE & CO, NEW ORLEANS | 1,186.00 | YAMNER & COMPANY INC, JERSEY CITY Total | 260.00 |

A list of the top ten brokers utilized by Treasury’s external investment managers for Pool 98 is included below. Commissions paid to those brokers totaled \$791,770.

Pool 98
Top Ten Broker List
FY 2009-2010

| Broker | Commission |
|--|------------|
| SEI INVESTMENTS DIST, JERSEY CITY | 213,871.32 |
| DEUTSCHE BK SECS INC, NY (NWSCUS33) | 182,418.48 |
| UNIVERSAL NETWORK EXCHANGE INC, NEW YORK | 160,580.00 |
| SEI FINANCIAL SERVICES CO, NEW YORK | 82,573.56 |
| MELLON FINANCIAL MRKTS LLC, JERSEY CITY | 74,238.76 |
| SEI FUNDS EVALUATION | 41,525.44 |
| ISI GROUP INC, NY | 21,680.00 |
| BARCLAYS CAPITAL LE, JERSEY CITY | 5,684.00 |
| BROADCOURT CAP CORP/SUB OF MLPF&S,NY | 4,626.00 |
| CITATION GROUP/BCC CLRG, NEW YORK | 4,572.16 |

Requirement 6 - Brokerage fees. (Continued)

The Pennsylvania State Treasury has retained SEI Investments Distribution Company, a third-party broker commission recapture agent, to administer an equity and fixed income client-directed trading program. Treasury encourages its investment managers to utilize the brokerage services offered by SEI for the security transactions generated on behalf of Treasury's investment programs, subject to obtaining best pricing and execution. All revenues derived from the recapture program are used for the benefit of the applicable investment program. For the fiscal year ended June 30, 2010, commissions recaptured through the broker commission recapture program for Pool 98 totaled \$677,770, resulting in net commissions of \$202,441 or \$.0091 per share. During this period, the average equity manager utilization percentage was 84%.

Requirement 7 - Securities lending information.

Treasury has retained Bank of New York Mellon (BNYM) Asset Servicing to administer a security lending program to generate additional revenue for the Commonwealth. The investment portfolios of the Commonwealth Investment Program are eligible to participate in the securities lending program. Security lending revenue generated from these portfolios totaled \$1,263,324 for the fiscal year ended June 30, 2010.

The Security Lending Authorization with BNYM is included in this report at Exhibit 3, including Exhibits A through E to the agreement, as well as its six amendments.

A summary of the Commonwealth Investment Program's lendable assets as of June 30, 2010, is provided below.

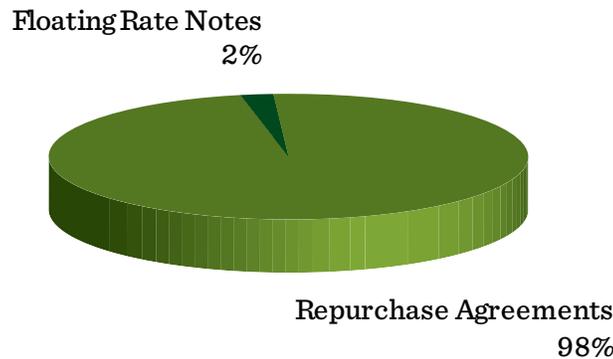
Commonwealth Investment Program Security Lending Program Summary June 30, 2010

| Pool | Market Value of Lendable Securities | Market Value of Securities on Loan | % of Lendable Securities on Loan |
|---------|---|--|--|
| Pool 99 | \$ - | \$ - | 0.00% |
| Pool 98 | 1,826,524,541 | 428,043,829 | 23.43% |
| | <u>\$ 1,826,524,541</u> | <u>\$ 428,043,829</u> | |

According to the terms of its Security Lending Guidelines, Treasury currently accepts only cash collateral on loans of securities related to Treasury funds. This cash collateral can be invested only in US Treasury notes, bonds and bills, Federal Agency securities, and repurchase agreements backed by the above securities subject to a minimum of 102% collateralization with daily updated valuation

The chart below shows the composition of the Cash Collateral Reinvestment Pool as of June 30, 2010.

**Cash Collateral Reinvestment Pool Holdings
June 30, 2010**



Requirement 8 - Proxy voting information.

Treasury has established specific proxy voting guidelines which are carried out by Glass Lewis, its third-party proxy voting agent. The proxy agent is responsible for executing proxy votes in a timely manner, maintaining records of all voting decisions, and reconciling proxy ballots for all accounts managed on Treasury's behalf. Glass Lewis is required to vote all proxies in accordance with Treasury's proxy voting guidelines, but Treasury reserves the right to specifically approve or determine any vote, either by issue or by security, if it chooses to deviate from its guidelines.

A copy of Glass Lewis's Proxy Policy Guidelines is attached to this report as Exhibit 4.

For the period July 1, 2009 through June 30, 2010, Glass Lewis voted 341 ballots, which contained 3,019 proposals. Of the 3,019 proposals, 2,794 represented management proposals and 225 represented shareholder proposals.

Requirement 9 - Information on securities litigation.

During the 2008-2009 fiscal year, Treasury did not actively participate in any securities litigation.

APPENDIX

| | |
|--|-----------|
| Glossary | Exhibit 1 |
| Commonwealth Investment Program Shareholder Summary | Exhibit 2 |
| Securities Lending Authorization (Including Exhibits A through E, and First through Fifth Amendments) | Exhibit 3 |
| Glass Lewis Proxy Guidelines | Exhibit 4 |

EXHIBIT I
GLOSSARY



PENNSYLVANIA
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ROB McCORD, TREASURER

EXHIBIT 1

GLOSSARY

| | |
|-----------------------------------|--|
| Alternative Investments | An investment category consisting of nontraditional investments. Examples include, but are not limited to, venture capital, private equity, hedge funds, and real estate investment trusts (REITs). |
| Basis Point (bp) | A unit that is equal to 1/100 th of 1%, and is used to denote the change in a financial instrument. |
| Cash Equivalent | A domestic security with a high enough level of liquidity to be considered as good as cash. |
| Domestic Security | An equity or fixed security denominated in US dollars, issued under US laws and regulations, designed for US investors, and traded in US markets. |
| Equity Security | Common stock of a publicly traded company and securities convertible into common stock, as well as preferred stock, 144a securities, and warrants. |
| Fixed Income Security | A security that encompasses both Adjustable Rate or Variable Rate Securities and Fixed Rate Securities. An Adjustable Rate or Variable Rate Security is defined as a domestic fixed income security that is structured so that it provides a return in the form of periodic payments that may vary over the instrument's life, due to a change in interest rate, and a return of principal by maturity. A Fixed Rate Security is defined as a domestic security that provides a return in the form of periodic payments that are consistent and predetermined for the instrument's life, from purchase, and a return of principal by maturity. |
| Fund | A Commonwealth account with prescribed objectives and restrictions. |
| High Yield | An investing style in which the portfolio contains bonds with speculative credit ratings of BB (Standard & Poor's) or Ba (Moody's) or lower, or such bonds themselves. |
| Intermediate-Term Security | A security that matures in 13 months to 10 years. |

| | |
|----------------------------------|--|
| Investment Manager | An individual or organization registered with and currently in compliance with the Investment Company Act of 1940 and retained by the Treasury Department to manage the investments of one or more portfolios. The term includes any employees of an organization involved in providing such services to Treasury. An investment manager is also a Treasury employee who has been assigned investment responsibility for one or more portfolios. |
| Long-Term Security | A security that matures in greater than 10 years. |
| Moody's | The independent rating agency Moody's Investors Service. |
| Net Asset Value Per Share | The total of a pool's assets less liabilities, divided by the number of outstanding shares owned in the pool. |
| Pool | The totality of assets from various funds combined for the purpose of making joint investments from which each of the participating funds benefits proportionately. A pool may consist of one or more portfolios. |
| Portfolio | That portion of assets within a pool that is allocated to a specific investment manager for investment with a particular investment discipline or objective. |
| Program | A discrete and defined set of identifiable procedures and objectives. |
| Repurchase Agreements | An agreement by the Treasury Department and/or its investment manager(s) to buy obligations of the United States Government and its agencies on a certain date from a bank or non-bank financial institution and then sell the same obligation of the United States Government and its agencies back to that particular institution on a specific date in the future at the same price plus an additional amount as agreed to by the parties. |
| Securities | The investment securities that are defined as acceptable by the Treasury Department's Investment Policy. |
| Short-Term Security | A security that matures in 13 months or less. |

Standard & Poor's (S&P)

The independent rating agency Standard and Poor's Ratings Service.

Standard Deviation (Std Dev)

A measure of the dispersion of a set of data from its mean that measures investment volatility.

Weighted Average Maturity (WAM)

The weighted average of the time until all securities within a portfolio mature.

EXHIBIT II

COMMONWEALTH INVESTMENT PROGRAM SHAREHOLDER SUMMARY



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EXHIBIT 2
COMMONWEALTH INVESTMENT PROGRAM
SHAREHOLDER SUMMARY
JUNE 30, 2010

| Fund # | Name | Shares | Cost Basis | MV Pool 98 | MV Pool 99 | Total MV |
|--------|-------------------------------------|-------------|----------------|----------------|------------------|------------------|
| 1 | General | 106,618,839 | \$ 101,772,811 | \$ 110,883,593 | \$ 2,868,985,462 | \$ 2,979,869,054 |
| 2 | | 26,056,132 | 24,943,278 | 27,098,377 | 190,528,414 | 217,626,791 |
| 3 | Wild Resource | 20,845 | 20,783 | 21,679 | 314,068 | 335,747 |
| 4 | Energy Development | 5,637,914 | 5,801,800 | 5,863,431 | 1,587,294 | 7,450,724 |
| 5 | State Racing | 16,862,779 | 16,463,197 | 17,537,290 | 6,688,940 | 24,226,230 |
| 6 | Hazardous Sites Cleanup | 17,230,577 | 17,333,178 | 17,919,800 | 18,812,776 | 36,732,576 |
| 7 | Highway Beautification | 822,501 | 832,784 | 855,401 | 8,103 | 863,504 |
| 8 | Environmental Stewardship | 57,712,458 | 57,299,617 | 60,020,956 | 3,211,338 | 63,232,294 |
| 9 | Recycling Fund | 54,202,290 | 54,772,344 | 56,370,382 | 4,718,572 | 61,088,954 |
| 10 | Motor License | 875,690,622 | 855,960,352 | 910,718,247 | 1,182,771,665 | 2,093,489,912 |
| 11 | Game | 40,506,016 | 40,151,155 | 42,126,256 | 4,304,074 | 46,430,331 |
| 12 | Fish | 35,247,006 | 35,702,862 | 36,656,887 | 14,701,029 | 51,357,916 |
| 13 | Banking | 13,143,238 | 13,365,815 | 13,668,968 | 31,072 | 13,700,040 |
| 14 | Milk Marketing Board | 2,157,398 | 2,175,490 | 2,243,694 | 776,271 | 3,019,965 |
| 15 | State Farm Products | 384,399 | 373,047 | 399,775 | 472,239 | 872,014 |
| 16 | Oil & Gas Lease | 8,868,370 | 8,865,255 | 9,223,105 | 208,836,541 | 218,059,646 |
| 17 | State Treasury Armory | 2,649,833 | 2,699,292 | 2,755,826 | 501,751 | 3,257,577 |
| 18 | Historical Preservation | 2,607,665 | 2,590,007 | 2,711,972 | 162,778 | 2,874,749 |
| 19 | PA Infrastructure Bank | 48,108,925 | 48,263,646 | 50,033,282 | 43,143 | 50,076,425 |
| 20 | Surface Mining Conserv. | 58,573,881 | 59,018,977 | 60,916,836 | 1,406,478 | 62,323,314 |
| 21 | Special Administration | 1,004,720 | 981,997 | 1,044,909 | 5,404,969 | 6,449,878 |
| 22 | Capitol Restoration Trust | 302,787 | 303,014 | 314,899 | 70,657 | 385,556 |
| 23 | Vocational Rehabilitation | 566,345 | 525,621 | 588,999 | 9,771,271 | 10,360,269 |
| 24 | Pharmaceutical Assis | 28,308,533 | 26,573,857 | 29,440,875 | 43,791,086 | 73,231,960 |
| 25 | Boating | 22,097,592 | 22,321,252 | 22,981,496 | 745,659 | 23,727,155 |
| 26 | Administration | 0 | - | - | 2,202,845 | 2,202,845 |
| 27 | Liquid Fuels Tax | 0 | - | - | 5,510,622 | 5,510,622 |
| 28 | Liquor License | 0 | - | - | 2,392,089 | 2,392,089 |
| 29 | Fire Insurance Tax | 0 | - | - | 88,828,292 | 88,828,292 |
| 30 | Volunteer Companies Loan | 27,851,883 | 28,213,231 | 28,965,958 | 9,031,467 | 37,997,425 |
| 31 | Manufacturing | 20,252,369 | 19,720,662 | 21,062,464 | 6,183,000 | 27,245,463 |
| 32 | Purchasing | 0 | - | - | 39,338,089 | 39,338,089 |
| 33 | Employment for the Blind | 3,068,911 | 3,104,707 | 3,191,668 | - | 3,191,668 |
| 34 | Industrial Development | 40,431 | 41,862 | 42,049 | 928 | 42,976 |
| 35 | Nursing Home Loan Dev. | 0 | - | - | - | - |
| 36 | Disaster Relief | 0 | - | - | - | - |
| 37 | Pennvest Drinking Water | 42,852,691 | 43,248,136 | 44,566,799 | 7,584,837 | 52,151,636 |
| 39 | Land & Water Development | 0 | - | - | 667,585 | 667,585 |
| 40 | Water Facilities Loan | 0 | - | - | - | - |
| 41 | Capital Loan | 0 | - | - | - | - |
| 42 | PA Economic Revitalization | 0 | - | - | 5,474,581 | 5,474,581 |
| 43 | Deferred Compensation | 0 | - | - | - | - |
| 44 | Land & Water Dev. Sinking | 0 | - | - | 1,025 | 1,025 |
| 45 | Sinking | 0 | - | - | 145,245 | 145,245 |
| 46 | Nursing Home Loan Sinking | 0 | - | - | - | - |
| 47 | PA Economic Rev. Sinking | 0 | - | - | - | - |
| 48 | Project 70 Land Acquistion | 0 | - | - | - | - |
| 49 | Tax Note Sinking | 0 | - | - | - | - |
| 50 | Water Facilities Loan | 0 | - | - | - | - |
| 51 | Conrad Weiser Memorial Park | 88,425 | 88,905 | 91,962 | 2,030 | 93,992 |
| 52 | Judicial Admin Leave | 2,826,314 | 2,841,500 | 2,939,367 | - | 2,939,367 |
| 53 | PA Historical/Museum Comm. | 156,802 | 157,653 | 163,074 | 3,600 | 166,674 |
| 54 | Agric. College Land Script | 613,233 | 616,539 | 637,762 | 4,464 | 642,226 |
| 55 | State College Exper. Farm | 23,876 | 24,002 | 24,831 | 174 | 25,005 |
| 56 | State School | 568,035 | 572,790 | 590,756 | 13,017 | 603,773 |
| 57 | Vietnam Conflict Vet. Comp | 0 | - | - | - | - |
| 58 | State Insurance | 11,387,160 | 11,486,388 | 11,842,646 | 61,210 | 11,903,856 |
| 59 | Federal Revenue Sharing Trust | 0 | - | - | - | - |
| 60 | Disaster Relief Redemption | 0 | - | - | - | - |
| 61 | State Employees Retirement | 0 | - | - | - | - |
| 62 | Public School Employees' Retirement | 0 | - | - | - | - |
| 66 | Clean System Upgrade | 74,032 | 74,433 | 76,993 | 1,699 | 78,692 |
| 67 | Workmen's Compensation | 0 | - | - | - | - |
| 68 | Energy Conserv. & Assist | 5,849 | 5,913 | 6,083 | 116 | 6,199 |
| 69 | Workmens' Compens. Super. | 6,575,759 | 6,400,627 | 6,838,789 | 3,185,937 | 10,024,726 |
| 70 | Medical Profess. Liability | 0 | - | - | - | - |
| 71 | Tobacco Settlement | 0 | - | - | - | - |

Pennsylvania Treasury Annual Investment Report

| Fund # | Name | Shares | Cost Basis | MV Pool 98 | MV Pool 99 | Total MV |
|--------|--|-------------|-------------|-------------|-------------|-------------|
| 72 | Real Estate Recovery | 446,387 | 452,062 | 464,242 | 26,641 | 490,883 |
| 73 | Noncoal Surface Mining Conserv. | 12,827,021 | 12,936,693 | 13,340,102 | 81,229 | 13,421,331 |
| 74 | Social Security Contribution | 0 | - | - | - | - |
| 75 | PSERS Health Insurance Fund | 0 | - | - | - | - |
| 76 | Municipal Pension Aid | 0 | - | - | 224,326,511 | 224,326,511 |
| 77 | Supplemental Municipal Pension | 70,736 | 72,198 | 73,566 | 1,624 | 75,190 |
| 78 | PA Municipal Employ Retire | 2,721,603 | 2,524,162 | 2,830,467 | 5,433,977 | 8,264,444 |
| 79 | Higher Ed. Assistance | 38,786,489 | 36,113,704 | 40,337,948 | 184,129,978 | 224,467,926 |
| 80 | Emergency Med. Oper. Serv. | 21,739,000 | 21,849,834 | 22,608,560 | 1,360,097 | 23,968,656 |
| 81 | State Restaurant | 1,508,036 | 1,521,098 | 1,568,357 | 813 | 1,569,170 |
| 82 | State Workmens Insurance | 0 | - | - | 9,077,462 | 9,077,462 |
| 83 | Solid Waste | 616,839 | 620,184 | 641,513 | 13,983 | 655,496 |
| 84 | State Stores | 0 | - | - | 45,190,225 | 45,190,225 |
| 85 | Rehabilitation Center | 0 | - | - | 4,367,832 | 4,367,832 |
| 86 | Coal & Clay Mine Sub Ins. | 68,691,206 | 69,452,127 | 71,438,854 | 5,818,396 | 77,257,250 |
| 87 | Coal Lands Improvement | 2,396,776 | 2,478,941 | 2,492,647 | 46,411 | 2,539,057 |
| 88 | Minority Business Development | 2,329,544 | 2,350,283 | 2,422,726 | 1,134,772 | 3,557,498 |
| 91 | Capital Debt | 0 | - | - | 31,130,678 | 31,130,678 |
| 92 | Volunteer Companies | 0 | - | - | - | - |
| 93 | Budget Stabilization Reserve Fund | 0 | - | - | 740,649 | 740,649 |
| 94 | Tax Stabilization Reserve | 0 | - | - | - | - |
| 96 | PA Veterans' Memorial Trust | 328,641 | 332,194 | 341,787 | 3,214 | 345,001 |
| 97 | Anthracite Emergency Bond | 472,478 | 475,341 | 491,378 | 10,348 | 501,726 |
| 101 | Low Level Waste | 2,550,459 | 2,571,160 | 2,652,477 | 33,457 | 2,685,934 |
| 104 | PA Infrastructure Invest. Authority | 101,980,774 | 103,913,039 | 106,060,005 | 16,069,666 | 122,129,670 |
| 105 | Pennvest Bonds Authority | 123,755 | 128,159 | 128,705 | 2,449 | 131,154 |
| 106 | Pennvest Revolving | 0 | - | - | 35,303 | 35,303 |
| 107 | Pennvest Non Revolving Equity Fund | 0 | - | - | 29,498 | 29,498 |
| 108 | Pennvest Redemption | 0 | - | - | 1,775,113 | 1,775,113 |
| 109 | Pennvest Water Pollution | 232,653,499 | 235,607,351 | 241,959,639 | 5,129 | 241,964,768 |
| 110 | Deferred Compensation | 0 | - | - | - | - |
| 111 | Machinery & Equipment Loan | 57,528,178 | 59,015,743 | 59,829,305 | 7,364,628 | 67,193,933 |
| 112 | Insurance Liquidation | 66,538,063 | 67,838,413 | 69,199,586 | 975,843 | 70,175,428 |
| 113 | Agricultural Conservation | 4,805,782 | 4,851,098 | 4,998,014 | - | 4,998,014 |
| 114 | Agr. Conserv. Easement | 0 | - | - | - | - |
| 115 | Children's Trust | 856,253 | 859,510 | 890,503 | 280,115 | 1,170,618 |
| 116 | Revolving Aid Fund | 4,854,481 | 4,912,917 | 5,048,660 | 303,394 | 5,352,054 |
| 117 | Catastrophic Loss Benefit | 91,670,157 | 94,005,898 | 95,336,963 | 432,622 | 95,769,585 |
| 118 | Storage Tank Fund | 7,155,904 | 7,201,932 | 7,442,140 | 3,356,203 | 10,798,343 |
| 119 | Underground Storage Tank | 20,708,394 | 20,463,055 | 21,536,730 | 2,785,605 | 24,322,334 |
| 121 | Resting Facilities Siting | 489 | 492 | 509 | 11 | 520 |
| 123 | Motor Vehicle Trans. Rec. | 1,736,869 | 1,749,268 | 1,806,344 | 96,828 | 1,903,172 |
| 125 | Hazardous Material Response | 6,618,931 | 6,716,254 | 6,883,688 | 375,944 | 7,259,632 |
| 126 | PHFA Home Buyer Fund | 0 | - | - | - | - |
| 127 | Local Govt. Cap. Loan | 2,166,357 | 2,194,726 | 2,253,011 | 818,755 | 3,071,766 |
| 128 | Local Sales and Use Tax | 0 | - | - | 21,438,544 | 21,438,544 |
| 129 | PICA | 0 | - | - | 985,936 | 985,936 |
| 130 | Public Transportation | 0 | - | - | 6,814,310 | 6,814,310 |
| 131 | Acid Mine Drain | 17,129,700 | 17,309,283 | 17,814,888 | - | 17,814,888 |
| 132 | PHFA Investment | 0 | - | - | - | - |
| 133 | Local Crime Justice | 0 | - | - | 1,840,757 | 1,840,757 |
| 134 | Local Crime Justice Sink | 0 | - | - | - | - |
| 136 | Global Security Lending Revenue Invest | 0 | - | - | - | - |
| 137 | Refund of Axle Tank | 0 | - | - | - | - |
| 138 | Clean Air | 48,446,076 | 48,996,842 | 50,383,919 | 9,797,440 | 60,181,359 |
| 139 | Home Investment Trust | 0 | - | - | 106,117 | 106,117 |
| 140 | Phila. Reg. Port Author. | 0 | - | - | 1,014,886 | 1,014,886 |
| 141 | Port of PGH Commission | 3,642,262 | 3,710,231 | 3,787,952 | 977,407 | 4,765,359 |
| 143 | Tuition Acct Guaranteed Saving Program | 0 | - | - | - | - |
| 144 | Pennvest Trustee | 0 | - | - | - | - |
| 145 | Remining Environment | 0 | - | - | - | - |
| 146 | Remining Financial Assurance | 2,860,834 | 2,884,097 | 2,975,268 | 211,890 | 3,187,158 |
| 147 | Environmental Education | 898,806 | 887,534 | 934,758 | - | 934,758 |
| 148 | Self-Ins. Guaranty | 37,216,697 | 37,984,299 | 38,705,365 | 2,662,619 | 41,367,984 |
| 149 | Keystone Recreation, Park | 0 | - | - | 120,460,615 | 120,460,615 |
| 150 | Keystone Rec/Park-Sink | 0 | - | - | - | - |
| 151 | PA Employee Benefit Trust | 10,366,627 | 10,422,858 | 10,781,292 | 238,039 | 11,019,332 |
| 152 | Nutrient Mgmt | 213,571 | 212,186 | 222,113 | 1,009,778 | 1,231,891 |
| 153 | Allegh. Reg. Asset Tax | 0 | - | - | 14,397,807 | 14,397,807 |
| 154 | Ben Franklin/IRC Partnership | 0 | - | - | - | - |
| 155 | Organ Donation | 2,198,887 | 2,256,440 | 2,286,842 | 95,514 | 2,382,356 |
| 156 | Insurance Fraud | 0 | - | - | 4,519,916 | 4,519,916 |
| 157 | Automobile Theft | 0 | - | - | 1,671,385 | 1,671,385 |
| 158 | Industrial Sites Cleanup | 9,940,576 | 10,058,263 | 10,338,199 | 2,144,820 | 12,483,019 |
| 159 | DNA Detection | 3,428,669 | 3,494,482 | 3,565,816 | 2,761,384 | 6,327,200 |

| Fund # | | Shares | | | | |
|--------|---|------------|------------|------------|-------------|-------------|
| | | | | 52,272,871 | | 58,041,710 |
| 161 | Ben Franklin Tech Development | 29,489,839 | 29,920,030 | 30,669,433 | 6,145,292 | 36,814,725 |
| 162 | M-Care | 57,888,609 | 57,720,535 | 60,204,153 | 88,133,727 | 148,337,881 |
| 163 | Patient Safety Trust Fund | 704,626 | 710,658 | 732,811 | 5,596,549 | 6,329,359 |
| 164 | Substance Abuse Education & Demand Reduction Fund | 9,879,620 | 10,020,293 | 10,274,805 | 851,247 | 11,126,052 |
| 165 | Benefits Completion Plan Fund | 0 | - | - | - | - |
| 166 | Wireless E-911 Emergency Services Fund | 6,002,030 | 5,606,071 | 6,242,111 | 2,306,120 | 8,548,231 |
| 167 | Rightful Owners Claims Payment Fund | 56 | 56 | 58 | 36,864 | 36,922 |
| 168 | State Gaming Fund | 0 | - | - | 202,812,195 | 202,812,195 |
| 169 | Compulsive and Problem Gambling Treatment Fund | 0 | - | - | 8,098,761 | 8,098,761 |
| 170 | Property Tax Relief Fund | 0 | - | - | 543,449,963 | 543,449,963 |
| 171 | PA Gaming Econ Dev & Tourism Fund | 0 | - | - | 83,896,381 | 83,896,381 |
| 172 | Pennsylvania Race Horse Development Fund | 0 | - | - | 10,329,212 | 10,329,212 |
| 173 | Emergency Energy Assistance Fund | 0 | - | - | - | - |
| 174 | Broadband Outreach and Aggregation Fund | 0 | - | - | 3,887,877 | 3,887,877 |
| 175 | Education Technology Fund | 2,235,310 | 2,100,558 | 2,324,723 | 3,397,693 | 5,722,415 |
| 176 | Educational Assistance Program Fund | 327,374 | 333,204 | 340,469 | 5,475,783 | 5,816,252 |
| 177 | Job Training Fund | 1,263,220 | 1,265,175 | 1,313,748 | 1,251,324 | 2,565,072 |
| 178 | Community College Capital Fund | 0 | - | - | 1,807,911 | 1,807,911 |
| 179 | Growing Greener Bond Fund | 0 | - | - | 67,478,770 | 67,478,770 |
| 180 | Growing Greener Bond Sinking Fund | 0 | - | - | - | - |
| 181 | Water Supply and Wastewater Treatment Fund | 0 | - | - | 26,766,827 | 26,766,827 |
| 182 | Water Supply and Wastewater Treatment Sinking Fund | 0 | - | - | - | - |
| 183 | Conservation District Fund | 292,041 | 290,053 | 303,723 | 534,563 | 838,286 |
| 184 | Uninsured Employers Guaranty Fund | 0 | - | - | 1,741,008 | 1,741,008 |
| 185 | Persian Gulf Conflict Veterans' Compensation Bond Fund | 0 | - | - | 3,515,468 | 3,515,468 |
| 186 | Persian Gulf Conflict Veterans' Compensation Bond Sinking Fund | 0 | - | - | - | - |
| 187 | The Public Transportation Trust Fund | 59,374,612 | 56,426,974 | 61,749,596 | 56,668,824 | 118,418,420 |
| 190 | Fire Prevention and Public Safety Fund | 0 | - | - | - | - |
| 191 | Cigarette Fire Safety & Firefighter Protection Act Enforcement Fund | 0 | - | - | 186,851 | 186,851 |
| 192 | Mine Safety Fund | 0 | - | - | 31,446 | 31,446 |
| 193 | Water Resources Fund | 0 | - | - | - | - |
| 194 | Water and Sewer Assistance Bond Fund | 0 | - | - | 136,190,477 | 136,190,477 |
| 195 | Water and Sewer Assistance Bond Sinking Fund | 0 | - | - | - | - |
| 196 | Keystone Help Program | 0 | - | - | - | - |
| 197 | Special Juvenile Victim Compensation Fund | 0 | - | - | - | - |
| 381 | 101-CF New Equipment | 0 | - | - | 18,762,740 | 18,762,740 |
| 382 | 102-CF Public Improvement | 0 | - | - | 381,838,357 | 381,838,357 |
| 384 | 104-CF TAP | 0 | - | - | 125,871,353 | 125,871,353 |
| 386 | 106-CF St. Pub. Sch. Bldg. | 0 | - | - | 3,544 | 3,544 |
| 387 | 107-CF Redev. Asst. Proj. | 0 | - | - | 234,066,571 | 234,066,571 |
| 389 | 109-CF Flood Control Proj. | 0 | - | - | 12,159,064 | 12,159,064 |
| 391 | 111-CF General Services | 0 | - | - | 4,086,445 | 4,086,445 |
| 394 | 113-CF Bridge Projects | 0 | - | - | 112,249,136 | 112,249,136 |
| 395 | 114-CF Highway Projects | 0 | - | - | - | - |
| 451 | Chester Downs | 0 | - | - | 1,500,000 | 1,500,000 |
| 452 | Pocono Downs | 0 | - | - | 1,500,000 | 1,500,000 |
| 453 | Philadelphia Park | 0 | - | - | 1,500,000 | 1,500,000 |
| 454 | Penn National | 0 | - | - | 1,500,000 | 1,500,000 |
| 455 | The Meadows | 0 | - | - | 1,500,000 | 1,500,000 |
| 456 | Sugar House Casino | 0 | - | - | - | - |
| 457 | Foxwoods Casino Philadelphia | 0 | - | - | - | - |
| 458 | PITG Gaming Casino | 0 | - | - | 1,500,000 | 1,500,000 |
| 459 | Mount Airy Casino | 0 | - | - | 1,500,000 | 1,500,000 |
| 460 | Sands Bethworks Casino | 0 | - | - | 1,500,000 | 1,500,000 |
| 461 | Presque Isle Downs | 0 | - | - | 1,500,000 | 1,500,000 |

Totals

2,650,712,957 \$ 2,632,663,539 \$ 2,756,741,475 \$ 7,648,960,243 \$ 10,405,701,717

EXHIBIT III

SECURITIES LENDING AUTHORIZATION (INCLUDING EXHIBITS A THROUGH E, AND FIRST THROUGH FIFTH AMENDMENTS)



PENNSYLVANIA

TREASURY

Earn. Learn. Invest.

ROB McCORD, TREASURER

SECURITIES LENDING AUTHORIZATION .

**by and between
COMMONWEALTH OF PENNSYLVANIA
Treasury Department**

and

MELLON BANK, N.A.

SECURITIES LENDING AUTHORIZATION

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SECURITIES LENDING AUTHORIZATION

This Securities Lending Authorization (this "Agreement") made as of the 2nd day of November, 1998, by and between the **COMMONWEALTH OF PENNSYLVANIA** ("Commonwealth") acting by and through its Treasury Department as custodian for the assets of certain Funds, as defined below, of the Commonwealth (hereinafter, the "Client") and **MELLON BANK, N.A.** (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client issued a Request for Proposals for Domestic and Global Master Custody Services, Safekeeping Services, and Securities Lending Services on January 9, 1998 (the "RFP"), attached hereto as Exhibit A and made a part hereof; and

WHEREAS, the Lending Agent submitted a proposal to provide certain services to the Client by response dated February 11, 1998 (the "Proposal"), incorporated herein by reference and made a part hereof; and

WHEREAS, the Lending Agent in its capacity as the Client's Custodian Bank pursuant to that certain Master Custody Agreement of even date herewith maintains custody of certain securities owned by the funds listed on Exhibit B, attached hereto (each a "Fund" and collectively the "Funds"), which exhibit may be modified from time to time by written notice from the Client to the Lending Agent; and

WHEREAS, the Client desires to authorize the Lending Agent to establish, manage and administer a Securities Lending Program in accordance with the provisions hereof with respect to the lendable securities held by each of the Funds (the "Program") that have elected to participate in the Program; and

WHEREAS, the Lending Agent is willing to lend securities from time to time on behalf of the Funds; and

WHEREAS, having determined that such loan transactions are authorized by law for each of the Funds and that the Funds have the financial resources for such transactions, the Client has authorized the Lending Agent to engage in lending such securities, subject to the terms and conditions hereinafter set forth;

NOW, THEREFORE, in consideration of the mutual promises and covenants herein contained, and intending to be legally bound hereby, the parties hereto agree as follows:

0. The above recitals are to be considered part of the substance of this Authorization.

1. **Appointment of Lending Agent.** The Client hereby authorizes and appoints the Lending Agent, as agent for each of the Funds, to lend securities of United States issuers and non-United States issuers held by each such Fund to such borrowers as may be selected by the Lending Agent for the Program (each a "Borrower"). The Client hereby acknowledges that it is independent of the Lending Agent and that it has authority to execute this Agreement with the Lending Agent on behalf of the Funds. The Lending Agent shall from time to time, but in no event less than monthly, provide the Client with a list of the Borrowers in the Program. The Client may, with written notice to the Lending Agent, restrict one or more Borrowers from borrowing securities from any or all of the Funds. Exhibit C attached hereto lists the Borrowers in the Program as of the date hereof.

2. **Requirements of Client.** If required to prevent self-dealing or any other transaction prohibited by law, rule or regulation, the Client agrees to identify for the Lending Agent those persons who exercise investment discretion or render investment advice with respect to assets held in each of the Funds who (or whose affiliates) are Borrowers under the Program. The Client also agrees to notify the Lending Agent promptly in writing of all future appointments and terminations regarding such persons.

3. **Conduct of Program.** The Lending Agent shall have responsibility for negotiating the terms of each loan and for collecting all required collateral, whether in the form of cash, U.S. government securities, irrevocable letters of credit issued by banks independent of the Borrowers or other forms approved by the Client for use as collateral (the "Collateral"), on behalf of the Funds. The Lending Agent shall have authority to do or cause to be done all acts by and on behalf of the Funds as it shall determine to be desirable, necessary or appropriate to implement and administer the Program contemplated hereby. With regard to all of the Funds, the Lending Agent acknowledges that it is a fiduciary with respect to such Funds to the extent the Lending Agent exercises any discretionary authority under this Agreement and shall perform in such fiduciary capacity with regard to such Funds.

4. **Collateral.** By the close of the business day on which the securities are delivered to the Borrower, the Lending Agent shall obtain from such Borrower Collateral in an amount equal, as of such date, to 102% in the case of securities of United States issuers, and 105% in the case of securities of non-United States issuers, of the market value of any securities loaned, including any accrued interest.

5. **Marking to Market.** If at the close of trading on any business day, the market value of the Collateral previously delivered by the Borrower and held in connection with any loan of securities of United States issuers is less than 100% of the market value of such loaned securities as of such business day, the Lending Agent shall demand that the Borrower deliver an amount of additional Collateral by the close of the next business day sufficient to cause the market value of all Collateral delivered in connection with such loan to equal 102% of the market value of such loaned securities, including accrued interest. If at the close of trading on any business day, the market value of the Collateral previously delivered by the Borrower and held in connection with any loan of securities of non-United

States issuers is less than 105% of the market value of the loaned securities as of such business day, the Lending Agent shall demand that the Borrower deliver an amount of additional Collateral by the close of the next business day sufficient to cause, the market value of all Collateral to equal 105% of the market value of such loaned securities, including accrued interest. Notwithstanding the foregoing, for Collateral held in connection with loans of securities of non-United States issuers, it is understood and agreed that certain standard industry practices may from time-to-time preclude the Lending Agent from obtaining additional Collateral by the close of the next business day unless the market value of the Collateral previously delivered by the Borrower is less than 100% of the market value of such loaned securities, including accrued interest. For purposes hereof, the term "market value" of cash Collateral means the value of any cash Collateral or additional cash Collateral as of the time of receipt thereof by the Lending Agent from the Borrower, unadjusted for any subsequent increases or decreases in value as a result of any investment thereof by the Lending Agent pursuant to Section 6 below.

6. **Collateral Investment.** The Lending Agent is hereby authorized to invest and reinvest, on behalf of the Funds, any and all cash Collateral in accordance with the provisions hereof. Cash Collateral received by the Lending Agent on behalf of the Funds shall be held and maintained by the Lending Agent in a collective investment vehicle created and maintained by the Lending Agent or an affiliate for investment of behalf of the Funds. Such collective investment vehicle shall be invested and reinvested in accordance with the investment guidelines established for such collective investment vehicle, which guidelines are set forth in Section C of Exhibit D, which Exhibit is incorporated herein in its entirety ("the Policy and Guidelines"). In the event that the amount of earnings on invested Collateral is insufficient to pay the entire rebate or other amount payable to a Borrower under any loan of securities and, therefore, results in negative earnings, the amount of such negative earnings shall be paid by the Fund for whose account such loan was made and the Lending Agent, on a monthly basis, in accordance with and in the same proportion as their respective percentage entitlements to earnings as set forth in Exhibit E hereto. The Client acknowledges that certain events, including but not limited to the Client's termination of participation in the Program, certain changes to the composition of lendable securities of the Funds, extraordinary changes in applicable interest rates or the bankruptcy or insolvency of any issuer of a security may result in a loss to the Funds. Notwithstanding any other provision hereof, the Client acknowledges and agrees that any losses of principal from investing and reinvesting Collateral shall be at the risk and for the account of the Fund for whose account such Collateral is held. If at any time the Collateral is insufficient to satisfy the obligation to return the full amount owed to the Borrower, the Fund for whose account such Collateral is held shall be solely responsible for such shortfall in the absence of negligence or willful misconduct on the part of the Lending Agent. In the event the Lending Agent is unable to obtain any Funds' share of negative earnings or shortfalls from losses of principal from revenues derived from securities lending activities, the Lending Agent is hereby authorized to obtain such amounts directly from such Fund, to the extent permitted by applicable law.

7. **Allocation of Lending Opportunities.** The Client acknowledges that the Lending Agent has been appointed as a Lending Agent by other clients on behalf of other funds and that the Lending Agent will allocate securities loan opportunities among its securities lending clients, including the Client herein and the Funds, by such reasonable and equitable methods as the Lending Agent deems appropriate, in accordance with the Lending Agent's allocation policy and applicable law. While the Lending Agent will make reasonable efforts to lend each of the participating Funds' securities, nothing in this Agreement shall be deemed to impose upon the Lending Agent any obligation, in the event it makes a loan of another securities lending client's securities, to make a loan of any of the participating Funds' securities, whether or not such loan could have been made in accordance with this Agreement, and whether or not the Lending Agent has made fewer or more loans for any other securities lending client than for this Client and the Funds. Lending Agent does not represent or warrant that any amount or percentage of any of the Funds' securities will in fact be loaned to a Borrower.

