Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 6

MEETING DATE: **April 18, 2018**

SUBJECT: **Affirmation of Existing SCERS Policies**

SUBMITTED FOR: **_X_ Consent** **___ Deliberation and Action** **___ Receive and File**

RECOMMENDATION

Staff recommends that the Board affirm the following two policies accompanying this item in the new SCERS policy format:

- Directed Brokerage Transactions and Commissions Recapture Policy
- Prime Broker and Counterparty Risk Policy

PURPOSE

To collect, reformat, affirm, and organize all Board policies in one central location to ensure proper administration of all SCERS Board policies.

DISCUSSION

The policy formatting and affirmation project continues with two more policies for the Board's affirmation in the SCERS policy format on consent. The attachments to this agenda item summarize the revisions to these two policies. (Please note that agenda Item 12 presents an additional policy for discussion and adoption, and Item 13 presents a proposed new policy for discussion and comment from SCERS' participating employers.)

A policy represents the general principles by which an entity is guided in the management of its affairs. The policies adopted by the Board provide guidance and direction for the management of the system and govern day-to-day activities.

The policies included in this agenda item are existing policies that are being reformatted into the new standard SCERS policy format with a few minor, technical revisions. Several attachments accompany this memorandum to assist the Board. The first is a brief summary of the policy transition. Following that, for each policy submitted, there is a title page, the policy in the new standard SCERS policy format, and the current version of the existing policy.

These are provided so the Board can confirm that the changes being made are predominantly format changes.

BACKGROUND

Over the past couple of years, Staff has been collecting Board and Staff policies to create a library of all policies that govern SCERS' strategic, legal, administrative, and operational activities.

As part of this current policy project, Staff determined the universe of existing Board policies (approximately 40), researched archive Board materials to identify the policy history for Board adoption and subsequent revision, classified the policies by category, and identified the SCERS executive responsible for overseeing each policy's application.

To date, the Board has affirmed its existing and adopted new policies in the new SCERS policy format as follows:

- Seven policies at the December 2017 meeting
- Five policies at the January 2018 meeting
- Four policies at the February 2018 meeting
- One policy at the March 2018 meeting

ATTACHMENTS

1. Summary of Policy Changes
2. Directed Brokerage Transactions and Commissions Recapture Policy
3. Prime Broker and Counterparty Risk Policy

Prepared by:

/S/

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/S/

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Reviewed by:

/S/

Eric Stern
Chief Executive Officer

ATTACHMENT 1

Directed Brokerage Transactions and Commission Recapture Policy

The Directed Brokerage Transactions and Commission Recapture Policy was first adopted by the Board in October 1996. The most recent amendment was adopted on August 22, 2002, and has since then remained unchanged. Staff has reformatted the 2002 policy, and deleted obsolete wording regarding how the list of approved designated commission recapture brokers is developed. State Street Bank is SCERS' custodian. State Street Global Markets maintains a Correspondent Broker Network, and provides a list of the brokers for SCERS' use in communicating this policy to SCERS' investment managers who trade public securities.

Staff requests the Board affirm the reformatted policy.

Prime Broker and Counterparty Risk Policy

The Prime Broker and Counterparty Risk Policy was adopted by the Board on April 19, 2012 as a supplement to the Hedge Fund Investment Policy Statement (IPS) to provide guidelines for staff and consultants in evaluating and monitoring the counterparty risk of hedge fund managers who use prime brokers in executing the hedge fund's investment strategy. Staff has reformatted the policy and updated the term "hedge fund/manager" to "absolute return fund/manager," and to make this a stand-alone policy rather than a supplement to the Hedge Fund IPS. Staff is reviewing the current collection of asset-class IPS with plans to revise and consolidate those polices at the asset category level. The reformatted policy includes a new "Background" section to describe counterparty risk and the rationale for establishing robust due diligence guidelines in selecting absolute return fund managers.

Staff requests the Board affirm the reformatted policy.

ATTACHMENT 2

DIRECTED BROKERAGE TRANSACTIONS AND COMMISSIONS RECAPTURE POLICY

DOCUMENTS:

1 - POLICY PRESENTED IN REVISED POLICY FORMAT

For affirmation by the Board on April 18, 2018

2 - POLICY AS AMENDED BY THE BOARD

On August 22, 2002

DIRECTED BROKERAGE TRANSACTIONS AND COMMISSIONS RECAPTURE POLICY

Revision Date:	**April 18, 2018**	**Policy Number:**	**032**
Revision Number:	**2**		

PURPOSE

The purpose of this policy is to provide direction to SCERS public equity investment managers in the conduct of investment trades to control commission costs while maintaining the manager's primary and foremost requirement to obtain best net execution.

POLICY

When a SCERS investment manager believes that "all things being equal," the manager can direct a trade and still achieve best net execution as required by the manager's investment management agreement with SCERS, the manager shall direct trades as follows:

A. **U.S. stock exchange listed securities**: Obtain a commission of three cents or less per share or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 30% of U.S. exchange transaction commissions to a commission recapture broker.

B. **Non-U.S. stock exchange listed securities:** Obtain a commission that is 25% or more below the prevailing local market rate or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 25% of non-U.S. exchange transaction commissions to a commission recapture broker.

A designated commission recapture broker is a broker that offers a commission recapture program through which a portion of the direct commissions is credited to an institutional investor such as SCERS that is included on SCERS' list of approved designated commission recapture brokers as maintained by SCERS' custodian bank. The recaptured commissions shall be treated as income to SCERS, and shall not be used to purchase services.

APPLICATION

Staff shall provide each of SCERS' public securities investment managers a copy of this policy and SCERS' list of approved designated commission recapture brokers, as that list may be amended from time to time without revision to this policy.

