ILLINOIS STATE BOARD OF INVESTMENT

Transition Management Policy

Transition management is defined as the professional management of trading out of one portfolio of marketable securities ("legacy" portfolio) and into another portfolio of marketable securities ("target" portfolio), while controlling for the timeliness of trades, explicit and implicit costs, and market exposure relative to a predetermined benchmark. Transition management includes, but is not limited to, the termination and hiring of investment advisers. It also may apply to rebalancing between asset classes, large cash contributions/withdrawals to and from an investment adviser and strategy changes within the Fund. Transition management is most commonly utilized in domestic equity, international equity and fixed income portfolios.

- **Commission cost** is the fee paid to a broker for executing a transaction.
- **Bid/ask spread cost** is the amount by which the ask price exceeds the bid.
- **Market impact cost** is the effect trading will have on the market price of the shares being traded.
- **Opportunity cost** is the cost of market movements over the time it takes to trade.

A. Objective

Transitions are an important and inevitable element of portfolio management. The optimal method to use in executing a transition may vary significantly from one transition to another based on the types of assets involved and the timeframe in question. Generally, the Board's objective in an investment adviser transition is to implement the change in a cost-effective, timely manner while maintaining the appropriate market exposure. It is imperative to note that the cost of a transition is not commissions alone, but also bid/ask spread, market impact and opportunity cost. The market impact cost is the effect trading will have on the market price of the shares being traded. The opportunity cost, sometimes referred to as implementation shortfall, is the cost of market movements over the time it takes to trade. Efforts should be made to minimize the total cost rather than any single cost component.

B. Transition Manager Pool Selection Process

The Board's investment staff shall manage the transition manager pool selection process, in coordination with the Board's Consultant. The Board's transition manager pool shall consist of Board approved transition managers. To be considered for inclusion in the transition manager pool, transition managers must complete the Board's Transition Management Request for Competitive Proposal ("RFP") process. Proposals shall be evaluated based upon the following criteria: quality and completeness of the response, ability to fulfill the requirements of the scope of services, qualifications and experience of the firm, historical track record of the transition manager's aggregate transition activity, process and business model for transition management, including whether the transition manager will accept fiduciary responsibility for the transition, the presence or absence of conflicts of interest, confidentiality protections and reporting capabilities, among others.

Advertisements for the RFP shall be placed in the State newspaper, in one or more industry periodicals and posted on the Board's website at least 14 days before the response to the proposal document is due. The Board's investment staff shall also distribute the RFP document to investment staff's and Consultant's universe of known transition managers. Investment staff and Consultant shall encourage minority-owned, women-owned and persons-with-disability-owned transition managers to participate in the competitive proposal process.

Uniform documents shall be used for the solicitation, review, and acceptance of transition management services and shall be posted on the Board's web-site. Documents may differ based on the specific transition. All interested respondents shall return their proposals to the Board's investment staff or Consultant, as directed by the RFP. Investment staff shall open the responses, record them and thoroughly review each for content, quality and compliance with RFP requirements. Investment staff shall compile a list of all respondents to the competitive proposal process.

Following review and evaluation of the proposals from interested firms, the field of candidates is narrowed to a smaller list of the most highly qualified firms. At this point, the Board's investment staff and Consultant shall meet with representatives of each firm to obtain an independent assessment of the firm's capabilities. Following the interviews with the selected firms, the Board's investment staff and Consultant shall recommend to the Board three or more transition managers for inclusion in the transition manager pool. The finalists may appear before the Board to present their firms' qualifications. The Board shall accept or modify the recommendation and make the final decision with respect to the pool's composition, if satisfied with the firms' capabilities.

The Board reserves the right to reject any or all transition management proposals. The transition manager pool shall be reevaluated every three years.