8. **Rights of Borrower in Respect of the Securities.** Until such time as a loan of securities is terminated and such securities are returned to the Lending Agent, a Borrower shall have all incidents of ownership of the securities loaned, including, but not limited to, the right to transfer the securities to others; provided, however, that Borrower will be obligated to the Lending Agent with respect to amounts equivalent to all dividends, interest and distributions pertaining to the securities. The Lending Agent shall collect for, and credit to, the account of each Fund amounts equivalent to all interest, dividends or other distributions paid with respect to securities loaned to Borrowers on behalf of each such Fund, subject to any applicable withholding taxes, transfer taxes and other necessary costs. The Client (on behalf of itself and the Funds) hereby waives the right to vote any voting securities loaned to a Borrower or participate in any dividend reinvestment program during the term of any such loan provided, however, that subject to the Lending Agent's receipt from the Client of seven (7) days notice in the case of domestic securities and ten (10) days notice in the case of foreign securities prior to the record date of a Fund's desire to exercise any voting rights associated with any loaned security of such Fund, the Lending Agent shall use its best efforts to cause such loaned security to be returned to the Fund from which it was lent prior to the record date relating to such voting rights.

9. **Remedies for Failure to Deliver Securities.** (a) In the event that any loan made pursuant to this Agreement is terminated and the loaned securities, or any portion thereof, shall not have been returned to the Fund for whose account such loan was made for any reason (including, without limitation, the insolvency or bankruptcy of the Borrower) within the time specified by the applicable securities loan agreement, the Lending Agent, at its expense and subject to the provisions of subsection (b) herein, shall (i) promptly replace the loaned securities, or any portion thereof, not so returned with other securities of the same issuer, class, and denomination and with the same dividend rights and other economic benefits as such securities possessed at the close of business on the date as of which the loaned securities should have been returned, or (ii) if it is unable to purchase such securities on the open market, credit the applicable Fund with the market value of such

unreturned loaned securities, such market value to be determined as of the close of business on the date immediately preceding the date of default. Until such time as the actions in clauses (i) or (ii), herein, have been consummated, any dividends or interest which have accrued on the loaned securities, whether or not received from the Borrower, shall be credited by the Lending Agent to the Fund from whose account such loan was made.

(b) The Client and each Fund shall have, as to the Collateral, all of the rights and remedies of a secured party under applicable law. In the event that the Lending Agent should be required to make any payment or incur any loss or expense in connection with any securities loaned on behalf of any Fund pursuant to (a) above, the Lending Agent shall, to the extent of any such payment and/or loss or expense, be subrogated and succeed to all such rights and remedies of the Client and/or such Fund against the Borrower under the applicable securities loan agreement and to the collateral securing the Borrower's obligations to the Lending Agent under such securities loan agreement and any and all applicable law. If for any reason the Lending Agent cannot assert any such rights and remedies against the Borrower and/or its successors and assigns in its own right, the Client and/or the appropriate Fund shall, at the expense of the Lending Agent, file and prosecute such complaints and lawsuits and take such action as the Lending Agent may reasonably request in connection with the recovery of any such deficiency and shall otherwise cooperate with the Lending Agent in any such litigation in accordance with applicable law.

10. **Standard of Care; Indemnification.** Except as provided in Section 9, the Lending Agent shall not be liable with respect to any losses incurred by the Fund in connection with the Program, except to the extent that such losses result from the Lending Agent's negligence or willful misconduct in its administration of the Program or breach of its obligations under this Agreement. The Lending Agent hereby indemnifies and agrees to defend, hold and save harmless the Client and each of the Funds and each of their respective employees, officers and boards of Trustees from and against all claims, suits, actions, liabilities, losses and costs resulting from the negligence or intentional misconduct of the Lending Agent in the administration of the Program or the performance of its obligations hereunder. This Section 10 shall survive the termination of this Authorization.

11. **Compensation to the Lending Agent.** In consideration for the securities lending services to be provided by the Lending Agent hereunder, the Lending Agent shall be entitled to compensation as set forth in Exhibit E attached hereto. The Lending Agent is hereby authorized to charge such compensation against and collect such compensation from the revenues derived from the securities lending activities. The compensation paid to the Lending Agent hereunder is solely in consideration of securities lending services rendered by the Lending Agent and is in addition to any other compensation to which the Lending Agent may be entitled for services rendered for Client or the Funds under other agreements.

11.1 **Reporting and Recordkeeping.** The Lending Agent shall provide to each Fund, at no additional cost, any and all reports set forth in the Proposal with such frequency as set forth in the Proposal or at such other times as may be mutually agreed upon. Such reports shall include, without limitation, those set forth in the Proposal and such other reports as may be reasonably requested. Each Fund shall have the right, at its own expense and with prior written notice to the Lending Agent, to inspect the Lending Agent's books and records directly and exclusively relating to such Fund's participation in the Program during normal business hours or to designate an accountant to make such inspection.

12. **Assignability.** The parties hereto will not assign this Agreement without first obtaining the written consent of the other party; provided, however, the Lending Agent may assign all or a portion of this Agreement to Boston Safe Deposit and Trust Company or any other affiliate without the consent of the Client. This Agreement will be binding upon, and inure to the benefit of, the respective successors or permitted assigns of the Lending Agent and the Client. Notwithstanding the foregoing, it is hereby acknowledged and agreed that the Lending Agent may utilize the services of one or more of its affiliates including, without limitation, Boston Safe Deposit and Trust Company, as sub-agent, for the Funds, to perform all or any portion of the services to be provided by the Lending Agent pursuant hereto, provided, however, that the use of such sub-agent shall not limit the liability of the Lending Agent for the performance of its obligations hereunder and the Lending Agent shall be responsible for the acts and omissions of such sub-agent to the same extent as though such acts or omissions were (and such acts or omissions shall be deemed to be) the acts or omissions of the Lending Agent.

13. **Amendment and Termination.** This Agreement may not be amended or modified except by written agreement duly executed by or on behalf of the parties hereto. This Agreement may be terminated at any time at the option of the Client upon thirty (30) days prior written notice to the Lending Agent or at the option of the Lending Agent upon one hundred eighty (180) days prior written notice to the Client; provided, however, that the Lending Agent shall not be under any obligation to make securities loans if such loans are not in the best interest of the Client. In the event that this Agreement is terminated, the Lending Agent shall not make any further securities loans on behalf of the Client or any of the Funds after it has given or received, as the case may be, notice of such termination and shall promptly take all reasonable actions to terminate all securities loans then outstanding. The obligations and the rights of the Client, the Funds and the Lending Agent under this Agreement with respect to any outstanding loans shall survive and continue despite any termination of this Agreement until fully performed or satisfied.

13.1 **Term.** The term of this Agreement shall be for a period of two (2) years, commencing on November 2, _____, 1998, unless otherwise terminated pursuant to Section 13. This Agreement may be extended at the option of the Client for three (3) additional terms of one (1) year each.

13.2. **Opt-Out Mechanism and Amendment of Investment Policy and Guidelines.** The parties hereto acknowledge and shall give effect to the right of any Fund

to terminate its participation in the Program established hereunder. Each Fund may terminate its participation in the Program by furnishing at least thirty (30) days advance written notice to the Client and the Lending Agent. The parties hereto further understand and agree that each Fund may from time to time, in its sole discretion, amend the Securities Lending Investment Policy and Guidelines set forth in Exhibit D as said Policy and Guidelines relate to it. Such Fund-initiated amendments of said Policy and Guidelines shall be communicated in writing to the Client and the Lending Agent at least thirty (30) days prior to the intended effective date provided, however, that no such amendment shall be implemented unless approved by the Client and the Lending Agent within ten (10) days of receipt thereof. In the event the Lending Agent does not approve the implementation of an amendment to the Policy and Guidelines, the Lending Agent shall immediately notify the affected Fund and the Client of the nature of the impediment and shall fully cooperate with the affected Fund and the Client to implement an alternative acceptable to the affected Fund, the Client and the Lending Agent.

14. **Accounting for Cash Collateral Investment Vehicles.** While the vehicles maintained by the Lending Agent or its affiliate for the investment of cash collateral are currently accounted for based upon a \$1.00 net asset value per unit, there is no guarantee that such accounting treatment shall continue since the vehicles governing instruments permit a change to account for fund assets on a marked to market basis, or that even if a \$1.00 net asset value is utilized, that there will not be differences from time to time between \$1.00 and the underlying fair market value of the net assets attributable to such unit. The Lending Agent shall give prior notice to the Client and the Funds of changes in accounting treatment.

15. **Notices.** Any notice, request, demand or other communication in connection with this Agreement shall be deemed to have been given or made when received by the party to whom directed. All such notices and other communications shall be in writing unless otherwise provided herein and shall be directed, if to the Lending Agent to:

Mellon Bank, N.A.
Two Mellon Bank Center
Room 675
Pittsburgh Pennsylvania, 15259
Attention: Global Securities Lending Contract Administration Unit

and if to the Client to:

Robert J. Schwartz, Esq. and
Chief Counsel
Legal Bureau
Pennsylvania Treasury
Room 127, Finance Building
Harrisburg, Pennsylvania 17120

Robert E. Patterson
Chief Investment Officer
Investment Center
Pennsylvania Treasury
Room 126, Finance Building
Harrisburg, Pennsylvania 17120

with copies to:

John C. Lane
Chief Investment Officer
Public School Employees' Retirement System
5 North Fifth Street
Harrisburg, Pennsylvania 17101

Peter M. Gilbert
Chief Investment Officer
State Employees' Retirement System
30 North Third Street
Harrisburg, Pennsylvania 17108-1147

James B. Allen
Secretary
Pennsylvania Municipal Retirement Board
Suite 301 Eastgate Center
1010 North Seventh Street
Harrisburg, Pennsylvania 17102

or otherwise in accordance with the latest unrevoked written direction from any party to the other party hereto.

15.1 **Order of Precedence.** If any conflict or discrepancy should arise in the terms and conditions of this Authorization or in the interpretation thereof, the order of precedence for resolution shall be the following:

- (a) This Authorization, excluding the exhibits;
- (b) The Funds' Securities Lending Investment Policy and Guidelines (Exhibit D); and
- (c) The RFP (Exhibit A)
- (d) The Proposal;
- (e) The remaining exhibits to this Authorization.

16. **Conditions of Effectiveness.** The obligations of the Lending Agent under this Agreement are subject to the satisfaction of the conditions precedent that the Lending Agent shall have received written certification (i) written certification of the Client's authority to make and carry out this Agreement on behalf of itself and each of the Funds; (ii) written certification that all such action has been duly authorized by all necessary proceedings on its part; (iii) the resolutions adopted by the independent administrative

board of each Fund authorizing the Fund's participation in the Program; and (iv) the names, true signatures and incumbency of the officer or officers or other officials of the Client authorized to execute, deliver and perform this Agreement on behalf of the Client and each of the Funds, all in form and substance reasonably satisfactory to the Lending Agent. The Client represents and warrants that each of the Funds may legally enter into the securities loans contemplated by this Agreement, that it has the legal right to transfer the lendable securities in connection with such loans, and that such loans will create legal, valid and binding obligations enforceable against each such Fund in accordance with their terms.

16.1 Year 2000.

(a) Lending Agent agrees that each hardware, software, or firmware item purchased or leased by the Commonwealth from the Lending Agent shall be guaranteed under warranty to securely process date/time data (including but not limited to, calculating and sequencing) from, into, and between the twentieth and twenty-first centuries, and the years 1999 and 2000, including all leap year calculations. The Lending Agent represents that it is now and intends to remain throughout the term of this Agreement in compliance with the standards of the National Automated Clearing House Association.

(b) Lending Agent represents that Year 2000 transition issues are and will continued to be considered in providing services under this Agreement.

(c) Lending Agent represents and warrants that it will take all reasonable steps necessary to cause the proprietary Custody Management System and Institutional Accounting System utilized to provide services under this Agreement (collectively, the "Systems") to properly process date/time data from, into and between the 20th and 21st centuries including when used in combination with nonproprietary data, systems, software or other information technology, provided such nonproprietary data, systems, software or other information technology properly exchanges date/time data with the Systems.

(d) To the extent that any of the services provided by the Lending Agent under this Agreement are dependent upon information technology of a third-party (other than a depository, clearing agency or book-entry system), the Lending Agent will take all reasonable steps to utilize, where practicable, third parties whose information technology will properly process date/time data from, into and between the 20th and 21st centuries and properly exchange date/time data with the Systems.

(e) For violation of any of the above provisions, the Treasury may terminate this and any other agreement with the Lending Agent, claim liquidated damages in an amount equal to the value of anything received in breach of these provisions, claim damages for all expenses incurred in obtaining another Lending Agent to complete performance hereunder. These rights and remedies are cumulative, and the use or nonuse of any one shall not preclude the use of all or any other. These rights and

remedies are in addition to those the Commonwealth may have under law, statute, regulation or otherwise.

(f) The Lending Agent shall be responsible and remain liable under this warranty for the performance of services by subcontractors, other third parties, and assignees of the Lending Agent to the extent of Lending Agent's negligence or willful misconduct in the hiring or retention of such third party.

This warranty provision shall be in effect until the later of December 31, 2002 or the termination of this Agreement.

17. **Governing Law.** This Agreement shall be construed in accordance with, and governed by the laws of the Commonwealth of Pennsylvania, without giving effect to conflict of laws principles, and except insofar as the same are or may be preempted or superseded by applicable Federal law.

18. **Miscellaneous.** This Agreement supersedes any other agreement between the parties covering loans of securities by the Lending Agent on behalf of the Funds. The provisions of this Agreement are severable and the invalidity or unenforceability of any provision hereof shall not affect any other provision of this Agreement. No single or partial waiver of any right hereunder shall preclude any other or further exercise thereof, or the exercise of any other right hereunder.

19. **Lending Agent Integrity Provisions.**

(a) Definitions

(i) "confidential information" means information that is not public knowledge, or available to the public on request, disclosure of which would give an unfair, unethical, or illegal advantage to another desiring to contract with the Client.

(ii) "consent" means written permission signed by a duly authorized officer or employee of the Client, provided that where the material facts have been disclosed, in writing, by prequalification, bid, proposal, or contractual terms, the Client shall be deemed to have consented by virtue of execution of this Agreement.

(iii) "Lending Agent" means the individual or entity that has entered into this Agreement with the Client, including directors, officers, partners, managers, key employees, and owners of more than 5 percent interest.

(iv) "financial interest" means:

(1) ownership of more than 5 percent interest in any business; or

(2) holding a position as an officer, director, trustee, partner, employee, or

the like, or holding any position of management.

(v) "gratuity" means any payment of more than nominal monetary value in the form of cash, travel, entertainment, gifts, meals, lodging, loans, subscriptions, advances, deposits of money, services, employment or contracts of any kind.

(b) The Lending Agent shall maintain the highest standards of integrity in the performance of this Agreement and shall not take action in violation of state or federal laws, regulations, or other requirements that govern contracting with the Client.

(c) The Lending Agent shall not disclose to others any Confidential Information gained by virtue of this Agreement [except to the extent required by law, legal process, or regulatory authority having jurisdiction over the Lending Agent].

(d) The Lending Agent shall not, in connection with this or any other agreement with the Client, directly or indirectly, offer, confer, or agree to confer any pecuniary benefit on anyone as consideration of the decision, opinion, recommendation, vote, other exercise of discretion, or violation of a known legal duty any officer or employee of the Client.

(e) The Lending Agent shall not, in connection with this or any other agreement with the Client, directly or indirectly, offer, give, or agree or promise to give to anyone any gratuity for the benefit of or at the direction of request of any officer of employee of the Client.

(f) Except with the consent of the Client, neither the Lending Agent nor anyone in privity with him shall accept or agree to accept from, or give or agree to give to, any gratuity from any person in connection with the performance of work under this Agreement except as provided therein.

(g) Except with the consent of the Client, the Lending Agent shall not have a financial interest in any other Lending Agent, subcontractor, or supplier providing services, labor, or material on this project.

(h) The Lending Agent, upon being informed that any violation of these provisions has occurred or may occur, shall immediately notify the Client in writing.

(i) The Lending Agent, by execution of this Agreement and by the submission of any bills or invoices for payment pursuant thereto, certifies and represents that it has not violated any of these provisions.

(j) The Lending Agent shall, upon request of the Office of State Inspector General, reasonably and promptly make available to that office and its representatives, for inspection and copying, all business and financial records of the Lending Agent, of

concerning, and referring to this Agreement with the Client or which are otherwise relevant to the enforcement of these Lending Agent Integrity Provisions.

(k) For violation of any kind of the provisions of this Section 19, the Client may terminate this and any other agreement with the Lending Agent, claim liquidated damages in an amount equal to the value of anything received in breach of these provisions, or claim damages for all expenses incurred in obtaining another Lending Agent to complete performance hereunder. These rights and remedies are cumulative, and the use or nonuse of any one shall not preclude the use of all or any other. These rights and remedies are in addition to those the Client may have under law, statute, regulation or otherwise.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first set forth above.

Authorized Signer of:

**COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT**

By: Barbara Hafer

Name: Barbara Hafer
Title: Treasurer

Authorized Officer of:

MELLON BANK, N.A.

By: Stephen R. Crosby
Name: **STEPHEN R. CROSBY**
Title: **Senior Vice President**

Approved as to Form and Legality:

Robert J. Schwartz
Chief Counsel
Treasury Department

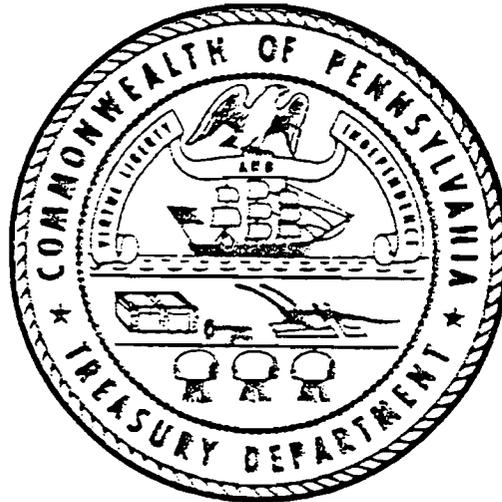
Office of Attorney General

David J. DeVries

REQUEST FOR PROPOSAL

for providing

**Domestic and Global Master Custody Services,
Safekeeping Services, and
Securities Lending Services**



**ISSUING OFFICE:
OFFICE OF STATE TREASURER
COMMONWEALTH OF PENNSYLVANIA
129 FINANCE BUILDING
HARRISBURG, PA 17120**

**BARBARA HAFER
State Treasurer**

PART I

GENERAL INFORMATION FOR CONTRACTORS

I-1 PURPOSE

This Request for Proposal ("RFP") is designed to provide interested contractors with sufficient information to enable them to prepare and submit proposals to provide (1) Master Custody Services for the Domestic and Global Portfolios of the Commonwealth of Pennsylvania (Commonwealth), (2) Safekeeping Services for physical assets held by the Treasury Department through its sub-custodian bank and (3) the Securities Lending Programs in accordance with the written policies of the Funds (identified section II-1, *infra*) that have delegated the investment authority for securities lending to the State Treasurer. This RFP addresses the contractor's ability to provide specific securities settlement and reporting safekeeping, corporate action, and lending functions in terms of service, performance, capacity, and capability.

I-2 ISSUING OFFICE

This RFP is issued for the Commonwealth by the Treasury Department. The Treasury Department is the sole point of contact for this RFP.

I-3 SCOPE

This RFP contains instructions governing the proposals to be submitted and the material to be included therein; a description of the services to be provided; requirements which must be met to be eligible for consideration; general evaluation criteria; and other requirements to be met by each potential contractor.

I-4 PROBLEM STATEMENT

The purpose of this RFP is to obtain the service or services of a custodian of assets and a securities lending agent for the period July 1, 1998 through June 30, 2003. The Agreement may be terminated at any time by the Treasurer upon 60 days prior written notice to the custodian and/or securities lending agent.

I-5 TYPE OF CONTRACT

The Treasurer expects to award a five year contract(s) to include any or all of the services described in Part II, "Custodial Requirements for the Commonwealth of Pennsylvania." Negotiations for all of these services may be undertaken with bidders whose proposals show them to be qualified, responsible and capable of performing the work; whose proposals provide the Commonwealth with services that best meet the needs of the Commonwealth and the funds; and whose bids are favorable relative to the proposals.

I-6 SIZE AND TECHNICAL COMPETENCE REQUIREMENTS

Firms bidding on this contract must meet the following criteria:

For custody services:

- At least \$100 billion in custody assets under management and \$200 billion of combined master trust and custody assets under management
- At least 10 years experience in the custody business (The experience of any subcontractor will not be considered for this qualification)

For securities lending:

- A lending pool of at least \$100 billion
- An average daily balance of outstanding loans of \$25 billion
- At least 10 years experience in securities lending. (The experience of any subcontractor will not be considered for this qualification)

I-7 WORK STATEMENT

Within this RFP, the Treasury Department provides a detailed description of the services to be performed. Estimated asset values, automation specifications, processing, and reporting requirements are provided. The expected levels of service and assistance the selected contractor is expected to provide are also overviewed. Respondents are advised that the Treasury Department seeks to receive proposals for services addressing the needs of domestic and global portfolios, and safekeeping services for physical securities and securities lending services.

I-8 DEFINITION OF PARTIES

The following is a brief definition of parties involved in the custody, safekeeping, and securities lending process:

- Contractor - party presenting a bid on this RFP;
- Treasurer - party requesting bids on this RFP. Treasurer is also the legal custodian of the assets of the Commonwealth of Pennsylvania;

- Treasury Department - department which assists the Treasurer in carrying out her duties;
- Funds - parties which have the exclusive control and management responsibilities for the assets contemplated for custody, safekeeping, and securities lending under this contract. A list of the Funds are included in Part II of this RFP;
- Portfolios - individual accounts assigned by the Funds to specific investment managers. Each Fund may have multiple investment managers.
- External Investment Manager - firm hired by a Fund to make certain investment decisions relative to a particular portfolio of a Fund.
- Fund Consultant - firm hired by the Fund(s) to provide investment consulting services.

I-9 REJECTION OF PROPOSALS

The Treasury Department reserves the right to reject any and all proposals received as a result of this RFP process, to negotiate separately with competing contractors, and to award a contract based on services other than those set forth in this RFP.

I-10 INCURRING COSTS

The Treasury Department is not liable for any costs incurred by contractors in the creation of a response to this RFP or incurred prior to the execution of a formal contract.

I-11 AMENDMENT TO THE RFP

If it becomes necessary to revise any part of this RFP, an amendment will be issued to all contractors who received the original RFP.

I-12 RESPONSE DATE

To be considered, proposals must arrive at the Issuing Office on or before the time and date specified in the cover letter. Contractors mailing proposals should allow sufficient mail delivery time to ensure timely receipt of their proposals. Any proposal not received in the Issuing Office prior to the time specified in the cover letter will be disqualified. Proposals received after the deadline will be returned unopened to the sender.

I-13 PROPOSALS

To be considered, contractors must submit a complete response to this RFP, using the format described in the following paragraph.

Each proposal must be submitted in one (1) bound original, fifteen (15) bound copies and one (1) unbound copy to the Treasury Department. No other distribution of proposals is to be initiated by the contractor. Proposals must be signed by an official authorized to bind the contractor to its provisions. For this RFP, the proposal must remain valid for at least one hundred eighty (180) days. Moreover, the contents of the proposal of the successful contractor will become contractual obligations if a contract is entered into. Failure to meet any material requirement of the RFP may result in disqualification.

I-14 FORMAT FOR REQUIRED INFORMATION

All proposals must be submitted using the following format. Final documents submitted to the Treasury Department must include eight (8) tabbed sections, as presented in Part IV to XI of this RFP. The divisions are intended to facilitate both the collection and review of information. Each of these sections should be addressed and responded to completely in the RFP, or the RFP will be deemed incomplete and not eligible for consideration. In addressing these sections, all proposals must address the firm's capabilities with regard to domestic and global portfolios and securities lending. Any supplemental information thought to be relevant, but not applicable to the enumerated categories, should be provided as an appendix to the proposal. If publications are supplied by the contractor to respond to one of the enumerated categories, the response should include reference to the document number and page numbers. This will provide a quick reference for the evaluators. Proposals not providing this reference will be considered to contain no reference materials for additional documents. To allow for timely review of proposals, please limit references of this nature to those most relevant.

Bidders are advised that the cost data to be provided under Part XI must be bound and sealed separately from the remainder of the proposal. Failure to comply with this requirement shall result in the disqualification of the proposal without further consideration.

I-15 ECONOMY OF PREPARATION

Proposals should be prepared simply and economically, providing a straightforward, concise description of the contractor's qualifications and ability to meet the requirements of this RFP.

I-16 PRESENTATIONS

Contractors who submit proposals must be prepared to make an oral and/or on-site (contractor's place of business) presentation of their capabilities and qualifications to perform as described in their written response to the RFP. Such presentations provide an opportunity for the contractors to clarify their proposals thus ensuring a thorough mutual understanding of the services to be provided to the Treasury Department and the Funds. The Treasury Department will schedule presentations as required.

I-17 PRIME CONTRACTOR RESPONSIBILITIES

The selected contractor will assume responsibility for all services offered in their proposal whether they provide such services themselves or utilize the services of a third party. The Treasury Department will accept proposals submitted by joint venture firms. In the event a joint venture proposal is selected, the Treasury Department will designate an individual contractor to be the sole point of contact with regard to contractual and service related matters. Any function that will be subcontracted must be identified in the proposal. The Treasury Department reserves the right to approve or reject any subcontractor. The selection of any subcontractor must be approved in writing by the Treasury Department.

I-18 DISCLOSURE OF PROPOSAL CONTENTS

Cost and price information disclosed in the proposals will be held in confidence and, except for the selected proposal, will not be revealed or discussed with competitors. All other materials submitted become the property of the Treasury Department and may be returned or reviewed and evaluated by any person, other than competitor bidders, at the discretion of the Treasury Department. The Treasury Department has the right to use any or all ideas presented in any response to the RFP. Selection or rejection of the proposal does not affect this right.

I-19 CONTRACT

The selected contractor will be expected to enter into negotiations with the Treasury Department which will result in a formal contract between the parties.

I-20 COMMONWEALTH PARTICIPATION

No Treasury Department personnel will be involved in providing the services requested. Robert J. Schwartz, Chief Counsel, or his designee, will act as liaison person. All inquiries should be referred to this individual in writing at the following address: Room 127, Finance Building, Harrisburg, PA 17120.

I-21 PREPROPOSAL CONFERENCE

The Department will hold a preproposal conference on the date and at the place specified in the cover letter. The purpose of the conference is to clarify any points in the RFP which may not have been clearly understood. Questions must be in writing and forwarded to the Treasury Department prior to the meeting to ensure that sufficient analysis can be made before an answer is supplied. All questions and all answers will be supplied to each prospective contractor in attendance; written questions and answers also will be submitted to all Contractors who receive the RFP. The Treasury Department reserves the

right to group similar questions from different contractors together providing only a single response. In view of the limited facilities available for the conference, it is requested that representations be limited to two (2) individuals per contractor. The preproposal conference is for information purposes only.

I-22 NEWS RELEASES

The Contractor will not make news releases pertaining to this project without the prior written approval of authorized Treasury Department personnel, and then only in coordination with the Treasury Department.

I-23 COMMITMENT TO ENHANCE SOCIALLY/ECONOMICALLY RESTRICTED BUSINESSES

The Commonwealth of Pennsylvania strongly encourages the submission of proposals by SERBs.

To achieve the objective of enhancing SERB participation, the Commonwealth has established SERB utilization as a selection criterion in the evaluation process.

The Bureau of Contract Administration and Business Development ("BCABD") in the Department of General Services will evaluate the aforementioned criterion and will assign a point value to be considered within the overall RFP total point tabulation.

Proposals submitted by individuals claiming SERB status or proposals submitted by individuals reflecting joint venture and subcontracting opportunities with SERBs must submit documentation verifying their claim.

SERBs are businesses whose economic growth and development has been restricted based on social and economic bias. Such businesses are BCABD-certified minority- and women-owned businesses and certain restricted businesses whose development has been impeded because their primary or headquarters facilities are physically located in areas designated by the Commonwealth as being enterprise zones. A businesses will not be considered socially/economically restricted if one of the following conditions exists:

1. The business has gross revenues exceeding \$4 million annually.
2. The concentration of an industry is such that more than 50 percent of the market is controlled by the same type of SERB (Minority Business Enterprise (MBE) or Women Business Enterprise (WBE)).

Proposers not considered to be socially/economically restricted businesses seeking to identify such businesses for joint venture and subcontracting opportunities are encouraged to contact:

Department of General Services
Bureau of Contract Administration and Business Development
Room 502, North Office Building
Harrisburg, PA 17125
Phone: (717) 787-7380
1-800-822-2903
FAX: (717) 787-7052

I-24 COMMONWEALTH CONTRACT PROVISIONS

All contractors must comply with the Commonwealth Contract Provisions as set forth in Appendix D to this RFP.

I-25 COMMONWEALTH HELD HARMLESS

All contractors shall be responsible for and shall agree to indemnify and hold harmless the Commonwealth from damages to property or injuries (including death) to any person(s) and any other losses, damages, expenses, claims, demands, suits and actions by any party against the Commonwealth in connection with the work performed by the contractor.

I-26 DEBRIEFING CONFERENCES

Contractors whose proposals are not selected will be notified of the name of the selected contractor and will be given the opportunity to be debriefed. The Treasury Department will schedule the time and location of the conferences.

PART II

**CUSTODIAL REQUIREMENTS
FOR THE
COMMONWEALTH OF PENNSYLVANIA**

II-1 OVERVIEW

Through this RFP, the Treasury Department represents three state and municipal pension funds and four agencies (collectively, the "Funds"), with assets totaling in excess of \$62 billion. The Funds are as follows:

- Public School Employees' Retirement System (PSERS)
- Pennsylvania Municipal Retirement System (PMRS)
- State Employees' Retirement System (SERS)
- State Workers Insurance Fund (SWIF)
- Worker's Compensation Security Fund (WCSF)
- State Lottery Fund (Lottery)
- Insurance Liquidations Fund (Liquidations)

The three retirement funds are qualified pension plans for state or municipal employees; PSERS' holdings, excluding the securities lending collateral pool, are valued at approximately \$39 billion, SERS at \$21 billion, and PMRS at \$800 million. The SWIF is valued at approximately \$1.4 billion and is administered by the State Worker's Compensation Board to receive premiums paid on worker's compensation insurance policies issued by the board to various subscribers. The WCSF is valued at approximately \$363 million and derives its revenue from annual assessments on insurance companies who insure, and those employers authorized to self-insure, employer liability for payment of Worker's Compensation under the Worker's Compensation Act. The Lottery Fund is valued at approximately \$17 million and is administered by the State Lottery Board and receives monies from the sale of lottery tickets for the payment of lottery prizes and other payments to benefit Pennsylvania senior citizens. The Insurance Liquidations Fund is valued at approximately \$85 million and is administered by the Insurance Department and is comprised of monies and assets due insolvent insurance carriers for the payment of such carriers' obligations to creditors and policyholders. The objective of each of these Funds is to meet their obligations through prudent and effective investments in high quality and well diversified domestic and global portfolios, emphasizing a long-term investment approach. In order to efficiently and effectively meet their objective, these Funds, including their investment managers, must have open communication channels with the selected contractor(s) for all daily custodial operational issues and all securities lending and corporate action issues.

The State Treasurer serves as custodian for all seven Funds, and pursuant to state law, is required to preaudit all proposed expenditures from

each of the Funds. Decisions affecting the investment guidelines, and use of investment managers for each Fund is administered separately under guidelines defined by the individual agency, including the selection, use and termination of investment managers.

Finally, the State Treasurer serves as custodian for physical and book-entry collateral held on behalf of sixteen (16) Commonwealth agencies, and thus desires safekeeping services for these assets. Such services are to include coupon clipping, receipt and delivery of securities, income collection and distribution, and registration services.

II-2 OPERATIONAL NEEDS OF THE TREASURY DEPARTMENT AND FUNDS

The size and volumes of transactions generated by each of the Funds fluctuates greatly. The core requirements of the Funds, i.e. settlement and clearing of securities trades, timely and accurate reporting, are similar, though there are differences from fund to fund in more specific needs, based on specifications set forth by the various agencies. The selected custodian must be able to settle all transactions in a diversified portfolio of domestic and global capital markets investments (equities, bonds, short-term money market securities, derivative instruments, private placements, venture capital, real estate, etc.) in a timely and efficient manner. (A profile of the domestic and global portfolios of PSERS and SERS is provided in Appendix B and a summary of domestic and global transactions, by asset class, for PSERS and SERS is provided in Appendix C.) The designated custodian must be able to collect income and process proxies, registrations, class actions, bankruptcies and other corporate actions. In addition, the designated custodian must have the ability to maintain automated (on-line) real-time communications with each of the individual funds, their managers and the Treasury Department separately, and have the ability to provide consolidated and customized reports. The designated custodian should have the systems and organization in place to handle unusual requests as they occur and provide monthly reconciliation of investment managers.

From a potential custodian's point of view, there are a number of additional factors to the operation of the Funds which should be taken into consideration when responding to the RFP.

Preaudit Function - The State Treasurer, in addition to acting as custodian for the seven Funds, is required, under state law, to preaudit all requested disbursements from the State Treasury. Through this process, the Treasury Department must review and approve all trades prior to settlement. All domestic trades are processed and settled on an automated, on-line securities processing system. The successful contractor must be capable of establishing an automated, on-line compliance system which will screen all trades using rules described more completely in Appendix A. The compliance system must include the ability to perform the required preaudit functions for securities issued and/or

traded in foreign capital markets, including those markets settling on a same-day basis, as well as for foreign exchange transactions. An outline of the Treasury Department's audit requirements is provided as Appendix A.

Depository Trust Company - Domestic book-entry securities held in custody by the Treasury Department through its current subcustodian bank are currently registered with the Depository Trust Company. In responding to the questions in Part VI, and in your opening statement, please describe whether your organization would have the ability, i.e. on-line communication, and willingness to assume this relationship. If your organization cannot assume this relationship, please explain the reason and your proposed alternative.

Global Custody - The Treasury Department requires the services of a global custodian capable of providing a complete range of products. Specifically, the Treasury Department seeks the services of a contractor capable of providing timely and accurate settlement of transactions in all time zones and settlement cycles, complete multicurrency accounting and reporting, analysis and tracking of foreign tax reclaims, execution of foreign exchange transactions, notification and monitoring of capital changes and corporate actions, on-line, real-time access to accurate, complete multi-currency accounting and reporting data which also allows a single-access method of retrieving information on global and domestic portfolios. In responding to Parts IV through XI of this RFP, bidders must provide responses which address the Funds' domestic and global portfolios.

Automation - The Treasury Department maintains an automated securities settlement function. Accordingly, the successful contractor must be able to meet the Treasury Department's need for an automated securities processing function and compliance system. Included in the successful contractor's automated capabilities should be the ability to receive confirms and to affirm trades settling through the DTC-ID System, reconciliation of confirms and affirmations, and the ability to transmit trade instructions on non-DTC eligible securities, including trades settling in foreign capital markets. Updated status reports of outstanding trades, information on pricing/valuation of holdings, and daily/monthly valuation of portfolios will also be required.

Discussed below are the hardware and systems currently used by the Treasury Department and the Funds. If these systems are not adequate in permitting the effective and efficient use of your on-line systems, please identify current hardware and software needed to allow the effective and efficient use of your on-line systems.

The Treasury Department is connected to the current custodian via a 56 KBPS digital line multiplexed from the custodian's data center to the Treasury Department's data center. A 19.2 segment supports the NJE/SNI file transfer and on-line functions connected to the Treasury Department's host. A 9.6 segment is extended from the Treasury Department's data center to the data centers of the three retirement systems. The Treasury Department's mainframe

hardware configuration consists of an IBM ES/9000, Model 210 CPU, and an IBM 3380, Models J and K DASD. The Treasury Department utilizes an STK 3420 reel magnetic tape drive, a Xerox 9790 printer, an IBM 3720 communications controller, as well as an IBM 3137 11L communications controller with 16 MB token ring gateway. Finally, the Treasury Department's mainframe terminals consist of IBM 3179 and 3192. The Treasury Department utilizes the following software to support its mainframe applications associated with its custody functions: VSE/ESA, VM/ESA, POWER, CICS, SQL/DS, VSAM, RSCS, VTAM, NCP, OFFICEVISION, and QMF. The Treasury Department also utilizes a 16 MB token ring local area network (LAN) configuration with IBM compatible 386/486 PCs, with HP and IBM 4019 printers. The LAN is supported by DOS, Windows, and OS/2 LAN server Software.

The State Employees' Retirement System currently has approximately 30 workstations accessing the present custodian. Each desktop is equipped with a Pentium based PC with a minimum of 16 MB of RAM and an 800 MB disk drive. All PCs are connected to a 10BaseT LAN (currently running Novell Netware 3.12). The PCs are all using Windows 95 as the operating system, and Microsoft Office 95 Professional (Word 7.0, Excel 7.0, Access 7.0) as productivity tools. These workstations access the custodian using TCP/IP protocol via a router located at the State Treasury. The software utilized is Global Quest which is provided by the current custodian.

The Public School Employees' Retirement System currently has 40 workstations accessed to the present custodian, and projects the expansion of an additional 5 workstations. Each desktop is equipped with a 486DXR or Pentium PC with a minimum of 16 MB of RAM and a hard drive of at least 600 MB. The computers are connected on an Ethernet (UTP) LAN. The current network operating system on the desktop is a combination of Windows for Workgroups and Windows 95 from Microsoft Corp. These desktops access a file server running Windows NT Server 3.51. The networking protocol is TCP/IP. PSERS utilizes Windows, Lotus 1-2-3, Excel, and Word software (standard spreadsheet or ASCII format).

Investment Managers - In addition to investment decisions made in-house by employees of the Funds, each fund maintains the services of external portfolio managers to more fully diversify and strengthen the underlying investment base. Thus, the successful contractor must be capable of providing an on-line communications link between itself, the Funds, the investment managers, Fund consultants, and the Treasury Department. In addition, the successful contractor must be capable of interfacing and reporting with managers in all time zones.

Securities Lending -The scope of the securities lending activities involving each Fund shall be determined by the Board or governing body of each Fund. The securities lending program is designed to generate incremental income from lending securities (both domestic and global equities and fixed income instruments) to qualified borrowers that provide collateral in exchange

for the right to use the securities. The Treasury Department and the Funds are seeking a full-service contractor who can provide full time zone coverage and the appropriate short-term investment vehicles in local markets to accommodate the investment of local currency collateral. The investing of this collateral will follow the investment guidelines developed by the Funds and the Treasury Department with the principal objectives being liquidity and the preservation of capital. The Securities Lending Guidelines, Objectives, and Monitoring Policies are included in Appendix E.

Corporate Actions - The State Treasurer facilitates various "corporate actions" arising from the Funds' ownership of securities (i.e. performing functions that relate to proxy voting, registrations, shareholder derivative actions and other litigation, regulatory agency enforcement actions, bankruptcies, stock splits, dividends, etc.). Foremost among the areas that should be addressed is developing a means of open communications with all parties on all daily operational issues, including corporate action matters, voting proxies, and filing class action claims on behalf of the Funds.