Staff shall monitor SCERS' transactions costs and provide the Board a quarterly report on the impact of directed trades and commission recapture on trade execution costs.

SCERS will conduct an annual review of the commission recapture sharing percentage and determine that the percentage is consistent with industry practice.

BACKGROUND

A significant portion of SCERS' multi-billion dollar investment portfolio is invested in publicly traded equity securities in several investment markets globally. Transaction costs are incurred whenever a security is bought or sold. Transaction costs are made up of the direct fee or commission and the market impact of executing a trade. One common way for an institutional investor to control commission costs is through commission recapture. This policy provides direction to SCERS' equity investment managers in the conduct of investment trades to control commission costs, but not interfere with the manager's first and foremost obligation to achieve "best net execution."

RESPONSIBILITIES

Executive Owner: Chief Investment Officer

POLICY HISTORY

Date	Description
02-21-2018	*Board to affirm in revised policy format*
08-22-2002	Board amended Inv. Policy No. 2001-01 by Resolution 2002-02
01-18-2001	Board approved Investment Policy No. 2001-01 that replaced the previous policy
October 1996	Board adopted policy

RESOLUTION NO. SCERS 2002-02

RESOLUTION OF THE BOARD OF RETIREMENT OF THE SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM AMENDING SCERS INVESTMENT POLICY No. 2001-01, DIRECTED BROKERAGE TRANSACTIONS AND COMMISSIONS

BE IT RESOLVED AND ORDERED that the Board of Retirement of the Sacramento County Employees' Retirement System hereby approves SCERS Investment Policy No. 2001-01, Directed Brokerage Transactions and Commissions Policy, as amended in the form attached.

On a motion by Member Suter, seconded by Member Norris, the foregoing Resolution was passed and adopted by the Board of the Sacramento County Employees' Retirement System, this 22 day of August, 2002, by the following vote, to wit.

AYES: Members, Hoganson, Suter, Norris, Cox, DeVore, Hickox, Kelly

NOES: Members, None.

ABSENT: Member Woods. (Member Diepenbrock left early)

ADOPTED: August 22, 2002

President of the Board of the
Sacramento County Employees'
Retirement System

ATTEST:

Secretary of the Board of the
Sacramento County Employees'
Retirement System

SCERS INVESTMENT POLICY NO. 2001-01, AS AMENDED

In Re: Directed Brokerage Transaction and Commission Policy

AUTHORITY

The Sacramento County Employees' Retirement System (SCERS) Board of Retirement (Board) is responsible for the management of the system's assets under authority granted by Article XVI, Section 17 of the California Constitution.

Article XVI, Section 17(c) of the California Constitution provides that "the members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aim."

PURPOSE

As a multi-billion dollar defined benefit plan, SCERS invests almost $2 billion in publicly traded equity securities in several investment markets. These investments incur transaction costs whenever a security is bought or sold. The transaction costs are divided into two components; the first component is the direct fee or commission. The second component is the market impact of executing the trade. The purpose of this policy is to provide direction to SCERS equity investment managers in the conduct of investment trades to control commission costs, but not interfere with the manager's requirement to obtain "best net execution". If in the managers' opinion directing a trade will not result in "best net execution" then the manager must first and foremost achieve the best net execution.

This policy replaces the Directed Brokerage Transaction and Commission Policy adopted by the Board in October of 1996.

POLICY

When an Investment Manager believes that "all things being equal" they can direct a trade and still achieve best net execution, as required by their Investment Management Agreement, they shall direct trades as follows:

U.S. stock exchange listed securities: obtain a commission of three cents a share or less or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 30% of U.S. commissions to a commission recapture broker.

International stock exchange listed securities: obtain a commission that is 25% below the prevailing local market rate or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 25% of non-U.S. commissions to a commission recapture broker.

Designated brokers shall be those offering commission recapture programs through which a portion of the direct commissions is credited to a plan sponsor that agree to provide such services to SCERS, The recaptured commissions shall be treated as income to SCERS. The commissions shall not be used to purchase services. In choosing the brokers to be designated by the Board, SCERS staff shall consult with SCERS investment mangers to determine which brokers are most widely used by the managers and that they have found provide "best net execution". A list of from one to five brokers and provided to the Board for its approval.

The Board directs its staff to write to Investment Managers to convey to them its desires with respect to placing trades, indicating the Board's assessment of the value to SCERS of directed trades and commission recapture and providing the approved list of designated recapture brokers.

In adopting this policy the Board also directs staff to monitor transaction costs and provide to it an analysis of the impact of directed trades and commission recapture on trade execution costs. On an annual basis SCERS will conduct a review of the commission recapture sharing percentage to determine that the percentage is consistent with industry practice.

ATTACHMENT 3

PRIME BROKER AND COUNTERPARTY RISK POLICY

DOCUMENTS:

1 - POLICY PRESENTED IN REVISED POLICY FORMAT

For affirmation by the Board on April 18, 2018

2 - POLICY AS ADOPTED BY THE BOARD

On April 19, 2012

PRIME BROKER AND COUNTERPARTY RISK POLICY

Revision Date:	April 18, 2018	Policy Number:	039
Revision Number:	1		

PURPOSE

The purpose of this policy is to establish guidelines for assessing, mitigating, managing, and monitoring the counterparty risks associated with investment managers', particularly absolute return managers', use of prime brokers.

POLICY

Counterparty risks associated with the use of prime brokers will be assessed in the due diligence process by measuring and quantifying the level of exposures inherent in the absolute return investment strategy and operations, and evaluating the measures, processes and other risk controls of each absolute return fund by comparing funds to a set of industry best practices outlined in this policy.