For transitions occurring prior to the finalization of the Board's transition manager pool or during a competitive bidding period, Board investment staff and investment consultant shall solicit proposals from at least three qualified transition managers and prudently select the transition manager best suited to handle the particular transition at issue based on relevant factors such as: ability to fulfill the requirements of the scope of services, qualifications and experience of the firm, historical track record of the transition manager's aggregate transition activity, process and business model for transition management, including whether the transition manager will accept fiduciary responsibility for the transition, the presence or absence of conflicts of interest, confidentiality protections, reporting capabilities and the overall estimated costs and/or fees for the transition.

Each transition manager selected for the transition pool shall enter a transition management agreement with the Board, which shall establish terms and conditions for the relationship in general (i.e, fiduciary responsibilities, transparency requirements, conflict of interest disclosures, indemnification, insurance requirements and state law requirements etc.) and include stringent confidentiality terms to protect against information leakage to the marketplace. Entry into a transition management agreement with the Board shall not be construed as a guarantee of a minimum level of transition assignments to be assigned to the transition manager, which shall be made evident in any transition management agreement executed by the Board

C. Transition Manager Assignment / Scope of Services

The criteria for choosing a transition manager to execute a transition will vary, just as the circumstances and types of portfolios being transitioned will vary. The Board's investment staff does not use the same metrics in evaluating a transition manager when rebalancing from fixed income to large cap equity as when changing international equity managers with similar mandates. Investment staff shall consider the fact that some transition managers tend to over-emphasize the value that can be added by their trading desks. Further, investment staff shall also consider that a firm which touts its ability to execute cheaply relative to the benchmark may be neglecting other important aspects of the transition. In more liquid portfolios, the trading efficiency advantage diminishes, while crossing opportunities increase. Investment staff shall also consider the fact that a firm which focuses too heavily on trading also may miss those crosses that would significantly lower costs. Conversely, a smaller capitalization, less liquid portfolio will have fewer crossing opportunities and the potential for value added through superior trading increases. Finally, the Board's investment staff shall take into consideration that a firm which focuses on maximizing crosses may accumulate excessive and unnecessary costs associated with time delays.

Prior to engaging in a transition, the Board's investment staff shall distribute a detailed transition work request to the transition manager pool, which shall include the following information, at a minimum: (i) a description of the specific need for the transition services, (ii) identification of the goals for the transition, including identifying the specific legacy portfolio of securities and any new accounts, (iii) custodial contact information, (iv) investment advisory contact information and (v) a request for a written transition work plan, timeline, pre-trade analysis and disclosure report, containing, among other things, a breakdown of all estimated explicit (i.e., commissions, custody, taxes, duties, foreign exchange) and implicit (i.e., market impact, opportunity costs, bid/ask spread) costs of the transition. Further, investment staff shall encourage transition managers to utilize minority broker-dealers in the execution of the Board's transitions and may establish minority brokerage goals for specific transitions in the transition work request. Transition managers in the pool shall submit specific proposals to investment staff based on the transition work request.

The Board's investment staff and Consultant shall review the proposals submitted by the transition manager pool and prudently craft a transition manager recommendation for the Executive Director's review, selecting the transition manager best suited to execute the particular transition. Each individual transition assignment established under a transition management agreement between the Board and a transition manager within the pool shall be documented in a transition work order, setting forth, at a minimum, the specific tasks, deliverables, schedules and costs for the specific transition assignment. Each transition work order shall be subject to the terms of the transition manager's transition management agreement with the Board and incorporated as an attachment thereto. All transition work orders shall be approved in writing by the Executive Director or the Executive Director's designee. The Executive Director has authority to execute the transition work order on the Board's behalf. Investment staff shall provide a detailed performance evaluation for each transition assignment at the Board's next regularly scheduled meeting following the applicable transition.

In most instances transition management services shall be executed by a transition manager in the Board's approved transition manager pool. However, in some instances, the Board's investment staff may believe it is more appropriate for one of the Board's Advisers to provide these services. In this instance, investment staff shall provide complete documentation of its reasoning in a recommendation submitted to the Executive Director for approval, including any recommendations provided by the Board's investment Consultant, and prepare appropriate legal documentation for the specific transition assignment, including items required within a transition work order. Further, investment staff shall provide a detailed performance evaluation for the specific transition assignment to the Board, as detailed above.