Communications on Corporate Actions - The Treasury Department does not currently possess the technological capability to provide an on-line mechanism to provide notifications and status reports on corporate actions of the Funds or their agents. The successful bidder should be capable of providing the Treasury Department and the participating Funds or their agents with an on-line capability to receive notices, action alerts, and status reports on all corporate actions. In addition, the successful contractor must offer a means of actually performing corporate actions on behalf of the individual Funds (three of which are detailed more fully below).

Proxy Voting - The current subcustodian performs the proxy voting function for domestic and international portfolios of the Funds by contracting with Institutional Shareholder Services (ISS). The current subcustodian has established on-line communications with ISS for the purpose of reporting information relating to the portfolio stock holdings.

The successful bidder should propose a means of performing the proxy voting function in an efficacious but cost-effective manner.

Class Action Claims - Bidders should propose a means of monitoring all class action cases that are filed or pending, determining whether the individual Funds are eligible class members, and obtaining, filing, and administering class action claims and recoveries. When necessary, the subcustodian will be expected to communicate with the predecessor subcustodians to obtain data on periods during which stock was held and other information relevant to claim filings. The proposal should also include the production of routine reports to the Funds that show newly

filed claims, the status of pending claims, and the amounts recovered in cases that have settled.

Bankruptcy Claims - Bidders should propose a comprehensive means of handling bankruptcy claims on behalf of the individual Funds.

Physical Securities - In addition to book-entry securities, the Treasury Department is responsible for the custody of physical securities, including mortgages and non-negotiable instruments. These assets are currently held in the safekeeping of the current custodian bank. The successful contractor will be required to transfer all such instruments to its safekeeping facilities, (or to transfer the same or portions thereof to the Treasury Department), ensuring that all such assets are fully accounted for and that a computerized inventory of such assets is maintained during the term of its contract. Unit pricing for the custody of physical securities or another reasonable means of allocating the cost of safekeeping physical securities to specific Funds is necessary in the event the Treasury Department assumes the responsibility of providing such services instead of the successful contractor. In addition, the successful contractor will be required to provide the same levels of service for physical securities, as applicable, as provided for book-entry securities. Finally, the successful bidder must be willing to produce a complete written inventory monthly to the Treasury Department and the applicable Funds.

Safekeeping Services - In addition to maintaining custody of the Funds' assets, the Treasury Department is required to provide safekeeping services for assets held as collateral for sixteen (16) individual Commonwealth agencies. The successful contractor will be required to provide safekeeping services for these assets. Specifically, the successful contractor will be required to provide safekeeping facilities, establish separate accounts for each individual agency, provide coupon clipping services for bearer bonds, receive and deliver assets, collect income (including dividends, interest and principal payments), provide income collection, distribution, and reorganization services for assets held at a central depository, and provide full records of all account activity.

Cash Requirements - The following are a variety of the cash requirements of the Funds and the Treasury Department:

1. **Aggregation of Currencies** - the contractor must be able to aggregate currencies from the various portfolios of the each of the Funds in determining if the Fund has an overdraft position for each currency;
2. **Line of Credit** - the contractor must be able to provide, through its parent bank, a line of credit to each of the Funds. The line of credit will be secured by the assets of the Funds;
3. **Next Day Cash Settlement** - the contractor must be able to provide next day cash settlements.

Other Services - In addition to the above mentioned services, the Treasury Department requires that the successful contractor provide tax

withholding and filing services on behalf of the Lottery Fund for payouts of lottery winnings.

Indemnification - For all services contemplated under the terms of this RFP, the Treasury Department will require the successful contractor, and its subcontractors, to agree to the following contractual language:

Contractor hereby indemnifies and agrees to defend, hold and save harmless the Commonwealth of Pennsylvania, the State Treasurer, the Treasury Department and its employees, the Funds and their Board of Trustees and employees from any and all claims, suits, actions, liabilities, and costs of any kind whatsoever resulting from contractor's negligence or intentional misconduct in the administration of this Agreement.

In the contractor's cover letter to the Treasurer, the contractor must acknowledge that they have read and understand the indemnification language specified above and are willing to abide by such language. Failure to acknowledge this will disqualify the contractor from any further consideration for the services requested.

Expected Sequence of Events

| | |
|---|-----------------------------|
| Issue RFP | January 9, 1998 |
| Deadline for Written Questions | January 22, 1998 |
| Responses to Written Questions | February 2, 1998 |
| Proposals Due | February 13, 1998 |
| Evaluation of Proposals | February 16 - March 6, 1998 |
| Site Visits as Necessary | March, 9 - March 13, 1998 |
| Selection of Custodian | March 20, 1998 |
| Contract Negotiation | March 23- April 17, 1998 |
| Conversion Begins | April 20, 1998 |
| Conversion Complete, Contract Begins | July 1, 1998 |

PART III

CRITERIA FOR SELECTION

III-1 PROPOSAL EVALUATION

The Treasurer will appoint an RFP Committee to review the proposals. The RFP Committee will begin review of proposals as soon as practical after receipt. This Committee will be responsible for reviewing and evaluating all contractor proposals for an understanding of the services required, qualifications of the contractor, qualifications of personnel, soundness of approach, SERB participation, and fees.

This RFP Committee will first select two or three finalists, who at the discretion of the RFP Committee might be required to make presentations as described in Part I, Section I-12.

III-2 SELECTION CRITERIA

The following areas of consideration will be used in making the selection:

- A. Contractor's Understanding of Treasury's and Funds' Needs. The RFP Committee will assess each contractor's understanding of its short (immediate) and long term needs. The contractor's grasp of these needs and their approach to satisfying them are critically important to the selection process. Additionally, the contractor's willingness to provide informal consulting with respect to examining the effectiveness of the Treasury Department's and the Funds' internal operations in achieving the efficient settlement of securities transactions is equally important.
- B. Contractors Qualifications. The contractor's commitment to the operational services, and the expertise of their personnel are as important as the contractor's ability to provide the services. The RFP Committee will also heavily weigh the contractor's quality, both in terms of services and personnel, their technological commitment, their experience, and the comments from the references which must be provided. Personnel will be evaluated by the qualifications identified in the bidder's proposal of the proposed client service team.
- C. Soundness of Approach. Emphasis will be placed by the selection committee on the contractor's detailed descriptions and techniques in addressing the custody needs of the Treasury Department and the Funds. The RFP Committee will also consider the completeness of the proposal vis-à-vis the goals and objectives of the Treasury Department and the Funds.

- D. Available Facilities. Emphasis by the committee with respect to the physical facility where processing takes place will include the location, the technology, the appearance and the security maintained at the facility. The contractor should be prepared to present disaster recovery procedures in place or planned, as well as to discuss back-up procedures and/or facilities. Accuracy and automation are extremely important issues for the Treasury Department and the Funds and will be weighed heavily in the decision process.
- E. Security. The Treasury Department and the Funds are also extremely concerned with the security and confidentiality of all transactional information. Therefore, each contractor should be cognizant of this need and address security issues throughout their response, in terms of types of transmission security, reporting security, and transactional confidentiality employed within the various operating systems.
- F. Cost. While cost is always an important issue for any governmental body, it will not be a deciding factor by itself. The lowest bidder will not necessarily be awarded the business, if in the eyes of the RFP Committee, another contractor can better meet the overall goals and objectives of the Treasury Department and the Funds.
- G. SERB Participation. Credit for SERB participation will be awarded according to the following:
1. Proposals submitted by BCABD-approved SERBs.
 2. Commitments by vendors not considered to be SERBs which significantly utilize approved SERBs in joint ventures.
 3. Commitments by vendors not considered to be SERBs which aggressively pursue the use of approved SERBs in subcontracting opportunities.

PART IV

ORGANIZATION

IV-1 GENERAL

- a) Give a brief history of your firm including the year organized, ownerships, affiliate companies, and relationships. How long have you provided custodian services?
- b) Provide the following indicators of financial stability:
 - 1) Audited financial statements for the past three (3) years.
 - 2) Any special audit reports regarding settlements, cash management, income collection, securities lending, internal control, etc. for the past three (3) years.
 - 3) Financial ratios for the past three (3) years:
 - Primary capital to Total Assets, Tier I and Tier II
 - Non-performing Loans to Total Loans
 - Net Operating Income to Average Total Assets
 - 4) Audit Reports on Internal Controls for 1995 and 1996 and 1997, if available prepared in accordance with SAS 70.
- c) Is your financial institution currently involved in any type of merger/acquisition/restructure activity? If so, describe how the outcome will impact your custody and securities lending services. A number of major custody banks have exited the securities processing and custody business over the last few years. Describe your organization's commitment to this business
- d) Please discuss in detail any lawsuits against your firm or its principal/owners/officers in the last five years which relate specifically to the services the Treasurer is requesting.
- e) List the major business units of the firm (including master trust/custody and global custody) and the percentage of total annual revenue and profits generated by each unit.
- f) Provide a complete organizational chart which identifies the operating and reporting relationships of master trust/custody and global custody services within the bank, as well as its relationship with the rest of the bank. Indicate changes, if any, projected to be made in the organizational structure to implement custodian work for the Commonwealth.

- g) Provide a description of the development of your master trust/custody and global custody services, including dates of both implementation of key elements, and enhancements to the service.
- h) Provide a description of the physical locations where your master trust/custody and global custody services are performed, including where physical securities are held.
- i) Give a brief synopsis of your firm's business plan for the master trust/custody and global custody services including proposed spending and staffing levels.
- j) What percentage of the firm's total product development budget is currently earmarked for the master trust/custody and global custody area? How many people are currently assigned to the product development group? In addition, please provide data on your firm's product development budget for the master trust/custody and global custody area for the past three (3) years as compared to actual expenditures for those three years.
- k) What support does senior management provide in the search for improvement in master trust/custody and global custody?
- l) Please submit a copy of your standard master trust/custody and global custody agreements and highlight any specific indemnification clauses. Discuss your willingness to agree to the indemnification provision set forth in Part II-2.
- m) List all insurance coverages relevant to the department handling master trust functions. Please indicate the type and amount. What is and is not covered? Which insurer(s) provide coverage? What is(are) the insurance carrier(s) rating(s)? Also, please indicate your willingness to add the Treasurer as a loss-payee on the fidelity bond(s).
- n) If the custodian plans to use external consultants or subcontractors, the custodian shall provide a staff organization and resumes of the consultants or subcontractors. The Custodian shall also provide its contingency plan(s) in the event of a break in services provided by the consultants and/or subcontractors. Treasury and the Funds reserve the right to disapprove any subcontractors. In any contract resulting from this RFP, the custodian shall assume all responsibility for all services performed and shall specifically assume all liability for any and all such services provided by subcontractors selected by the custodian. Please indicate your understanding of this requirement in your response.

- o) Please discuss opportunities which your institution offers to clients for training and continuing education.

IV-2 ADMINISTRATION

- a) Provide a description of personnel and resources dedicated to master trust/custody and global custody services. Provide a biographical sketch of key officers in the master trust/custody and global custody area, particularly those who would be responsible to the Treasury Department and each Fund's liaison(s).
- b) What approach to account administration is used (i.e. account teams, account manager with support group) in your organization? What is the average, and the maximum number of accounts per administrator or account team, and how is each client assignment made?
- c) Provide a description of major functions that are to be performed by the account administrator responsible for this account. Identify and describe the staff or functional group which supports the administrator in providing service to the client, as well as identifying back-ups for the relationship.
- d) Describe the experience of each of the individuals on the client service team. Describe other accounts that this administrator will be servicing. In addition, please describe the experience levels, including qualifications, for staff accountants and their managers.
- e) Describe the methods you use to measure the performance of your professional staff. Provide a copy of any bank-sponsored training programs required for bank personnel.
- f) Comment on the personnel turnover your organization has experienced in the master trust/custody and global custody area over the past three years. Please differentiate between individuals leaving the firm and those moving to other departments within the firm.
- g) How do you monitor legislative and/or regulatory changes affecting master trust/custody and global custody administration? How are these changes communicated to clients?
- h) How do you monitor class actions, shareholder derivative actions, other litigation, and regulatory enforcement actions affecting securities comprising Fund portfolios?

- i) Describe any ongoing educational sessions, user conferences, publications or other means you have for keeping clients fully educated and for providing a forum for new ideas and needs.
- j) How do you monitor customer satisfaction? Do you provide your clients with the ability to participate in the annual evaluations of their support group, as well as overall product performance?
- k) Discuss the manner in which your senior management would respond to Treasury and the Fund's requests and communications regarding both routine and exceptional custodian matters.
- l) Please provide a copy of your problem identification and resolution standards.

IV-3 INVESTMENT MANAGER RELATIONS

- a) Describe how your organization interacts with investment managers. Describe how you interface with and provide reporting to investment managers in their time zones.
- b) Explain your procedures for notifying investment managers of trades and cash balances, including negative foreign cash balances.
- c) Estimate typical daily transaction volume, i.e. security purchases and sales. In addition, estimate the daily transaction volume by type of transaction.
- d) How do you monitor investment manager satisfaction? Please describe your problem resolution process.
- e) How do managers communicate trade data? Do you use the DTC trade affirmation system? Do you have an automated system such as download of trades from manager's PC?
- f) Please describe your procedures for reconciling the investment activities and positions with investment managers and communicating with the Treasury Department and applicable Fund. How and when is the reconciliation accomplished? If a client or the general consultant reports a discrepancy between your value and the manager's, what steps would you take to reconcile the differences. Include a copy of your written policies/standards. How long is the reconciliation process?
- g) Discuss your ability to establish a management reporting and compliance system linking the Funds, their managers, the Treasury Department, and custodians in order to allow the Treasury

Department to perform its required preaudit of all proposed transactions, in all time zones and settlement cycles.

- h) Do you conduct surveys of investment management satisfaction. If so, please provide a summary of your recent survey.
- i) What procedures are used to assure accurate trade information is entered into the system? How is trade information matched between manager and broker. What is the error rate?

IV-4 CLIENT INFORMATION

- a) List the name and total asset value of your state level public fund custody clients, and the length of time each relationship has been with your organization. Indicate also what percentage of your total master trust/custody and global custody revenue is generated from these clients.
- b) State the total number of custody clients, the total number of master trust/custody and global custody clients and the total amount of assets for these clients. Please show the number of these accounts with assets under \$1 billion, \$1-10 billion, \$10-25 billion, \$25-50 billion, and over \$50 billion. In addition, for each client indicate the volume of transactions as well as the composition of their portfolios by asset class.
- c) List the total number of accounts lost and won during the past five years and provide the reasons for the account loss(es). Provide the organization, contact name and title, phone numbers and addresses. Include information as to the size of the account, length of relationship and type of service provided.
- d) Provide the organization, contact name and title, phone numbers and addresses of five (5) existing clients similar to the proposed Commonwealth account whom we may contact for references. Include information as to the size of the account, length of relationship and type of service provided.
- e) Provide a list of all transitions and conversions completed by the bank during the past three (3) years. Indicate the size of these conversions and the length of time required to complete. Include contact name and title, phone numbers and addresses.

PART V

ACCOUNTING, REPORTING, AND AUDITING

V-1 ACCOUNTING

- a) Provide a complete description of your accounting system, including, but not limited to:
- Processing cycles (cut-offs, etc.)
 - Reconciliation reports and audit processes
 - Interfaces with securities movement system and performance/ analytics system
 - cash settlement
- b) How flexible is your accounting system? How long does it take to adjust the accounting system to accommodate new investment vehicles? Does your system accommodate financial futures and options, index options, etc.? If so, explain how.
- c) Does your system provide multiple currency accounting? Please provide a sample report; can it be customized?
- d) Currently, we maintain a logical numbering sequence for accounts based on asset class designations. Can your accounting system accommodate this requirement? Describe internal procedures to establish a new account and link it with cash and accounting reports, including time frames.
- e) Does your system report or accommodate trade date, contractual settlement date, cash basis accounting or a combination? Please explain.
- f) What is the lag time between trade execution, the posting of the transaction to your accounting system and availability of on-line transaction data to the client? Are you able to account for all securities held in custody, including those held by a subcustodian, on a contemporaneous basis?
- g) Explain the methodology and policies in place for accrual accounting. What transactions are not accrued?

- h) Please describe your system to forecast, reconcile, monitor, and report interest and dividend income, received vs. expected/earned? Please provide a sample report. Do you track late collections of income? Can you produce a tracking report detailing outstanding claims? Do you notify clients of failures to collect or late collections of income?
- i) Describe the custodian's method of handling fails and fail float. Describe how short-term investment of funds pending settlement will be handled.
- j) How do you account for and report amortizations? List available methods.
- k) Do you have the capacity to report brokerage commissions by broker, account and by transaction? Do you have the capacity to provide specialized brokerage commission reports (i.e. commissions paid to minority brokers, soft dollars commissions), including reports involving secondary brokers?
- l) What methods do you employ to record inventory of book value on security holdings? (e.g. FIFO, LIFO, average cost)
- m) Discuss how corrections and reversals are processed. In addition, discuss how reversals in the same month are processed and reported.
- n) Discuss how investment transactions (cash and noncash) are recorded for the special investment classifications such as real estate, venture capital, and private equities. Cash transactions would include allocations/purchases and distributions/sales/income. Noncash transactions would include stock distributions, undistributed income, etc.
- o) Discuss how you and your subcustodians calculate and monitor foreign tax reclaims. Discuss your and your subcustodians' procedures for monitoring and updating databases of international trade and tax treaties to ensure that changes will be reflected in the processing of tax reclaims. Discuss your willingness to provide these services on behalf of individual Funds if requested.

V-2 REPORTING

- a) List and discuss the purpose, frequency, timing, accuracy, auditing, and receipt of each report provided under your basic master trust/custody and global custody services. Include examples of these reports. In addition, please indicate which reports are available on-line and if the ability to customize is available.

- b) Provide a complete description and copies of all other reports available to clients. Please indicate which of these reports are standard and which are customized, including time frames required to develop, test, and deliver customized reporting. In addition, please indicate which of these reports are available on-line.
- c) How many days after the end of the reporting period do you make available:
- monthly transaction statements?
 - monthly portfolio accountings?
 - monthly plan accountings?

Are these reports available on-line, and how soon after the end of the reporting period are they available on-line?

- d) What steps are taken to ensure the accuracy of your reports? Are reports audited before they are made available to clients? If so, by whom? Provide a copy of your reporting standards.
- e) Which reports are not fully automated? Do you plan to automate them? If so, when?
- f) Please indicate your present methods of report communication.
- g) Discuss the types of exception reports generated regularly. Explain procedures in resolution of exceptions.
- h) Discuss the reconciliation procedures among you and your subcustodian banks (for international trades) for accurate reporting.
- i) Discuss your policies and procedures in addressing identified and communicated issues/errors, including the time line.
- j) Discuss the methods used for the valuation of special investments such as real estate, venture capital and private equities. How frequently are the valuations updated?
- k) Discuss how domestic and international transactions which do not meet trading deadlines are accounted for and reported.
- l) Discuss your ability to produce monthly composite reports for selected sub-asset classes as well as individual asset classes.
- m) Discuss your ability to provide both calendar and fiscal year period reporting.

n) Discuss your ability to:

- Design and provide special reports on a "one time" or "re-occurring" basis.
- Back load data. How long is data kept on line? How accessible is it at a later date?
- Re-create a portfolio at a given point in time.
- Provide an integrated, single-access method for viewing and manipulating data on domestic and global portfolios.

In addition, discuss the development time to perform such functions.

- o) Discuss your ability to provide on-line access to security history information. How long will the security history information be available on-line? Are you prepared to generate and update for each Fund a monthly inventory of its securities together with a data image of pertinent trade confirmations, such inventory to be produced and delivered to Treasury and each Fund on CD-ROM or other reasonable format or media as may be specifically directed by a Fund? Discuss your ability to accept security history information from the current custodian.
- p) Discuss your ability to provide tax withholding, reporting and filing services on behalf of the Lottery Fund for payouts of lottery winnings.
- q) Discuss your ability to extract database files and disseminate (via magnetic tape, floppy disk, or other electronic medium as required) to the Funds and their agents for the purpose of performing reconciliation functions and performance measurement analytics. In addition, discuss your willingness and ability to accept a transmission of information to your database.
- r) Discuss your ability to provide, at a minimum, daily on-line downloadable reports which will enable Treasury and the Funds to reconcile daily transactions, cash balances, asset listing and cash projections in a format usable by Treasury and the Funds. The custodian will also provide daily on-line information to the Treasury and the Funds for pending transactions, failed transactions, corporate actions, and current market values. Please include examples of the daily reports available to provide this information and indicate if the reports are batch oriented or on-line, real-time.
- s) Can valuations be prepared on an ad hoc basis (mid-month)? How long would it take to prepare these valuations? Would these include accruals and other accounting adjustments?

- t) Do you have systems available which can group data in such a way which would assist the Funds in evaluating the investment manager's adherence to portfolio guidelines. (For example, can the system group by country, sector, maturity, etc.) Do you have the capability to monitor investment managers' derivatives exposure? Please describe the system capabilities.
- u) Discuss your ability to provide the following special/custom reports in the following formats:
- Annual Portfolio Holdings (disk and hard copy)
 - Annual and Semi-annual Investment Portfolio (disk and hard copy)
 - Monthly Option Buyback Report (hard copy)
 - Monthly Transaction Reversals (hard copy)
 - Monthly Listing of Fixed Income Securities (disk)
 - Monthly Listing of Equities (disk)
 - Monthly Listing of AMEX, NYSE, and NASDAQ OTC-Traded Foreign Securities (disk)
 - Monthly income receipts and disbursements report by manager and a composite report at the Fund level
 - Quarterly and Monthly Listing of Equities as Percentage of Outstanding Shares (disk and hard copy)
 - Monthly Listing of All Common Stock Holdings by Asset and Relevant Percentages (disk)
 - Monthly Listing of All Securities that Trade on the NASDAQ OTC Exchange (disk)
 - Monthly Listing of all Equities that Percentage of Outstanding Shares Exceeds 1% (disk)
 - Monthly Listing of All Settlement Transactions (disk)
 - Monthly Listing of Fixed Income Securities Held as Percentage of Par Value Outstanding (disk and hard copy)
 - Monthly Schedule of Common Stocks (alphabetically) (includes cost and market value of individual stocks as percentage of all common stocks and as percentage of total fund) (hard copy)
 - Monthly Brokerage Commission Reports (Equity) (includes MTD and YTD commissions paid and commissions per share by broker, manager and broker within manager) (hard copy)
 - Monthly Brokerage Commission Reports (Fixed Income) (same as equity except par value and principal amounts reported instead of commissions) (hard copy)
 - Monthly Brokerage Commission Detail Report (transactions with totals by manager within broker) (hard copy)
 - Daily transaction report - cash and non-cash activity (hard copy and access database)

- Daily cash forecasting reports for the day, next five days, and next ten days
- Daily on-line report of investment purchases and sales for the next business day.

V-3 AUDITING

- a) If selected to be custodian, you will be required to have our selected third party auditor audit the conversion for completeness and accuracy. Please acknowledge your willingness to abide by this requirement.
- b) Auditing personnel from the Treasury, the Funds, and external auditors (State and independent) are to be allowed access to relevant safekeeping areas, trust processing area, and to all data relating to the Treasury and the Funds' accounts. This includes access and review of the custodian's standard internal audit programs, work papers and reports to management specifically as they relate to the Treasury and the Funds' account. Please acknowledge your willingness to abide by this requirement.
- c) Upon a change in custodian, or at least once during the contract period, Treasury may request the Custodian's Internal Audit Department to verify the following, and report exceptions to Treasury and the Funds for follow up:
 - 1. Portfolio positions for cash, cash equivalents and securities;
 - 2. Any income items listed on the outstanding receivable report;
 - 3. All reconciliations of transferred securities and cash;
 - 4. All reconciling items between the custodian and depository agents;
 - 5. Any open trades and any corporate action items for one month prior and one month following the conversion date;
 - 6. Month end pricing/valuation accuracy of the portfolio; and
 - 7. Status of all tax reclaim filings

Upon completion of the work, a report of findings will be issued to the Treasury and the Chief Financial Officers and the Director of Internal Audit of the Funds.

PART VI

CUSTODY AND SETTLEMENT

VI-1 SAFEKEEPING AND SETTLEMENT

- a) Discuss your settlement procedures in domestic and foreign markets. Discuss your willingness and ability to provide a means to permit the Treasury Department, in accordance with the requirements outlined in Appendix A, to electronically review and approve/disapprove all transactions (including, but not limited to domestic/global, futures, options, foreign exchange) prior to settlement through an electronic compliance system.
- b) A majority of the domestic depository eligible assets of the Commonwealth are currently held within DTC. Please describe any existing or proposed links you have with DTC. If you are not a member of DTC, discuss your willingness and ability to become a member of DTC.
- c) Are you a member of the Depository Trust Company (DTC)? To which other domestic and global depository systems do you belong and what services do you use at these depositories? In addition, in which depositories are you an indirect participant through any subcustodian participation? Describe your procedures for settlement and registration.
- d) Identify in which markets you utilize your own safekeeping facilities. Identify in which markets you utilize the services of a subcustodian, and identify such subcustodians.
- e) Describe the procedures/criteria you use to select subcustodians. Do you require such subcustodians to comply with SEC and ERISA requirements?
- f) Discuss your ability to establish a separate account, in the name of the Commonwealth, at depositories to hold assets of the Commonwealth. The custodian will be required to obtain a nominee name to be reserved for the assets of Treasury and each of the Funds, and all marketable securities that are to be held in this nominee name unless the Treasury or the Funds instructs the custodian otherwise.

- g) Describe your procedures for handling depository ineligible securities and describe any necessary involvement of second party banks in the clearing of such transactions. Describe your use of other clearing services.
- h) What percentage of eligible GNMA securities are held in book-entry form? What are your plans for depositing eligible securities?
- i) Please describe collection and crediting procedures for interest and principal paydowns for all mortgage backed and pass-through securities.
- j) Describe, in detail, your buy/sell fail procedures.
- k) Describe what support you provide in the analysis, reporting and follow up of fails.
- l) Describe the physical security and security systems of your vault and custody areas. Would you provide lists of what is being held on a regular basis (i.e., monthly)? How would you handle settlements for securities which would be delivered to your vault for safekeeping? Also describe, in detail, the services you offer to address the Treasury Department's need for safekeeping services for assets held as collateral for Commonwealth agencies.
- m) Have any securities held by you as custodian or by your subcustodians been misplaced or lost? If yes, please describe the circumstances and resolution.
- n) Describe procedures to avoid failed trades caused by the securities lending program if you administered the program and if administered by an independent third-party.
- o) The quality of the work in your master trustee/custodian's area and the speed with which requests are responded to are of great importance to the Treasury Department and the Funds. Describe your quality control tracking and monitoring methods to us, and include as an attachment copies of your quality measurement reports.
- p) Describe your policies concerning:
 - Collection and crediting of interest and dividend income
 - Investment of cash balances
 - Memorandum entries

- q) How do you handle corrections/reversals (i.e. as adjustments or as offsetting purchases and sales)? Do you have the ability to generate a separate reversals report?
- r) Discuss your ability to install a terminal linking Treasury and each of the Funds with the DTC ID Confirmation System. Comment on the feasibility of a separate account at DTC and feed for each account at the Commonwealth. What would be the associated costs for security lending, trading, etc? How long would it take to transition all securities and reregister if it was feasible?
- s) Please detail your procedures for receiving IPO distributions from venture capital partnerships.
- t) If you maintain your own subcustody network, please address the following questions:
1. Describe your selection and monitoring process for your subcustodian network.
 2. Are your communications (e.g. trade notifications and dividends) with your subcustodian automated?
 3. How many people are responsible for maintaining your subcustodian network?
 4. In the last five years, have you terminated any subcustody contracts? What were the reasons for this termination(s)?
 5. List the banks in your global custodian network. Describe your global settlement and income collection procedures in a non-commingled fund environment.

If you DO NOT maintain your own subcustody network, please address the following questions:

1. With which bank(s) do you contract for international custody? What were the particular criteria that led you to select this bank(s)?
2. How long have you worked with this bank(s) in this capacity?
3. Is international custody accounting integrated with domestic custody?
4. Is communication with the international custody bank automated?

VI-2 CORPORATE ACTIONS

For each of the following questions, differentiate between domestic and foreign corporate action capabilities if they are different.

- a) Indicate your sources of corporate action information and the frequency each is used. Can you provide a report that classifies

corporate actions by type of proxy and by vote? Can you monitor investment manager adherence to proxy voting guidelines?

- b) Describe your procedures for notifying your clients of corporate actions, including the process for late notified corporate actions. Do these procedures include on-line reporting? Do you have the ability to generate a separate corporate actions report?
- c) Describe your procedures for monitoring the collection of, and researching non-received, corporate actions. Do the procedures include on-line monitoring of corporate actions?
- d) Describe your policies and procedures for notifying clients of class actions, shareholder derivative actions and other litigation, regulatory agency enforcement actions and bankruptcy actions. Also describe your procedures for monitoring class actions, shareholder derivative actions and other litigation, regulatory agency enforcement actions and bankruptcy actions. Do the procedures include the ability to provide on-line notification and monitoring? What research is required on your part to respond to class actions?
- e) Explain your standard proxy procedures and any alternative services you offer, including summary voting activity reports. How is the client assured that all proxies have been voted? Include details on whether you are capable of providing on-line corporate action, class action, shareholder derivative actions and other litigation, regulatory agency enforcement actions, and bankruptcy action filing services on behalf of the Funds.
- f) What summary reporting, if any, will be provided? Please include a sample report.
- g) Discuss procedures in reporting corporate actions in various stages of information: initial declaration/announcement and final corporate action information stage. Discuss control procedures implemented to ensure accuracy of your corporate action postings. Explain procedures for processing cancellations and/or corrections.
- h) Discuss extent of on-line access of your corporate action postings. Can postings to your system be downloaded to a spreadsheet software package such as Microsoft Excel for client's review?
- i) Describe procedures in reporting cash corporate actions (i.e. tender offer, rights) from noncash corporate actions (i.e. stock split, stock distribution). Are they reported separately?

- j) Describe your procedures for monitoring and researching non-received corporate actions.

VI-3 PRICING

- a) Name all sources used to price assets to market, including how frequently prices are updated.

| <u>Sources</u> | <u>Frequency</u> |
|--|------------------|
| US Bonds | |
| US Stocks | |
| US Convertibles | |
| US Mortgage Backed | |
| US Options | |
| US Futures | |
| US Mortgage Loans | |
| US Private Placements | |
| US Municipals | |
| Foreign Equities | |
| Foreign Bonds | |
| Foreign Options | |
| Foreign Futures | |
| Real Estate | |
| Partnerships (Venture Capital and Real Estate) | |
| Illiquid Securities | |

- b) Do asset valuations include accrued income and pending transactions?
- c) How are valuation differences resolved between the investment manager and the master custodian?
- d) How do you price sale transactions - LIFO, FIFO, average cost?
- e) Are purchases priced as of trade date, settlement date, or month end?
- f) Can the client specify alternate pricing sources? List alternatives.
- g) What procedures do you have in effect, if any, to investigate unusual or significant pricing changes from the previous day?
- h) Do you have a specific dollar or percent change limit before a supervisor needs to approve the value used?

- i) Discuss your ability to price all publicly-traded securities, including thinly-traded and/or unique securities (e.g., high yield bonds) on at least a monthly basis.
- j) How are month-end pricing discrepancies with investment managers resolved? Specifically address the issue of fixed income securities and derivatives, particularly currency forwards.
- k) Please provide examples of the pricing mechanisms for derivatives.

VI-4 CONVERSION

- a) Please describe the conversion process indicating the safeguards against securities loss, income payments missed and accounting discrepancies. Please provide an estimated conversion calendar.
- b) Do you have a special team and/or department assigned to handle the transition of new clients?
- c) In addition to the normal monthly portfolio reports, please describe what, if any, reports are available during the conversion.
- d) What are the typical problems a client should expect to encounter during a transfer, and how might they be eliminated?
- e) What was your most complicated conversion? How long did it take to complete? What specific problems were encountered and how were they resolved?
- f) As mentioned in Part II, a portion of the Treasury Department's securities are currently held physically by the current custodian in its vault. Please describe the procedures for transferring/transporting these securities.
- g) Explain your policy for ensuring that client personnel are properly trained on your policies, procedures and on-line systems before, during and after conversion.

PART VII

CASH MANAGEMENT

The Commonwealth manages its cash internally but will use the custodian's sweep and cash management facilities in emergency situations.

- a) Describe your system for monitoring cash balances. If cash is swept automatically:
 - how often is it swept?
 - to what balance?
 - can balances below that threshold be invested elsewhere?
 - how are investment managers advised of available cash/negative cash?
 - are there transaction costs? If so, what are they?
 - how large a withdrawal is possible with a single days notice?
 - how often is interest accrued and when is it credited?
- b) Describe all of your short-term investment fund alternatives, being sure to include the following information for each alternative:
 - Fund name
 - Investment philosophy and objectives
 - Types of allowable investments and asset mix
 - Maturity mix and parameters
 - Average quality and maturity
 - Minimum purchase unit
 - Frequency with which monies can be contributed or withdrawn
 - Quarterly performance data for the past two years
 - Management/administrative fees and conditions
 - Management/administrative staff background information
- c) Is participation in a short-term investment fund account required?
- d) When repurchase agreements are done with short-term investment funds, how is collateral secured?
- e) Describe your fail float procedures including monitoring failed trades, compensation, reporting, etc. Do all clients get the benefit of the float or is it only provided on a special basis? In addition, please provide sample reports.
- f) Do you net buy and sell float?
- g) Can fail float earnings be separated in such a way that the performance of the investment managers not be affected?

- h) Discuss your policies concerning daylight overdrafts. How would you accommodate trade executions by investment managers occurring after the Treasury Department has invested all available cash?
- i) For cash held in local foreign currency, do you offer automatic investment in competitive short-term debt securities? If so, please indicate in which markets and indicate any limitations, including but not limited to, minimum balances, payment increments and frequencies. Provide the three-year history of your short-term returns for each major currency.
- j) For cash held in local currency, do you offer the ability to execute foreign exchange transactions? Under what circumstances? Discuss your willingness and ability to accommodate the Treasury Department's need to review and approve, through its preaudit function, foreign exchange transactions prior to execution.
- k) For global markets, the interest penalty for cash overdrafts is substantial. Discuss policies and procedures for assessing foreign overdraft fees, including but not limited to, documents provided, frequency of charges, overdraft rates determination, and overdraft claims and collection process from brokers/managers.
- l) Each of the individual Funds may have more than one account under custody. In order to limit overdraft charges, it is desired that the custodian aggregate currencies in the calculation of overdraft charges. Please discuss your ability to aggregate currencies on daily basis.
- m) PSERS, SERS, and PMRS may desire to establish a line of credit with your financial institution secured by the assets of each Fund. Would you be willing to offer a line of credit to each fund? If so, please indicate the amount of credit your institution would be willing to provide to PSERS, SERS, and PMRS. What would be the annual fee to establish such a line of credit (please express fee as a percentage of the total credit offered in basis points)?
- n) Describe the capabilities and methodologies for equitizing investment manager cash balances.

PART VIII

SECURITIES LENDING

Securities lending is an asset management function and, as such, is within the exclusive control and management of the Funds. Included in Appendix E are those policies and procedures which will govern the securities lending program. Should the Commonwealth choose to use the custodian bank for securities lending services, that custodial bank must be willing to abide by the policies developed by the Funds. The Funds shall have the right to modify the policies as well as opt out of lending their securities. Please keep these facts in mind when completing the fee portion of your proposal. The collateral pool for all the Commonwealth Funds must be separated from other clients' collateral pools.

Please describe in detail the bank's securities lending program including:

- a) Describe the securities lending programs you manage for your domestic and global custody clients. How long have the programs been in existence? Indicate the current asset base, number of clients involved, average daily outstandings, and total income for each of the previous three years. Identify the lendable pool by asset class and market, and identify the percentage of assets on loan by asset class and market. Is there a minimum portfolio size of lendable assets?
- b) Describe your activities in international (non U.S.) lending/operations. From what geographical locations are your lending activities conducted? How many hours a day is your lending program operational?
- c) Discuss the methods used to allocate loans to the different funds.
- d) Please provide biographical information on the key individuals administering the securities lending program.
- e) How many brokers are on the approved borrowing list? Describe how brokers are screened and approved. Who is responsible for the analysis? Provide a list of approved borrowers and the credit limits of each.
- f) How frequently are:
 - new brokers added?
 - approved brokers reviewed?
 - existing brokers deleted?
- g) What limits and guidelines exist as to the amounts which brokers may borrow?

- h) Have any of your authorized borrowers done the following:
- Defaulted on a loan? Why, and how was it corrected?
 - Failed to mark to market collateral? Why, and how was it corrected?
- i) What collateral requirements do you impose? What do you accept as collateral and why? (e.g., If you accept sovereign bonds, why?) Discuss your procedures regarding the use of letters of credit as collateral. From what institutions do you accept letters of credit? Discuss your willingness and ability to invest collateral in domestic and global markets.
- j) Describe the process for accounting for lent securities and for collateral. Do you have the ability to monitor and report the percentage of portfolio/funds on loan?
- k) Describe your policies relating to the monitoring of collateral, procedures for adjusting collateral position and frequency with which positions are marked-to-market and why (e.g., Do you always mark to 102%, or do you mark only when below 100%).
- l) Is the collateral maturity matched with the average loan maturity? If no,
- Who manages the mismatch?
 - What factors determine the size (in days) of the mismatch?
- m) Discuss your ability to enforce limits given by the Funds regarding the maximum percentage of assets which are out on loan at any particular time? Are securities eligible for loan segregated by account?
- n) Discuss what on-line reporting capabilities you can provide for obtaining securities lending status information. Provide examples of all reports available through your lending program. Indicate which reports are available on-line.
- o) Describe support services available, including but not limited to:
- Mark to market
 - Credit analysis of borrowers
 - On-line instructing and reporting capabilities
- p) Describe your policies regarding indemnification against losses for securities lending. Discuss your willingness and ability to agree to the indemnification provision set forth in Part II-2.
- q) Given the listing of individual fund holdings set forth in Appendix B and the policies described in Appendix E, provide a simulation of anticipated lending revenues. Discuss proposals to increase the Funds' incremental

income with little or no corresponding increase in risk. Discuss the expected incremental income for each proposal. Discuss whether you are willing to guarantee income from securities lending. If so, in what amount and in what manner?