A. Measuring and quantifying prime broker/counterparty risk

The potential scope and significance of counterparty risk associated with prime brokers will be estimated and assessed for each absolute return fund in the due diligence process. The scope of a fund's counterparty risk to prime brokers is a complex assessment that incorporates an understanding of the absolute return fund's investment strategy and operations within its ecosystem (counterparties, the specific agreements, and jurisdiction).

Four of the most important determinants of risk exposure include:

1. Where assets (including cash) are held or custodied;
2. The types of transactions and securities traded, particularly in cases where trades remain unsettled, in over-the-counter ('OTC') derivatives, in repurchase transactions and in bank loans;
3. The re-hypothecation of assets; and
4. Whether assets are held with a domestic or non-U.S. prime broker.

B. Evaluating the measures, processes, and other risk controls of each absolute return fund

The capabilities of potential absolute return managers to mitigate risk will be evaluated for each manager primarily by:

1. Developing a sufficient level of knowledge of the risk controls and risk mitigation procedures based on the questions outlined in the "Prime Broker/Counterparty Risk Due Diligence Questions," Appendix 1; and
2. Comparing each absolute return fund's practices against a set of industry best practices defined in the "Best Practices for Prime Broker/Counterparty Risk," Appendix 2.

C. Monitoring and Oversight

When the determination is made that the absolute return fund manager's prime broker/counterparty risk exposure and risk management program is sufficiently strong to support making an investment with the manager, an ongoing monitoring program will be implemented to assure that risk exposure continues to be within an acceptable range and that the manager is continuing to execute its risk mitigation and risk management program properly. Among other things, this will include:

1. Contractually mandating transparency to the metrics necessary to gauge risk exposure.
2. Contractually mandating disclosure of changes in risk management practices and procedures.
3. Regular reporting of risk exposure and risk management information.
4. Periodic meetings with the manager to re-assess the risk mitigation and risk management program, and to discuss risk exposures and any recent developments.

APPLICATION

The assessment of an absolute return manager's prime broker/counterparty risk exposure and risk management program is an important element in determining whether an investment should be made or maintained with an absolute return manager. However, since it involves both a quantitative and qualitative evaluation, it is not susceptible to rigid rules or hard limits.

For example, it may be the case that the manager has minimal exposure to prime broker/ counterparty risk, but SCERS may elect to not place funds with the manager due to poor risk mitigation practices and/or a weak risk management program. Alternatively, it may be the case that the absolute return manager has a more substantial exposure to prime broker/counterparty risk, but SCERS staff and consultants are comfortable in placing funds with the manager because the manager has very strong risk mitigation practices and a strong risk management program.

The goal of this policy is to clearly set forth the considerations that will impact how a conclusion is reached in any given case. Evaluation and assessment of an absolute return fund's prime broker/counterparty risk exposure will be incorporated in the due diligence process and reports that outline the basis for the investment decision.

BACKGROUND

As a general statement, the term ‘counterparty risk’ can be defined as the risk that the party on the other side of a transaction or investment engagement will not perform some or all of its responsibilities. For purposes of this policy, the counterparty refers to the entity that the absolute return manager selects to hold assets or execute investment transactions, and the risk that the absolute return manager will not be paid or able to reclaim assets held by the selected counterparty. Absolute return managers may maintain assets at a custodian bank; however, most maintain assets with prime brokers as the counterparty, which provide absolute return managers with financing of investment positions and support short sale transactions.

While assets held with a U.S.-based prime broker are protected by various provisions of federal laws, including SEC regulations and the U.S. bankruptcy code, assets held by non-U.S. prime brokers (typically prime brokers based in the United Kingdom) receive less in the way of investor protection, including: (1) the prime broker liquidity requirements are not as stringent, and while certain assets must be segregated (i.e., cash, fully paid for securities), there may not be sufficient liquidity in the event of bankruptcy for those assets to be readily reclaimable; (2) the bankruptcy process lacks a facilitating trustee; (3) there are no-pre-set limits on the level of re-hypothecation; and (4) assets that are re-hypothecated are automatically put in the name of the prime broker which can result in the absolute return manager becoming an unsecured creditor in the event of insolvency of the prime broker.

While investors have historically undertaken measures to manage and mitigate counterparty risk, the true scope of the risk exposure was brought home during the global credit crisis (GFC), when the failure of Lehman Brothers illustrated that even a large, and seemingly credible counterparty can fall into bankruptcy, leaving investors unable to get back all of their assets because they were commingled with the assets of Lehman Brothers and other investors, and not held separately in the name of the investor.

As a result of this and similar events, U.S. regulators have endeavored to increase protections for investors, and investors have become more focused on the measures that can be taken to mitigate this area of counterparty risk. In the case of an absolute return manager, this means having a vigorous, properly resourced program of counterparty risk oversight and management. For SCERS, it means assessing whether the absolute return manager’s counterparty risk management program is sufficiently strong to support making an investment with the manager.

To perform this assessment, it is important that SCERS understands where the absolute return manager’s assets are held, understands the types of investment transactions being made and securities held by the absolute return manager, evaluates the measures being taken by the absolute return manager to mitigate and manage the risk exposure relative to the best practices of the investment industry, and have a monitoring process that will assure that the risk exposure continues to be within an acceptable range and that the absolute return manager is continuing to execute its risk mitigation and management program properly.

RESPONSIBILITIES

Executive Owner: Chief Investment Officer

POLICY HISTORY

Date	Description
04-18-2018	*Board to affirm in revised policy format*
04-19-2012	Board approved new policy

Prime Broker/Counterparty
Risk Due Diligence Questions

1. Inquire as to the firm's criteria for selecting new counterparties.

   ⇒ *The manager should have objective and documented criteria for selecting counterparties.*

2. Inquire as to whom within the manager's organization is responsible for authorizing new counterparties and for, on an ongoing basis, approving the continued use of existing counterparties.