A transition manager's scope of services may include, but is not necessarily limited to, the following:

1. Providing a transition work plan, timeline, pre-trade analysis and disclosure report, containing, among other things:
    - (i) An analysis of implementation shortfall distribution;
    - (ii) An analysis of the three month historical returns for the target and legacy portfolios;
    - (iii) A factor analysis, including sector, market capitalization, estimated bid/ask analysis and liquidity summaries for the target and legacy portfolios;
    - (iv) An estimate of how tracking error between the legacy and target portfolio will be reduced over the transition period;
    - (v) A plan for executing the transition in terms of methods of execution and the estimated explicit and implicit transition cost attribution to successfully complete the transition;
    - (vi) A disclosure report outlining the actual and potential conflicts of interest posed by the particular transition and proposed measures to manage those conflicts and prevent information leakage to the market;
    - (vii) Historical track records of the transition manager's aggregate transition activity, as well as historical track records of similar transitions, where available; and
    - (viii) An estimate of implementation shortfall to be incurred during the

transition period.

2. Communicating and coordinating the transition process in cooperation with the Board's investment staff, Custodian, Advisers and any other third parties to ensure that the assets are transitioned in the most efficient and cost-effective manner possible;
3. Trading securities from the legacy portfolio(s) to the target portfolio(s) as a fiduciary and agent on behalf of the Board, as well as trading in a principal capacity, if approved in advance by the Executive Director; these trading services could involve multiple investment strategies and encompass both multiple asset classes~~,~~ and multiple managers across all capitalization ranges;
4. Minimizing tracking error and maintaining asset class or benchmark exposure;
5. Preserving capital shall be taken into consideration through the expert use of trading, "cherry picking" of the legacy portfolio for the target portfolio, internal and external crossing networks, cash and all other approved tools required to accomplish a smooth transition;
6. Utilizing futures, swaps and ETFs, for risk reduction purposes only; and
7. Providing recurring written reports to investment staff throughout the transition event, as well as providing detailed reports regarding the performance and cost of the transition; the reports shall include the following information, at a minimum:
   - (i) a daily performance review that compares the performance of the transition with the theoretical performance of the target portfolio during the transition period, specifically addressing the level of implementation shortfall incurred in the transition;
   - (ii) a trading summary identifying the execution methods utilized and how much of the transition was executed for each method as measured by market value;
   - (iii) a cost analysis identifying the commissions, execution costs and opportunity costs for the transition;
   - (iv) a buy/sell detail report that identifies the dollar value, number of securities and/or units, time stamps and commissions paid for each execution method grouped by sell transactions and buy transactions;
   - (v) a report identifying all brokers utilized in the transition and the dollar and share volume executed through each broker, as well as commissions paid to each broker;
   - (vi) a report that provides a reconciliation of the transition manager's pre-trade estimates for transition execution methods and costs to the actual results;
   - (vii) a cost detail report that breaks down the implied trading costs into execution costs and timing costs for each trade executed; and
   - (viii) a complete revenue disclosure report and attestation of same, which shall include all revenue made by the transition manager, affiliates of the transition manager, third party broker dealers and

counterparties to trades.

D. Performance Measurement/Board Reporting

Investment staff shall provide a detailed performance evaluation for each transition assignment at the Board’s next regularly scheduled meeting following the applicable transition, assessing the transition manager’s performance, cost effectiveness and implementation efficiency.

In addition, investment staff will provide to the Board, on an annual basis, a summary report of all portfolio transition activity occurring over the course of the fiscal year.

The Board’s Consultant may provide evaluation and reporting services regarding the performance of the Board’s transition managers, as well as aid in the solicitation and evaluation of bids submitted by transition managers for specific transitions; however, a lack of participation by Consultant in the Board’s transition processes, as outlined above, shall not invalidate any action taken by the investment staff in accordance with this Policy.

Adopted: September 25, 2009
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