- r) Describe the method used to assess fees and the percentage split between the Funds and the custodian applied to profits from securities lending.
- s) Please describe the method and frequency of distribution of income.
- t) Please describe the average annual incremental return attributable to securities lending that you have provided to your similar size clients for the last three(3) years.
- u) Please describe the method of protecting voting rights on securities loaned; (i.e. ability to recall stock prior to the proxy record date and how this will be accommodated).
- v) Please describe your securities lending policies regarding minimum market value of collateral, type, and quality of collateral and the maximum amount of assets lent to a single borrower.
- w) Provide your standard securities lending agreement with borrowers.
- x) Provide your standard lending agreement with master trust clients. Please highlight the specific indemnification clause(s).
- y) Do you offer "fail coverage"? If so, in what markets? Describe your fail coverage program.
- z) Please describe all short term investment vehicles you may have which would be suitable for investment of cash collateral, in accordance with the policies on Securities Lending attached. Please provide your firm's investment guidelines for the collateral pool.
- aa) Describe your ability to provide Treasury and the Funds a securities lending report each month which contains the following, by Fund and by sub-account:
 - 1. Average total lendable assets in dollars;
 - 2. Average lendable assets by category (Governments, Agencies, Corporate Bonds, Stocks, other) in dollars;
 - 3. Average lendable assets on loan by category in dollars;
 - 4. Percentage of average lendable assets on loan by category;
 - 5. Loan spread by category in basis points;
 - 6. Income by category in dollars;
 - 7. Total return in basis points on lendable assets by category;

8. Security lending market comments for past month and upcoming months;
 9. Maximum loans outstanding during month by broker vs. maximum broker loan limit per policies (Fund only); and
 10. Quarterly analysis of income projections vs. actual income realized (Fund only).
-
- bb) Describe any instances in the last three (3) years where losses have been incurred in your lending program; include the amounts, the causes and the corrective measures taken.
 - cc) Describe all risk to which the Funds will be exposing itself through the lending of securities, nationally and internationally, with your bank. Include a discussion of a potential bankruptcy of a borrower or a subcustodian and the impact of foreign law upon the account of the Treasury and the Funds.
 - dd) How do you measure the performance of your:
 - Loan traders (the individuals who initiate loans)?
 - Collateral portfolio manager(s)?
 - ee) How do you measure the performance of the overall lending program?
 - ff) Describe the documentation available to satisfy the reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 28.
 - gg) Describe your procedure to remedy a default on a loan, including buy back and/or liquidation of collateral.

PART IX

PERFORMANCE MEASUREMENT AND COMPLIANCE SERVICES

- a) Provide a comprehensive review of your performance measurement and portfolio analytics service available to clients. Please identify the cost of these services separately in the cost proposal.
- b) How is performance computed?
- c) Is your performance reporting package internally generated or provided by external vendors? If external, which vendor?
- d) Describe what services are available on-line.
- e) Provide examples of all available performance/analytical reports (please include performance attribution reports and performance analytics reports). Indicate frequency and available delivery dates. Please provide sample reports.
- f) Are peer universe comparisons available by investment manager and by asset class or total plan composite?
- g) Is the economic (notional) value of derivatives included in the performance analysis and attribution?
- h) Discuss your ability to integrate international and domestic performance measurement to get total plan results.
- i) Can you report differentiation between security performance and currency performance? Describe.
- j) Do you provide rates of return by asset segment? By country/currency?
- k) Discuss your ability to monitor and report on foreign exchange transactions executed by third parties.
- l) When are performance reports available after the end of the reporting period?
- m) Do you provide an automated compliance (guideline monitoring) system for the monitoring of investment policies such as restricted securities, industry limitations, issuer limitations, currency limitations, security limitations, investment type limitations, country limitations, asset group limitations, issue ratings, issuer ratings, etc. Please describe the capabilities of your compliance system. Include samples of all reports

offered and discuss if they are available on-line, in hard copy, or both. Discuss your ability to provide such as system to Treasury and the Funds as part of your custodial bid.

- n) Discuss any other compliance services you may offer and provide example reports.

... (faint, mostly illegible text) ...

PART X

INFORMATION SYSTEMS

The Commonwealth has the computer systems described on page 10-11 of this RFP. There are no budgeted funds for computer upgrades or new equipment. The successful bidder will have to use the existing systems or pay for the upgrades to these systems as necessary. As the hardware/software changes, the custodian will have to continue to upgrade the systems for the Commonwealth as necessary.

- a) Describe your computer system's capability (hardware/software). Have you developed your software internally or purchased it from an outside vendors and/or consultants? Who maintains the software? Do you intend to change software or operating system for the server or PC platform? If so, please discuss your plans for the change.
- b) How long has your master trust/custody accounting software been in place? Detail those major enhancements, to date, since your accounting software was put into production. Is your system dedicated to the master trust/custody area or shared with other units within the organization? If shared, please describe the priority sequence. How much excess capacity does your system currently have? What enhancements are scheduled for the next 12-24 months?
- c) Explain the relationship between systems that report accounting data and those that report performance data. How are they integrated and how do they accommodate input changes?
- d) Describe the programming staff that supports the master trust/custody system. What, if any, is their relationship with the other units within the organization?
- e) Describe your standards for response time on inquiries for your on-line system. Provide the history of your response time.
- f) Describe the report output options available from your system (e.g. on-line, hard copy, microfiche). Please provide sample reports.
- g) Describe the system backup, and security procedures currently in use.
- h) Please comment on those aspects of your systems capabilities which you believe differentiate your organization from others.
- i) Describe the data security system that will preclude unauthorized access or data entry to our account. How do you prevent co-mingling of Treasury and Fund data with other customer data?

- j) Does your on-line access system include information regarding on-line trade entry. What specific information would be available to us in an on-line form? During what hours could we access your database?
- k) Does your on-line access system have flexible formatting capabilities and "what if" analysis capabilities? Please describe.
- l) Does your on-line access system provide the flexibility to allow access from a remote, dial-up location? If so, please describe any technical limitations.
- m) Describe the types of data and information which will be available to the Treasury and the Funds via on-line inquiries. Describe the type of data which will be available for downloading to Treasury and the funds.
- n) Describe any hardware or software that would be required by the Treasury Department and the Funds if we were your client. The hardware and software must be provided to the Treasury Department and the Funds. Is the system compatible with a local area network? Describe. Will there be any costs to the Commonwealth, the Treasury or the Funds for this hardware and software?
- o) Describe the procedures for requesting customized reports and/or system modifications. Discuss how the custodian can assure Treasury and the Funds that requests will be handled expeditiously and provide examples of special requests from other clients and the time and costs involved to complete the project.
- p) Describe interfaces to other systems such as DTC, PTC and FRB. If no interface(s) exist, describe procedures for addressing this issue.
- q) Describe the availability of current equity and bond market information and on-line pricing. Include the sources of information and the frequency of updates. What is the cost to the Treasury and the Funds?
- r) Does the custodian have or plan electronic document imaging systems? If so, what system?
- s) Are all hardware and software provided by the custodian Year 2000 compliant? Are those of your sub-custodians also compliant? If not, when is the target date for Year 2000 compliance?
- t) Describe your disaster recovery procedures. Do these include use of a hot site? If your systems suffer a disaster, what is the period of downtime until they are restored? Have these plans and facilities been tested? If so, what was the result?

- u) Identify the technical team with whom Treasury and the Funds will be working in relation to computer hardware, software and data communications issues. Identify the contact person with whom Treasury and the Funds will interface to resolve technical problems.
- v) Please discuss the training to be provided to the Treasury Department, the Funds, and the investment managers in the use of your information systems.
- w) Please discuss your plan and developments to prepare for when the European Economic and Monetary Union goes into effect.
- x) Do you currently offer a fee management system which is capable of calculating fixed and performance-based manager fee arrangements? If so, please provide a sample of reports generated. Are these reports available on-line?

PART XI

FEES AND PRICING PROFORMAS

XI-1 FEES

Please note that prior to completing this section that the successful bidder for the domestic and international custody and safekeeping services may not be the successful bidder for the securities lending services. Upon review of the proposals, a determination will be made whether or not to use a third party agent for securities lending or possibly retain the function in-house at the Funds. Therefore, it is important that each of the four separate fee quotes noted below be competitively bid. In addition, the Treasurer reserves the right to cancel securities lending services at any time and revert to a custody only arrangement. Should this occur, the bid used for custody only will be enforced for the remainder of the contract term.

The proposer is required to provide four separate fee quotes as follows:

1. Domestic and International Custody Only - this fee should be a fixed fee except for any charges for utilizing a third party security lender which should be explained and priced in detail. Any charges for a line-of-credit should also be indicated. Please include the cost of compliance (guideline monitoring) system in the quoted fee. Please indicate the cost of the performance measurement systems separately by Fund as some or all of the Funds may choose not to use your systems for performance measurement. If any services described in your technical proposal are not included in your base fixed fee, please describe those services and provide a fee for utilizing such services by Fund. All services discussed in your technical proposal will be considered included in the international and custody fee unless described separately.
2. Safekeeping Only - this fee should be a fixed fee for physical custody of securities. The Treasury Department may wish to perform this service in the future.
3. Securities Lending Only - please provide the fee split between the proposer as agent (in percent) and Treasury and the Funds as lender (in percent). Include any additional charges for not being the custodian of the assets. It is required that cash management charges be factored into the percentages. Please consider the full indemnification provisions noted earlier in this RFP.
4. Domestic and International Custody, Safekeeping, and Securities Lending - please indicate the fixed fee for all but securities lending which should be shown as a percentage split.

Please provide information on any costs for additional services not contemplated in the fees discussed above. In addition, please identify any one-time fees.

Finally, the successful bidder must provide a means of equitably allocating costs among all Funds and report this to the Treasurers office. Securities lending income should be allocated based on actual income earned by each participating Fund. In addition, the contractor should be able to provide the Funds an allocation of securities lending income by investment manager.

TREASURY DEPARTMENT AUDIT REQUIREMENTS

The Treasury Department is required by state law to audit all requisitions for payment prior to disbursement. Thus, the Treasury Department is required to audit proposed security purchases prior to authorizing payment from the State Treasury. In auditing proposed securities transactions, the Treasury Department audits such proposed transactions in order to determine compliance with any legal restrictions, as well as limitations imposed by the respective administrative body. In order to allow the Treasury Department to fulfill its obligation to audit requests for payment prior to settlement in the most efficient and timely manner, the custodian should provide an automated, on-line compliance system which will screen all trades using the following general investment policy restrictions:

Listed below are general investment policy restrictions and system requirements necessary to determine compliance therewith:

1. Restrictions on a portfolio manager's ownership of outstanding shares of individual corporations. This requires an examination of outstanding shares data and percentage ownership by individual portfolio managers.
2. Restrictions on a portfolio manager's ownership in any one corporation which exceeds percentage limitations of the portfolio's assets. This requires an analysis of asset holdings as a percentage of total holdings for each company held in a portfolio.
3. Restrictions on a portfolio manager's ownership in any single issue which exceeds a certain percentage to total portfolio holdings.
Restrictions on a portfolio manager's holdings in preferred issues. This requires an analysis of preferred issue holdings as percentage of total portfolio holdings.
4. Restrictions on brokerage commissions. This requires an analysis of per share broker commissions.
5. Restrictions on domestic portfolio manager's holdings of foreign securities. This requires an analysis of the exchange from which the security was purchased.
6. Restrictions on short sales. This requires an analysis of long/short positions.
7. Restrictions on private or direct placements. This requires an examination of whether the security was purchased on an exchange.
8. Restrictions on margin purchases. This requires an analysis of total issues purchased, price and total amount of trade.
9. Restrictions on asset classes. This requires an analysis of the type of asset purchased for the account (i.e. equity, fixed income, etc.)
10. Restrictions on investing in foreign countries. This requires an analysis of the home country of the issuing entity.

PORTFOLIO PROFILE

PUBLIC SCHOOL EMPLOYEE'S RETIREMENT SYSTEM As of November 30, 1997

| <u>Asset Class</u> | <u>Market Value (000's)</u> |
|---|-----------------------------|
| Domestic Equity | \$ 18,496,988 |
| Global Equity | 7,208,995 |
| Domestic Fixed | 5,717,770 |
| Global Fixed | 3,382,714 |
| Real Estate | 2,374,327 |
| Unallocated Cash | 1,648,214 |
| Venture Capital | 444,685 |
| Futures | 541,618 |
| Private Placements | 114,920 |
| Index Options/Tactical Asset Allocation | 28,639 |
| Post Employment Healthcare | 56,809 |
| Total Fund | \$ 40,015,679 |

STATE EMPLOYEE'S RETIREMENT SYSTEM As of November 30, 1997

| <u>Asset Class</u> | <u>Market Value (000's)</u> |
|---------------------------|-----------------------------|
| Domestic Equity | \$ 9,455,596 |
| Domestic Fixed | 3,548,002 |
| International Equity | 3,061,194 |
| International Fixed | 1,252,886 |
| Tactical Asset Allocation | 1,087,255 |
| Real Estate | 1,603,818 |
| Venture Capital | 326,358 |
| Alternative Investments | 405,640 |
| Cash | 44,027 |
| Currency Overlay Program | 19,333 |
| Total Fund | \$ 20,804,109 |

11. Restrictions on foreign country allocations by portfolio managers. This requires an analysis of amounts invested in individual foreign countries as a percentage of the total individual portfolio's assets.
12. Restrictions on purchasing fixed income securities below established ratings. This requires an analysis of rating assigned to corporate fixed income securities.
13. Restrictions on the purchase of rights and warrants. This requires an analysis of the type of security.
14. Restrictions on the purchase of open and closed-end mutual funds. This requires an analysis of the type of investment.
15. Restrictions on the purchase, participation, or other direct investment in gas, oil, or other mineral or exploration or development program. This requires an analysis of the type of investment.
16. Restriction on the purchase of commodities. This requires an analysis of the type of investment.
17. Restriction on the purchase/sale of equity options and futures by certain portfolio managers. This requires an analysis by the type of investment.

Trades falling outside the established parameters should be identified by the custodian's compliance system in exception reports generated daily for review by the Treasury Department and the respective Funds. The Treasurer should have the ability to view all trades on a daily basis. Treasury will then have the ability to disapprove trades not in compliance with the general investment policy restrictions. This will be a revision in the Treasury Department's current policy of approving all trades manually.

HISTORY OF INVESTMENT TRANSACTIONS

PUBLIC SCHOOL EMPLOYEE'S RETIREMENT SYSTEM -- 12/31/96-11/30/97

| <u>Types of Transactions</u> | <u>Number of Transactions</u> | <u>Dollar Amount (\$ millions)</u> |
|------------------------------|-------------------------------|------------------------------------|
| DOMESTIC | | |
| Equity Purchases | 25,355 | 9,595 |
| Equity Sales | 12,941 | 9,682 |
| Fixed Income Purchases | 1,725 | 13,531 |
| Fixed Income Sales | 6,481 | 13,100 |
| Option Purchases | 829 | 312 |
| Option Sales | 832 | 244 |
| Futures Purchases | 961 | -- |
| Futures Sales | 941 | -- |
| TOTAL DOMESTIC | 50,065 | 46,464 |
| INTERNATIONAL | | |
| Equity Purchases | 8,712 | 4,688 |
| Equity Sales | 5,565 | 3,434 |
| Fixed Income Purchases | 427 | 4,651 |
| Fixed Income Sales | 384 | 4,477 |
| Options Purchases | -- | -- |
| Options Sales | -- | -- |
| Cash Equivalent Purchases | 7,543 | 21,852 |
| Cash Equivalent Sales | 5,379 | 23,273 |
| TOTAL INTERNATIONAL | 28,010 | 62,375 |

STATE EMPLOYEE'S RETIREMENT SYSTEM - 12/31/96-11/30/97

| <u>Types of Transactions</u> | <u>Number of Transactions</u> | <u>Dollar Amount (\$ millions)</u> |
|------------------------------|-------------------------------|------------------------------------|
| DOMESTIC | | |
| Equity Purchases | 10,544 | 3,949 |
| Equity Sales | 8,657 | 3,713 |
| Fixed Income Purchases | 1,498 | 5,446 |
| Fixed Income Sales | 1,520 | 5,272 |
| Fixed Income Paydowns | 9,806 | 143 |
| Other Purchases | 5,090 | 10,252 |
| Other Sales | 3,443 | 10,447 |
| TOTAL DOMESTIC | 40,558 | 39,222 |
| INTERNATIONAL | | |
| Equity Purchases | 5,827 | 2,635 |
| Equity Sales | 7,348 | 2,477 |
| Fixed Income Purchases | 371 | 5,114 |
| Fixed Income Sales | 1,227 | 7,588 |
| TOTAL INTERNATIONAL | 14,773 | 17,814 |

APPENDIX D

COMMONWEALTH CONTRACT PROVISIONS

CONTRACTOR RESPONSIBILITY PROVISIONS

1. Contractor certifies that it, its affiliates and subsidiaries are not currently under suspension or debarment by the Commonwealth, any other state, or the federal government.
2. If contractor enters into any subcontracts under this contract with subcontractors who are currently suspended or debarred by the Commonwealth or federal government or who become suspended or debarred by the Commonwealth or federal government during the term of this contract or any extensions or renewals thereof, the Commonwealth shall have the right to require the contractor to terminate such subcontracts.
3. The contractor agrees that it shall be responsible for reimbursing the Commonwealth for all necessary and reasonable costs and expenses incurred by the Office of the Inspector General relating to an investigation of the contractor's compliance with the terms of this or any other agreement between the contractor and the Commonwealth which results in the suspension or debarment of the contractor.

OFFSET PROVISION FOR COMMONWEALTH CONTRACTS

The contractor agrees that the commonwealth may set off the amount of any state tax liability or other debt of the contractor or its subsidiaries that is owed to the Commonwealth and not being contested on appeal against any payments due the contractor under this or any other contract with the Commonwealth.

CONTRACTOR INTEGRITY PROVISIONS

1. **Definitions**
 - a. Confidential information means information that is not public knowledge, or available to the public on request, disclosure of which would give an unfair, unethical, or illegal advantage to another desiring to contract with the Commonwealth.

b. Consent means written permission signed by a duly authorized officer or employee of the Commonwealth, provided that where the material fact have been disclosed, in writing, by prequalification, bid, proposal, or contractual terms., the Commonwealth shall be deemed to have consented by virtue of execution of this agreement.

c. Contractor means the individual or entity that has entered into this agreement with the Commonwealth, including directors, officers, partners, managers, key employees, and owners of more than 5 percent interest.

d. Financial Interest means:

- (1) ownership of more than 5 percent interest in any business; or
- (2) holding a position as an officer, director, trustee, partner, employee, or the like, or holding any position of management

e. Gratuity means any payment of more than nominal monetary value in the form of cash, travel, entertainment, gifts, meals, lodging, loans, subscriptions, advances, deposits of money, services, employment, or contracts of any kind.

2. The contractor shall maintain the highest standards of integrity in the performance of this agreement and shall take not action in violation of state or federal laws, regulations, or other requirements that govern contracting with the Commonwealth.

3. The Contractor shall not disclose to others any confidential information gained by virtue of this agreement.

4. The contractor shall not, in connection with this of any other agreement with the Commonwealth, directly or indirectly, offer, confer, or agree to confer any pecuniary benefit on anyone as consideration of the decision; opinion, recommendation, vote, other exercise of discretion, or violation of a known legal duty any officer or employee of the Commonwealth.

5. The contractor shall not, in connection with this or any other agreement with the Commonwealth, directly or indirectly, offer, give, or agree or promise to give to anyone any gratuity for the benefit of or at the direction of request of any officer of employee of the Commonwealth.

6. Except with the consent of the Commonwealth, neither the contractor nor anyone in privity with him shall accept or agree to accept from, or give or agree to give to, any gratuity from any person in connection with the performance of work under this agreement except as provided therein.
7. Except with the consent of the Commonwealth, the contractor shall not have a financial interest in any other contractor, subcontractor, or supplier providing services, labor, or material on this project.
8. The contractor, upon being informed that any violation of these provisions has occurred or may occur, shall immediately notify the Commonwealth in writing.
9. The contractor, by execution of this agreement and by the submission of any bills or invoices for payment pursuant thereto, certifies and represents that he has not violated any of these provisions.
10. The contractor shall, upon request of the Office of State Inspector General, reasonably and promptly make available to that office and its representatives, for inspection and copying, all business and financial records of the contractor, of concerning, and referring to this agreement with the Commonwealth or which are otherwise relevant to the enforcement of these provisions.
11. For violation of any kind of the above provisions, the Commonwealth may terminate this and any other agreement with the contractor, claim liquidated damages in an amount equal to the value of anything received in breach of these provisions, claim damages for all expenses incurred in obtaining another contractor to complete performance hereunder. These rights and remedies are cumulative, and the use or nonuse of any one shall not preclude the use of all or any other. These rights and remedies are in addition to those the Commonwealth may have under law, statute, regulation, or otherwise.

NONDISCRIMINATION CLAUSE

During the term of this contract, Contractor agrees as follows:

1. Contractor shall not discriminate against any employee, applicant for employment, independent contractor or any other person because of race color, religious creed, ancestry, national origin, physical ability, age or sex.

Contractor shall take affirmative action to ensure that applicants are employed and that employees or agents are treated during employment, without regard to their race, color, religious creed, ancestry, national origin, physical ability, age or sex. Such affirmative action shall include, but is not limited to employment, upgrading, demotion, or transfer, recruitment or recruitment advertising; layoff or termination; rates of pay or other forms of compensation and selection for training.

Contractor shall post in conspicuous places, available to employees, agents applicants for employment and other persons, a notice to be provided by the contracting agency setting forth the provisions of this nondiscrimination clause.

2. Contractor shall in advertisements or requests for employment placed by it or on its behalf state all qualified applicants will receive consideration for employment without regard to race, color, religious creed, ancestry, national origin, physical ability, age or sex.

3. Contractor shall send each labor union or workers' representative with which it has a collective bargaining agreement or other contract or understanding, a notice advising said labor union or workers' representative of its commitment to this nondiscrimination clause. Similar notice shall be sent to every other source of recruitment regularly utilized by contractor.

4. It shall be no defense to a finding of noncompliance with this nondiscrimination clause that contractor has delegated some of its employment practices to any union, training program or other source of recruitment which prevents it from meeting its obligations. However, if the evidence indicates that contractor was not on notice of the third-party discrimination or made a good faith effort to correct it, such factor shall be considered in mitigation in determining appropriate sanctions.

5. Where the practices of a union or any training program or other source of recruitment will result in the exclusion of minority group persons, so that contractor will be unable to meet its obligations under this nondiscrimination clause, contractor shall then employ and fill vacancies through other nondiscriminatory employment procedures.

6. Contractor shall comply with all state and federal laws prohibiting discrimination in hiring or employment opportunities. In the event of contractor's noncompliance with the nondiscrimination clause of this contract or with any such laws, this contract may be terminated or suspended, in whole or in part, and contractor may be declared temporarily ineligible for further Commonwealth contracts, and other sanctions may be imposed and remedies invoked.

7. Contractor shall furnish all necessary employment documents and records to, and permit access to its books, records and accounts by, the contracting agency and the Office of Administration, Bureau of Affirmative Action for purposes of investigation to ascertain compliance with the provisions of this clause. If contractor does not possess documents or records reflecting the necessary information requested, it shall furnish such information on reporting forms supplied by the contracting agency or the Bureau of Affirmative Action.

8. Contractor shall actively recruit minority subcontractors or subcontractors with substantial minority representation among their employees.

9. Contractor shall include the provisions of this nondiscrimination clause in every subcontract so that such provisions will be binding upon each subcontractor.

10. Contractor's obligations under this clause are limited to contractor's facilities within Pennsylvania or, where the contract is for purchase of goods manufactured outside of Pennsylvania, the facilities at which such goods are actually produced.

THE AMERICANS WITH DISABILITIES ACT

During the term of this contract, the Contractor agrees as follows:

1. Pursuant to federal regulations promulgated under the authority of The Americans with Disabilities Act, 28 C.F.R. & Section 35.101 et seq., the Contractor understands and agrees that no individual with a disability shall, on the basis of the disability, be excluded from participation in this contract or from activities provided for under this contract. As a condition of accepting and executing this contract, the Contractor agrees to comply with the "General Prohibitions Against Discrimination," 28 C.F.R. & Section 35.130, and all other regulations promulgated under Title II of The Americans with Disabilities Act which are applicable to the benefits, services, programs, and activities provided by the Commonwealth of Pennsylvania through contracts with outside contractors.

2. The Contractor shall be responsible for and agrees to indemnify and hold harmless the Commonwealth of Pennsylvania from all losses, damages, expenses, claims, demands, suits and actions brought by any party against the Commonwealth of Pennsylvania as a result of the Contractors' failure to comply with the provisions of paragraph 1 above.

YEAR 2000 PROVISION

1. Contractor agrees that each hardware, software, or firmware item purchased or leased by the Commonwealth shall be guaranteed under warranty to securely process date/time data (including but not limited to, calculating and sequencing) from, into, and between the twentieth and twenty-first centuries, and the years 1999 and 2000, including all leap-year calculations.

2. For violation of any of the above provisions, the Commonwealth may terminate this and any other agreement with the contractor, claim liquidated damages in an amount equal to the value of anything received in breach of these provisions, claim damages for all expenses incurred in obtaining another contractor to complete performance hereunder. These rights and remedies are cumulative, and the use or nonuse of any one shall not preclude the use of all or any other. These rights and remedies are in addition to those the Commonwealth may have under law, statute, regulation or otherwise.

SOCIALLY/ECONOMICALLY RESTRICTED
BUSINESS UTILIZATION

The Contractor must provide the Department of General Services, Bureau of Contract Administration and Business Development, with quarterly reports that indicate whether the Contractor utilized a Minority Business Enterprise, Women's Business Enterprise or Socially/Economically Restricted Business for activities under Contract during the quarter and list the names of and the amount paid to the Minority Business Enterprise, Women's Business Enterprise, or Socially/Economically Restricted Business utilized. The first such report shall be due on the 100th day after the starting date of this contract, and subsequent reports shall be the each 100th day thereafter.

I. Securities Lending

The primary objectives of lending the Funds' securities are to:

- A.** Safeguard securities through management of counterparty risk;
- B.** Safeguard capital through receipt of sufficient collateral; and
- C.** Enhance portfolio earnings keeping the previous objectives in mind.

II. Management of Cash Collateral

The primary objectives of the management of cash collateral supporting securities loans are to:

- A.** Safeguard principal;
- B.** Assure all cash collateral is invested in a timely manner;
- C.** Maintain a diversified portfolio of investments;
- D.** Maintain adequate liquidity to meet the anticipated maturities of security loans; and
- E.** Consistent with these objectives, to optimize the spread between the collateral earnings and the rebate rate paid to the borrower of securities.

III. Management of Non-Cash Collateral

The primary objectives of non-cash collateral are to:

- A.** Maintain high quality collateral sufficient enough to protect the Funds' interest in loaned securities; and
- B.** Maintain non-cash collateral in a risk-free fashion.

B. General Lending Guidelines

- I. The Contractor shall pay by the 10th business day of each month, in federal funds, via wire transfer, all income earned by the Funds' for the preceding month.
- II. All transfer taxes, fees and necessary costs with respect to the transfer of the borrowed securities must be paid by the Contractor as they become due, and not later than the date of termination on each loan.
- III. The Contractor must collateralize and mark-to-market daily all loaned securities. The proper method of collateralization will be the market convention (market price times 102% for domestic, 105% for international) plus accrued interest. Loan collateral below these levels must be adjusted within 24 hours and prior to the securities being re-loaned to the same borrowers.
- IV. The Contractor shall indemnify, defend, hold and save harmless the Funds' from any claims, actions, demands, losses, or lawsuits of any kind whatsoever, arising from broker default and operational errors.
- V. The Contractor is permitted to loan securities to the following brokers up to the following limits:
 - A. Domestic brokers with short-term debt ratings of A-1 (Standard and Poor's) and P-1 (Moody's) - \$3 billion
 - B. Domestic brokers rated A-2/P-2 or split rated A-1/P-2 or A-2/P-1 - \$2 billion
 - C. Foreign brokers rated A-1/P-1 - \$2 billion
 - D. Foreign brokers rated A-2/P-2 or split rated A-1/P-2 or A-2/P-1 - \$1 billion

For purposes of diversification, the greater of \$200 million or 25 percent of the loaned securities can be with any single broker.

The Contractor will present to the Funds' on an annual basis a list of all potential borrowers and the applicable credit exposure. The Funds' reserves the right to eliminate or add borrowers and to adjust credit limits to each borrower.

- VI. The Contractor shall maintain the Funds' collateral so that it is separately identified from that of all other money, securities, and collateral held by the Contractor. The Contractor shall construct and maintain a "firewall" so that in the event of a bankruptcy by the Contractor, the Funds' assets shall be immediately returned to the Funds'.
- VII. The Funds' may, at its discretion, have its auditors determine whether or not the "firewall" exists and is adequate. The auditors of the Funds's choice will perform "agreed upon procedures," and these auditors may be the Contractor's independent auditors, the Funds's independent auditor, the State Comptroller's Office, the State's Treasury Office, the State's Auditor General's Office, or any other the Funds' authorized auditors. The Contractor will provide access and space, and will pay for the procedures contracted for by the Funds'.

- VIII. The Contractor will be required to warrant that the securities lending program meets the requirements of IRS Code Section 512(a)(5) and 512(b)(1) and other applicable provisions of the law, which excludes income earned by the Funds' through participation in the securities lending program from possible unrelated business taxable income. The Contractor will be required to agree to indemnify the Funds' from all unrelated business tax claims resulting from the program.
- IX. The Contractor shall comply with the responsibilities and reporting requirements in the Funds's Securities Lending Monitoring Policy.
- X. The Contractor will be responsible for the preservation of the Funds's voting rights for all loaned securities.
- XI. The Contractor shall warrant that it maintains errors and omissions insurance providing a prudent amount of coverage for negligent acts or omissions and that such coverage is applicable to the Contractor's actions under the contract.
- XII. The Contractor may be required to retain a third party to evaluate the collateral pool risk, at its own expense, with findings supplied to the Funds'. The Contractor is required to provide the Funds' with the findings of any other evaluation of the collateral pool risk performed by third parties.
- XIII. The Contractor shall cooperate in the Funds's annual review of contract performance, providing all information and records to the Funds' as the Funds' may, in its sole discretion, determine to be necessary for the Funds' determination as to the continuation of the contract term.
- XIV. The Contractor shall supply the Funds' with the completed, audited financial reports necessary to comply with the Governmental Accounting Standards Board Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*.

C. Cash Collateral Investment Guidelines

the Funds' has established the following investment guidelines. The Contractor will invest cash collateral proceeds and shall follow these guidelines explicitly. If, at any time, the collateral portfolio is in violation of these guidelines (i.e. a credit rating downgrade), the Contractor shall notify the Funds' immediately in writing, and will effect the necessary transactions to bring the portfolio into compliance. Collateral for loaned international securities may only be invested in instruments denominated in U.S. Dollars. To be eligible for cash collateral investment, a security must be rated by at the required quality level by at least two nationally recognized statistical rating agencies. (A list of these agencies is provided as Exhibit A of these guidelines.) If rated by more than two major rating agencies, the two lowest ratings apply. Split rated issues are considered to have the lower of the available ratings. For a credit-enhanced issue to be eligible for purchase, the provider of the enhancement must be an AAA-rated financial institution.

- I. Acceptable cash collateral investment instruments include:
 - A. Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations;
 - B. Repurchase agreements collateralized at 102% by debt obligations of the U.S. Government or its agencies (this does not include mortgage-backed securities) marked-to-market daily. Repurchase agreements collateralized at 105% by A3/A- or higher rated corporate debt or AAA asset-backed securities or commercial paper with a minimum P-1/A-1 rating. Collateral must be rated by at least two nationally recognized statistical rating agencies. If rated by more than two major rating agencies, the lowest two ratings apply. Split rated issues are considered to have the lower of the two ratings;
 - C. Obligations of domestic and foreign banks, including banker's acceptances, certificates of deposit, domestic and off-shore bank time deposits, bonds (Euro), floating rate notes (Euro) and other debt instruments subject to the maturity limitations described below. The banks must be rated at least A3/ A- or equivalent;
 - D. Instruments issued by domestic corporations including corporate notes and floating rate notes rated A2/A or equivalent. Commercial paper of domestic corporations must be rated A-1/P-1 or equivalent. Floating rate notes must reprice daily, weekly, monthly or quarterly and utilize a standard repricing index such as LIBOR, Treasury Bills, commercial paper or Federal funds;

- E. U.S. dollar-denominated instruments issued by sovereigns, sovereign supported credits, and instruments of foreign banks and corporations. The foreign banks and corporations must be rated at least A2/A or equivalent. Commercial paper of foreign banks and corporations must be rated A-1/P-1;
- F. Yankee Securities must be rated A2/A or equivalent;
- G. Insurance company funding agreements, guaranteed investment contracts (GICs) and bank investment contracts (BICs) are acceptable if the issuer has a long-term debt rating or claims paying ability rating of at least A1/A+ or equivalent. In addition, GIC/BIC investments must contain an unconditional put feature that can be exercised within 90 days at par value;
- H. Money market funds as defined under SEC Regulation 270.2a-7; and
- I. Asset-backed securities rated AAA whose underlying loans or receivables are against automobiles or credit cards.

Unless specifically identified in these guidelines, investment in derivative securities, unsecured obligations of institutions whose primary business is to function as a broker/dealer, interest only and principal only stripped mortgages, and swap transactions are prohibited.

- II. The cash collateral investment portfolio can invest in adjustable rate securities tied to LIBOR, Fed Funds, Treasury Bills and Commercial Paper indices. To limit exposure of the cash collateral investment portfolio to interest rate risk, the following adjustable rate securities are specifically prohibited:
 - A. any securities whose interest rate reset provisions are based on a formula that magnifies changes in interest rates, such as "inverse floaters" and "leveraged floaters";
 - B. securities whose interest rate reset provisions are tied to long-term interest rates so that a change in the slope of the yield curve could result in the value of the instrument falling below par, such as "Constant Maturity Treasury (CMT) floaters";
 - C. securities on which interest is not paid above a certain level, such as "capped floaters" or that cease to pay any interest when a certain level is reached, such as "range floaters";
 - D. securities whose interest rate reset provisions are tied to more than one index so that a change in the relationship between these indices may result in the value of the instrument falling below par, such as "dual index floaters"; and
 - E. securities whose interest rates reset provision is tied to an index that materially lags short-term interest rates, such as "Cost of Funds Index (COFI) floaters" or Prime floaters.

- III. Maturity and duration constraints are as follows:
- A. Notwithstanding the following, the average life of the collateral investment portfolio shall not differ from the average life of the outstanding loans by more than 14 days. Loans on an open basis (i.e. can be called by either party on one day notice) will be considered as one day instruments. The average life of floating rate instruments will be calculated to the reset date. In addition, these guidelines are intended to eliminate any negative convexity risk (i.e. contraction or extension risk), and the Contractor is expected to invest the collateral portfolio in the full spirit of this intention;
 - B. Fixed-rate notes, bonds, and debentures may not exceed a term of 14 months fixed from date of purchase to final stated maturity or unconventional put date. Fixed-rate asset-backed securities will have a projected maximum average life of 14 months and a final stated maturity that does not exceed five years;
 - C. Floating rate and variable rate securities may not exceed a term of two years fixed from date of purchase to final stated maturity. Floating rate asset-backed securities will have a projected maximum average life of two years and a final stated maturity that does not exceed five years. The interest rate reset on each of these securities must occur no less frequently than every three months;
 - D. Repurchase agreements, excluding U.S. Treasuries or agencies, will have a maximum term of one month. U.S. Treasuries or agencies will have a maximum term of three months; and
 - E. Money market mutual funds will be considered to have a maturity of one day.
- IV. Diversification standards are as follows:
- A. The greater of \$100 million or 3 percent of the collateral pool may be invested in the obligations of any one issuer, except for those of the U.S. Treasury and agencies carrying an explicit federal government guarantee;
 - B. No more than 15 percent of the portfolio may be invested in the securities issued by participants in anyone corporate sector, except for the financial sector, which is limited to 25 percent of the portfolio;
 - C. Investment in securities issued by broker-dealers is specifically prohibited;
 - D. Zero-coupon U.S. government issues are limited to 15 percent of the portfolio. All other zero-coupon issues are specifically prohibited. U.S. Treasury Bills, commercial paper, and U.S. agency discount notes are not considered zero-coupon issues;
 - E. No more than 40 percent of the portfolio may be invested in floating rate or variable rate securities;

- F. No more than 40 percent of the portfolio may be invested in asset-backed securities;
- G. No more than 30 percent of the portfolio may be invested in commercial debt and commercial paper;
- H. The portfolio may not be invested in illiquid securities. For purposes herein, an illiquid security is defined to be an issue that is not salable without the sale proceeds being materially impacted due to a lack of other trading activity in the security. the Funds' therefore expects the Contractor to invest only in liquid short-term securities; and
- I. The greater of \$300 million or 25% of the aggregate Repurchase Agreement's balance can be with a single Repurchase Broker.

D. Non-Cash Collateral Guidelines

the Funds' has an established policy for the types of acceptable non-cash collateral which follow. To be eligible as non-cash collateral, a security must be rated by at the required quality level by at least two nationally recognized statistical rating agencies. (A list of these agencies is provided as Exhibit A of these guidelines.) If rated by more than two major rating agencies, the two lowest ratings apply. Split rated issues are considered to have the lower of the available ratings.

- I. Irrevocable bank letters of credit issued by an entity other than the Borrower or an affiliate of the Borrower with a financial strength rating of A2/A or its equivalent;
- II. Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations;
- III. Instruments issued by domestic corporations including corporate notes and floating rate notes rated A2/A or equivalent. Commercial paper of domestic corporations must be rated A-1/P-1 or equivalent. Floating rate notes must reprice daily, weekly, monthly or quarterly and utilize a standard repricing index such as LIBOR, Treasury Bills, commercial paper or Federal funds;
- IV. Obligations of domestic and foreign banks, including banker's acceptances, certificates of deposit, domestic and off-shore bank time deposits, bonds (Euro), floating rate notes (Euro) and other debt instruments subject to the maturity limitations described below. The banks must be rated at least A3/ A- or equivalent; and
- V. U.S. dollar-denominated instruments issued by sovereigns, sovereign supported credits, and instruments of foreign banks and corporations. The foreign banks and corporations must be rated at least A2/A or equivalent. Commercial paper of foreign banks and corporations must be rated A-1/P-1.

Exhibit A
List of Nationally Recognized Statistical Rating Agencies

Duff & Phelps
Fitch Investors Service
International Bank Credit Group
Moody's Investor Services
Standard & Poor's
Thompson Bank Watch

Securities Lending Monitoring Policy

Purpose

The the Funds' securities lending program is designed to generate incremental income from lending securities to qualified borrowers who provide collateral in exchange for the right to use the securities. The investing of this collateral is expected to follow the investment guidelines developed by the Funds' with the principal objectives being liquidity and preservation of capital. There are no goals or expectations on a specific amount of income to be generated from the securities lending program. The reason for setting no goals or expectations is to minimize incentives to violate the guidelines established in an effort to generate higher income levels. Incremental income levels will be dictated by the market's demand for securities in our portfolio.

The purpose of this Securities Lending Monitoring Policy is to define the process for management and oversight of the securities lending program.

Responsibilities:

The Securities Lending Monitoring Policy is disseminated below through the assignment of responsibilities within the securities lending program to the Funds's Finance Committee, Staff, Consultant, and Contractors.

Finance Committee:

1. Approve Securities Lending Monitoring Policy and Securities Lending Objectives and Guidelines;
2. Review securities lending program performance annually with Staff, and
3. Upon recommendation from the staff, approve which portions of the portfolio may be lent.