   ⇒ *Managers should have formal, written procedures for approving counterparties, including limiting the authorization of new counterparties to senior management.*

3. Inquire as to the due diligence process and areas of focus when selecting a new counterparty.

   ⇒ *Managers should perform rigorous due diligence procedures of counterparties prior to engaging in dealings with such counterparties. In doing so, managers should obtain and evaluate appropriate information in order to assess the following:*

   - *The counterparty's credit worthiness (recognizing that subsidiaries and affiliates of counterparties may have different creditworthiness than parent companies);*
   - *The counterparty's stability and financial health;*
   - *The counterparty's experience level and ability to provide the desired level of service to meet the needs of the manager's business;*
   - *The attractiveness of the terms the counterparty is willing to provide;*
   - *The counterparty's internal control structure, including the efficiency, security and timeliness of the following areas:*
     - ◊ *Transaction processing and settlement;*
     - ◊ *Trade verification and margining;*
     - ◊ *Collateral management;*
     - ◊ *Reporting;*
     - ◊ *Ability to provide financing;*
     - ◊ *Valuation procedures;*
     - ◊ *Adequate and competent staff;*
     - ◊ *Use of custodians and sub-custodians, if applicable, and particularly in developing markets;*
     - ◊ *Appropriate terms and structure surrounding the movement of cash and collateral; and*
     - ◊ *The regulatory and business environment in which the counterparty operates.*

- *The structure of the prime broker entity.*

  A number of financial institutions maintain separate broker-dealer entities for proprietary/ principal trading and for prime broker/agency trading. This structure is likely favorable as there is a chance that even if the proprietary/principal trading broker-dealer entity were to become insolvent, the prime broker/agency trading broker-dealer entity would not. This factor is particularly important when there is heightened concern about the financial institution's proprietary/ principal trading.

4. Inquire as to the firm's views and/or policies regarding the credit risk and exposure to a single financial institution.

   ⇒ *Managers should establish credit ratings standards and limits for aggregate allowable exposure to any single financial institution.*

5. Inquire as to how the firm prepares for events (e.g., Credit Crisis, prime broker/dealer crises or failures) that would necessitate the firm shift its counterparty exposure to other providers on short notice.

   ⇒ *The manager's selection of counterparties should include the analysis of actions that could be taken in the event the financial condition of a specific counterparty deteriorates and doubts arise about its ability to perform in accordance with the agreements and contracts which have been executed. For example, inquiries should be made regarding a given counterparty's capacity in the event it became desirable to move assets to a different counterparty quickly due to a market event or alternative financing providers should become necessary.*

6. Inquire as to the manager's personnel who are involved with and responsible for the review and negotiation of documents governing the relationships with counterparties.

   ⇒ *Documents should be fully negotiated and executed before the commencement of activity. Appropriate resources should be devoted to the documentation and negotiation process and counsel should be consulted as necessary. Managers should have model terms sheets containing the desired terms for commonly negotiated documents such as ISDA master agreements and prime brokerage agreements to reduce operational burdens and default risk resulting from inconsistent terms.*

7. Inquire as to the terms that have been negotiated with current counterparties regarding trade termination and default provisions and the ability to change the terms of the agreements. Specifically, inquire as to the terms in the manager's prime brokerage and/or ISDA agreements:

   a. Have any terms changed within the past 12 months?

   b. Is the prime brokerage agreement subject to a lock up? If so, what is the term and scope of the lock up? Does it include changes to margin terms, fees and other charges, interest rates and spreads, minimum net equity requirements, terminating or demanding the payment of a loan and terminating short positions?

c. What are the termination events? Can the counterparty exercise termination rights if a termination event has occurred or only when it has occurred and is continuing (i.e. is there a “fish or cut bait” provision)? Do any termination events apply to the counterparty?

d. Are there cross default provisions between counterparty agreements?

e. What are the events of default? Can the counterparty exercise rights if an event of default has occurred or only when it has occurred and is continuing (i.e. is there a “fish or cut bait” provision)?

f. Does the manager have dispute rights regarding how positions are valued by the counterparty?

g. Are margin calls and payments due on demand or is there a transfer deadline?

h. Are the collateral provisions bilateral? Can the manager withdraw excess collateral from the manager’s account?

i. Are any positions re-hypothecated? In other words, has a prime broker lent out any of the fund’s securities without the manager’s expressed permission?

j. Does the agreement impose any portfolio parameters? If so, what positions are covered/excluded? Do remedies apply to the whole portfolio or only to the noncompliant portions of the portfolio?

k. Does the prime brokerage agreement set financing limits? If so, what are they?

l. Have any of the fund’s counterparties ever materially reduced the availability of leverage?

m. What controls have been negotiated with regards to the close out mechanisms if there has been an event of default?

n. What services are still available to the fund after notice is given that the lock up is expiring? Can the fund put on new positions during that period? Does the lock up ratchet down as positions are unwound or can balances be increased?

⇒ *Negotiating documents governing the terms of the relationship at the outset is critical and allows managers to preserve financial strength under adverse conditions. Managers should negotiate terms relating to:*

- *Trade termination and default risks;*
- *Liquidity risks and management of margin;*
- *Counterparty default risk.*

⇒ *Managers should fully understand the implications of the terms in their agreements on the counterparty’s obligations to extend credit or provide services as well as the counterparty’s ability to close trades, modify terms or increase collateral requirements. Managers should carefully negotiate margin and financing terms to ensure a counterparty cannot modify terms due to a market event as opposed to a specific fund event.*

8. Inquire as to the risk mitigation provisions, such as netting and collateral, which are currently utilized to reduce counterparty risk. Are assets segregated and protected?

⇒ *Protections against counterparty default risk should include:*

- *Ratings-based termination events applying to the counterparty (alternatively, require a guarantee if a counterparty is not rated);*
- *Requirements to hold collateral with rated custodians;*
- *Restrictions on dealer's abilities to re-hypothecate upon credit downgrade events; and*
- *Confirmation that custodians hold assets in proper client segregated accounts.*
- *Use of global netting agreements.*

9. Inquire as to the manager's ongoing counterparty monitoring procedures. Who in the organization is responsible for counterparty monitoring?

⇒ *Managers should be vigilant in monitoring the credit worthiness and financial health of their counterparties on an ongoing basis. Periodic due diligence updates should be completed on all current counterparties, and documented on a timely basis.*

10. Inquire as to the working relationship with current counterparties with respect to the recurring interaction between the organizations.

⇒ *Relationships with counterparties should be managed to enable open ongoing communication and allow for contact with designated account representatives if guidance is necessary in a financial distress situation.*

11. Inquire as to the procedures regarding and individuals responsible for collateral and margin management including cash management procedures to provide necessary liquidity.

⇒ *Margin and collateral terms can have a material effect on a fund's liquidity. A sound framework should be implemented to manage cash balances in a way that facilitates and plans for margin calls from counterparties. Managers should dedicate appropriate professionals to understand and take responsibility for:*

- *Compliance with covenants in counterparty agreements;*
- *Anticipating and preparing for potential margin and collateral requirements;*
- *Validating the accuracy of valuations performed by counterparties which affect collateral; and*
- *Verifying and meeting margin calls timely.*

12. Inquire as to the type of information that is provided to counterparties.

⇒ *At the beginning of the relationship, managers and counterparties should agree as to the type and frequency of information that will be provided. Managers should assign responsibility for providing and assisting with such reporting. Managers should be* *cognizant of the counterparty's policies regarding confidentiality and information barriers within the organization to ensure information provided is used solely for credit evaluation purposes.*

13. Inquire as to the manager's procedures for maintaining compliance with covenants in documents governing relationships with counterparties

    ⇒ *Managers should assign responsibility for the ongoing review of compliance with covenants to appropriate level personnel at the firm. Managers should have procedures in place to track compliance with covenants on an ongoing basis.*

14. Inquire whether the manager uses or has considered using private sector clearing houses, such as CLS, for foreign exchange settlements, or trust capabilities provided by the prime brokers?

    ⇒ *Managers should stay informed as to industry options available to mitigate counterparty risk and use them as it seems appropriate for their strategy and operations.*

Best Practices for Prime Brokers/Counterparty Risk

1. The manager utilizes best efforts to hold assets with onshore prime brokers or custodians versus offshore prime brokers.

2. The manager selects and spreads assets held across a diversified set of prime brokers (onshore and offshore) which is appropriate to the investment strategy and risks. This includes the establishment of credit ratings standards and limits on aggregate exposure to any one counterparty and the limitation of excess cash to any counterparty or prime broker.

3. A dedicated team of professionals with a significant level of operational experience assigned to manager counterparty risk.

4. A formal internal process to select and approve counterparty relationships including:
   a. Counterparties chosen based on the nature of the business.
   b. Utilizes only well-known, established financial institutions with institutional quality credit ratings.
   c. Establishes policies and procedures for the selection and approval of new counterparty relationships.
   d. Counterparty risk is legally analyzed to prepare for asset restitution.

5. A formal process to quantify, assess and monitor counterparty exposure periodically. This includes quantifying and monitoring the aggregate exposures at each counterparty with periodic reports. It also includes assessing the financial wherewithal of the counterparty periodically by reviewing appropriate metrics such as financial statements, CDS spreads, yield spreads, credit ratings, and news and corporate events.

6. The review and negotiation of documents governing the relationships with counterparties is done by established in-house and or well-known third party attorneys (to achieve market terms) before the commencement of activity. Negotiations should be centrally managed, and managers should have model term sheets containing the desired terms for commonly-negotiated documents, such as ISDA master agreements and prime brokerage agreements, to reduce operational burdens and default risk resulting from inconsistent terms.

7. The manager has a process to ensure compliance. This includes an understanding of agreed-upon terms by middle- and back-office personnel and feedback with investment professionals trading in securities or transacting in assets held offshore. The manager should fully understand the implications of the terms in their agreements relating to the counterparty's obligations to extend credit or provide services as well as the counterparty's ability to close trades, modify terms or increase collateral requirements and incorporate this in their trading operations.

8. The manager establishes market terms in ISDA and prime brokerage agreements. Key terms include:
    a. Inability to transfer assets to offshore prime broker affiliates.
    b. Maximum allowance for re-hypothecation is 140%.
    c. Favorable bi-lateral agreements; (4) Favorable NAV triggers.
    d. Timeline to declare defaults; (6) Tri-party agreements shifting assets held to custodians.
    e. Novation agreements to shift assets in emergencies.
    f. Committed financing.

9. The manager has procedures for monitoring and investment of excess cash, if any, which is held by offshore prime broker, including processes and systems to sweep or transfer excess cash from offshore prime brokers to onshore prime brokers and custodians on a daily basis.

10. The manager engages in active management of margin and collateral.

11. The manager has the capability to transfer assets held at prime brokers within a short time frame.

12. The manager has the capability to purchase insurance on counterparties such as in the form of CDS when appropriate.

13. The manager obtains expedient resolution and proactive reporting of potential or actual default or termination events with counterparties, leading to no unresolved events.