Investment Staff

1. Report to the Finance Committee annually on the performance and compliance of the securities lending program.
2. Monitor Contractors' compliance with program guidelines on an ongoing basis and notify the Finance Committee of any violation.
3. Review the Securities Lending Monitoring Policy and Securities Lending Objectives and Guidelines annually and recommend changes to the Finance Committee.
4. Review and evaluate the quarterly reports, as defined below, from the Contractors. Design and request changes to the quarterly report format as needed.
5. Oversee the resolution of the sell-fail disagreements between Contractors and investment managers.
6. Update approved broker/borrower list and lending limits as necessary.

7. Make recommendations on which portion of the the Funds' portfolio should be lent.

Contractors

1. The Contractor will notify the Funds' Staff immediately if there is a violation of the Securities Lending Guidelines.
2. The Contractor will provide a quarterly report (summarizing monthly information) including, but not limited to, the following:
 - A. a statement of compliance with the Securities Lending Guidelines, also noting any securities in the collateral portfolio that were down-graded;
 - B. the daily lending activity and income earned, and an average volume of securities loaned by broker, asset category, and manager account, summarized for each month over the quarter (including year-to-date statistics);
 - C. listing of portfolio holdings, with portfolio level statistics, for each month end, including market values, cost, maturity, duration, yield-to-maturity, and credit quality;
 - D. sell-fail statistics for each month, including the number of fails, claim amounts, claims as a percentage of lending income, and claims as a percentage of loan balances;
 - E. the monthly net income earned as a percentage of average loan balances, designed to measure the return earned on loans by asset category;
 - F. the net income earned as a percentage of the lending asset base (defined in "h" below) in each category;
 - G. the average monthly gross spread in each asset category (the gross spread will be calculated as the yield earned on the collateral portfolio plus the fee paid on non-cash collateral minus the rebate paid to the broker-dealer, and represents the earnings available to split between the Contractor and the Funds');
 - H. the average market value of the assets available for lending each month (lending asset base) by asset category;
 - I. the average monthly loan balances as a percentage of the average monthly lending asset base in each category;
 - J. the monthly average maturity of the collateral portfolio and the broker loan portfolio; and
 - K. a review of the loan spreads and volume available in the market segments in which the Funds' lends.

EXHIBIT B

EXHIBIT B

List of Funds

1. Public School Employees' Retirement System
2. Pennsylvania Municipal Retirement System
3. State Employees' Retirement System
4. State Workers Insurance Fund
5. Worker's Compensation Security Fund
6. State Lottery Fund
7. Insurance Liquidations Fund

EXHIBIT C

**(Includes original Global Securities Lending Approved
Borrowers List and Approved Borrowers as of June 2010)**

EXHIBIT C

Global Securities Lending Approved Borrowers

The following is the list of Borrowers in the Program referred to in Section 1 (entitled Appointment of Lending Agent) of the Securities Lending Authorization dated as of November 2, 1998 by and between MELLON BANK, N.A., as Lending Agent, and Commonwealth of Pennsylvania acting by and through its Treasury Department as custodian of certain assets of the Commonwealth, as Client.

Domestic Broker/Dealers

1. ABN Amro Incorporated *
2. Barclays Capital, Inc. *
3. Bear Stearns & Company, Inc. *¹
4. Bear Stearns Securities Corp. ¹
5. BT Alex Brown, Inc.
6. Chase Securities Inc.
7. CIBC Oppenheimer Corp.
8. Credit Agricole Securities, Inc.
9. Credit Suisse First Boston Corporation *
10. Dean Witter Reynolds, Inc.
11. Deutsche Bank Securities Inc. *
12. Donaldson, Lufkin & Jenrette Securities Corporation *
13. Dresdner Kleinwort Benson North America LLC *
14. First Chicago Capital Markets, Inc. * ²
15. Fleet Securities, Inc.
16. Fuji Securities, Inc. *
17. Goldman, Sachs & Company *
18. Greenwich Capital Markets, Inc. *
19. HSBC Securities, Inc. *
20. ING Baring Furman Selz LLC
21. Jefferies & Company, Inc.
22. J.P. Morgan Securities, Inc. *
23. Lehman Brothers, Inc.
24. Lewco Securities Corp.
25. Merrill Lynch Government Securities, Inc. * ³
26. Merrill Lynch, Pierce, Fenner & Smith, Inc. ³
27. Morgan Stanley & Co., Inc. * ⁴
28. MS Securities Services, Inc. ⁴
29. NationsBank Montgomery Securities, Inc. *
30. Nesbitt Burns Securities, Inc. *
31. Neuberger & Berman, LLC
32. Nomura Securities International, Inc. *
33. PaineWebber Inc. *
34. Paloma Securities L.P.
35. Paribas Corporation *
36. Prudential Securities, Inc. *
37. Raymond James & Associates, Inc.
38. RBC Dominion Securities Corp.
39. Republic New York Securities Corp.

**Global Securities Lending
Approved Borrowers**

(Page 2 of 2)

Domestic Broker/Dealers (cont.)

- 40. Salomon Smith Barney, Inc. *
- 41. SG Cowen Securities Corp.
- 42. TD Securities (USA) Inc.
- 43. Warburg Dillon Read, LLC *
- 44. Weiss, Peck & Greer

Other Domestic

- 45. Bankers Trust Company
- 46. First National Bank of Chicago ²
- 47. Morgan Guaranty Trust Co. of New York
- 48. State Street Bank and Trust Company

International Brokers & Banks

- 49. Australia and New Zealand Banking Group
- 50. Bankers Trust International, PLC
- 51. Banque Paribas
- 52. Credit Suisse First Boston (Europe), Ltd.
- 53. Deutsche Bank, AG
- 54. Goldman Sachs International
- 55. Lehman Brothers International (Europe)
- 56. London Global Securities
- 57. Merrill Lynch International Ltd.
- 58. Morgan Stanley & Co. International, Ltd.
- 59. Nomura International PLC
- 60. Salomon Brothers International, Ltd.
- 61. Societe Generale
- 62. UBS AG

* Denotes Primary US Government Securities Dealer

¹ Treated as single entity for credit & processing purposes.

² Treated as single entity for credit & processing purposes.

³ Treated as single entity for credit & processing purposes.

⁴ Treated as single entity for credit & processing purposes.

10/08/98 (ALLEXA)

**BNY Mellon
Securities Lending
Approved Borrowers**

| <u>Domestic Broker/Dealers</u> | | <u>International Brokers & Banks</u> | |
|--------------------------------|---|--|--|
| 1 | ABN AMRO Securities (USA) LLC | 63 | Banc of America Securities Ltd |
| 2 | Alpine Associates L.P. | 64 | Bank of Scotland PLC |
| 3 | Alpine Partners L.P. | 65 | Barclays Bank PLC |
| 4 | Banc of America Securities LLC * 2 | 66 | Barclays Capital Securities Ltd. |
| 5 | Banca IMI Securities Corp | 67 | BNP Paribas S. A. 6 |
| 6 | Bank of New York Mellon | 68 | BNP Paribas Securities Services |
| 7 | Barclays Capital, Inc.* | 69 | Cater Allen International Ltd. |
| 8 | BMO Capital Markets Corp * 3 | 70 | Citigroup Global Markets Limited 16 |
| 9 | BNP Paribas Securities Corp * 4 | 71 | Credit Suisse Securities (Europe), Ltd. |
| 10 | BNP Paribas Prime Brokerage Inc. | 72 | Commerzbank AG |
| 11 | BNY Converge Execution Solutions LLC | 73 | Deutsche Bank, AG |
| 12 | Calyon Securities (USA) Inc. 20 | 74 | Fortis Bank (Netherlands) NV |
| 13 | Cantor Fitzgerald & Co. | 75 | Fortis Global Arbitrage HK |
| 14 | CIBC World Markets Corporation | 76 | Fortis GMK UK Ltd. |
| 15 | Citadel Securities LLC | 77 | Goldman Sachs International |
| 16 | Citigroup Global Markets Inc. * 1 | 78 | HSBC Bank PLC |
| 17 | Credit Suisse Securities (USA) LLC * 15 | 79 | HSBC France |
| 18 | Daiwa Securities America, Inc | 80 | ING Bank NV |
| 19 | Deutsche Bank Securities Inc. * 7 | 81 | JP Morgan Markets Ltd. 23 |
| 20 | Dresdner Kleinwort Securities LLC * | 82 | JP Morgan Securities, Ltd. |
| 21 | First Clearing, LLC | 83 | Macquarie Bank Limited |
| 22 | Fortis Securities LLC | 84 | Merrill Lynch International 14 |
| 23 | FTN Financial Capital Markets | 85 | MF Global (UK) Ltd |
| 24 | Goldman, Sachs & Company * | 86 | Mitsubishi UFJ Securities International PLC |
| 25 | Guggenheim Liquidity Services LLC | 87 | Morgan Stanley & Co. International, plc. |
| 26 | HBK Global Securities L.P. | 88 | Morgan Stanley Securities, Ltd. |
| 27 | HSBC Securities (USA) Inc. * | 89 | Natixis 5 |
| 28 | ING Financial Markets LLC 9 | 90 | Nomura International PLC |
| 29 | Jannet Montgomery Scott LLC | 91 | Royal Bank of Canada Europe Ltd. |
| 30 | Jefferies and Co. Inc. | 92 | Skandinaviska Enskilda Banken AB |
| 31 | J.P. Morgan Clearing Corp | 93 | Societe Generale |
| 32 | J.P. Morgan Securities, Inc. * 8 | 94 | Societe Generale New York Branch ** |
| 33 | KDC Merger Arbitrage Fund L.P. | 95 | Royal Bank of Scotland PLC |
| 34 | Knight Clearing Services LLC | 96 | The Royal Bank of Scotland N.V. |
| 35 | Lazard Capital Markets, LLC | | The Royal Bank of Scotland N.V., New York Branch** |
| 36 | Maple Securities USA Inc. | | UBS AG |
| 37 | Merrill Lynch, Pierce, Fenner & Smith, Inc. | | |
| 38 | MF Global Securities Inc. | | |
| 39 | Mitsubishi UFJ Securities (USA) | | |
| 40 | Morgan Stanley & Co., Inc. * | | |
| 41 | MS Securities Services, Inc. | | |
| 42 | Mizuho Securities (USA) Inc | | |
| 43 | National Financial Services, LLC | | |
| 44 | Natixis Securities North America Inc. | | |
| 45 | NewEdge USA, LLC | | |
| 46 | Nomura Securities International, Inc. * | | |
| 47 | Pershing LLC | | |
| 48 | Pierpont Securities LLC | | |
| 49 | Raymond James & Associates | | |
| 50 | RBC Capital Markets Corp. 13 | | |
| 51 | RBS Dominion Securities Inc. | | |
| 52 | RBS Securities Inc 22 | | |
| 53 | RCap Securities, Inc. | | |
| 54 | Scotia Capital (USA) Inc. | | |
| 55 | SG Americas Securities LLC * | | |
| 56 | South Street Securities LLC | | |
| 57 | State Street Bank & Trust | | |
| 58 | TD Securities (USA) Inc. | | |
| 59 | Timber Hill LLC | | |
| 60 | UBS Securities LLC. * 17 | | |
| 61 | Wells Fargo Securities, LLC | | |
| 62 | Wachovia Bank National Association 11 | | |
| * | Denotes Primary US Government Securities Dealer. | | |
| ** | Denotes single trading limit for multiple entity borrowers | | |
| + | Borrower added to the program this month. | | |
| ++ | Borrower deleted from the program this month. | | |
| 1. | Formerly Salomon Smith Barney Inc. | | |
| 2. | Formerly merged with Fleet Securities | | |
| 3. | Formerly Nesbitt Burns Corp. | | |
| 4. | Formerly Paribas Corporation | | |
| 5. | Formerly IXIS Corporate and Investment Bank | | |
| 6. | Formerly Paribas | | |
| 7. | Formerly Deutsche Banc Alex. Brown Inc. | | |
| 8. | Formerly Chase Securities, Inc. and JP Morgan Securities | | |
| 9. | Formerly ING Bearings Corp. | | |
| 10. | Formerly Morgan Guaranty & Chase Man Bk | | |
| 11. | Formerly First Union National Bank | | |
| 12. | Formerly Prudential Sec., Inc. & Wachovia Sec., Inc. | | |
| 13. | Formerly RBC Dominion Securities Corp. | | |
| 14. | Formerly Merrill Lynch International Ltd. | | |
| 15. | Formerly Credit Suisse First Boston Corporation | | |
| 16. | Formerly Salomon Brothers International, Ltd. | | |
| 17. | Formerly UBS Warburg LLC | | |
| 18. | Formerly Neuberger & Berman, LLC merged with Lehman Brother, Inc. | | |
| 19. | Formerly UBS Limited | | |
| 20. | Formerly Credit Lyonnais Securities (USA) Inc. | | |
| 21. | Formerly Prudential | | |
| 22. | Formerly Greenwich Capital Markets, Inc | | |
| 23. | Bear Stearns International Ltd. | | |

EXHIBIT D

EXHIBIT D

**Commonwealth of Pennsylvania
Participating Funds
Securities Lending Objectives and Guidelines
Index**

| | |
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A. Objectives

1. Securities Lending

The Participating Funds' (herein to potentially include the Public School Employees' Retirement System, the State Employees' Retirement System, and the Pennsylvania Municipal Retirement System) securities lending program is designed to generate incremental income from lending securities to qualified borrowers who provide collateral in exchange for the right to use the securities. The investing of this collateral is expected to follow the investment guidelines developed by the Participating Funds with the principal objectives being liquidity and preservation of capital. There are no goals or expectations on a specific amount of income to be generated from the securities lending program. The reason for setting no goals or expectations is to minimize incentives to violate the guidelines established in an effort to generate higher income levels. Incremental income levels will be dictated by the market's demand for securities in our portfolio.

The primary objectives of lending the Participating Funds' securities are to:

- a) Safeguard securities through management of counterparty risk;
- b) Safeguard capital through receipt of sufficient collateral; and
- c) Enhance portfolio earnings keeping the previous objectives in mind.

2. Management of Cash Collateral

The primary objectives of the management of cash collateral supporting securities loans are to:

- a) Safeguard principal;
- b) Assure all cash collateral is invested in a timely manner;
- c) Maintain a diversified portfolio of investments;
- d) Maintain adequate liquidity to meet the anticipated maturities of security loans; and
- e) Consistent with these objectives, to optimize the spread between the collateral earnings and the rebate rate paid to the borrower of securities.

3. Management of Non-Cash Collateral

The primary objectives of non-cash collateral are to:

- a) Maintain high quality collateral sufficient enough to protect the Participating Funds' interest in loaned securities; and
- b) Maintain non-cash collateral in a fashion to minimize risk.

B. General Lending Guidelines

1. The Contractor shall credit to the account of the appropriate Participating Fund by the 10th business day of each month, in immediately available funds, via wire transfer, all income earned by each Participating Fund for the preceding month.
2. All transfer taxes, fees and necessary costs with respect to the transfer of the borrowed securities shall be paid by the Contractor or the borrower as they become due.
3. The Contractor must collateralize all loaned securities. The proper method of collateralization will be the market convention (market price times 102% for domestic, 105% for international) plus accrued interest.
4. The Contractor must mark to market daily all loaned securities. Loan collateral below 100% for domestic and 105% for international securities must be adjusted to limits discussed in B.3. above within 24 hours and prior to the securities being re-loaned to the same borrowers. Notwithstanding the foregoing, with respect to collateral held in connection with loans of securities of non-United States issuers, certain standard industry practices may from time-to-time preclude the Contractor from obtaining additional collateral by the close of the next business day unless the market value of the collateral previously delivered by the Borrower is less than 100% of the market value of such loaned securities, including accrued interest, under no circumstances, however, will the collateral be permitted to remain below 100% of the value of the loaned securities.
5. (a) In the event that any loan is terminated and the loaned securities, or any portion thereof, shall not have been returned to the Participating Fund for whose account such loan was made for any reason (including, without limitation, the insolvency or bankruptcy of the borrower) within the time specified by the applicable securities on loan agreement, the Contractor, at its expense, shall (i) promptly replace the loaned securities, or any portion thereof, not so returned with other securities of the same issuer, class, and denomination and with the same dividend rights and other economic benefits as such securities possessed at the close of business on the date as of which the loaned securities should have been returned, or (ii) if it is unable to purchase such securities on the open market, credit the applicable Participating Fund with the market value of such unreturned loaned securities, such market value to be determined as of the close of business on the date as of which such loaned securities should have been returned by the Borrower. Until such time as actions (i) or (ii) have been consummated, any dividends or interest which has accrued on the loaned securities, whether or not received from the Borrower, shall be credited by the Contractor to the Participating Fund from whose account such loan was made.
(b) The Contractor shall indemnify, defend, hold and save harmless each Participating Fund from any claims, actions, demands, losses, or lawsuits of any kind resulting from the negligence or willful misconduct of the Contractor, its agents or employees.

6. The Contractor will present to the Participating Funds on a periodic basis, but not less than monthly, a list of all potential borrowers. The Participating Funds reserve the right to eliminate borrowers from the program.
7. The Contractor shall maintain the Participating Funds' collateral so that it is separately identified from all other money, securities, and collateral held by the Contractor. The Contractor shall segregate the property of the Participating Funds on the books and records of the Contractor in such a manner so that in the event of a bankruptcy by the Contractor, the Participating Funds' assets shall be immediately returned to the applicable Participating Fund.
8. The Participating Funds may, at their discretion, have its auditors determine whether or not the segregation of assets described in paragraph 7 exists and is adequate. The auditors of The Participating Funds' choice will perform "agreed upon procedures," and these auditors may be the Contractor's independent auditors, any of the Participating Funds' independent auditors, the State Comptroller's Office, the State's Treasury Office, the State's Auditor General's Office, or any other Participating Fund authorized auditors. The Contractor will provide access and space, and will pay for the procedures contracted for by the Participating Funds.
9. The Contractor shall comply with the responsibilities and reporting requirements in each applicable Participating Fund's Securities Lending Monitoring Policy.
10. The Contractor will use its best efforts to preserve each Participating Fund's voting rights for all loaned securities to the extent requested to do so in a timely manner.
11. The Contractor shall warrant that it maintains errors and omissions insurance providing a prudent amount of coverage for negligent acts or omissions and that such coverage is applicable to the Contractor's actions under the contract.
12. The Contractor may annually be required to retain a third party to evaluate the collateral pool risk, at its own expense, with findings supplied to the Participating Funds. The Contractor is required to provide the Participating Funds with the findings of any other evaluation of the collateral pool risk performed by third parties as long as providing those reports does not violate local, state, or federal laws or regulations.
13. The Contractor shall cooperate in the Participating Funds' annual review of contract performance, providing all information and records to the Participating Funds as the Participating Funds may, in their sole discretion, reasonably determine to be necessary for the Participating Funds' determination as to the continuation of the contract term.
14. The Contractor shall supply each Participating Fund with the completed, audited financial reports necessary to comply with the Governmental Accounting Standards Board Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*. Such financial reports should be provided on a quarterly basis as required by the funds.

C. Cash Collateral Investment Guidelines

The Participating Funds have established the following investment guidelines. The Contractor will invest cash collateral proceeds and shall follow these guidelines explicitly. If, at any time, the collateral portfolio is in violation of these guidelines (i.e., a credit rating downgrade), the Contractor shall notify the Participating Funds promptly in writing to the extent reasonably feasible, at which time the Participating Funds will direct the Contractor on the next course of action (i.e., continue to hold the security, sell the security, etc.). This in no means limits the Contractor's ability to sell (or retain) the security should it deem it in the best interest of the Participating Funds to do so and absent contrary direction. Collateral for loaned international securities may only be invested in instruments denominated in U.S. Dollars. To be eligible for cash collateral investment, a security must be rated by both Moody's Investor Service and Standard & Poors ("Rating Agencies") at the required quality level at the time of purchase. Split rated issues are considered to have the lower of the available ratings. For a credit-enhanced issue to be eligible for purchase, the provider of the enhancement must be an AAA-rated financial institution.

1. Acceptable cash collateral investment instruments include:
 - a) Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations;
 - b) Repurchase agreements collateralized at 102% by debt obligations of the U.S. Government or its agencies marked-to-market daily. Repurchase agreements collateralized at 105% by A3/A- or higher rated corporate debt or AA- or better asset-backed securities or commercial paper with a minimum P-1/A-1 rating. Collateral must be rated by both Rating Agencies. Split rated issues are considered to have the lower of the two ratings. The Participating Funds understand that for tri-party repurchase agreements, the collateral may, at times, be rated by only one Rating Agency or may have a split rating with the second rating being lower than A3/A-. The tri-party repurchase agreements collateralized by corporate debt will be considered in conformity with these guidelines as long as at least one Rating Agency has a rating of A3/A- or higher;
 - c) Obligations of domestic and foreign banks, including banker's acceptances, certificates of deposit, domestic and off-shore bank time deposits, bonds (Euro), floating rate notes (Euro) and other debt instruments subject to the maturity limitations described below. The banks must be rated at least A2/A;
 - d) Instruments issued by domestic corporations including corporate notes and floating rate notes rated A2/A or better. Commercial paper and other short-term paper of domestic corporations must be rated A-1/P-1 or better. Floating rate notes must reprice daily, weekly, monthly or quarterly and utilize a standard repricing index such as LIBOR, Treasury Bills, commercial paper or Federal funds;

- e) U.S. dollar-denominated instruments issued by sovereigns, sovereign supported credits, and instruments of foreign banks and corporations. The foreign banks and corporations must be rated at least A2/A. Commercial paper and other short-term paper of foreign banks and corporations must be rated A-1/P-1 or better;
- f) Yankee Securities must be rated A2/A or better;
- g) Insurance company funding agreements, guaranteed investment contracts (GICs) and bank investment contracts (BICs) are acceptable if the issuer has a long-term debt rating or claims paying ability rating of at least A1/A+. In addition, GIC/BIC investments must contain an unconditional put feature that can be exercised within 90 days at par value;
- h) Money market funds as defined under SEC Regulation 270.2a-7. Any investment management or similar type fees paid by any money market, commingled fund, or mutual fund to Mellon Bank, N.A. or any of its affiliates shall be rebated to the Participating Funds in direct proportion to the Participating Funds' share of the commingled account; and
- i) Asset-backed securities rated AAA.

Unless specifically identified in these guidelines, investment in derivative securities, unsecured obligations of institutions whose primary business is to function as a broker/dealer, interest only and principal only stripped mortgages, swap transactions, and repurchase agreements collateralized by whole loan mortgage-backed securities are prohibited.

2. The cash collateral investment portfolio can invest in adjustable rate securities tied to LIBOR, Fed Funds, Treasury Bills and Commercial Paper indices. To limit exposure of the cash collateral investment portfolio to interest rate risk, the following adjustable rate securities are specifically prohibited:
 - a) any securities whose interest rate reset provisions are based on a formula that magnifies changes in interest rates, such as "inverse floaters" and "leveraged floaters";
 - b) securities whose interest rate reset provisions are tied to long-term interest rates so that a change in the slope of the yield curve could result in the value of the instrument falling below par, such as "Constant Maturity Treasury (CMT) floaters";
 - c) securities on which interest is not paid above a certain level, such as "capped floaters" or that cease to pay any interest when a certain level is reached, such as "range floaters" when the ceiling rate is less than 500 basis points above the current repricing index at the time of purchase;
 - d) securities whose interest rate reset provisions are tied to more than one index so that a change in the relationship between these indices may result in the value of the instrument falling below par, such as "dual index floaters"; and

- e) securities whose interest rates reset provision is tied to an index that materially lags short-term interest rates, such as “Cost of Funds Index (COFI) floaters” or Prime floaters.

3. Maturity and duration constraints are as follows:

- a) Notwithstanding the following, the weighted average life of the collateral investment portfolio shall not exceed 45 days. The average life of floating rate instruments will be calculated to the reset date. In addition, these guidelines are intended to eliminate any negative convexity risk (i.e. contraction or extension risk), and the Contractor is expected to invest the collateral portfolio in the full spirit of this intention;
- b) Fixed-rate notes, bonds, and debentures may not exceed a term of 13 months fixed from date of purchase to final stated maturity or unconventional put date. Fixed-rate asset-backed securities will have a projected maximum average life of 13 months and a final stated maturity that does not exceed five years;
- c) Floating rate and variable rate securities may not exceed a term of two years fixed from date of purchase to final stated maturity. Floating rate asset-backed securities will have a projected maximum average life of two years and a final stated maturity that does not exceed five years. The interest rate reset on each of these securities must occur no less frequently than quarterly;
- d) Repurchase agreements, excluding U.S. Treasuries or agencies, will have a maximum term of 33 days. U.S. Treasuries or agencies will have a maximum term of 94 days; and
- e) Money market mutual funds will be considered to have a maturity of one day.
- f) Normal settlement period practices are to be used for all security purchases and sales (i.e., no extended settlement periods are allowed).

4. Diversification standards are as follows:

- a) The greater of \$100 million or 3 percent of the collateral pool may be invested in the obligations of any one issuer, except for those of the U.S. Treasury and agencies carrying an explicit federal government guarantee;
- b) No more than 25 percent of the portfolio may be invested in the securities issued by participants in any one corporate sector, except for the financial and banking sectors, which are each limited to 35 percent of the portfolio;
- c) Investment in securities issued by broker-dealers is specifically prohibited;
- d) Zero-coupon U.S. government issues are limited to 15 percent of the portfolio. All other zero-coupon issues are specifically prohibited. U.S. Treasury Bills, commercial paper, and U.S. agency discount notes are not considered zero-coupon issues;
- e) No more than 40 percent of the portfolio may be invested in floating rate or variable rate securities;

- f) No more than 40 percent of the portfolio may be invested in asset-backed securities;
- g) No more than 30 percent of the portfolio may be invested in commercial paper;
- h) The portfolio may not be invested in illiquid securities. For purposes herein, an illiquid security is defined to be an issue that is not salable without the sale proceeds being materially impacted due to a lack of other trading activity in the security. The Participating Funds therefore expects the Contractor to invest only in liquid short-term securities. Bank time deposits are considered liquid herein as long as the maturity of such instruments is less than 94 days; and
- i) The greater of \$300 million or 25% of the aggregate Repurchase Agreement's balance can be with a single Repurchase Broker.

D. Non-Cash Collateral Guidelines

The Participating Funds have an established policy for the types of acceptable non-cash collateral which follow. To be eligible as non-cash collateral, a security must be rated at the required quality level by each of the Rating Agencies. Split rated issues are considered to have the lower of the ratings.

- 1. Irrevocable bank letters of credit issued by an entity other than the Borrower or an affiliate of the Borrower with a financial strength rating of A2/A; and
- 2. Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations.

E. Monitoring Policy

1. Purpose

The purpose of this Securities Lending Monitoring Policy is to define the process for management and oversight of the securities lending program.

2. Responsibilities

The Securities Lending Monitoring Policy is disseminated below through the assignment of responsibilities within the securities lending program to PSERS's Finance Committee, Investment Staff, and Contractors.

- a) Finance Committee (PSERS Only):
 - (1) Approve Securities Lending Objectives and Guidelines;
 - (2) Review securities lending program performance annually with Staff; and
 - (3) Upon recommendation from the staff, approve which portions of the portfolio may be lent.

b) Investment Staff (PSERS Only):

- (1) Report to the Finance Committee annually on the performance and compliance of the securities lending program.
- (2) Monitor Contractors' compliance with program guidelines on an ongoing basis and notify the Finance Committee of any violation.
- (3) Review the Securities Lending Objectives and Guidelines annually and recommend changes to the Finance Committee.
- (4) Review and evaluate the quarterly reports, as defined below, from the Contractors. Design and request changes to the quarterly report format as needed.
- (5) Oversee the resolution of the sell-fail disagreements between Contractors and investment managers.
- (6) Review approved broker/borrower list.
- (7) Make recommendations on which portion of the portfolio should be lent.

c) Contractors (this section will be applicable to all Participating Funds):

- (1) The Contractor will notify PSERS Staff immediately if there is a violation of the Securities Lending Guidelines.
- (2) The Contractor will provide a quarterly report (summarizing monthly information) including, but not limited to, the following:
 - (i) the daily lending activity and income earned, and an average volume of securities loaned by broker, asset category, and manager account, summarized for each month over the quarter (including year-to-date statistics);
 - (ii) listing of portfolio holdings, with portfolio level statistics, for each month end, including market values, cost, maturity, date to reset, yield-to-maturity, and credit quality;
 - (iii) the monthly net income earned as a percentage of average loan balances, designed to measure the return earned on loans by asset category;
 - (iv) the net income earned as a percentage of the lending asset base (defined in "vi" below) in each category;
 - (v) the average monthly gross spread in each asset category (the gross spread will be calculated as the yield earned on the collateral portfolio plus the fee paid on non-cash collateral minus the rebate paid to the broker-dealer, and represents the earnings available to split between the Contractor and PSERS);
 - (vi) the average market value of the assets available for lending each month (lending asset base) by asset category;
 - (vii) the average monthly loan balances as a percentage of the average monthly lending asset base in each category;

- (viii) the monthly average maturity of the collateral portfolio and the broker loan portfolio; and
- (ix) a review of the loan spreads and volume available in the market segments in which PSERS lends.
- (x) completed, audited financial reports necessary to comply with the Governmental Accounting Standards Board Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*.

EXHIBIT E

Securities Lending Fee Split

The following is the fee split referred to in Section 11 (entitled Compensation to the Lending Agent) of the Securities Lending Authorization dated as of November 2, 1998, by and between MELLON BANK, N.A., as Lending Agent, and the COMMONWEALTH OF PENNSYLVANIA TREASURY DEPARTMENT as Client.

1. Subject to the payment provisions set forth in the following paragraph, Lending Agent shall retain an amount equal to (i) 0% of the first \$18,000,000 net securities lending revenues per Contract Year generated under this Agreement; (ii) 20% of the net securities lending revenues in excess of \$18,000,000 and up to and including \$33,000,000 per Contract Year generated under this Agreement; and (iii) 10% of the net securities lending revenues in excess of \$33,000,000 per Contract Year generated under this Agreement all as compensation for its securities lending services and the Funds (from whose account such revenue generating loans were made) shall be entitled to the remainder of such net securities lending revenues on a pro rata basis. For purposes hereof, (a) net securities lending revenues shall mean (i) all loan premium fees derived from Lending Agent's acceptance of non-cash Collateral; plus (ii) all ordinary gains and losses, income and earnings from the investment and reinvestment of cash Collateral on behalf of each Fund minus broker rebate fees paid by the Lending Agent to the Borrower; and (b) "Contract Year" shall mean the period beginning on the date hereof and ending on the first anniversary of such date and each successive one-year period thereafter.

2. (A) The Lending Agent shall remit to the Client, on or before the tenth business day of each month during each Contract Year, an amount equal to (i) the first \$1,500,000 of the net securities lending revenues attributable to the immediately preceding month; plus (ii) 90% of net securities lending revenues in excess of \$1,650,000 attributable to the immediately preceding month; and, (B) subject to reconciliation as hereinafter provided, the Lending Agent shall be entitled to retain a monthly amount equal to (i) all net securities lending revenues attributable to the immediately preceding month in excess of \$1,500,000 up to, but not to exceed \$150,000; plus (ii) 10% of net securities lending revenues in excess of \$1,650,000 attributable to the immediately preceding month. Within thirty days of the end of each Contract Year, the total amount of net securities lending revenues generated by the Lending Agent in respect of this Agreement during the preceding Contract Year and the aggregate of all amounts retained by the Lending Agent on a monthly basis pursuant to this Paragraph 2 shall be reconciled with the amount of net securities lending revenues to which the Lending Agent is entitled for such preceding Contract Year, determined on an annual basis, pursuant to Paragraph 1 above. In the event that the aggregate monthly compensation received by the Lending Agent pursuant to this Paragraph 2 for the preceding Contract Year exceeds the annual amount to which the Lending Agent is entitled under Paragraph 1 above, then the Lending Agent shall promptly credit the account of the appropriate Fund or Funds with such excess.

FIRST AMENDMENT
TO
SECURITIES LENDING AUTHORIZATION

THIS FIRST AMENDMENT TO SECURITIES LENDING AUTHORIZATION is made and effective as of September 5, 2000 ("Amendment") by and between the COMMONWEALTH OF PENNSYLVANIA (the "Commonwealth"), acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth as further identified below (hereinafter, "Client") and MELLON BANK, N.A., a national banking association organized under the laws of the United States, (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client and Lending Agent have entered into a certain Securities Lending Authorization dated as of November 2, 1998 (the "Agreement"); and

WHEREAS, the Client and Custodian Bank desire to amend the Agreement in certain respects as hereinafter provided;

NOW, THEREFORE, in consideration of the mutual covenants set forth in the Agreement and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties hereto agree as follows:

1. The Agreement is hereby amended by deleting Section 13 therefrom and substituting in lieu thereof the following:

"13. Amendment and Termination. Except as specifically provided in Section 13.2 hereof relating to amendments pertaining to individual Funds only, this Agreement may not be amended or modified except by written agreement duly executed by or on behalf of the parties hereto. This Agreement may be terminated at any time at the option of the Client upon thirty (30) days prior written notice to the Lending Agent or at the option of the Lending Agent upon one hundred eighty (180) days prior written notice to the Client; provided, however, that the Lending Agent shall not be under any obligation to make securities loans if such loans are not in the best interest of the Client. In the event that this Agreement is terminated, the Lending Agent shall not make any further securities loans on behalf of the Client or any of the Funds after it has given or received, as the case may be, notice of such termination and shall promptly take all reasonable actions to terminate all securities loans then outstanding. The obligations and the rights of the Client, the Funds and

the Lending Agent under this Agreement with respect to any outstanding loans shall survive and continue despite any termination of this Agreement until fully performed or satisfied.

2 The Agreement is hereby amended by deleting Section 13.2 therefrom and substituting in lieu thereof the following:

“13.2. Opt-Out Mechanism and Amendment of Investment Policy and Guidelines. The parties hereto acknowledge and shall give effect to the right of any Fund to terminate its participation in the Program established hereunder. Each Fund may terminate its participation in the Program by furnishing at least thirty (30) days advance written notice to the Client and the Lending Agent. The parties hereto further understand and agree that subject to the following procedures, each Fund may from time to time, in its sole discretion, amend the Securities Lending Investment Policy and Guidelines set forth in Exhibit D as said Policy and Guidelines relate to such Fund. Such Fund-initiated amendments of said Policy and Guidelines shall be communicated in writing to the Client and the Lending Agent by the Fund initiating such amendment at least fifteen (15) days prior to the intended effective date thereof (the “Notice”). Fund-initiated amendments of said Policy and Guidelines shall become effective, and shall be implemented by the Lending Agent, 15 days following receipt of Notice thereof by the Lending Agent and the Client unless the Lending Agent and/or the Client shall have issued a written objection thereto to the initiating Fund. In the event that the Lending Agent or the Client does not approve the implementation of Fund- initiated amendment to the Policy and Guidelines (which approval shall in no event be unreasonably withheld or delayed), the Lending Agent or the Client, as the case may be, shall promptly notify the initiating Fund thereof and of the nature of the objection and shall cooperate with the initiating Fund to implement an alternative which is mutually acceptable to such Fund and the Client or the Lending Agent, as the case may be.. The Lending Agent may rely upon the representations of the Fund as to whether and when the required Notice has been provided by the Fund to the Client in accordance with this Section and as to the expiration of the Notice period specified herein . Any Fund-initiated amendment to the Securities Lending Investment Policy and Guidelines set forth in Exhibit D hereto which become effective pursuant to the provisions of this Section shall be deemed to constitute an amendment to this Agreement to the limited extent of the Fund to which such amendment or modification is applicable without further action by the Client and shall supersede and replace any prior inconsistent provision hereof as it relates to such Fund only.”

3. The Agreement is hereby amended by deleting Subsection C of Exhibit D (entitled “Cash Collateral Investment Guidelines”) therefrom and substituting in lieu thereof a new Subsection C to Exhibit D in form and substance identical to that which is attached hereto as Attachment I.

4. Except as expressly amended hereby, all of the provisions of the Agreement shall remain unchanged; shall continue in full force and effect; and are hereby

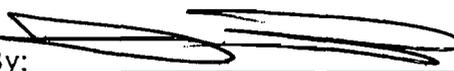
ratified and confirmed in all respects. Upon the effectiveness of this Amendment, all references in the Agreement to "this Agreement" (and all indirect references such as "herein", "hereby", "hereunder", and "hereof") shall be deemed to refer to the Agreement as amended by this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed as of the date set forth above.

COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT

MELLON BANK, N.A.

By: *Barbara Hafer*
Name: Barbara Hafer
Title: State Treasurer
Date: September 1, 2000

By: 
Name: Jeffrey L. Newman
Title: President of Global
Securities Lending

ATTACHMENT 1
TO
FIRST AMENDMENT TO SECURITIES LENDING AUTHORIZATION

made and effective as of September 5, 2000 by and between the

COMMONWEALTH OF PENNSYLVANIA

acting by and through its Treasury Department and

MELLON BANK, N.A.

C. Cash Collateral Investment Guidelines

The Participating Funds have established the following investment guidelines. The Contractor will invest cash collateral proceeds and shall follow these guidelines explicitly. If, at any time, the collateral portfolio is in violation of these guidelines (i.e., a credit rating downgrade), the Contractor shall notify the Participating Funds promptly in writing to the extent reasonably feasible, at which time the Participating Funds will direct the Contractor on the next course of action (i.e., continue to hold the security, sell the security, etc.). This in no means limits the Contractor's ability to sell (or retain) the security should it deem it to be in the best interest of the Participating Funds to do so and absent contrary direction. Unless, and except to the extent otherwise specifically agreed in writing, Collateral for loaned international securities may only be invested in instruments denominated in U.S. Dollars. To be eligible for cash collateral investment, a security must be rated by both Moody's Investor Service and Standard & Poors ("Rating Agencies") at the required quality level at the time of purchase. Split rated issues are considered to have the lower of the available ratings. For a credit-enhanced issue to be eligible for purchase, the provider of the enhancement must be a AAA-rated financial institution.