SCERS’ Hedge Fund Policy
Prime Brokers/Counterparty Risk

A. Policy Objectives

This policy supplements SCERS’ Hedge Fund Investment Policy Statement (‘Hedge Fund IPS’) by outlining guidelines for assessing, mitigating, managing and monitoring, the counterparty risks associated with hedge fund managers’ use of prime brokers.

As a general statement, the term ‘counterparty risk’ can be defined as the risk that the party on the other side of a transaction or investment engagement will not perform some or all of its responsibilities. For current purposes, the counterparty in question is the entity that the hedge fund manager selects to hold assets or execute investment transactions, and the risk is that the hedge fund manager will not be paid or able to reclaim assets held by the selected counterparty.

While investors have undertaken measures to manage and mitigate counterparty risk for many years, the true scope of the risk exposure was brought home during the ‘Credit Crisis’ when the failure of Lehman Brothers illustrated that even a large, and seemingly credible counterparty can fall into bankruptcy, leaving investors unable to get back all of their assets because they were commingled with the assets of Lehman Brothers and other investors, and not held separately in the name of the investor.

As a result of this and similar events, U.S. regulators have endeavored to increase protections for investors, and investors have become even more focused on the measures that can be taken to mitigate this area of counterparty risk. In the case of a hedge fund manager, this means having a vigorous, properly resourced program of counterparty risk oversight and management. For SCERS, it means assessing whether the hedge fund manager’s counterparty risk management program is sufficiently strong to support making an investment with the manager.

To perform this assessment, it is important that SCERS understands: (1) Where the hedge fund manager’s assets are held; (2) The types of investment transactions being made and securities held by the hedge fund manager; and (3) The risk implications of (1) and (2). Next, SCERS must evaluate the measures being taken by the hedge fund manager to mitigate and manage the risk exposure relative to the best practices of the investment industry. Finally, if it is determined that a hedge fund manager’s counterparty risk management program is strong enough to support making an investment with the manager, SCERS and its partners must have a monitoring process that will assure that the risk exposure continues to be within an acceptable range and that the hedge fund manager is continuing to execute its risk mitigation and management program properly. These steps will be discussed in the following sections including investment guidelines, monitoring and implementation protocol.

B. Investment Guidelines

Counterparty risks associated with the use of prime brokers will be assessed in the due diligence process by: (1) Measuring and quantifying the level of exposures inherent in the investment strategy and operations of the hedge fund; and, (2) Evaluating the measures, processes and other risk controls of each hedge fund by comparing funds to a set of industry best practices outlined in this document.

1. **Measuring and quantifying prime broker/counterparty risk:**

   An estimate of the potential scope and significance of counterparty risk associated with prime brokers will be assessed for each hedge fund in the due diligence process. The scope of a hedge fund's counterparty risk to prime brokers is a complex assessment that incorporates an understanding of the hedge fund's investment strategy and operations within its ecosystem (counterparties, the specific agreements, and jurisdiction). Four of the most important determinants of risk exposure include: (1) Where assets (including cash) are held or custodied; (2) The types of transactions and securities traded, particularly in cases where trades remain unsettled, in over-the-counter ('OTC') derivatives, in repurchase transactions and in bank loans; (3) The rehypothecation of assets; and, (4) Whether assets are held with a domestic or non-U.S. prime broker.

2. **Evaluating the measures, processes and other risk controls of each hedge fund:**

   An evaluation of the capabilities of potential hedge fund managers to mitigate risk will be conducted for each hedge fund manager primarily by: (1) Developing a sufficient level of knowledge of the risk controls and risk mitigation procedures based on the questions outlined in **Appendix 1**; and, (2) Comparing each hedge fund's practices against a set of industry best practices defined in **Appendix 2**.

C. Monitoring and Oversight

When the determination is made that the hedge fund manager's prime broker/counter-party risk exposure and risk management program is sufficiently strong to support making an investment with the manager, an ongoing monitoring program will be implemented to assure that risk exposure continues to be within an acceptable range and that the hedge fund manager is continuing to execute its risk mitigation and risk management program properly. Among other things, this will include:

- Contractually mandating transparency to the metrics necessary to gauge risk exposure.

- Contractually mandating disclosure of changes in risk management practices and procedures.

- Regular reporting of risk exposure and risk management information.
- Monthly meetings with the manager to discuss developments, including risk exposure and the risk management program.
- Annual operational due diligence review, including re-assessment of the risk mitigation and risk management program.

D. Implementation Protocol

The assessment of a hedge fund manager's prime broker/counterparty risk exposure and risk management program is an important element in determining whether an investment should be made with or maintained in a hedge fund manager. However, since it involves both a quantitative and qualitative evaluation, it is not susceptible to rigid rules or hard limits. For example, it may be the case that the hedge fund manager has minimal exposure to prime broker/counterparty risk, but SCERS may elect to not place funds with the manager due to poor risk mitigation practices and/or a weak risk management program. Alternatively, it may be the case that the hedge fund manager has a more substantial exposure to prime broker/counterparty risk, but Staff and its partners are comfortable in placing funds with the manager because the manager has very strong risk mitigation practices and a strong risk management program. The goal of the proposed policy, therefore, is to clearly set forth the considerations that will impact how a conclusion is reached in any given case.

The evaluation of a hedge fund's prime broker/counterparty risk exposure will be implemented in accordance with SCERS' Hedge Fund IPS. Specifically, these evaluations and assessments will be incorporated in the due diligence process and reports that outline the basis for the investment decision.

Appendix 1

Prime Broker/Counterparty Risk Due Diligence Questions

1. Inquire as to the firm's criteria for selecting new counterparties.

   ⇒ *The manager should have objective and documented criteria for selecting counterparties.*

2. Inquire as to whom within the manager's organization is responsible for authorizing new counterparties and for, on an ongoing basis, approving the continued use of existing counterparties.