1. Acceptable cash collateral investment instruments include:
 - a) Instruments issued or fully guaranteed by the U.S. Government, Federal agencies, or sponsored agencies or sponsored corporations;
 - b) Repurchase agreements collateralized at 102% by debt obligations of the U.S. Government or its agencies marked-to-market daily. Repurchase agreements collateralized at 105% by A3/A- or higher rated corporate debt or AA- or better asset-backed securities or commercial paper with a minimum P-1/A-1 rating. Collateral must be rated by both Rating Agencies. Split rated issues are considered to have the lower of the two ratings. The participating funds understand that for tri-party repurchase agreements, the collateral may, at times, be rated by only one Rating Agency or may have a split rating with the second rating being lower than A3/A-. The tri-party repurchase agreements collateralized by corporate debt will be considered in conformity with these guidelines as long as at least one Rating Agency has a rating of A3/A- or higher;

- c) Obligations of domestic and foreign banks, including banker's acceptances, certificates of deposit, domestic and off-shore bank time deposits, bonds (Euro), floating rate notes (Euro) and other debt instruments subject to the maturity limitations described below. The banks must be rated at least A2/A;
- d) Instruments issued by domestic corporations including corporate notes and floating rate notes rated A2/A or better. Commercial paper and other short-term paper of domestic corporations must be rated A-1/P-1 or better. Floating rate notes must reprice daily, weekly, monthly or quarterly and utilize a standard repricing index such as LIBOR, Treasury Bills, commercial paper or Federal funds;
- e) U.S. dollar-denominated instruments issued by sovereigns, sovereign supported credits, and instruments of foreign banks and corporations. The foreign banks and corporations must be rated at least A2/A Commercial paper and other short-term paper of foreign banks and corporations must be rated A-1/P-1 or better;
- f) Yankee Securities must be rated A2/A or better;
- g) Insurance company funding agreements, guaranteed investment contracts (GICs) and bank investment contracts (BICs) are acceptable if the issuer has a long-term debt rating or claims paying ability rating of at least A1/A+. In addition, GIC/BIC investments must contain an unconditional put feature that can be exercised within 90 days at par value;
- h) Money market funds as defined under SEC Regulation 270.2a-7. Any investment management or similar type fees paid by any money market, commingled fund, or mutual fund to Mellon Bank or any of its affiliates shall be rebated to the participating funds in direct proportion to the participating funds' share of the commingled account; and
- i) Asset-backed securities rated AAA.

Unless specifically identified in these guidelines, investment in derivative securities, unsecured obligations of institutions whose primary business is to function as a broker/dealer, interest only and principal only stripped mortgages, swap transactions, and repurchase agreements collateralized by whole loan mortgage-backed securities are prohibited.

2. The cash collateral investment portfolio can invest in adjustable rate securities tied to LIBOR, Fed Funds, Treasury Bills and Commercial Paper indices. To limit exposure of the Fund's portfolio to interest rate risk, the following adjustable rate securities are specifically prohibited:
 - a) any securities whose interest rate reset provisions are based on a formula that magnifies changes in interest rates, such as "inverse floaters" and "leveraged floaters";
 - b) securities whose interest rate reset provisions are tied to long-term interest rates so that a change in the slope of the yield curve could result in the

value of the instrument falling below par, such as “Constant Maturity Treasury (CMT) floaters”;

- c) securities on which interest is not paid above a certain level, such as “capped floaters” or that cease to pay any interest when a certain level is reached, such as “range floaters” when the ceiling rate is less than 500 basis points above the current repricing index at the time of purchase;
- d) securities whose interest rate reset provisions are tied to more than one index so that a change in the relationship between these indices may result in the value of the instrument falling below par, such as “dual index floaters”; and
- e) securities whose interest rates reset provision is tied to an index that materially lags short-term interest rates, such as “Cost of Funds Index (COFI) floaters” or Prime floaters.

3. Maturity and duration constraints are as follows:

- a) Notwithstanding the following, the weighted average life of the Fund’s investment portfolio shall not exceed 60 days. The average life of floating rate instruments will be calculated to the reset date. In addition, these guidelines are intended to eliminate any negative convexity risk (i.e. contraction or extension risk), and the Fund’s management is expected to invest the Fund’s portfolio in the full spirit of this intention.
- b) Fixed-rate notes, bonds, and debentures may not exceed a term of 13 months fixed from date of purchase to final stated maturity or unconventional put date. Fixed-rate asset-backed securities will have a projected maximum average life of 13 months and a final stated maturity that does not exceed five years.
- c) Floating rate and variable rate securities may not exceed a term of three years fixed from date of purchase to final stated maturity. Floating rate asset-backed securities will have a projected maximum average life of three years and a final stated maturity that does not exceed five years. The interest rate reset on each of these securities must occur no less frequently than quarterly.
- d) Repurchase agreements, excluding those for U.S. Treasuries or agencies, will have a maximum term of 33 days. U.S. Treasuries or agencies will have a maximum term of 94 days.
- e) Money market mutual funds will be considered to have a maturity of one day.
- f) Normal settlement period practices are to be used for all security purchases and sales (i.e., no extended settlement periods are allowed).

4. Diversification standards are as follow:

- a) The greater of \$100 million or 5 percent of the Fund may be invested in the obligations of any one issuer, except for those of the U.S. Treasury and agencies carrying an explicit federal government guarantee;

- b) No more than 25 percent of the Fund may be invested in the securities issued by participants in any one corporate sector, except for the financial and banking sectors, which are each limited to 40 percent of the portfolio;
- c) Investment in securities issued by broker-dealers is specifically prohibited;
- d) Zero-coupon U.S. government issues are limited to 15 percent of the Fund. All other zero-coupon issues are specifically prohibited. U.S Treasury Bills, commercial paper, and U.S. agency discount notes are not considered zero-coupon issues;
- e) No more than forty percent of the Fund may be invested in floating rate or variable rate securities;
- f) No more than forty percent of the Fund may be invested in asset-backed securities;
- g) No more than forty percent of the Fund may be invested in commercial paper;
- h) The Fund may not be invested in illiquid securities. For purposes hereof, an illiquid security is defined to be an issue that is not salable without the sale proceeds being materially impacted due to a lack of other trading activity in the security. Bank time deposits are considered liquid for purposes hereof as long as the maturity of such instruments is less than 94 days; and
- i) The greater of \$300 million or 15% of the aggregate prior days portfolio balance may be invested in Repurchase Agreements with a single counterparty.

**SECOND AMENDMENT
TO
SECURITIES LENDING AUTHORIZATION**

THIS SECOND AMENDMENT TO SECURITIES LENDING AUTHORIZATION is made and effective as of November 29, 2001 ("Amendment") by and between the **COMMONWEALTH OF PENNSYLVANIA** (the "Commonwealth"), acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth (hereinafter, "Client") and **MELLON BANK, N.A.**, a national banking association organized under the laws of the United States, (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client and Lending Agent have entered into a certain Securities Lending Authorization dated as of November 2, 1998 (as amended by the First Amendment, as hereinafter defined, the "Agreement"); and

WHEREAS, the Client and Lending Agent entered into a certain First Amendment to Securities Lending Authorization dated as of September 5, 2000 (the "First Amendment"); and

WHEREAS, the Client and Lending Agent desire to further amend the Agreement in certain respects as hereinafter provided;

NOW, THEREFORE, in consideration of the mutual covenants set forth in the Agreement and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties hereto agree as follows:

1. The Agreement is hereby amended by deleting the first sentence of Section 1 therefrom and substituting in lieu thereof the following:

"The Client hereby authorizes the Lending Agent, as agent for the Funds, to lend US Securities and Foreign Securities (as hereinafter defined) held by each such Fund to such borrowers as may be selected by the Lending Agent for the Program (each a "Borrower"). For purposes hereof and unless otherwise agreed, (i) "U.S Securities" shall mean securities which are cleared and principally settled in the United States; and (ii) "Foreign Securities" shall mean securities which are cleared and principally settled outside of the United States."

2. The Agreement is hereby amended by deleting Section 4 therefrom and substituting in lieu thereof the following:

4. Collateral. Concurrently with the delivery of a Fund's securities to a Borrower, the Lending Agent shall obtain from such Borrower Collateral in an amount equal, as of such date, to the Required Percentage of the market value of any securities loaned, including any accrued interest. For purposes hereof, (i) "Required Percentage" shall mean (i) 102% with respect to U.S. Securities; (ii) 105% with respect to Foreign Securities except in the case of loans of Foreign Securities which are denominated and payable in US Dollars, in which event the "Required Percentage" shall be 102%; and (iii) such other percentage(s) as may be otherwise mutually agreed from time to time by Addendum to this Agreement.

3 The Agreement is hereby amended by deleting Section 5 therefrom and substituting in lieu thereof the following:

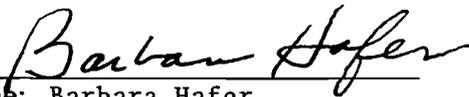
"5. Marking to Market. If at the close of trading on any business day, the market value of the Collateral previously delivered by a Borrower and held in connection with any loan of a Fund's securities is less than the Minimum Percentage of the market value of such loaned securities as of such business day, the Lending Agent shall demand that the Borrower deliver an amount of additional Collateral by the close of the next business day sufficient to cause the market value of all Collateral delivered in connection with such loan to equal or exceed the Required Percentage of the market value of such loaned securities, including accrued interest. Notwithstanding the foregoing, for Collateral held in connection with loans of certain Foreign Securities, it is understood and agreed that certain standard industry practices may from time-to-time preclude the Lending Agent from obtaining additional Collateral by the close of the next business day unless the market value of the Collateral previously delivered by the Borrower is less than 100% of the market value of such loaned securities, including accrued interest. For purposes hereof, the term "market value" of cash Collateral means the value of any cash Collateral or additional cash Collateral as of the time of receipt thereof by the Lending Agent from the Borrower, unadjusted for any subsequent increases or decreases in value as a result of any investment thereof by the Lending Agent pursuant to Section 6 below. For purposes hereof, "Minimum Percentage" shall mean (i) 100% with respect to U.S. Securities; (ii) 105% with respect to Foreign Securities except in the case of loans of Foreign Securities which are denominated and payable in US Dollars, in which event the "Minimum Percentage" shall be 100% and (iii) such other percentage(s) as may be otherwise mutually agreed from time to time by Addendum to this Agreement."

4. Except as expressly amended hereby, all of the provisions of the Agreement shall remain unchanged; shall continue in full force and effect; and are hereby ratified and confirmed in all respects. Upon the effectiveness of this Amendment, all references in the Agreement to "this Agreement" (and all indirect references such as "herein", "hereby", "hereunder", and "hereof") shall be deemed to refer to the Agreement as amended by this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed as of the date set forth above.

COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT

MELLON BANK, N.A.

By: 
Name: Barbara Hafer
Title: State Treasurer

By: 
Name: JEFFREY L. NEWMAN
Title: President,
Global Securities Lending

**THIRD AMENDMENT
TO
SECURITIES LENDING AUTHORIZATION**

THIS THIRD AMENDMENT TO SECURITIES LENDING AUTHORIZATION is made and effective as of January 1, 2002 (the "Effective Date") by and between the **COMMONWEALTH OF PENNSYLVANIA** (the "Commonwealth"), acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth (hereinafter, "Client") and **MELLON BANK, N.A.**, a national banking association organized under the laws of the United States, (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client and Lending Agent have entered into a certain Securities Lending Authorization dated as of November 2, 1998 (as amended by the First Amendment and Second Amendment, each as hereinafter defined, the "Agreement"); and

WHEREAS, the Client and Lending Agent entered into a certain First Amendment to Securities Lending Authorization dated as of September 5, 2000 (the "First Amendment"); and Second Amendment to Securities Lending Authorization dated as of November 29, 2001 and

WHEREAS, in order to recognize certain changes in the market affecting the provision of the securities lending services by the Lending Agent including, without limitation, an increase in the cost of providing such services since the date of the original Agreement, the Client and Lending Agent desire to further amend the Agreement in certain respects as hereinafter provided;

NOW, THEREFORE, in consideration of the mutual covenants set forth in the Agreement and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties hereto agree as follows:

1. Capitalized terms not otherwise defined herein shall have the meanings assigned to such terms in the Agreement. In the event of any conflict between the terms and provisions of this Third Amendment and any other provision of this Agreement, the terms and provisions of this Third Amendment shall prevail.

2. The Agreement is hereby amended by deleting the reference to "Insurance Liquidations Fund" from Exhibit B thereto and adding the following additional Funds to the List of Funds set forth as Exhibit B thereto:

"Health Account For Tobacco Settlement Fund
Underground Storage Tank Indemnity Fund
Tuition Account Program Fund
PA Treasury Department Funds"

3. From and after the Effective Date, the Agreement is hereby amended by deleting Exhibit E therefrom in its entirety and substituting in lieu thereof a new Exhibit E in form and substance identical to that which is attached hereto as Attachment 1.

4. The Agreement is hereby amended by deleting Section 13.1 therefrom and substituting in lieu thereof the following:

“13.1. Term. The term of this Agreement shall commence as of the date hereof and shall continue to and including December 31, 2005 unless sooner terminated pursuant to Section 13 hereof or, with respect to one or more of the Funds, pursuant to Section 13.2 hereof .

5. Except as expressly amended hereby, all of the provisions of the Agreement shall remain unchanged; shall continue in full force and effect; and are hereby ratified and confirmed in all respects. Upon the effectiveness of this Amendment, all references in the Agreement to “this Agreement” (and all indirect references such as “herein”, “hereby”, “hereunder”, and “hereof”) shall be deemed to refer to the Agreement as amended by this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Third Amendment to be duly executed as of the date set forth above.

COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT

MELLON BANK, N.A.

By: 
Name: Barbara Hafer
Title: State Treasurer

By: 
Name: JEFFREY L. NEWMAN
Title: President,
Global Securities Lending

ATTACHMENT 1

to

Third Amendment to Securities Lending Authorization Agreement by and between the **COMMONWEALTH OF PENNSYLVANIA**, acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth (as, Client) and **MELLON BANK, N.A.**, a national banking association organized under the laws of the United States, (as Lending Agent).

EXHIBIT E

Securities Lending Fee Split

The following is the fee split referred to in Section 11 (entitled "Compensation to the Lending Agent") of the Securities Lending Authorization dated as of November 2, 1998, as amended, by and between MELLON BANK, N.A., as Lending Agent, and the COMMONWEALTH OF PENNSYLVANIA TREASURY DEPARTMENT as Client.

1. Subject to the payment provisions set forth in Paragraph 3 below and the limitations set forth in Paragraph 2 below, as compensation for its securities lending services, Lending Agent shall retain an amount equal to:

- (a) 0% of an amount equal to 45% of the net securities lending revenues generated under this Agreement per each Contract Year; plus
- (b) 20% of an amount equal to 45% of the net securities lending revenues generated under this Agreement per each Contract Year; plus
- (c) 50% of an amount equal to the remaining 10% of the net securities lending revenues generated under this Agreement per each Contract Year

and the Funds (from whose account such revenue generating loans were made) shall be entitled to the remainder of such net securities lending revenues on a pro rata basis.

2. Notwithstanding Paragraph 1 or any other provision hereof, it is understood and agreed that in the event that the aggregate net securities lending revenue for any Contract Year is less than the Minimum Annual Revenue Amount (as hereinafter defined) the Funds (from whose account such revenue generating loans were made) shall be entitled to receive the first \$18,000,000.00 of such net securities lending revenues on a pro rata basis and the remainder of such net securities lending revenues, if any, shall be retained by the Lending Agent as compensation for its securities lending services. In the event that this Agreement is terminated for any reason on any date other than the last day of a calendar year, the amount payable to the Funds pursuant to this Paragraph and the Minimum Annual Revenue Amount shall be reduced and

prorated by multiplying each such amount by a fraction equal to the number of months in such partial year during which this Agreement remained in effect over 12.

3. For purposes hereof:
 - (a) "Minimum Annual Revenue Amount" shall mean \$20,930,233.00 or such other amount as the parties may from time to time agree in writing;
 - (b) "Net securities lending revenues" shall mean (i) all loan premium fees derived from Lending Agent's acceptance of non-cash Collateral; plus (ii) all gains and losses, income and earnings from the investment and reinvestment of cash Collateral on behalf of each Fund minus broker rebate fees paid by the Lending Agent to the Borrower; and
 - (c) "Contract Year" shall mean the period beginning on the Effective Date hereof and ending on December 31, 2002 and each successive calendar year period thereafter

4. (a) The Lending Agent shall remit to the Client, on or before the tenth business day of each month during each Contract Year, an amount equal to 86% of the net securities lending revenues attributable to the immediately preceding month; and,

(b) subject to annual reconciliation as hereinafter provided, the Lending Agent shall be entitled to retain a monthly amount equal to 14% of net securities lending revenues attributable to the immediately preceding month.

Within thirty days of the end of each Contract Year, the total amount of net securities lending revenues generated by the Lending Agent in respect of this Agreement during the preceding Contract Year and the aggregate of all amounts retained by the Lending Agent on a monthly basis pursuant to this Paragraph 4(b) shall be reconciled with the amount of net securities lending revenues to which the Lending Agent is entitled for such preceding Contract Year, determined on an annual basis, pursuant to Paragraphs 1 and 2 above. In the event that the amount of the aggregate monthly net securities lending revenues retained by the Lending Agent pursuant to this Paragraph 4 for the preceding Contract Year exceeds the annual amount to which the Lending Agent is entitled under Paragraphs 1 or 2 above, then the Lending Agent shall promptly credit the account of the appropriate Fund or Funds with such excess.

**FOURTH AMENDMENT
TO
SECURITIES LENDING AUTHORIZATION**

THIS FOURTH AMENDMENT TO SECURITIES LENDING AUTHORIZATION is made and effective as of January 1, 2005 (the "Effective Date") by and between the **COMMONWEALTH OF PENNSYLVANIA** (the "Commonwealth"), acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth (hereinafter, "Client") and **MELLON BANK, N.A.**, a national banking association organized under the laws of the United States, (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client and Lending Agent have entered into a certain Securities Lending Authorization dated as of November 2, 1998 (as amended by the First Amendment, Second Amendment, AND Third Amendment, each as hereinafter defined, the "Agreement"); and

WHEREAS, the Client and Lending Agent entered into a certain First Amendment to Securities Lending Authorization dated as of September 5, 2000 (the "First Amendment"); Second Amendment to Securities Lending Authorization dated as of November 29, 2001 (the "Second Amendment"); and Third Amendment to Securities Lending Authorization dated as of January 1, 2002 (the "Third Amendment")

WHEREAS, the Client and Lending Agent desire to further amend the Agreement in certain respects as hereinafter provided;

NOW, THEREFORE, in consideration of the mutual covenants set forth in the Agreement and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties hereto agree as follows:

1. Capitalized terms not otherwise defined in herein shall have the meanings assigned to such terms in the Agreement. In the event of any conflict between the terms and provisions of this Third Amendment and any other provision of this Agreement, the terms and provisions of this Third Amendment shall prevail.

2. From and after the Effective Date, the Agreement is hereby amended by adding the following at the end of Section 6 (entitled "Collateral Investment") thereof:

"The parties hereto recognize that the collective investment vehicle in which Cash Collateral invested by the Lending Agent on the Funds' behalf will be subject to fluctuations in market value. Market-driven deviations from the Policy and

Guidelines (defined as deviations from the policy and Guidelines that occur due to market fluctuations in the value of assets after the time of purchase thereof) shall be corrected by the Lending Agent as soon as prudently possible and the Lending Agent shall report each such market-driven deviation to the Client, the Pennsylvania School Employees Retirement System, and such of the other Funds as the Client may request, quarterly with the compliance certification otherwise provided by the Lending Agent. Active breaches (willful breaches of the Policy and Guidelines that occur at the time of purchase activity) shall be considered a violation of the Policy and Guidelines and must be corrected as soon as prudently possible.”

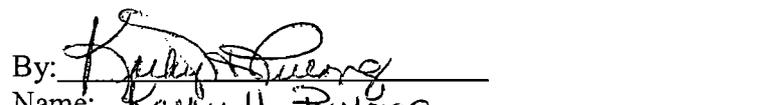
3. Except as expressly amended hereby, all of the provisions of the Agreement shall remain unchanged; shall continue in full force and effect; and are hereby ratified and confirmed in all respects. Upon the effectiveness of this Amendment, all references in the Agreement to “this Agreement” (and all indirect references such as “herein”, “hereby”, “hereunder”, and “hereof”) shall be deemed to refer to the Agreement as amended by this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Fourth Amendment to be duly executed as of the date set forth above.

COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT

MELLON BANK, N.A.

By: 
Name: JAMES M. DARR
Title: DEPUTY TREASURER
& CHIEF COUNSEL

By: 
Name: Kathy H. Rulong
Title: Executive Director
Mellon Global Securities Services

**FIFTH AMENDMENT
TO
SECURITIES LENDING AUTHORIZATION**

THIS FIFTH AMENDMENT TO SECURITIES LENDING AUTHORIZATION is made and effective as of March 26, 2007 (the "Effective Date") by and between the **COMMONWEALTH OF PENNSYLVANIA** (the "Commonwealth"), acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth (hereinafter, "Client") and **MELLON BANK, N.A.**, a national banking association organized under the laws of the United States, (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client and Lending Agent have entered into a certain Securities Lending Authorization dated as of November 2, 1998 (as amended by the First Amendment, Second Amendment, Third Amendment, and Fourth Amendment thereto, each as hereinafter defined, and as otherwise amended, restated, modified or supplemented from time to time, the "Agreement"); and

WHEREAS, the Client and Lending Agent entered into a certain First Amendment to Securities Lending Authorization dated as of September 5, 2000 (the "First Amendment"); Second Amendment to Securities Lending Authorization dated as of November 29, 2001 (the "Second Amendment"); Third Amendment to Securities Lending Authorization dated as of January 1, 2002 (the "Third Amendment"); and Fourth Amendment to Securities Lending Authorization dated as of January 1, 2005 (the "Fourth Amendment")

WHEREAS, the Client and Lending Agent desire to further amend the Agreement in certain respects as hereinafter provided;

NOW, THEREFORE, in consideration of the mutual covenants set forth in the Agreement and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties hereto agree as follows:

1. From and after the Effective Date, all references in the Agreement to the "Master Custody Agreement" by and among the parties hereto shall be deemed to refer instead to that certain Amended, Restated and Consolidated Master Custody Agreement by and among the parties hereto and dated and effective as of the date hereof (the "master Custody Agreement"). Capitalized terms not otherwise defined in herein shall have the meanings assigned to such terms in the Agreement. In the event of any conflict between the terms and provisions of this Fifth Amendment and any other provision of this Agreement, the terms and provisions of this Fifth Amendment shall prevail.

2. The Agreement is hereby amended by deleting Section 13.1 therefrom and substituting in lieu thereof the following:

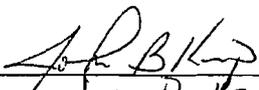
“13.1. Term. The term of this Agreement shall commence as of the Effective Date and shall continue to and including December 31, 2008 and shall continue thereafter for an additional term or terms concurrent with the term of the Master Custody Agreement as the same may be extended from time to time in accordance with the provision thereof, all unless sooner terminated pursuant to Section 13 hereof or, with respect to one or more of the Funds, pursuant to Section 13.2 hereof.

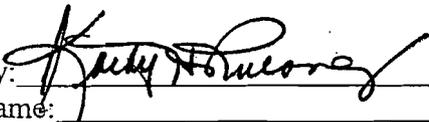
3. Except as expressly amended hereby, all of the provisions of the Agreement shall remain unchanged; shall continue in full force and effect; and are hereby ratified and confirmed in all respects. Upon the effectiveness of this Amendment, all references in the Agreement to “this Agreement” (and all indirect references such as “herein”, “hereby”, “hereunder”, and “hereof”) shall be deemed to refer to the Agreement as amended by this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Fifth Amendment to be duly executed as of the date set forth above.

COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT

MELLON BANK, N.A.

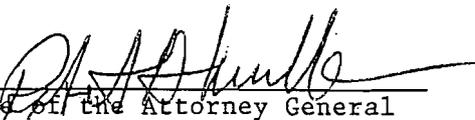
By: 
Name: JOHN B KEMP
Title: DEPUTY TREASURER

By: 
Name: KATHY H. RULONG
Title: Executive Vice President
Mellon Global Securities Lending

EIN: 25-0659306

APPROVED AS TO FORM AND LEGALITY:


Sally Ann Ulrich, Chief Counsel
Treasury Department
Date: 3/13/07


Office of the Attorney General
Date: _____

**SIXTH AMENDMENT
TO
SECURITIES LENDING AUTHORIZATION**

THIS SIXTH AMENDMENT TO SECURITIES LENDING AUTHORIZATION is made and effective as of Sept. 5, 2008 (the "Effective Date") by and between the **COMMONWEALTH OF PENNSYLVANIA** (the "Commonwealth"), acting by and through its Treasury Department as custodian for the assets of various funds of the Commonwealth (hereinafter, "Client") and **THE BANK OF NEW YORK MELLON, successor by operation of law to MELLON BANK, N.A.**, (hereinafter the "Lending Agent").

WITNESSETH:

WHEREAS, the Client and Lending Agent have entered into a certain Securities Lending Authorization dated as of November 2, 1998 (as amended by the First Amendment, Second Amendment, Third Amendment, Fourth Amendment and Fifth Amendment thereto, each as hereinafter defined, and as otherwise amended, restated, modified or supplemented from time to time, the "Agreement"); and

WHEREAS, the Client and Lending Agent entered into a certain First Amendment to Securities Lending Authorization dated as of September 5, 2000 (the "First Amendment"); Second Amendment to Securities Lending Authorization dated as of November 29, 2001 (the "Second Amendment"); Third Amendment to Securities Lending Authorization dated as of January 1, 2002 (the "Third Amendment"); Fourth Amendment to Securities Lending Authorization dated as of January 1, 2005 (the "Fourth Amendment"); and Fifth Amendment to Securities Lending Authorization dated as of March 26, 2007 (the "Fifth Amendment")

WHEREAS, the Client and Lending Agent desire to further amend the Agreement in certain respects as hereinafter provided;

NOW, THEREFORE, in consideration of the mutual covenants set forth in the Agreement and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties hereto agree as follows:

1. The Agreement is hereby amended by deleting Section 6 (entitled "Collateral Investment") therefrom in its entirety and substituting in lieu thereof the following:

6. **Collateral Investment**. The Lending Agent is hereby authorized to invest and reinvest, on behalf of the Funds, any and all cash Collateral in accordance with the provisions hereof.

(i) Cash Collateral received by the Lending Agent on behalf of each of the Public School Employees' Retirement System and/or the State Employees' Retirement System, shall be held and maintained by the Lending Agent in a segregated cash Collateral account established for each such Fund and shall be invested and reinvested in accordance with the respective investment guidelines set forth in Section C of Exhibit D, which Exhibit is incorporated herein in its entirety ("the Policy and Guidelines"), and which investment guidelines may be changed by each Fund from time to time, subject to the Lending Agent's acceptance, which acceptance shall not be unreasonably withheld; and

(ii) Cash Collateral received by the Lending Agent on behalf of each of the Funds other than those specified in (i) above shall be held and maintained by the Lending Agent in a collective cash Collateral account created and maintained by the Lending Agent or an affiliate for investment on behalf of such Funds. The assets of such collective cash Collateral account shall be invested and reinvested in accordance with the investment guidelines established for such collective cash Collateral account, which guidelines are otherwise set forth in the Policy and Guidelines and which may be changed by the Client from time to time, subject to the Lending Agent's acceptance, which acceptance shall not be unreasonably withheld.

In the event that the amount of earnings on invested Collateral is insufficient to pay the entire rebate or other amount payable to a Borrower under any loan of securities and, therefore, results in negative earnings, the amount of such negative earnings shall be paid by the Fund for whose account such loan was made and the Lending Agent on a monthly basis, in accordance with and in the same proportion as their respective percentage entitlements to earnings as set forth in Exhibit E hereto. The Client acknowledges that certain events, including but not limited to the Client's termination of participation in the Program, certain changes to the composition of lendable securities of the Funds, extraordinary changes in applicable interest rates or the bankruptcy or insolvency of any issuer of a security may result in a loss to the Funds. Notwithstanding any other provision hereof, the Client acknowledges and agrees that any losses of principal from investing and reinvesting Collateral shall be at the risk and for the account of the Fund for whose account such Collateral is held. If at any time the Collateral is insufficient to satisfy the obligation to return the full amount owed to the Borrower, the Fund for whose account such Collateral is held shall be solely responsible for such shortfall in the absence of negligence or willful misconduct on the part of the Lending Agent. In the event the Lending Agent is unable to obtain any Funds' share or negative earnings or shortfalls from losses of principal from revenues derived from securities lending activities, the Lending Agent is hereby authorized to obtain such amounts directly from such Fund, to the extent permitted by applicable law.

The parties hereto recognize that the cash Collateral accounts in which Cash Collateral invested by the Lending Agent on the Funds' behalf will be subject to fluctuations in market value. Market-driven deviations from the Policy and Guidelines (defined as deviations from the policy and Guidelines that occur due to market fluctuations in the value of assets after the time of purchase thereof) shall be corrected by the Lending Agent as soon as prudently possible and the Lending Agent shall report each such market-driven deviation to the respective Fund and the Client, quarterly with the compliance certification otherwise provided by the Lending Agent. Active breaches (willful breaches of the Policy and Guidelines that occur at the time of purchase activity) shall be considered a violation of the Policy and Guidelines and must be corrected as soon as prudently possible.

2. Except as expressly amended hereby, all of the provisions of the Agreement shall remain unchanged; shall continue in full force and effect; and are hereby ratified and confirmed in all respects. Upon the effectiveness of this Amendment, all references in the Agreement to "this Agreement" (and all indirect references such as "herein", "hereby", "hereunder", and "hereof") shall be deemed to refer to the Agreement as amended by this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Sixth Amendment to be duly executed as of the date set forth above.

COMMONWEALTH OF PENNSYLVANIA
TREASURY DEPARTMENT

THE BANK OF NEW YORK MELLON,
successor by operation of law to MELLON
BANK, N.A.

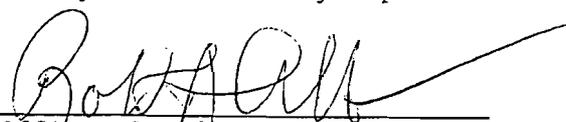
By: 
Name: Brian D. LaForme
Title: Director Investments + Banking

By: 
Name: KATHY H. RULAND
Title: Executive Vice President
BNY Mellon Global Securities Lending

APPROVED AS TO FORM AND LEGALITY:

EIN: 13-5160382

By: 
Leo Pandeladis, Chief Counsel
Pennsylvania Treasury Department

By: 
Office of Attorney General



Treasury Department
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120-0018

November 25, 2008

Mr. Michael McDermott
First Vice President
BNY Mellon Asset Servicing
Mellon Client Service Center, Suite 850
500 Ross Street
Pittsburgh, PA 15262-0001

RE: Collateral Guidelines for Treasury Funds

Dear Mr. McDermott: *Michael*

Pursuant to Section 13.2 of the Securities Lending Authorization, as amended, (the "Agreement") entitled Opt-Out Mechanism and Amendment of Investment Policy and Guidelines, please consider this to be formal notice of the amendment of the Securities Lending Investment Policy and Guidelines, Exhibit D to the Agreement, as said Policy and Guidelines relates to Treasury Funds. As used herein, the term "Treasury Funds" shall mean Funds other than those specified in Section 6(i) of the Agreement, as amended (Funds other than those of the Public School Employees' Retirement System and the State Employees' Retirement System). Exhibit D to the Agreement, entitled Securities Lending Investment Policy and Guidelines, is hereby amended as follows:

1. Section A.3., Management of Non-Cash Collateral, is hereby deleted in its entirety, with respect to Treasury Funds.
2. Section D., Non-Cash Collateral Guidelines, is hereby deleted in its entirety, with respect to Treasury Funds, and, with respect to Treasury Funds, is hereby replaced with the following: "Non-cash collateral is not acceptable collateral for the loan of securities related to Treasury Funds."

3. Pursuant to Section 6(ii) of the Agreement, please invest and reinvest the assets of the collective cash Collateral account for Funds other than those specified in Section 6(i) of the Agreement in accordance with the attached revised investment guidelines. Section C of Exhibit D to the Agreement is therefore, with respect to Treasury Funds, hereby deleted in its entirety and replaced with the attached revised investment guidelines.

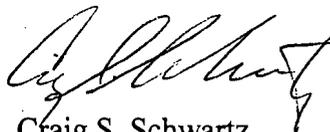
In accordance with these changes, please note that the investment of Treasury Funds in the Mellon GSL Euro Fund is not authorized.

Section 13.2 of the Agreement provides that fund-initiated amendments such as those set forth herein shall be effective 15 days following receipt of Notice thereof, provided BNY Mellon does not issue a written objection thereto and that BNY Mellon's approval shall in no event be unreasonably be withheld. Accordingly, please sign where specified below in order to memorialize BNY Mellon's approval of the above-described fund-initiated amendment to the Agreement with respect to Treasury Funds.

These revised guidelines are effective for the investment of collateral as of this date and nothing contained herein is to be construed as a requirement to liquidate investments in instruments that are not in compliance with the revised guidelines but are otherwise in compliance with the guidelines previously in effect.

Naturally, I am available at your convenience and can be reached at (717) 787-9737 if you have a question.

Respectfully,



Craig S. Schwartz
Deputy Chief Counsel

APPROVED BY BANK OF NEW YORK MELLON:



DATE: 12-2-08

Enclosure

Securities Lending Objectives and Guidelines
Exhibit D, Section C, Cash Collateral Investment Guidelines
Revised as to Treasury Funds
November 12, 2008

Permitted Investments:

- U.S. Treasury notes, bonds and bills.
- U.S. Government agency securities - the fund intends to invest in government sponsored entities such as the Federal Home Loan Mortgage Corp., Federal National Mortgage Association, Federal Home Loan Bank and Federal Farm Credit Bank. In addition the securities backed by the full faith and credit of the U.S. government such as the Government National Mortgage Association.
- Repurchase agreements backed by the above securities subject to a minimum of 102% collateralization with daily updated valuation.

Diversification:

- No more than twenty five percent per issuer.
- The funds minimum overnight (next business day) liquidity level will be targeted at not less than 20%.

Maturity:

- Securities will have a remaining maturity of 397 days or less from settlement date.
- The fund will have a dollar weighted average portfolio maturity of 60 days or less. Put features, floating and variable rate note reset dates will be used as the proxy for maturity date in calculating the weighted average maturity of the fund.

EXHIBIT IV
GLASS LEWIS PROXY GUIDELINES



PENNSYLVANIA
TREASURY
Earn. Learn. Invest.

ROB McCORD, TREASURER



PROXY PAPER POLICY GUIDELINES

AN OVERVIEW OF THE GLASS LEWIS APPROACH TO PROXY ADVICE FOR U.S. COMPANIES

2009 PROXY SEASON

For more information about Glass Lewis' policies or our approach to proxy analysis, please visit www.glasslewis.com or contact our Chief Policy Officer, Robert McCormick, at (415) 678-4228.

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I. A BOARD OF DIRECTORS THAT SERVES THE INTERESTS OF SHAREHOLDERS

Election of Directors

The purpose of Glass Lewis' proxy research and advice is to facilitate shareholder voting in favor of governance structures that will drive performance, create shareholder value and maintain a proper tone at the top. Glass Lewis looks for talented boards with a record of protecting shareholders and delivering value over the medium- and long-term. We believe that boards working to protect and enhance the best interests of shareholders are independent, have directors with diverse backgrounds, have a record of positive performance, and have members with a breadth and depth of relevant experience.

Independence

The independence of directors, or lack thereof, is ultimately demonstrated through the decisions they make. In assessing the independence of directors, we will take into consideration, when appropriate, whether a director has a track record indicative of making objective decisions. Likewise, when a director sits on multiple boards and has a track record that indicates a lack of objective decision making, that will also be considered when assessing the independence of directors. Ultimately, the determination of whether a director is independent or not must take into consideration both compliance with the applicable independence listing requirements as well as judgments made.

We look at each director nominee to examine the director's relationships with the company, the company's executives, and other directors. We do this to evaluate whether personal, familial, or financial relationships (not including director compensation) may impact the director's decisions. We believe that such relationships make it difficult for a director to put shareholders' interests above the director's or the related party's interests. We also believe that a director who owns more than 20% of a company can exert disproportionate influence on the board and, in particular, the audit committee.

Thus, we put directors into three categories based on an examination of the type of relationship they have with the company:

1. *Independent Director* – An independent director has no material financial, familial or other current relationships with the company, its executives, or other board members, except for board service and standard fees paid for that service. Relationships that existed within three to five years¹ before the inquiry are usually considered “current” for purposes of this test.

¹ NASDAQ originally proposed a five-year look-back period but both it and the NYSE ultimately settled on a three-year look-back prior to finalizing their rules. A five-year standard is more appropriate, in our view, because we

In our view, a director who is currently serving in an interim management position should be considered an insider, while a director who previously served in an interim management position for less than one year and is no longer serving in such capacity is considered independent. Moreover, a director who previously served in an interim management position for over one year and is no longer serving in such capacity is considered an affiliate for five years following the date of his/her resignation or departure from the interim management position. Glass Lewis applies a three-year look-back period to all directors who have an affiliation with the company other than former employment, for which we apply a five-year look back.

2. *Affiliated Director* – An affiliated director has a material financial, familial or other relationship with the company or its executives, but is not an employee of the company.² This includes directors whose employers have a material financial relationship with the company.³ In addition, we view a director who owns or controls 20% or more of the company’s voting stock as an affiliate.

We view 20% shareholders as affiliates because they typically have access to and involvement with the management of a company that is fundamentally different from that of ordinary shareholders. More importantly, 20% holders may have interests that diverge from those of ordinary holders, for reasons such as the liquidity (or lack thereof) of their holdings, personal tax issues, etc.

3. *Inside Director* – An inside director simultaneously serves as a director and as an employee of the company. This category may include a chairman of the board who acts as an employee of the company or is paid as an employee of the company. In our view, a director who derives more than 50% of total compensation from a company as a result of affiliated transactions with the director’s employer faces a conflict between making decisions that are in the best interests of the company versus those in the director’s own best interests. Therefore, we will recommend voting against such a director.⁴

Definition of “Material”: A material relationship is one in which the dollar value exceeds:
(i) \$50,000 (or where no amount is disclosed) for directors who are paid for a service

believe that the unwinding of conflicting relationships between former management and board members is more likely to be complete and final after five years. However, Glass Lewis does not apply the five-year look back period to directors who have previously served as executives of the company on an interim basis for less than one year.

² If a company classifies one of its non-employee directors as non-independent, Glass Lewis will classify that director as an affiliate.

³ We allow a five-year grace period for former executives of the company or merged companies who have consulting agreements with the surviving company. (We do not automatically recommend voting against directors in such cases for the first five years.) If the consulting agreement persists after this five-year grace period, we apply the materiality thresholds outlined in the definition of “material.”

⁴ Glass Lewis will recommend shareholders withhold support for directors if shareholders cannot vote against. This applies throughout the guidelines.

they have agreed to perform for the company, outside of their service as a director, including professional or other services; or (ii) \$120,000 (or where no amount is disclosed) for those directors employed by a professional services firm such as a law firm, investment bank, or consulting firm where the company pays the firm, not the individual, for services (This dollar limit would also apply to charitable contributions to schools where a board member is a professor; or charities where a director serves on the board or is an executive.); and any aircraft and real estate dealings between the company and the director's firm; or (iii) 1% of either company's consolidated gross revenue for other business relationships (e.g., where the director is an executive officer of a company that provides services or products to or receives services or products from the company).

Definition of "Familial": Familial relationships include a person's spouse, parents, children, siblings, grandparents, uncles, aunts, cousins, nieces, nephews, in-laws, and anyone (other than domestic employees) who shares such person's home. A director is an affiliate if the director has a family member who is employed by the company and who receives compensation of \$100,000 or more per year or the compensation is not disclosed.

Definition of "Company": A company includes any parent or subsidiary in a group with the company or any entity that merged with, was acquired by, or acquired the company.

Voting Recommendations on the Basis of Board Independence: Glass Lewis believes a board will be most effective in protecting shareholders' interests if it is at least two-thirds' independent. Where more than one-third of the members are affiliated or inside directors, we typically⁵ recommend voting against some of the inside and/or affiliated directors in order to satisfy the two-thirds threshold.

In the case of a less than two-thirds independent board, Glass Lewis strongly supports the appointment of a presiding or lead director with authority to set the meeting agendas and to lead sessions outside the insider chairman's presence. We note that each of the Business Roundtable, The Conference Board, and the Council of Institutional Investors advocates that two-thirds of the board be independent.

In addition, we scrutinize avowedly "independent" chairmen and lead directors. We believe that they should be unquestionably independent or the company should not tout them as such.

Committee Independence: We believe that only independent directors should serve on a company's audit, compensation, nominating, and governance committees.⁶ We typically

⁵ With a staggered board, if the affiliates or insiders that we believe should not be on the board are not up for election, we will express our concern regarding those directors, but we will not recommend voting against the affiliates or insiders who are up for election just to achieve two-thirds independence.

⁶ We will recommend voting against any audit committee member who owns 20% or more of the company's stock, and we believe that there should be a maximum of one director (or no directors if the committee is comprised of less

recommend that shareholders vote against any affiliated or inside director seeking appointment to an audit, compensation, nominating, or governance committee, or who has served in that capacity in the past year.

Separation of the Roles of Chairman and CEO: Glass Lewis believes that separating the roles of corporate officer and chairman creates a better governance structure than a combined executive/chairman position. An executive manages the business according to a course the board charts. Executives should report to the board regarding their performance in achieving goals the board set. This is needlessly complicated when a CEO sits on or chairs the board, since a CEO/chairman presumably will have significant influence over the board.

It can become difficult for a board to fulfill its role of overseer and policy setter when a CEO/chairman controls the agenda and the boardroom discussion. Such control can allow a CEO to have an entrenched position, leading to longer-than-optimal terms, fewer checks on management, less scrutiny of the business operation, and limitations on independent, shareholder-focused goal-setting by the board.

A CEO should set the strategic course for the company, with the board's approval, and the board should enable the CEO to carry out the CEO's vision for accomplishing the board's objectives. Failure to achieve the board's objectives should lead the board to replace that CEO with someone in whom the board has confidence.

Likewise, an independent chairman can better oversee executives and set a pro-shareholder agenda without the management conflicts that a CEO and other executive insiders often face. Such oversight and concern for shareholders allows for a more proactive and effective board of directors that is better able to look out for the interests of shareholders.

We do not recommend that shareholders vote against CEOs who serve on or chair the board. However, we typically encourage our clients to support separating the roles of chairman and CEO whenever that question is posed in a proxy (typically in the form of a shareholder proposal), as we believe that it is in the long-term best interests of the company and its shareholders.

Performance

The most crucial test of a board's commitment to the company and its shareholders lies in the actions of the board and its members. We look at the performance of these individuals as directors and executives of the company and of other companies where they have served. We also look at how directors voted while on the board.

than three directors) who owns 20% or more of the company's stock on the compensation, nominating, and governance committees.

Voting Recommendations on the Basis of Performance: We disfavor directors who have a record of not fulfilling their responsibilities to shareholders at any company where they have held a board or executive position. We typically recommend voting against:

1. A director who fails to attend a minimum of 75% of the board meetings or 75% of the total of applicable committee meetings and board meetings.⁷
2. A director who belatedly filed a significant form(s) 4 or 5, or who has a pattern of late filings if the late filing was the director's fault (we look at these late filing situations on a case-by-case basis).
3. A director who is also the CEO of a company where a serious and material restatement has occurred after the CEO had previously certified the pre-restatement financial statements.
4. A director who has received two vote against recommendations from Glass Lewis for identical reasons within the prior year at different companies (the same situation must also apply at the company being analyzed).
5. All directors who served on the board if, for the last three years, the company's performance has been in the bottom quartile of the sector and the directors have not taken reasonable steps to address the poor performance.
6. An insider director who derives more than 50% of the director's income from affiliated transactions with the company.

Audit Committees and Performance: Audit committees play an integral role in overseeing the financial reporting process because “[v]ibrant and stable capital markets depend on, among other things, reliable, transparent, and objective financial information to support an efficient and effective capital market process. The vital oversight role audit committees play in the process of producing financial information has never been more important.”⁸

When assessing an audit committee's performance, we are aware that an audit committee does not prepare financial statements, is not responsible for making the key judgments and assumptions that affect the financial statements, and does not audit the numbers or the disclosures provided to investors. Rather, an audit committee member monitors and oversees the process and procedures that management and auditors perform. The 1999 Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees stated it best:

⁷ However, where a director has served for less than one full year, we will not typically recommend voting against for failure to attend 75% of meetings. Rather, we will note the failure with a recommendation to track this issue going forward. We will also refrain from recommending to vote against directors when the proxy discloses that the director missed the meetings due to serious illness or other extenuating circumstances.

⁸ “Audit Committee Effectiveness – What Works Best.” PricewaterhouseCoopers. The Institute of Internal Auditors Research Foundation. 2005.

A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting – the full board including the audit committee, financial management including the internal auditors, and the outside auditors – form a ‘three legged stool’ that supports responsible financial disclosure and active participatory oversight. However, in the view of the Committee, the audit committee must be ‘first among equals’ in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process.

Standards for Assessing the Audit Committee: For an audit committee to function effectively on investors’ behalf, it must include members with sufficient knowledge to diligently carry out their responsibilities. In its audit and accounting recommendations, the Conference Board Commission on Public Trust and Private Enterprise said “members of the audit committee must be independent and have both knowledge and experience in auditing financial matters.”⁹

We are skeptical of audit committees where there are members that lack expertise as a Certified Public Accountant (CPA), Chief Financial Officer (CFO) or corporate controller or similar experience. While we will not necessarily vote against members of an audit committee when such expertise is lacking, we are more likely to vote against committee members when a problem such as a restatement occurs and such expertise is lacking.

Glass Lewis generally assesses audit committees against the decisions they make with respect to their oversight and monitoring role. The quality and integrity of the financial statements and earnings reports, the completeness of disclosures necessary for investors to make informed decisions, and the effectiveness of the internal controls should provide reasonable assurance that the financial statements are materially free from errors. The independence of the external auditors and the results of their work all provide useful information by which to assess the audit committee.

When assessing the decisions and actions of the audit committee, we typically defer to its judgment and would vote in favor of its members, but we would recommend voting against the following members under the following circumstances:¹⁰

⁹ Commission on Public Trust and Private Enterprise. The Conference Board. 2003.

¹⁰ Where the recommendation is to vote against the committee chair and the chair is not up for election because the board is staggered, we do not recommend voting against any members of the committee who are up for election; rather, we will simply express our concern with regard to the committee chair.

1. All members of the audit committee when options were backdated, there is a lack of adequate controls in place, there was a resulting restatement, and disclosures indicate there was a lack of documentation with respect to the option grants.
2. The audit committee chair, if the audit committee does not have a financial expert or has a financial expert who does not have a demonstrable financial background sufficient to understand the financial issues unique to public companies.
3. The audit committee chair, if the audit committee did not meet at least 4 times during the year.
4. The audit committee chair, if the committee has less than three members.
5. Any audit committee member who sits on more than three public company audit committees, unless the audit committee member is a retired CPA, CFO, controller or has similar experience, in which case the limit shall be four committees, taking time and availability into consideration including a review of the audit committee member's attendance at all board and committee meetings.
6. All members of an audit committee who are up for election and who served on the committee at the time of the audit, if audit and audit-related fees total one-third or less of the total fees billed by the auditor.
7. The audit committee chair when tax and/or other fees are greater than audit and audit-related fees paid to the auditor for more than one year in a row (i.e., we recommend against ratification of the auditor).
8. All members of an audit committee where non-audit fees include fees for tax services (including, but not limited to, such things as tax avoidance or shelter schemes) for senior executives of the company. Such services are now prohibited by the PCAOB.
9. All members of an audit committee that reappointed an auditor that we no longer consider to be independent for reasons unrelated to fee proportions.
10. All members of an audit committee when audit fees are excessively low, especially when compared with other companies in the same industry.
11. The audit committee chair¹¹ if the committee failed to put auditor ratification on the ballot for shareholder approval. However, if the non-audit fees or tax fees exceed audit plus audit-related fees in either the current or the prior year, then Glass Lewis will recommend voting against the entire audit committee.
12. All members of an audit committee where the auditor has resigned and reported that a section 10A¹² letter has been issued.
13. All members of an audit committee at a time when material accounting fraud occurred at the company.

¹¹ In all cases, if the chair of the committee is not specified, we recommend voting against the director who has been on the committee the longest.

¹² Auditors are required to report all potential illegal acts to management and the audit committee unless they are clearly inconsequential in nature. If the audit committee or the board fails to take appropriate action on an act that has been determined to be a violation of the law, the independent auditor is required to send a section 10A letter to the SEC. Such letters are rare and should be taken seriously.

14. All members of an audit committee at a time when annual and/or multiple quarterly financial statements had to be restated, and any of the following factors apply:
 - The restatement involves fraud or manipulation by insiders;
 - The restatement is accompanied by an SEC inquiry or investigation;
 - The restatement involves revenue recognition;
 - The restatement results in a greater than 5% adjustment to costs of goods sold, operating expense, or operating cash flows; or
 - The restatement results in a greater than 5% adjustment to net income, 10% adjustment to assets or shareholders equity, or cash flows from financing or investing activities.
15. All members of an audit committee if the company repeatedly fails to file its financial reports in a timely fashion. For example, the company has filed two or more quarterly or annual financial statements late within the last 5 quarters.
16. All members of an audit committee when it has been disclosed that a law enforcement agency has charged the company and/or its employees with a violation of the Foreign Corrupt Practices Act (FCPA).
17. All members of an audit committee when the company has aggressive accounting policies and/or poor disclosure or lack of sufficient transparency in its financial statements.
18. All members of the audit committee when there is a disagreement with the auditor and the auditor resigns or is dismissed.
19. All members of the audit committee if the contract with the auditor specifically limits the auditor's liability to the company for consequential damages or requires the corporation to use alternative dispute resolution.¹³
20. All members of the audit committee who served since the date of the company's last annual meeting, and when, since the last annual meeting, the company has reported a material weakness that has not yet been corrected, or, when the company has an ongoing material weakness from a prior year that has not yet been corrected.

We also take a dim view of audit committee reports that are boilerplate, and which provide little or no information or transparency to investors. When a problem such as a material weakness, restatement or late filings occurs, we take into consideration, in forming our judgment with respect to the audit committee, the transparency of the audit committee report.

Compensation Committee Performance: Compensation committees have the final say in determining the compensation of executives. This includes deciding the basis on which compensation is determined, as well as the amounts and types of compensation to be paid. This process begins with the hiring and initial establishment of employment agreements, including the terms for such items as pay, pensions and severance

¹³See the Council of Institutional Investors. "Corporate Governance Policies," p. 4, April 5, 2006; and "Letter from Council of Institutional Investors to the AICPA," November 8, 2006.

arrangements. It is important in establishing compensation arrangements that compensation be consistent with, and based on the long-term economic performance of the business's long-term shareholders returns.

Compensation committees are also responsible for the oversight of the transparency of compensation. This oversight includes disclosure of compensation arrangements, the matrix used in assessing pay for performance, and the use of compensation consultants. In order to ensure the independence of the compensation consultant, we believe the compensation committee should only engage a compensation consultant that is not also providing any services to the company or management apart from their contract with the compensation committee. It is important to investors that they have clear and complete disclosure of all the significant terms of compensation arrangements in order to make informed decisions with respect to the oversight and decisions of the compensation committee.

Finally, compensation committees are responsible for oversight of internal controls over the executive compensation process. This includes controls over gathering information used to determine compensation, establishment of equity award plans, and granting of equity awards. Lax controls can and have contributed to conflicting information being obtained, for example through the use of nonobjective consultants. Lax controls can also contribute to improper awards of compensation such as through granting of backdated or spring-loaded options, or granting of bonuses when triggers for bonus payments have not been met.

Coupled with new compensation disclosure requirements adopted by the SEC for the 2007 proxy season was a requirement for the presentation of the Compensation Discussion and Analysis (CD&A) report in each company's proxy. We review the CD&A in our evaluation of the overall compensation practices of a company, as overseen by the compensation committee. The CD&A is also integral to the evaluation of compensation proposals at companies, such as management-submitted advisory compensation vote proposals, which allow shareholders to vote on the compensation paid to a company's top executives. Beginning with AFLAC in 2008, there are now more than a dozen U.S. companies that are expected to allow shareholders such a vote in 2009.

In our evaluation of the CD&A, we examine, among other factors, the following:

1. The extent to which the company has used performance goals in determining overall compensation as an indication that pay is tied to performance.
2. How well (i.e., how clearly) the company has disclosed performance metrics and goals so that shareholders may make an independent determination that goals were met.
3. The extent to which the performance metrics, targets and goals are implemented to enhance company performance.
4. The selected peer group(s) so that shareholders can make a comparison of pay and performance across the appropriate peer group.

5. The amount of discretion granted management or the compensation committee to deviate from defined performance metrics and goals in making awards.

We evaluate compensation committee members on the basis of their performance while serving on the compensation committee in question, not for actions taken solely by prior committee members who are not currently serving on the committee.

When assessing the performance of compensation committees, we will recommend voting against the following:¹⁴

1. All members of the compensation committee who are up for election and served at the time of poor pay-for-performance (e.g., a company receives an F grade in our pay-for-performance analysis).¹⁵
2. Any member of the compensation committee who has served on the compensation committee of at least two other public companies that received F grades in our pay-for-performance model and who is also suspect at the company in question.
3. The compensation committee chair if the company received two D grades in consecutive years in our pay-for-performance analysis, and if during the past year the Company performed the same as or worse than its peers.¹⁶
4. All members of the compensation committee (during the relevant time period) if the company entered into excessive employment agreements and/or severance agreements.
5. All members of the compensation committee when performance goals were changed (i.e., lowered) when employees failed or were unlikely to meet original goals, or performance-based compensation was paid despite goals not being attained.
6. All members of the compensation committee if excessive employee perquisites and benefits were allowed.
7. The compensation committee chair if the compensation committee did not meet during the year, but should have (e.g., because executive compensation was restructured or a new executive was hired).
8. All members of the compensation committee when the company repriced options within the past two years and we would not have supported the repricing (e.g., officers and directors were allowed to participate).
9. All members of the compensation committee when vesting of in-the-money options is accelerated or when fully vested options are granted.

¹⁴ Where the recommendation is to vote against the committee chair and the chair is not up for election because the board is staggered, we do not recommend voting against any members of the committee who are up for election; rather, we will simply express our concern with regard to the committee chair.

¹⁵ Where there have been multiple CEOs in one year, we will consider not recommending to vote against and deferring judgment until the next year or a full year after arrival.

¹⁶ In cases where the company received two D grades in consecutive years, but during the past year the company performed better than its peers, we refrain from recommending to vote against the compensation chair.

10. All members of the compensation committee when option exercise prices were backdated. Glass Lewis will recommend voting against an executive director who played a role in and participated in option backdating.
11. All members of the compensation committee when option exercise prices were spring-loaded or otherwise timed around the release of material information.
12. All members of the compensation committee when a new employment contract is given to an executive that does not include a clawback provision and the company had a material restatement, especially if the restatement was due to fraud.
13. The chair of the compensation committee where the CD&A provides insufficient or unclear information about performance metrics and goals, where the CD&A indicates that pay is not tied to performance, or where the compensation committee or management has excessive discretion to alter performance terms or increase amounts of awards in contravention of previously defined targets.
14. All members of the compensation committee during whose tenure the committee failed to implement a shareholder proposal regarding a compensation-related issue, where the proposal received the affirmative vote of a majority of the voting shares at a shareholder meeting, and when a reasonable analysis suggests that the compensation committee (rather than the governance committee) should have taken steps to implement the request.¹⁷

Nominating and Governance Committee Performance: The nominating and governance committee, as an agency for the shareholders, is responsible for the governance by the board of the company and its executives. In performing this role, the board is responsible and accountable for selection of objective and competent board members. It is also responsible for providing leadership on governance policies adopted by the company, such as decisions to implement shareholder proposals that have received a majority vote.

Regarding the nominating and or governance committee, we will recommend that votes be withheld from the following:¹⁸

1. All members of the governance committee¹⁹ during whose tenure the board failed to implement a shareholder proposal with a direct and substantial impact on shareholders and their rights - i.e., where the proposal received enough shareholder votes (at least a majority) to allow the board to implement or begin to implement that proposal.²⁰ Examples of these types of shareholder proposals

¹⁷ In all other instances (i.e. a non-compensation-related shareholder proposal should have been implemented) we recommend that shareholders vote against members of the governance committee.

¹⁸ Where the recommendation is to vote against the committee chair and the chair is not up for election because the board is staggered, we do not recommend voting against any members of the committee who are up for election; rather, we will simply express our concern regarding the committee chair.

¹⁹ If the board does not have a governance committee (or a committee that serves such a purpose), we recommend voting against the entire board on this basis.

²⁰ Where a compensation-related shareholder proposal should have been implemented, and when a reasonable analysis suggests that the members of the compensation committee (rather than the governance committee) bear the

are majority vote to elect directors and requests for advisory votes on compensation policies.

2. The governance committee chair,²¹ when the chairman is not independent and an independent lead or presiding director²² has not been appointed.
3. In the absence of a nominating committee, the governance committee chair when there are less than five directors, or all members of the governance committee when there are more than 20 members on the board.
4. The governance committee chair, when the committee fails to meet at all during the year.
5. The governance committee chair, when for two consecutive years the company provides what we consider to be inadequate related party-transaction disclosure (i.e. the nature of such transactions and/or the monetary amounts involved are unclear or excessively vague, thereby preventing shareholders from being able to reasonably interpret the independence status of multiple directors above and beyond what the company maintains is compliant with SEC or applicable stock-exchange listing requirements).

Regarding the nominating committee, we will recommend that votes be withheld from the following:²³

1. All members of the nominating committee, when the committee nominated or renominated an individual who had a significant conflict of interest or whose past actions demonstrated a lack of integrity or inability to represent shareholder interests.
2. The nominating committee chair, if the nominating committee did not meet during the year, but should have (i.e., because new directors were nominated).
3. In the absence of a governance committee, the nominating committee chair²⁴ when the chairman is not independent, and an independent lead or presiding director has not been appointed.²⁵

responsibility for failing to implement the request, we recommend that shareholders only vote against members of the compensation committee.

²¹ If the committee chair is not specified, we recommend voting against the director who has been on the committee the longest. If the longest-serving committee member cannot be determined, we will recommend voting against the longest-serving board member serving on the committee.

²² We believe that one independent individual should be appointed to serve as the lead or presiding director. When such a position is rotated among directors from meeting to meeting, we will recommend voting against as if there were no lead or presiding director.

²³ Where the recommendation is to vote against the committee chair and the chair is not up for election because the board is staggered, we do not recommend voting against any members of the committee who are up for election; rather, we will simply express our concern regarding the committee chair.

²⁴ If the committee chair is not specified, we will recommend voting against the director who has been on the committee the longest. If the longest-serving committee member cannot be determined, we will recommend voting against the longest-serving board member on the committee.

4. The nominating committee chair when there are less than five directors, or all members of the nominating committee when there are more than 20 members on the board.²⁶
5. In rare instances, the nominating committee chair, when a director received a greater than 25% vote against the prior year and not only was the director not removed, but the issues that raised shareholder concern were not corrected.²⁷

Board-level Risk Management Oversight: Glass Lewis evaluates the risk management function of a public company board on a strictly case-by-case basis. Sound risk management, while necessary at all companies, is particularly important at financial firms which inherently maintain significant exposure to financial risk. We believe such financial firms should have a dedicated risk committee, or a committee of the board charged with risk oversight, as well as a chief risk officer who reports directly to that committee, not to the CEO or another executive. Moreover, many non-financial firms maintain strategies which involve a high level of exposure to financial risk. As such, any non-financial firm that has a significant hedging strategy or trading strategy that includes financial and non-financial derivatives should also have a risk committee or its equivalent along with a chief risk officer who reports directly to the board.

When analyzing the risk management practices of public companies, we take note of any significant losses or writedowns on financial assets and/or structured transactions. In cases where a company has disclosed a sizable loss or writedown, and where a reasonable analysis indicates that the company's board-level risk committee should be held accountable for poor oversight, we would recommend that shareholders vote against such committee members on that basis. In addition, in cases where a company maintains a significant level of financial risk exposure but fails to disclose any explicit form of board-level risk oversight (committee or otherwise)²⁸, we will consider recommending to vote against the chairman of the board on that basis.

Experience

We find that a director's past conduct is often indicative of future conduct and performance. We often find directors with a history of overpaying executives or of serving on boards where avoidable disasters have occurred appearing at companies that

²⁵ In the absence of both a governance and a nominating committee, we will recommend voting against the chairman of the board on this basis.

²⁶ In the absence of both a governance and a nominating committee, we will recommend voting against the chairman of the board on this basis.

²⁷ We apply an especially nuanced approach in this case. Considering that shareholder discontent clearly relates to the director who received a greater than 25% vote against rather than the nominating chair, we review the validity of the issue(s) that initially raised shareholder concern, follow-up on such matters, and only recommend to vote against the nominating chair if a reasonable analysis suggests that it would be most appropriate course of action.

²⁸ A committee responsible for risk management could be a dedicated risk committee, or another board committee, (usually the audit committee but occasionally the finance committee), depending on a given company's board structure and method of disclosure. In some cases, the entire board is charged with risk management.

follow these same patterns. Glass Lewis has a proprietary database of every officer and director serving at 8,000 of the most widely held U.S. companies. We use this database to track the performance of directors across companies.

Voting Recommendations on the Basis of Director Experience: We typically recommend that shareholders vote against directors who have served on boards or as executives of companies with records of poor performance, overcompensation, audit- or accounting-related problems, and/or other indicators of mismanagement or actions against the interests of shareholders.²⁹

Likewise, we examine the backgrounds of those who serve on key board committees to ensure that they have the required skills and diverse backgrounds to make informed judgments about the subject matter for which the committee is responsible.

Other Considerations

In addition to the three key characteristics – independence, performance, experience – that we use to evaluate board members, we consider conflict-of-interest issues in making voting recommendations.

Conflicts of Interest: We believe that a board should be wholly free of people who have an identifiable and substantial conflict of interest, regardless of the overall presence of independent directors on the board. Accordingly, we recommend that shareholders vote against the following types of affiliated or inside directors:

1. A CFO who is on the board: In our view, the CFO holds a unique position relative to financial reporting and disclosure to shareholders. Because of the critical importance of financial disclosure and reporting, we believe the CFO should report to the board and not be a member of it.
2. A director who is on an excessive number of boards: Glass Lewis will typically recommend voting against a director who serves as an executive officer of any public company while serving on more than two other public company boards and any other director who serves on more than six public company boards. Academic literature suggests that one board takes up approximately 200 hours per year of each member's time. We believe this limits the number of boards on which directors can effectively serve, especially those who are running another company.³⁰ Further, we note a recent study has shown that the average number of

²⁹ We typically apply a three-year look-back to such issues and also research to see whether the responsible directors have been up for election since the time of the failure, and if so, we take into account the percentage of support they received from shareholders.

³⁰ Our guidelines are consistent with the standards set forth by the NACD in its "Report of the NACD Blue Ribbon Commission on Director Professionalism," 2001 Edition, pp. 14-15 (also cited approvingly by the Conference Board in its "Corporate Governance Best Practices: A Blueprint for the Post-Enron Era," 2002, p. 17), which suggested that CEOs should not serve on more than 2 additional boards, persons with full-time work should not serve on more than 4 additional boards, and others should not serve on more than six boards.

outside board seats held by CEOs of S&P 500 companies is 0.7, down from 1.0 in 2003 and 2.0 in 1998.³¹

3. A director, or a director who has an immediate family member, providing consulting or other material professional services to the company: These services may include legal, consulting, or financial services. We question the need for the company to have consulting relationships with its directors. We view such relationships as creating conflicts for directors, since they may be forced to weigh their own interests against shareholder interests when making board decisions. In addition, a company's decisions regarding where to turn for the best professional services may be compromised when doing business with the professional services firm of one of the company's directors.
4. A director, or a director who has an immediate family member, engaging in airplane, real estate, or similar deals, including perquisite-type grants from the company, amounting to more than \$50,000: Directors who receive these sorts of payments from the company will have to make unnecessarily complicated decisions that may pit their interests against shareholder interests.
5. Interlocking directorships: CEOs or other top executives who serve on each other's boards create an interlock that poses conflicts that should be avoided to ensure the promotion of shareholder interests above all else.³²
6. All board members who served at a time when a poison pill was adopted without shareholder approval within the prior twelve months.

Size of the Board of Directors: While we do not believe there is a universally applicable optimum board size, we do believe boards should have at least five directors to ensure sufficient diversity in decision-making and to enable the formation of key board committees with independent directors. Conversely, we believe that boards with more than 20 members will typically suffer under the weight of “too many cooks in the kitchen” and have difficulty reaching consensus and making timely decisions. Sometimes the presence of too many voices can make it difficult to draw on the wisdom and experience in the room by virtue of the need to limit the discussion so that each voice may be heard.

To that end, we typically recommend voting against the chairman of the nominating committee at a board with fewer than five directors. With boards consisting of more than 20 directors, we typically recommend voting against all members of the nominating committee (or the governance committee, in the absence of a nominating committee).³³

³¹ *Spencer Stuart Board Index*, 2008, p. 18

³² There is no look-back period for this situation. This only applies to public companies and we only footnote it for the non-insider.

³³ The Conference Board, at p. 23 in its report “Corporate Governance Best Practices, Id.,” quotes one of its roundtable participants as stating, “[w]hen you’ve got a 20 or 30 person corporate board, it’s one way of assuring that nothing is ever going to happen that the CEO doesn’t want to happen.”

Controlled Companies

Controlled companies present an exception to our independence recommendations. The board's function is to protect shareholder interests; however, when an individual or entity owns more than 50% of the voting shares, the interests of the majority of shareholders are the interests of that entity or individual. Consequently, Glass Lewis does not recommend voting against directors on boards whose composition reflects the makeup of the shareholder population. In other words, affiliates and insiders who are associated with the controlling entity are not subject to the two-thirds independence rule.

Independence Exceptions: The independence exceptions that we make for controlled companies are as follows:

1. We do not require that controlled companies have boards that are at least two-thirds independent. So long as the insiders and/or affiliates are connected with the controlling entity, we accept the presence of non-independent board members.
2. The compensation committee and nominating and governance committees do not need to consist of independent directors.
 - a. We believe that standing nominating and corporate governance committees at controlled companies are unnecessary. Although having a committee charged with the duties of searching for, selecting, and nominating independent directors can be beneficial, the unique composition of a controlled company's shareholder base makes such committees weak and irrelevant.
 - b. Likewise, we believe that independent compensation committees at controlled companies are unnecessary. Although independent directors are the best choice for approving and monitoring senior executives' pay, controlled companies serve a unique shareholder population whose voting power ensures the protection of its interests. As such, we believe that having affiliated directors on a controlled company's compensation committee is acceptable. However, given that a controlled company has certain obligations to minority shareholders we feel that an insider should not serve on the compensation committee. Therefore, Glass Lewis will recommend voting against any insider (the CEO or otherwise) serving on the compensation committee.
3. Controlled companies do not need an independent chairman or an independent lead or presiding director. Although an independent director in a position of authority on the board – such as chairman or presiding director – can best carry out the board's duties, controlled companies serve a unique shareholder population whose voting power ensures the protection of its interests.
4. Where an individual or entity owns more than 50% of a company's voting power but the company is not a "controlled" company, we lower our independence requirement from two-thirds to a majority of the board and keep all other standards in place.

Size of the Board of Directors: We have no board size requirements for controlled companies.

Audit Committee Independence: We believe that audit committees should consist solely of independent directors. Regardless of a company's controlled status, the interests of all shareholders must be protected by ensuring the integrity and accuracy of the company's financial statements. Allowing affiliated directors to oversee audits could create an insurmountable conflict of interest.

Mutual Fund Boards

Mutual funds, or investment companies, are structured differently from regular public companies (i.e., operating companies). Typically, members of a fund's investment adviser are on the board and management takes on a different role from that of regular public companies. Thus, we focus on a short list of requirements, although many of our guidelines remain the same.

The following mutual fund policies are similar to the policies for regular public companies:

1. Size of the board of directors: The board should be made up of between five and twenty directors.
2. The CFO on the board: Neither the CFO of the fund nor the CFO of the fund's investment adviser should serve on the board.
3. Independence of the audit committee: The audit committee should consist solely of independent directors.
4. Audit committee financial expert: At least one member of the audit committee should be designated as the audit committee financial expert.

The following differences from regular public companies apply at mutual funds:

1. Independence of the board: We believe that three-fourths of an investment company's board should be made up of independent directors. This is consistent with a proposed SEC rule on investment company boards. The Investment Company Act requires 40% of the board to be independent, but in 2001, the SEC amended the Exemptive Rules to require that a majority of a mutual fund board be independent. In 2005, the SEC proposed increasing the independence threshold to 75%. In 2006, a federal appeals court ordered that this rule amendment be put back out for public comment, putting it back into "proposed rule" status. Since mutual fund boards play a vital role in overseeing the relationship between the fund and its investment manager, there is greater need for independent oversight than there is for an operating company board.
2. When the auditor is not up for ratification: We do not recommend voting against the audit committee if the auditor is not up for ratification because, due to the different legal structure of an investment company compared to an operating company, the auditor for the investment company (i.e., mutual fund) does not conduct the same level of financial review for each investment company as for an operating company.
3. Non-independent chairman: The SEC has proposed that the chairman of the fund board be independent. We agree that the roles of a mutual fund's chairman and CEO should be separate. Although we believe this would be best at all companies, we

recommend voting against the chairman of an investment company's nominating committee as well as the chairman if the chairman and CEO of a mutual fund are the same person and the fund does not have an independent lead or presiding director. Seven former SEC commissioners support the appointment of an independent chairman and we agree with them that "an independent board chairman would be better able to create conditions favoring the long-term interests of fund shareholders than would a chairman who is an executive of the adviser." (See the comment letter sent to the SEC in support of the proposed rule at <http://sec.gov/rules/proposed/s70304/s70304-179.pdf>)

Declassified Boards

Glass Lewis favors the repeal of staggered boards and the annual election of directors. We believe staggered boards are less accountable to shareholders than boards that are elected annually. Furthermore, we feel the annual election of directors encourages board members to focus on shareholder interests.

Empirical studies have shown: (i) companies with staggered boards reduce a firm's value; and (ii) in the context of hostile takeovers, staggered boards operate as a takeover defense, which entrenches management, discourages potential acquirers, and delivers a lower return to target shareholders.

In our view, there is no evidence to demonstrate that staggered boards improve shareholder returns in a takeover context. Research shows that shareholders are worse off when a staggered board blocks a transaction. A study by a group of Harvard Law professors concluded that companies whose staggered boards prevented a takeover "reduced shareholder returns for targets ... on the order of eight to ten percent in the nine months after a hostile bid was announced."³⁴ When a staggered board negotiates a friendly transaction, no statistically significant difference in premiums occurs.³⁵

During a March 2004 *Glass Lewis Proxy Talk* on staggered boards, the proponents of staggered boards could not identify research showing that staggered boards increase shareholder value. The opponents of such a structure marshaled significant support for the proposition that, holding everything else constant, classified boards reduce shareholder value. Lucian Bebchuk, a Harvard Law professor who studies corporate governance issues, concluded that charter-based staggered boards "reduce the market value of a firm by 4% to 6% of its market capitalization" and that "staggered boards bring about and not merely reflect this reduction in market value."³⁶

³⁴ Lucian Bebchuk, John Coates, Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants," December 2002, page 1.

³⁵ *Id.* at 2 ("Examining a sample of seventy-three negotiated transactions from 2000 to 2002, we find no systematic benefits in terms of higher premia to boards that have [staggered structures].").

³⁶ Lucian Bebchuk, Alma Cohen, "The Costs of Entrenched Boards" (2004).

Shareholders have increasingly come to agree with this view. In 2008 only 40% of U.S. companies had a classified board structure, down from approximately 60% of companies in 2004. Clearly, more shareholders have supported the repeal of classified boards. Resolutions relating to the repeal of staggered boards garnered on average over 70% support among shareholders in 2008, whereas in 1987, only 16.4% of votes cast favored board declassification.

Given the empirical evidence suggesting staggered boards reduce a company's value and the increasing shareholder opposition to such a structure, Glass Lewis supports the declassification of boards and the annual election of directors.

Mandatory Director Retirement Provisions

Director Term Limits

Glass Lewis believes that director age and term limits typically are not in shareholders' best interests. Too often they are used by boards as a crutch to remove board members who have served for an extended period of time. When used in that fashion, they are indicative of a board that has a difficult time making "tough decisions."

Academic literature suggests that there is no evidence of a correlation between length of tenure and director performance. On occasion, term limits can be used as a means to remove a director for boards that are unwilling to police their membership and to enforce turnover. Some shareholders support term limits as a way to force change when boards are unwilling to do so.

In our view, a director's experience can be a valuable asset to shareholders because of the complex, critical issues that boards face. However, we support periodic director rotation to ensure a fresh perspective in the boardroom and the generation of new ideas and business strategies. We believe the board should implement such rotation instead of relying on arbitrary limits. When necessary, shareholders can address the issue of director rotation through director elections.

However, if a board adopts term limits, it should follow through and not waive the limits. If the board waives its term limits, Glass Lewis will consider recommending voting against the nominating and/or governance committees, unless the rule was waived with sufficient explanation, such as consummation of a corporate transaction.

Director Age Limits

Glass Lewis believes that age limits are not in shareholders' best interests. Academic literature suggests that there is no evidence of a correlation between age and director performance. Like term limits, age limits are a crutch for boards that are unwilling to police their membership and decide when turnover is appropriate.

While we understand some institutions' support for age limits as a way to force change where boards are unwilling to make changes on their own, the long-term impact of age

limits is to restrict experienced and potentially valuable board members from service through an arbitrary cut-off date. Further, age limits unfairly imply that older (or in rare cases, younger) directors cannot contribute to company oversight. A director's experience can be valuable to shareholders because directors navigate complex and critical issues when serving on a board.

We believe that shareholders are better off monitoring the board's approach to corporate governance and the board's stewardship of company performance rather than imposing inflexible rules that don't necessarily correlate with returns or benefits for shareholders.

However, if a board has adopted age limits for directors and yet chooses to waive them, we will consider recommending to vote against the nominating and/or governance committees, unless the rule was waived for the purpose of completing a pending corporate transaction such as a merger.

Requiring Two or More Nominees per Board Seat

In an attempt to address lack of access to the ballot, shareholders sometimes propose that the board give shareholders a choice of directors for each open board seat in every election. But we feel that policies requiring a selection of multiple nominees for each board seat would discourage prospective directors from accepting nominations. A prospective director could not be confident either that he or she is the board's clear choice or that he or she would be elected. Therefore, Glass Lewis generally will vote against such proposals.

Shareholder Access

The SEC proposal: Shareholders have continuously sought a way to have a voice in director elections in recent years. Most of these efforts have centered on regulatory change, the latest iteration of which is the proxy access debate that has taken place intermittently at the SEC over the past several years. In July of 2007, the SEC responded by issuing two proposed rules, one to allow certain shareholders to submit director nominations for inclusion on management's proxy and the second to disallow shareholder access proposals from being submitted by shareholders. The former rule did not pass but the latter rule was subsequently approved by the SEC in November of 2007, allowing companies to exclude shareholder access proposals from their proxy statements, in effect reverting to the SEC position prior to AFSCME's challenge, ultimately upheld by the Second Circuit Court of Appeals, of the SEC's decision to allow AIG to exclude the group's access proposal.

During this window of opportunity prior to the SEC's final rulemaking in November, three companies faced access proposals in 2007. The proposals received considerable votes in favor, garnering nearly 40% support at Hewlett Packard, 42% support at UnitedHealth and passing with 51% of the votes at Cryo-Cell International. As a result of the SEC's rulemaking, no access proposals were voted on by shareholders in 2008 and it is unlikely shareholders will have the opportunity to vote on access proposals in 2009 as well.

Majority Vote for the Election of Directors

In stark contrast to the failure of shareholder access to gain acceptance, majority voting for the election of directors is fast becoming the *de facto* standard in corporate board elections at large US companies. In our view, the majority voting proposals are an effort to make the case for shareholder impact on director elections on a company-specific basis.

While this proposal would not give shareholders the opportunity to nominate directors or lead to elections where shareholders have a choice among director candidates, if implemented, the proposal would allow shareholders to have a voice in determining whether the nominees proposed by the board should actually serve as the overseer-representatives of shareholders in the boardroom. We believe this would be a favorable outcome for shareholders.

During 2008 Glass Lewis tracked 28 proposals to require a majority vote to elect directors, down from 54 proposals during 2007 and 147 proposals during 2006. The steep decline in the number of proposals being submitted was a result of many companies adopting some form of majority voting, including well over 2/3 of companies in the S&P 500 index. During both 2008 and 2007 the average vote in favor of such proposals was just over 50% versus 44% in 2006.

The plurality vote standard: Today, most companies elect directors by a plurality vote standard. Under that standard, if one shareholder holding only one share votes in favor of any nominee (including himself, if the director is a shareholder), that nominee "wins" the election and assumes a seat on the board. The common concern among companies with a plurality voting standard was the possibility that one or more directors would not receive a majority of votes, resulting in "failed elections." This was of particular concern during the 1980s, an era of frequent takeovers and contests for control of companies.

Advantages of a majority vote standard: If a majority vote standard was implemented, a nominee would have to receive the support of a majority of the shares voted in order to assume the role of a director. Thus, shareholders could collectively vote to reject a director they believe will not pursue their best interests. We think that this minimal amount of protection for shareholders is reasonable and will not upset the corporate structure nor reduce the willingness of qualified, shareholder-focused directors to serve in the future.

We believe that a majority vote standard will likely lead to more attentive directors. Occasional use of this power will likely prevent the election of directors with a record of ignoring shareholder interests in favor of other interests that conflict with those of investors. Glass Lewis will generally support proposals calling for the election of directors by a majority vote.

In response to the high level of support majority voting has garnered, many companies have voluntarily taken steps to implement majority voting or modified approaches to majority voting. These steps include modified approaches requiring directors that receive a majority of withheld votes to resign to amending company by-laws to require a majority vote of outstanding shares to elect directors but also retaining discretion to seat a director via a resignation policy. But a small number of companies, such as Lockheed Martin, have had a longstanding requirement of a majority of outstanding shares (a higher standard than votes cast) to elect a director.

We feel that the modified approach does not go far enough because requiring a director to resign is not the same as requiring a majority vote to elect a director and does not allow shareholders a definitive voice in the election process. Further, under the modified approach, the corporate governance committee could reject a resignation and, even if it accepts the resignation, the corporate governance committee decides on the director's replacement. And since the modified approach is usually adopted as a policy by the board or a board committee, it could be altered by the same board or committee at any time.