   ⇒ *Managers should have formal, written procedures for approving counterparties, including limiting the authorization of new counterparties to senior management.*

3. Inquire as to the due diligence process and areas of focus when selecting a new counterparty.

   ⇒ *Managers should perform rigorous due diligence procedures of counterparties prior to engaging in dealings with such counterparties. In doing so, managers should obtain and evaluate appropriate information in order to assess the following:*

   - *The counterparty's credit worthiness (recognizing that subsidiaries and affiliates of counterparties may have different creditworthiness than parent companies);*
   - *The counterparty's stability and financial health;*
   - *The counterparty's experience level and ability to provide the desired level of service to meet the needs of the manager's business;*
   - *The attractiveness of the terms the counterparty is willing to provide;*
   - *The counterparty's internal control structure, including the efficiency, security and timeliness of the following areas:*
     - ◊ *Transaction processing and settlement;*
     - ◊ *Trade verification and margining;*
     - ◊ *Collateral management;*
     - ◊ *Reporting;*
     - ◊ *Ability to provide financing;*
     - ◊ *Valuation procedures;*
     - ◊ *Adequate and competent staff;*
     - ◊ *The utilization of custodians and sub-custodians, if applicable, and particularly in developing markets;*
     - ◊ *Appropriate terms and structure surrounding the movement of cash and collateral; and*

- ◊ *The regulatory and business environment in which the counterparty operates.*

- ▪ *The structure of the prime broker entity.*

  - ◊ *A number of financial institutions, including Bear Stearns, maintain separate broker-dealer entities for proprietary/principal trading and for prime broker/agency trading. This structure is likely favorable as there is a chance that even if the proprietary/principal trading broker-dealer entity were to become insolvent, the prime broker/agency trading broker-dealer entity would not. This factor is particularly important when there is heightened concern about the financial institution's proprietary/principal trading, as was the case in Bear Stearns.*

4. Inquire as to the firm's views and/or policies regarding the credit risk and exposure to a single financial institution.

   ⇒ *Managers should establish credit ratings standards and limits for aggregate allowable exposure to any single financial institution.*

5. Inquire as to how the firm prepares for events, such as the Credit Crisis, Bear Stearns crisis, and failure of Lehman, that would necessitate that the firm shift its counterparty exposure to other providers on short notice.

   ⇒ *The manager's selection of counterparties should include the analysis of actions that could be taken in the event the financial condition of a specific counterparty deteriorates and doubts arise about its ability to perform in accordance with the agreements and contracts which have been executed. For example, inquiries should be made regarding a given counterparty's capacity in the event it became desirable to move assets to a different counterparty quickly due to a market event or alternative financing providers should become necessary.*

6. Inquire as to whom at the manager is involved with and responsible for the review and negotiation of documents governing the relationships with counterparties.

   ⇒ *Documents should be fully negotiated and executed before the commencement of activity. Appropriate resources should be devoted to the documentation and negotiation process and counsel should be consulted as necessary. Managers should have model terms sheets containing the desired terms for commonly negotiated documents such as ISDA master agreements and prime brokerage agreements to reduce operational burdens and default risk resulting from inconsistent terms.*

7. Inquire as to the terms that have been negotiated with current counterparties regarding trade termination and default provisions and the ability to change the terms of the agreements. Specifically, inquire as to the terms in the manager's prime brokerage and/or ISDA agreements:

   a. Have any terms changed within the past 12 months?

   b. Is the prime brokerage agreement subject to a lock up? If so, what is the term and scope of the lock up? Does it include changes to margin terms, fees and other charges, interest rates and spreads, minimum net equity requirements, terminating or demanding the payment of a loan and terminating short positions?

c. What are the termination events? Can the counterparty exercise termination rights if a termination event has occurred or only when it has occurred and is continuing (i.e. is there a "fish or cut bait" provision)? Do any termination events apply to the counterparty?

d. Do you have cross default provisions between counterparty agreements?

e. What are the events of default? Can the counterparty exercise rights if an event of default has occurred or only when it has occurred and is continuing (i.e. is there a "fish or cut bait" provision)?

f. Do you have dispute rights with regards to how positions are valued by the counterparty?

g. Are margin calls and payments due on demand or is there a transfer deadline?

h. Do you have bilateral collateral provisions? Can you withdraw excess collateral from your account?

i. Are any positions rehypothecated? In other words, has a prime broker lent out any of the fund's securities without the fund's expressed permission?

j. Does the agreement impose any portfolio parameters? If so, what positions are covered/excluded? Do remedies apply to the whole portfolio or only to the non-compliant portions of the portfolio?

k. Does your prime brokerage agreement set financing limits? If so, what are they?

l. Have any of the fund's counterparties ever materially reduced the availability of leverage?

m. What controls have been negotiated with regards to the close out mechanisms if there has been an event of default?

n. What services are still available to you after notice is given that your lock up is expiring? Can you put on new positions during that period? Does the lock up ratchet down as positions are unwound or can balances be increased?

⇒ *Negotiating documents governing the terms of the relationship at the outset is critical and allows managers to preserve financial strength under adverse conditions. Managers should negotiate terms relating to:*

- *Trade termination and default risks;*
- *Liquidity risks and management of margin;*
- *Counterparty default risk.*

⇒ *Managers should fully understand the implications of the terms in their agreements on the counterparty's obligations to extend credit or provide services as well as the counterparty's ability to close trades, modify terms or increase collateral requirements. Managers should carefully negotiate margin and financing terms to* *ensure a counterparty cannot modify terms due to a market event as opposed to a specific fund event.*

8. Inquire as to the risk mitigation provisions, such as netting and collateral, which are currently utilized to reduce counterparty risk. Are assets segregated and protected?