II. Transparency and Integrity of Financial Reporting

Auditor Ratification

The auditor's role as gatekeeper is crucial in ensuring the integrity and transparency of the financial information necessary for protecting shareholder value. Shareholders rely on the auditor to ask tough questions and to do a thorough analysis of a company's books to ensure that the information provided to shareholders is complete, accurate, fair, and that it is a reasonable representation of a company's financial position. The only way shareholders can make rational investment decisions is if the market is equipped with accurate information about a company's fiscal health. As stated in the October 6, 2008 Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury:

“The auditor is expected to offer critical and objective judgment on the financial matters under consideration, and actual and perceived absence of conflicts is critical to that expectation. The Committee believes that auditors, investors, public companies, and other market participants must understand the independence requirements and their objectives, and that auditors must adopt a mindset of skepticism when facing situations that may compromise their independence.”

As such, shareholders should demand an objective, competent and diligent auditor who performs at or above professional standards at every company in which the investors hold an interest. Like directors, auditors should be free from conflicts of interest and should avoid situations requiring a choice between the auditor's interests and the public's interests. Almost without exception, shareholders should be able to annually review an auditor's performance and to annually ratify a board's auditor selection. Moreover, in October 2008, the Advisory Committee on the Auditing Profession went even further, and recommended that “to further enhance audit committee oversight and auditor accountability . . . disclosure in the company proxy statement regarding shareholder ratification [should] include the name(s) of the senior auditing partner(s) staffed on the engagement.”³⁷

Voting Recommendations on Auditor Ratification: We generally support management's choice of auditor except when we believe the auditor's independence or audit integrity has been compromised. Where a board has not allowed shareholders to review and ratify

³⁷ “Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury.” p. VIII:20, October 6, 2008.

an auditor, we typically recommend voting against the audit committee chairman. When there have been material restatements of annual financial statements or material weakness in internal controls, we usually recommend voting against the entire audit committee.

Reasons why we may not recommend ratification of an auditor include:

1. When audit fees plus audit-related fees total less than the tax fees and/or other non-audit fees.
2. Recent material restatements of annual financial statements, including those resulting in the reporting of material weaknesses in internal controls and including late filings by the company where the auditor bears some responsibility for the restatement or late filing.³⁸
3. When the auditor performs prohibited services such as tax-shelter work, tax services for the CEO or CFO, or contingent-fee work, such as a fee based on a percentage of economic benefit to the company.
4. When audit fees are excessively low, especially when compared with other companies in the same industry.
5. When the company has aggressive accounting policies.
6. When the company has poor disclosure or lack of transparency in its financial statements.
7. Where the auditor limited its liability through its contract with the company.
8. We also look for other relationships or concerns with the auditor that might suggest a conflict between the auditor's interests and shareholder interests.

We typically support audit-related proposals regarding mandatory auditor rotation when the proposal uses a reasonable period of time (usually not less than 5-7 years).

Pension Accounting Issues

A pension accounting question often raised in proxy proposals is what effect, if any, projected returns on employee pension assets should have on a company's net income. This issue often arises in the executive-compensation context in a discussion of the extent to which pension accounting should be reflected in business performance for purposes of calculating payments to executives.

Glass Lewis believes that pension credits should not be included in measuring income that is used to award performance-based compensation. Because many of the assumptions used in accounting for retirement plans are subject to the company's discretion, management would have an obvious conflict of interest if pay were tied to pension income. In our view, projected income from pensions does not truly reflect a company's performance.

³⁸ An auditor does not audit interim financial statements. Thus, we generally do not believe that an auditor should be opposed due to a restatement of interim financial statements unless the nature of the misstatement is clear from a reading of the incorrect financial statements.

III. THE LINK BETWEEN COMPENSATION AND PERFORMANCE

Linking Pay with Performance

Glass Lewis strongly believes executive compensation should be linked directly with the performance of the business the executive is charged with managing. Glass Lewis has a proprietary pay-for-performance model that evaluates the pay of the top five executives at US companies. Our model benchmarks these executives' pay against their performance using three peer groups for each company: an industry peer group, a smaller sector peer group, and a geographic peer group. Using a forced curve and a school letter-grade system, we rank companies according to their pay-for-performance.

We use this analysis to inform our voting decisions on each of the compensation issues that arise on the ballot. Likewise, we use this analysis in our evaluation of the compensation committee's performance.

Limits on Executive Compensation

Generally, Glass Lewis believes shareholders should not be directly involved in setting executive pay. Such matters should be left to the compensation committee. We view the election of compensation committee members as the appropriate mechanism for shareholders to express their disapproval or support of board policy on executive pay. Further, we believe that companies whose pay-for-performance is in line with their peers should be able to pay their executives in a way that drives growth and profit, without destroying ethical values, giving consideration to their peers' comparable size and performance.

However, Glass Lewis favors performance-based compensation as an effective way to motivate executives to act in shareholders' best interests. Performance-based pay may be limited if CEO pay is capped at a low level rather than flexibly tied to company performance.

Limits on Executive Stock Options

Stock options are a common form of executive compensation. Making options a part of compensation may be an effective way to attract and retain experienced executives and other key employees. Tying a portion of an executive's pay to company performance also provides a good incentive for executives to maximize share value. Thus, we typically recommend that our clients oppose caps on executive stock options. However, stock option plans should prohibit re-pricing or acceleration of the options.

Linking Pay to Social Criteria

Glass Lewis believes that ethical behavior is an important part of executive performance and should be taken into account when evaluating performance and determining compensation. But Glass Lewis also believes that the compensation committee is in the

best position to set policy on management pay. Through director elections, shareholders can hold the compensation committee accountable for pay awarded.

Equity-Based Compensation Plans

Glass Lewis evaluates option- and other equity-based compensation plans using a detailed model and analyst review. We believe that equity compensation awards are useful, when not abused, for retaining employees and providing an incentive for them to act in a way that will improve company performance.

Equity-based compensation programs have important differences from cash compensation plans and bonus programs. Accordingly, our model and analysis takes into account factors such as plan administration, the method and terms of exercise, repricing history, express or implied rights to reprice, and the presence of evergreen provisions.

Our analysis is quantitative and focused on the plan's cost as compared with the business's operating metrics. We run twenty different analyses, comparing the program with absolute limits we believe are key to equity value creation and with a carefully chosen peer group. In general, our model seeks to determine whether the proposed plan is either absolutely excessive or is more than one standard deviation away from the average plan for the peer group on a range of criteria, including dilution to shareholders and the projected annual cost relative to the company's financial performance. Each of the twenty analyses (and their constituent parts) is weighted and the plan is scored in accordance with that weight.

In our analysis, we compare the program's expected annual expense with the business's operating metrics to help determine whether the plan is excessive in light of company performance. We also compare the option plan's expected annual cost to the enterprise value of the firm rather than to market capitalization because the employees, managers and directors of the firm create enterprise value and not necessarily market capitalization (the biggest difference is seen where cash represents the vast majority of market capitalization). Finally, we do not rely exclusively on relative comparisons with averages because we believe that academic literature proves that some absolute limits are warranted.

We evaluate option plans based on ten overarching principles:

1. Companies should seek more shares only when needed.
2. Plans should be small enough that companies need shareholder approval every three to four years (or less).
3. If a plan is relatively expensive, it should not grant options solely to senior executives and board members.
4. Annual net share count and voting power dilution should be limited.

5. Annual cost of the plan (especially if not shown on the income statement) should be reasonable as a percentage of financial results and should be in line with the peer group.
6. The expected annual cost of the plan should be proportional to the business's value.
7. The intrinsic value that option grantees received in the past should be reasonable compared with the business's financial results.
8. Plans should deliver value on a per-employee basis when compared with programs at peer companies.
9. Plans should not permit re-pricing of stock options.
10. Plans should not contain excessively liberal administrative or payment terms.

Option Exchanges

Glass Lewis views option repricing plans and option exchange programs with great skepticism. Shareholders have substantial risk in owning stock and we believe that the employees, officers, and directors who receive stock options should be similarly situated to align their interests with shareholder interests.

We are concerned that option grantees who believe they will be “rescued” from underwater options will be more inclined to take unjustifiable risks. Moreover, a predictable pattern of repricing or exchanges substantially alters a stock option's value because options that will practically never expire deeply out of the money are worth far more than options that carry a risk of expiration.

In short, repricings and option exchange programs change the bargain between shareholders and employees after the bargain has been struck. Re-pricing is tantamount to re-trading.

There is one circumstance in which a repricing or option exchange program is acceptable: if macroeconomic or industry trends cause a stock's value to decline dramatically, rather than specific company issues, and repricing is necessary to motivate and retain employees. In this circumstance, we think it fair to conclude that option grantees may be suffering from a risk that was not foreseeable when the original “bargain” was struck. In such a circumstance, we will support a repricing only if the following conditions are true:

- (i) officers and board members do not participate in the program;
- (ii) the stock decline mirrors the market or industry price decline in terms of timing and approximates the decline in magnitude;
- (iii) the exchange is value-neutral or value-creative to shareholders with very conservative assumptions and with a recognition of the adverse selection problems inherent in voluntary programs; and

(iv) management and the board make a cogent case for needing to motivate and retain existing employees, such as being in a competitive employment market.

Performance-Based Options

Shareholders commonly ask boards to adopt policies requiring that a significant portion of future stock option grants to senior executives be based on performance. Performance-based options are options where the exercise price is linked to an industry peer group's stock-performance index.

Glass Lewis believes in performance-based equity compensation plans for senior executives. We feel that executives should be compensated with equity when their performance and the company's performance warrants such rewards. While we do not believe that equity-based pay plans for all employees should be based on overall company performance, we do support such limitations for equity grants to senior executives (although some equity-based compensation of senior executives without performance criteria is acceptable, such as in the case of moderate incentive grants made in an initial offer of employment or in emerging industries).

Boards often argue that basing option grants on performance would hinder them in attracting talent. We believe that boards can develop a consistent, reliable approach to attract executives with the ability to guide the company toward its targets. If the board believes in performance-based pay for executives, then these proposals requiring the same should not hamper the board's ability to create equity-based compensation plans.

We generally recommend that shareholders vote in favor of performance-based option requirements.

Option Backdating, Spring-Loading, and Bullet-Dodging

Glass Lewis views option backdating, and the related practices of spring-loading and bullet-dodging, as egregious actions that warrant holding the appropriate management and board members responsible. These practices are similar to re-pricing options and eliminate much of the downside risk inherent in an option grant that is designed to induce recipients to maximize shareholder return. Backdating an option is the act of changing an option's grant date from the actual grant date to an earlier date when the market price of the underlying stock was lower, resulting in a lower exercise price for the option. Glass Lewis has identified over 270 companies that have disclosed internal or government investigations into their past stock-option grants.

Spring-loading is granting stock options while in possession of material, positive information that has not been disclosed publicly. Bullet-dodging is delaying the grants of stock options until after the release of material, negative information. This can allow option grants to be made at a lower price either before the release of positive news or following the release of negative news, assuming the stock's price will move up or down

in response to the information. This raises a concern similar to that of insider trading, or the trading on material non-public information.

The exercise price for an option is determined on the day of grant, providing the recipient with the same market risk as an investor who bought shares on that date. However, where options were backdated, the executive or the board (or the compensation committee) changed the grant date retroactively. The new date may be at or near the lowest price for the year or period. This would be like allowing an investor to look back and select the lowest price of the year at which to buy shares.

A 2006 study of option grants made between 1996 and 2005 at 8,000 companies found that option backdating can be an indication of poor internal controls. The study found that option backdating was more likely to occur at companies without a majority independent board and with a long-serving CEO; both factors, the study concluded, were associated with greater CEO influence on the company's compensation and governance practices.³⁹

Where a company granted backdated options to an executive who is also a director, Glass Lewis will recommend voting against that executive/director, regardless of who decided to make the award. In addition, Glass Lewis will recommend voting against those directors who either approved or allowed the backdating. Glass Lewis feels that executives and directors who either benefited from backdated options or authorized the practice have breached their fiduciary responsibility to shareholders.

Given the severe tax and legal liabilities to the company from backdating, Glass Lewis will consider recommending voting against members of the audit committee who served when options were backdated, a restatement occurs, material weaknesses in internal controls exist and disclosures indicate there was a lack of documentation. These committee members failed in their responsibility to ensure the integrity of the company's financial reports.

When a company has engaged in spring-loading or bullet-dodging, Glass Lewis will consider recommending voting against the compensation committee members where there has been a pattern of granting options at or near historic lows. Glass Lewis will also recommend voting against executives serving on the board who benefited from the spring-loading or bullet-dodging.

162(m) Plans

Section 162(m) of the Internal Revenue Code allows companies to deduct compensation in excess of \$1 million for the CEO and the next four most highly compensated executive officers upon shareholder approval of the excess compensation. Glass Lewis recognizes the value of executive incentive programs and the tax benefit of shareholder-approved incentive plans.

³⁹ Lucian Bebchuk, Yaniv Grinstein and Urs Peyer. "LUCKY CEOs." November, 2006.

We believe the best practice for companies is to provide reasonable disclosure to shareholders so that they can make sound judgments about the reasonableness of the proposed compensation plan. To allow for meaningful shareholder review, we prefer that these proposals include: specific performance goals, a maximum award pool, and a maximum award amount per employee. We also believe it is important to analyze the estimated grants to see if they are reasonable and in line with the company's peers.

We typically recommend against a 162(m) plan where: a company fails to provide at least a list of performance targets; a company fails to provide one of either a total pool or an individual maximum; or the proposed plan is excessive when compared with the plans of the company's peers.

The company's record of aligning pay with performance (as evaluated using our proprietary pay-for-performance model) also plays a role in our recommendation. Where a company has a record of reasonable pay relative to business performance, we are not typically inclined to recommend against a plan even if the plan caps seem large relative to peers because we recognize the value in special pay arrangements for continued exceptional performance.

As with all other issues we review, our goal is to provide consistent but contextual advice given the specifics of the company and ongoing performance. Overall, we recognize that it is generally not in shareholders' best interests to vote against such a plan and forgo the potential tax benefit since shareholder rejection of such plans will not curtail the awards, it will only prevent the tax deduction associated with them.

Director Compensation Plans

Glass Lewis believes that non-employee directors should receive compensation for the time and effort they spend serving on the board and its committees. In particular, we support compensation plans that include option grants or other equity-based awards that help to align the interests of outside directors with those of shareholders. Director fees should be competitive in order to retain and attract qualified individuals. But excessive fees represent a financial cost to the company and threaten to compromise the objectivity and independence of non-employee directors. Therefore, a balance is required.

Glass Lewis uses a proprietary model and analyst review to evaluate the costs of those plans compared to the plans of peer companies with similar market capitalizations. We use the results of this model to assist in making our voting recommendations on director compensation plans.

Full Disclosure of Executive Compensation

Glass Lewis believes that complete, timely and transparent disclosure of executive pay is critical to allowing shareholders to evaluate the extent to which the pay is keeping pace with company performance. When reviewing proxy materials, analysts investigate whether the company discloses the performance metrics that it uses to determine executive compensation. Performance metrics vary and may include items such as revenue growth, targets, or human resources issues.

However, we are concerned when a proposal goes too far in the level of detail that it requests for executives other than the most high-ranking leaders of the company. Shareholders are unlikely to need or be able to use compensation information for employees below the level of the most senior corporate officers.

Moreover, it is rarely in shareholders' interests to disclose competitive data about individual salaries below the senior executive level. Such disclosure could create internal personnel issues that would be counterproductive for the company and its shareholders. While we favor full disclosure for senior executives and we view pay disclosure at the aggregate level (e.g., the number of employees being paid over a certain amount or in certain categories) as potentially useful, we do not believe shareholders need or will benefit from detailed reports about individual management employees other than the most senior executives.

Shareholder Proposals Regarding Compensation Issues

Shareholder Proposals Regarding Severance Agreements

As a general rule, Glass Lewis believes that shareholders should not be involved in the approval and negotiation of individual severance plans. Such matters should be left to the board's compensation committee, which can be held accountable for its decisions through the election of directors.

When proposals are crafted to only require approval if the benefit exceeds 2.99 times the amount of the executive's base salary plus bonus, Glass Lewis typically supports such requests. Above this threshold, the company can no longer deduct severance payments as an expense, and thus shareholders are deprived of a valuable benefit. We believe that shareholders should be consulted before relinquishing such a right, and that such proposals would still leave companies with sufficient freedom to enter into the vast majority of severance arrangements.

Additionally, investors should monitor severance agreements when they are initially put in place. If shareholders initially approved of a severance agreement, it is inappropriate to vote against the compensation committee later on when the severance agreement goes into effect. However, in the absence of a shareholder vote on severance agreements, Glass Lewis will evaluate the role of the compensation committee when the agreement was adopted.

Shareholder Proposals on Advisory Votes on Compensation

Glass Lewis carefully reviews the compensation awarded to senior executives. We believe that this is an important area in which the board's priorities are revealed. However, as a general rule, Glass Lewis does not believe shareholders should be involved in the design, negotiation or approval of compensation packages. Such matters should be left to the compensation committee, which can be held accountable for its decisions through their election.

But sometimes proposals are made to allow shareholders advisory approval of the company's compensation practices. Glass Lewis believes that advisory votes on compensation provide an

effective mechanism for enhancing transparency in setting executive pay, improving accountability to shareholders, and providing for a more effective link between pay and performance. While a vote to approve compensation practices will not directly affect the board's ability to set compensation policy, it will allow shareholders to register their opinions regarding the company's compensation practices. We believe that a vote disapproving of a company's compensation practices may compel the board to re-examine its compensation practices and act accordingly.

The practice of voting on a company's compensation, in some cases by approving the compensation committee report, is standard in a small but growing number of countries, including the U.K. since 2002. A 2004 study for the British Department of Trade and Industry found that the advisory voting requirement has resulted in "a number of well publicized situations where [compensation] committees have changed their policy or practice as a result of direct shareholder voting."⁴⁰ The study also found that the extent to which companies consulted shareholders about compensation practices has greatly increased over the past two years.

Shareholder Proposals on Bonus Recoupments Following Restatements ("Clawbacks")

Glass Lewis carefully reviews the compensation awarded to senior executives and we believe that senior executives of a company should never receive compensation for performance that was not achieved by the company.

We believe shareholders would be well served by requiring the board to adopt a more detailed and stringent policy, rather than relying on regulatory action such as requirements under Sarbanes Oxley. When examining proposals that require companies to recoup executives' bonuses paid as a result of faulty accounting, Glass Lewis will first look to see if the company has already adopted a policy to recoup bonuses awarded to senior executives during a restatement, and whether that policy is included in the CEO's contract. When the board has already committed to a proper course, in our opinion, and their current policy covers the major tenets of the proposal at hand while giving the board adequate flexibility to exercise discretion over these matters, we see no need for further action.

In some instances, shareholder proposals call for board action that may contravene the board's legal obligations under its agreements with executives, such as employment agreements. In addition, the board's ability to exercise its judgment and reasonable discretion on this issue may be limited under such proposals, which may not be warranted, depending on the specific situation of the company in question. A recoupment policy should only affect senior executives and those directly responsible for the company's accounting errors.

Where a company is giving a new contract to an executive that does not include a clawback provision and the company has had a material restatement, especially if the restatement was due to fraud, Glass Lewis will recommend voting against the responsible members of the compensation committee. Compensation committee members have an obligation to build in

⁴⁰ Deloitte & Touche. "Report on the Impact of the Directors' Remuneration Report Regulations." (2004).

reasonable controls to executive contracts to prevent payments in the case of inappropriate behavior.

IV. Governance Structure and the Shareholder Franchise

Anti-Takeover Measures

Poison Pills (Shareholder Rights Plans)

Glass Lewis believes that poison pill plans are not generally in shareholders' best interests. They can reduce management accountability by substantially limiting opportunities for corporate takeovers. Rights plans can thus prevent shareholders from receiving a buy-out premium for their stock. Typically we recommend that shareholders vote against these plans to protect their financial interests and ensure that they have an opportunity to consider any offer for their shares, especially those at a premium.

We believe boards should be given wide latitude in directing company activities and in charting the company's course. However, on an issue such as this, where the link between the shareholders' financial interests and their right to consider and accept buyout offers is substantial, we believe that shareholders should be allowed to vote on whether they support such a plan's implementation. This issue is different from other matters that are typically left to board discretion. Its potential impact on and relation to shareholders is direct and substantial. It is also an issue in which management interests may be different from those of shareholders; thus, ensuring that shareholders have a voice is the only way to safeguard their interests.

In certain circumstances, we will support a limited poison pill to accomplish a particular objective, such as the closing of an important merger, or a pill that contains what we believe to be a reasonable 'qualifying offer' clause. We will consider supporting a poison pill plan if the qualifying offer clause includes the following attributes: (i) The form of offer is not required to be an all-cash transaction; (ii) the offer is not required to remain open for more than 90 business days; (iii) the offeror is permitted to amend the offer, reduce the offer, or otherwise change the terms; (iv) there is no fairness opinion requirement; and (v) there is a low to no premium requirement. Where these requirements are met, we typically feel comfortable that shareholders will have the opportunity to voice their opinion on any legitimate offer.

NOL Poison Pills

Similarly, Glass Lewis may consider supporting a limited poison pill in the unique event that a company seeks shareholder approval of a rights plan for the express purpose of preserving Net Operating Losses (NOLs). While companies with NOLs can generally carry these losses forward to offset future taxable income, Section 382 of the Internal Revenue Code limits companies' ability to use NOLs in the event of a "change of

ownership.”⁴¹ In this case, a company may adopt or amend a poison pill (“NOL pill”) in order to prevent an inadvertent change of ownership by multiple investors purchasing small amounts of stock at or near the same time, triggering a change in control under IRS rules, thereby depriving the company of the beneficial tax treatment of its NOLs. Often such NOL pills have trigger thresholds much lower than the common 15% or 20% thresholds, with some NOL pill triggers as low as 5%.

Glass Lewis evaluates NOL pills on a strictly case-by-case basis taking into consideration, among other factors, the value of the NOLs to the company, the likelihood of a change of ownership based on the size of the holding and the nature of the larger shareholders, the trigger threshold and whether the term of the plan is limited in duration (i.e., whether it contains a reasonable “sunset” provision) or is subject to periodic board review and/or shareholder ratification. However, we will recommend that shareholders vote against a proposal to adopt or amend a pill to include NOL protective provisions if the company has adopted a more narrowly tailored means of preventing a change in control to preserve its NOLs. For example, a company may limit share transfers in its charter to prevent a change of ownership from occurring.

Furthermore, we believe that shareholders should be offered the opportunity to vote on any adoption or renewal of a NOL pill regardless of any potential tax benefit that it offers a company. As such, we will consider recommending voting against those members of the board who served at the time when an NOL pill was adopted without shareholder approval within the prior twelve months and where the NOL pill is not subject to shareholder ratification.

Right of Shareholders to Call a Special Meeting

Glass Lewis strongly supports shareholders’ right to call special meetings. But to prevent abuse and waste of corporate resources by a minority of shareholders, we believe this right should be limited to a minimum of 15% of the shareholders requesting such a meeting. Generally, we believe a lower threshold may leave companies subject to meetings that may disrupt business operations to focus on the interests of a minority of owners. But when proposals are presented that would allow shareholders to call special meetings without a minimum threshold, we will support them because the benefit to shareholders outweighs the possible abuse of the right to call shareholder meetings.

Shareholder Action by Written Consent

Glass Lewis strongly supports shareholders’ right to act by written consent. As with the right to call special meetings, we believe such rights should be limited to a minimum of 15% of the shareholders requesting action by written consent, to prevent abuse and waste of corporate resources. Again, we believe a lower threshold may leave companies subject

⁴¹ Section 382 of the Internal Revenue Code refers to a “change of ownership” of more than 50 percentage points by one or more 5% shareholders within a three-year period. The statute is intended to deter the “trafficking” of net operating losses.

to meetings that may disrupt business operations to focus on the interests of a minority of owners. But we will support proposals to allow shareholders to act by written consent without a minimum threshold because shareholders are better off with this right than without it, and the benefit to shareholders outweighs the potential for abuse.

Fair Price Provisions

Fair price provisions, which are rare, require that certain minimum price and procedural requirements be observed by any party that acquires more than a specified percentage of a corporation's common stock. The provision is intended to protect minority shareholder value when an acquiring corporation seeks to accomplish a merger or other transaction which would eliminate or change the interests of the minority stockholders. The provision is generally applied against the acquirer unless the takeover is approved by a majority of "continuing directors" and holders of a majority, in some cases a supermajority as high as 80%, of the combined voting power of all stock entitled to vote to alter, amend, or repeal the above provisions.

The effect of a fair price provision is to require approval of any merger or business combination with an "interested stockholder" by 51% of the voting stock of the company, excluding the shares held by the interested stockholder. An interested stockholder is generally considered to be a holder of 10% or more of the company's outstanding stock, but the trigger can vary.

Generally, provisions are put in place for the ostensible purpose of preventing a back-end merger where the interested stockholder would be able to pay a lower price for the remaining shares of the company than he or she paid to gain control. The effect of a fair price provision on shareholders, however, is to limit their ability to gain a premium for their shares through a partial tender offer or open market acquisition which typically raise the share price, often significantly. A fair price provision discourages such transactions because of the potential costs of seeking shareholder approval and because of the restrictions on purchase price for completing a merger or other transaction at a later time.

Glass Lewis believes that fair price provisions, while sometimes protecting shareholders from abuse in a takeover situation, often act as an impediment to takeovers, potentially limiting gains to shareholders from a variety of transactions that could significantly increase share price. In some cases, even the independent directors of the board cannot make exceptions when such exceptions may be in the best interests of shareholders. Given the existence of state law protections for minority shareholders such as Section 203 of the Delaware Corporations Code, we believe it is in the best interests of shareholders to remove fair price provisions.

Authorized Shares

Glass Lewis believes that adequate capital stock is important to a company's operation. When analyzing a request for additional shares, we typically review four common reasons why a company might need additional capital stock:

- (i) **Stock Split** – We typically consider three metrics when evaluating whether we think a stock split is likely or necessary: The historical stock pre-split price, if any; the current price relative to the company's most common trading price over the past 52 weeks; and some absolute limits on stock price that, in our view, either always make a stock split appropriate if desired by management or would almost never be a reasonable price at which to split a stock.
- (ii) **Shareholder Defenses** – Additional authorized shares could be used to bolster takeover defenses such as a "poison pill." Proxy filings often discuss the usefulness of additional shares in defending against or discouraging a hostile takeover as a reason for a requested increase. Glass Lewis is typically against such defenses and will oppose actions intended to bolster such defenses.
- (iii) **Financing for Acquisitions** – We look at whether the company has a history of using stock for acquisitions and attempt to determine what levels of stock have typically been required to accomplish such transactions. Likewise, we look to see whether this is discussed as a reason for additional shares in the proxy.
- (iv) **Financing for Operations** – We review the company's cash position and its ability to secure financing through borrowing or other means. We look at the company's history of capitalization and whether the company has had to use stock in the recent past as a means of raising capital.

Issuing additional shares can dilute existing holders in limited circumstances. Further, the availability of additional shares, where the board has discretion to implement a poison pill, can often serve as a deterrent to interested suitors. Accordingly, where we find that the company has not detailed a plan for use of the proposed shares, or where the number of shares far exceeds those needed to accomplish a detailed plan, we typically recommend against the authorization of additional shares.

While we think that having adequate shares to allow management to make quick decisions and effectively operate the business is critical, we prefer that, for significant transactions, management come to shareholders to justify their use of additional shares rather than providing a blank check in the form of a large pool of unallocated shares available for any purpose.

Advance Notice Requirements for Shareholder Ballot Proposals

We typically recommend that shareholders vote against proposals that would require advance notice of shareholder proposals or of director nominees.

These proposals typically attempt to require a certain amount of notice before shareholders are allowed to place proposals on the ballot. Notice requirements typically range between three to six months prior to the annual meeting. Advance notice requirements typically make it impossible for a shareholder who misses the deadline to present a shareholder proposal or a director nominee that might be in the best interests of the company and its shareholders.

We believe shareholders should be able to review and vote on all proposals and director nominees. Shareholders can always vote against proposals that appear with little prior notice. Shareholders, as owners of a business, are capable of identifying issues on which they have sufficient information and ignoring issues on which they have insufficient information. Setting arbitrary notice restrictions limits the opportunity for shareholders to raise issues that may come up after the window closes.

Voting Structure

Cumulative Voting

We review cumulative voting proposals on a case-by-case basis, factoring in the independence of the board and the status of the company's governance structure. But we typically find these proposals on ballots at companies where independence is lacking and where the appropriate checks and balances favoring shareholders are not in place. In those instances we typically recommend in favor of cumulative voting.

Cumulative voting is a process that maximizes minority shareholders' ability to ensure representation of their views on the board. It can be important when a board is controlled by insiders or affiliates and where the company's ownership structure includes one or more shareholders who control a majority-voting block of company stock.

Glass Lewis believes that cumulative voting generally acts as a safeguard for shareholders by ensuring that those who hold a significant minority of shares can elect a candidate of their choosing to the board. This allows the creation of boards that are responsive to the interests of all shareholders rather than just a small group of large holders.

Academic literature indicates that where a highly independent board is in place and the company has a shareholder-friendly governance structure, shareholders may be better off without cumulative voting. The analysis underlying this literature indicates that shareholder returns at firms with good governance structures are lower and that boards can become factionalized and prone to evaluating the needs of special interests over the general interests of shareholders collectively.

Where a company has adopted a true majority vote standard (i.e., where a director must receive a majority of votes cast to be elected, as opposed to a modified policy indicated by a resignation policy only), Glass Lewis will recommend voting against cumulative voting proposals due to the incompatibility of the two election methods.

Where a company has not adopted a majority voting standard and is facing both a shareholder proposal to adopt majority voting and a shareholder proposal to adopt cumulative voting, Glass Lewis will support only the majority voting proposal. When a company has both majority voting and cumulative voting in place, there is a higher likelihood of one or more directors not being elected as a result of not receiving a majority vote. This is because shareholders exercising the right to cumulate their votes could unintentionally cause the failed election of one or more directors for whom shareholders do not cumulate votes.

Supermajority Vote Requirements

Glass Lewis believes that supermajority vote requirements impede shareholder action on ballot items critical to shareholder interests. An example is in the takeover context, where supermajority vote requirements can strongly limit the voice of shareholders in making decisions on such crucial matters as selling the business.

Transaction of Other Business at an Annual or Special Meeting of Shareholders

We typically recommend that shareholders not give their proxy to management to vote on any other business items that may properly come before the annual meeting. In our opinion, granting unfettered discretion is unwise.

Anti-Greenmail Proposals

Glass Lewis will support proposals to adopt a provision preventing the payment of greenmail, which would serve to prevent companies from buying back company stock at significant premiums from a certain shareholder. Since a large or majority shareholder could attempt to compel a board into purchasing its shares at a large premium, the anti-greenmail provision would generally require that a majority of shareholders other than the majority shareholder approve the buyback.

Mutual Funds: Investment Policies and Advisory Agreements

Glass Lewis believes that decisions about a fund's structure and/or a fund's relationship with its investment advisor or sub-advisors are generally best left to management and the members of the board, absent a showing of egregious or illegal conduct that might threaten shareholder value. As such, we focus our analyses of such proposals on the following main areas:

- The terms of any amended advisory or sub-advisory agreement;
- Any changes in the fee structure paid to the investment advisor; and
- Any material changes to the fund's investment objective or strategy.

We generally support amendments to a fund's investment advisory agreement absent a material change that is not in the best interests of shareholders. A significant increase in the fees paid to an investment advisor would be reason for us to consider recommending voting against a proposed amendment to an investment advisory agreement. However, in certain cases, we are more inclined to support an increase in advisory fees if such increases result from being

performance-based rather than asset-based. Furthermore, we generally support sub-advisory agreements between a fund's advisor and sub-advisor, primarily because the fees received by the sub-advisor are paid by the advisor, and not by the fund.

In matters pertaining to a fund's investment objective or strategy, we believe shareholders are best served when a fund's objective or strategy closely resembles the investment discipline shareholders understood and selected when they initially bought into the fund. As such, we generally recommend voting against amendments to a fund's investment objective or strategy when the proposed changes would leave shareholders with stakes in a fund that is noticeably different than when originally contemplated, and which could therefore potentially negatively impact some investors' diversification strategies.

V. Shareholder Initiatives and Management of the Firm

Glass Lewis evaluates shareholder proposals on a case-by-case basis. We generally favor proposals likely to increase shareholder value and/or promote and protect shareholder rights. We typically prefer to leave decisions regarding day-to-day management and policy decisions related to political, social, or environmental issues to management and the board except when we see a clear and direct link between the proposal and some economic or financial issue for the company.

We feel strongly that shareholders should not attempt to micromanage the business or its executives through the initiative process. Rather, shareholders should use their influence to push for governance structures that protect shareholders, including director elections, and then put in place a board they can trust to make informed and careful decisions that are in the best interests of the business and its owners. We believe shareholders should hold directors accountable for management and policy decisions through director elections.

Reimbursement of Solicitation Expenses

Glass Lewis feels that in some circumstances, replacing some or all directors on a company's board is warranted where the incumbent director or directors have failed in their oversight of management by failing to address continuously poor performance. Where a dissident shareholder is seeking reimbursement for his or her expenses and has received the support of a majority of shareholders, Glass Lewis generally will recommend in favor of reimbursing the dissident for expenses incurred in waging the contest.

In the rare case where a shareholder has put the shareholder's own time and money into a successful campaign to unseat a poorly performing director, we feel that the dissident should be entitled to reimbursement of expenses by the company. In such a situation, other shareholders express their agreement by virtue of their majority vote for the dissident and will share in the improved company performance.

But contests are expensive and distracting to the management and the board. Therefore, to avoid encouraging nuisance or agenda-driven contests, we only support the reimbursement of expenses

where the dissident has convinced at least a majority of shareholders to support a particular candidate or set of candidates.

Labor Practices and Non-Discrimination Policies

Where there is clear evidence of practices resulting in significant economic exposure to the company, Glass Lewis will support shareholder proposals that seek to address labor policies, such as shareholder proposals calling for increased disclosure of labor policies and of steps a company has taken to mitigate the risks associated with those policies.

In general, Glass Lewis believes labor and human resources policies are typically best left to management and the board, absent a showing of egregious or illegal conduct that might threaten shareholder value. Management is in the best position to determine appropriate practices in the context of its business.

However, Glass Lewis recognizes that companies with a record of poor labor relations or treatment of its workers can face risks, such as employee lawsuits, poor employee work performance and turnover, and regulatory investigations. Glass Lewis will hold directors accountable for company decisions related to labor and employment problems.

For example, at Wal-Mart's annual meeting in 2005 we recommended a vote in favor of a shareholder proposal to have the company prepare an equal employment opportunity report. We felt that there was significant potential economic exposure stemming from lawsuits and a federal investigation, both regarding the company's labor practices.

In our view, Wal-Mart's shareholders deserved to know if their company had engaged in discriminatory employment practices that made it vulnerable to lawsuits and a variety of potential economic losses stemming from lawsuits and potential negative market reaction. In addition, we felt the shareholders should be informed about specific steps Wal-Mart was taking to address these issues that could have had a negative impact on the stock price.

Military and US Government Business Policies

Glass Lewis believes that disclosure to shareholders of information on key company endeavors is important. However, we generally do not support resolutions that call for shareholder approval of policy statements for or against government programs that are subject to thorough review by the federal government and elected officials at the national level. We also do not support proposals favoring disclosure of information where such disclosure is already mandated by law, unless circumstances exist that warrant the extra disclosure. Shareholders should hold directors accountable for a corporation's egregious actions that threaten shareholder value, such as the bribing of public officials. For example, we will recommend voting against members of the audit committee (and any responsible director such as a CEO) when a law enforcement agency has charged a company and/or director with a violation of the FCPA.

Foreign Government Business Policies

Where a corporation operates in a foreign country, we believe that business policies regarding foreign operations are best left to management and the board, absent a showing of egregious or illegal conduct that might threaten shareholder value. However, the company and board may lack controls to help prevent such conduct, examples of which include money laundering or environmental violations such as at BP. We believe that shareholders should hold board members accountable for these issues when they face reelection, as they may subject the company to financial risk even if limited to reputational damage. In such instances, we will hold those board members responsible for oversight of internal controls and compliance, usually the audit committee and CEO, accountable for their actions by recommending voting against them.

Environmental Policies

When management and the board have displayed disregard for environmental risks, have engaged in egregious or illegal conduct, or have failed to adequately respond to current or imminent environmental risks that threaten shareholder value, we believe shareholders should hold directors accountable when they face reelection.

Glass Lewis recognizes the significant financial, legal and reputational risks to companies resulting from poor environmental practices or negligent oversight thereof. We believe part of the board's role is to ensure that management conducts a complete risk analysis of company operations, including those that have environmental implications. Further, directors should monitor management's performance in mitigating the environmental risks attendant with relevant operations in order to eliminate or minimize the risks to the company and shareholders.

While Glass Lewis recognizes that most environmental concerns are best addressed via avenues other than proxy proposals, when a substantial environmental risk has been ignored or inadequately addressed, we may recommend that votes be withheld from responsible members of the governance committee. In some cases, we may recommend that votes be withheld from all directors who were on the board when the substantial risk arose, was ignored, or was not mitigated.

Climate Change and Green House Gas Emission Disclosure Proposals

Glass Lewis will consider recommending a vote in favor of a reasonable proposal to disclose a company's approach to climate change and/or green house gas emissions when (1) a company has encountered problems such as lawsuits and/or government investigations or investors have established a link to impact on shareholder value from climate change and/or green house gas emission regulations, and (2) the company has failed to adequately disclose how it has addressed these problems. We will examine such proposals in light of requests made to the company for additional information, its response and whether there is a reasonable case as to the negative implications to shareholders and the company.

We will look favorably upon the proposals establishing that the problems at issue could have a negative implication for the company or its shareholders.

Reporting Contributions and Political Spending

Glass Lewis believes that disclosure of how a company uses its funds is an important component of corporate accountability to shareholders. A major issue is whether political contributions are being appropriately monitored and spent on behalf of shareholders to create shareholder value. Studies have shown that in some instances, management of some corporations have used stockholder assets to attempt to buy influence with legislators in a manner that ultimately had a negative impact on shareholder value.⁴²

Some campaign contributions are heavily regulated by federal, state, and local laws. Most jurisdictions have detailed disclosure laws so that information on some contributions is publicly available. Some progressive companies provide more information about certain political contributions on company websites, such as contributions to “527” organizations. We believe that the mechanism for disclosure of contributions and the standards for giving are best left to the board, except where a company does not adequately disclose information about its contributions to shareholders or where a company has a history of abuse in the donation process.

However, in cases where additional company disclosure is nonexistent or limited and there is some evidence or credible allegation that the Company is mismanaging corporate funds through political donations or has a record of doing so, Glass Lewis will consider supporting shareholder proposals seeking greater disclosure of political giving. If Glass Lewis discovers particularly egregious actions by the company, we will consider recommending voting against governance committee members or other responsible directors.

⁴² “The Green Canary: Alerting Shareholders and Protecting Their Investments.” The Center for Political Accountability. February 2005.