   ⇒ *Protections against counterparty default risk should include:*

   - *Ratings-based termination events applying to the counterparty (alternatively, require a guarantee if a counterparty is not rated);*
   - *Requirements to hold collateral with rated custodians;*
   - *Restrictions on dealer's abilities to rehypothecate upon credit downgrade events; and*
   - *Confirmation that custodians hold assets in proper client segregated accounts.*
   - *Use of global netting agreements.*

9. Inquire as to the manager's ongoing counterparty monitoring procedures. Who in the organization is responsible for counterparty monitoring?

   ⇒ *Managers should be vigilant in monitoring the credit worthiness and financial health of their counterparties on an ongoing basis. Periodic due diligence updates should be completed on all current counterparties, and documented on a timely basis.*

10. Inquire as to the working relationship with current counterparties with respect to the recurring interaction between the organizations.

    ⇒ *Relationships with counterparties should be managed to enable open ongoing communication and allow for contact with designated account representatives if guidance is necessary in a financial distress situation.*

11. Inquire as to the procedures regarding and individuals responsible for collateral and margin management including cash management procedures to provide necessary liquidity.

    ⇒ *Margin and collateral terms can have a material affect on a fund's liquidity. A sound framework should be implemented to manage cash balances in a way that facilitates and plans for margin calls from counterparties. Managers should dedicate appropriate professionals to understand and take responsibility for:*

    - *Compliance with covenants in counterparty agreements;*
    - *Anticipating and preparing for potential margin and collateral requirements;*
    - *Validation of the accuracy of valuations performed by counterparties which affect collateral; and*
    - *Verifying and meeting margin calls timely.*

12. Inquire as to the type of information that is provided to counterparties.

   ⇒ *At the beginning of the relationship, managers and counterparties should agree as to the type and frequency of information that will be provided. Managers should assign responsibility for providing and assisting with such reporting. Managers should be cognizant of the counterparties policies regarding confidentiality and information barriers within the organization to ensure information provided is used solely for credit evaluation purposes.*

13. Inquire as to the manager's procedures for maintaining compliance with covenants in documents governing relationships with counterparties

   ⇒ *Managers should assign responsibility for the ongoing review of compliance with covenants to appropriate level personnel at the firm. Managers should have procedures in place to track compliance with covenants on an ongoing basis.*

14. Inquire whether the manager utilizes or has considered utilizing private sector clearing houses, such as CLS for foreign exchange settlements, or trust capabilities provided by the prime brokers?

   ⇒ *Managers should stay informed as to industry options available to mitigate counterparty risk and utilize them as it seems appropriate for their strategy and operations.*

Appendix 2

Best Practices for
Prime Brokers/Counterparty Risk

1. The manager utilizes best efforts to hold assets with onshore prime brokers or custodians versus offshore prime brokers.

2. The manager selects and spreads assets held across a diversified set of prime brokers (onshore and offshore) which is appropriate to the investment strategy and risks. This includes the establishment of credit ratings standards and limits on aggregate exposure to any one counterparty and the limitation of excess cash to any counterparty or prime broker.

3. A dedicated team of professionals with a significant level of operational experience assigned to manager counterparty risk.

4. A formal internal process to select and approve counterparty relationships including:

    a. Counterparties chosen based on the nature of the business.

    b. Utilizes only well-known, established financial institutions with institutional-quality credit ratings.

    c. Establishes policies and procedures for the selection and approval of new counterparty relationships.

    d. Counterparty risk is legally analyzed to prepare for asset restitution.

5. A formal process to quantify, assess and monitor counterparty exposure periodically. This includes quantifying and monitoring the aggregate exposures at each counterparty with periodic reports. It also includes assessing the financial wherewithal of the counterparty periodically by reviewing appropriate metrics such as financial statements, CDS spreads, yield spreads, credit ratings, and news and corporate events.

6. The review and negotiation of documents governing the relationships with counterparties is done by established in-house and or well-known third party attorneys (to achieve market terms) before the commencement of activity. Negotiations should be centrally managed, and managers should have model term sheets containing the desired terms for commonly-negotiated documents, such as ISDA master agreements and prime brokerage agreements, to reduce operational burdens and default risk resulting from inconsistent terms.

7. The manager has a process to ensure compliance. This includes an understanding of agreed-upon terms by middle- and back-office personnel and feedback with

investment professionals trading in securities or transacting in assets held offshore. The manager should fully understand the implications of the terms in their agreements relating to the counterparty's obligations to extend credit or provide services as well as the counterparty's ability to close trades, modify terms or increase collateral requirements and incorporate this in their trading operations.

8. The manager establishes market terms in ISDA and prime brokerage agreements. Key terms include: (1) Inability to transfer assets to offshore prime broker affiliates; (2) Maximum allowance for rehypothecation is 140%; (3) Favorable bi-lateral agreements; (4) Favorable NAV triggers; (5) Timeline to declare defaults; (6) Tri-party agreements shifting assets held to custodians; (7) Novation agreements to shift assets in emergencies; and, (8) Committed financing.

9. The manager has procedures for monitoring and investment of excess cash, if any, which is held by offshore prime broker, including processes and systems to sweep or transfer excess cash from offshore prime brokers to onshore prime brokers and custodians on a daily basis.

10. The manager engages in active management of margin and collateral.

11. The manager has the capability to transfer assets held at prime brokers within a short time frame.

12. The manager has the capability to purchase insurance on counterparties such as in the form of CDS when appropriate.

13. The manager obtains expedient resolution and proactive reporting of potential or actual default or termination events with counterparties, leading to no unresolved events.