



Investment Committee

Agenda Item 6a

August 13, 2018

Item Name: Revision of the Private Equity Program Policy – Second Reading

Program: Private Equity

Item Type: Action

Recommendation

Approve the revised Private Equity Program Policy as presented in Attachment 1.

Executive Summary

Following the first reading of proposed changes to the Private Equity Program Policy (Policy) at the June 18, 2018 meeting of the Investment Committee (Committee), staff is returning with the Policy a second time for consideration by the Committee. As this is a second reading, staff is seeking action from the Committee.

Attachments 1 and 2 provide “clean” and “mark-up” versions of the proposed Policy with the recommended changes presented at the first reading. No additional changes are proposed at this time. An opinion letter from Meketa Investment Group, the Board’s Private Equity Investment Consultant, is provided as Attachment 3.

Strategic Plan

This item does not directly support the CalPERS 2017-22 Strategic Plan. The proposed revisions, as part of a clear and actionable policy framework, will contribute to the effective management and oversight of investment activities.

Investment Beliefs

This agenda item supports CalPERS Investment Belief 10 that strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives.

Background

Private Equity Program Policy Background – Format and Content

The existing Policy reflects changes approved through the 2014-16 Policy Revision Project, namely:

1. Application of a new template and organizational framework, and

2. Integration of specific investment constraints and limitations previously codified in the delegation resolution for the Private Equity Program's Senior Investment Officer¹ (PE-MID).

Additional information regarding these changes can be found in Agenda Item 7a of the December 14, 2015 Committee meeting².

Subsequently, in September of 2016, the direct Committee-to-PE-MID delegation was rescinded along with all other such direct board-level delegations to Investment Office staff. The rescissions were in recognition of:

1. The centralization of CalPERS' Board of Administration (Board) reporting lines to the Chief Executive Officer, replacing the previous governance model, which had several direct-to-the-Board reporting lines (such as the Chief Investment Officer, Chief Actuary, etc.), and
2. The prior migration of investment constraints and limitations from the delegations to CalPERS' statements of investment policy.

Additional information on the restructuring of the delegation resolutions for senior Investment Office staff is available in Agenda Item 3b of the September 19, 2016 Committee meeting³.

Analysis

Today's Item and General Policy Maintenance and Refinement Goals

Consistent with prior policy revision projects, the goal of staff's ongoing policy maintenance and refinement efforts is to:

- Increase consistency and clarity,
- Remove duplicative or procedural content, where appropriate, and
- Ensure alignment with business enhancements.

The proposed revisions to the Policy outlined in this item support the above-mentioned goals, with the changes redlined in Attachment 2, on pages:

1. 6 of 8 – Adjustment of the targets and ranges for the “buyouts” and “credit-related” strategies.
2. 6 and 7 (of 8) – Simplification of how staff-level authority limits (per commitment) are depicted.
 - a. Staff proposes to express staff's authority limits in dollar terms rather than “percentage of the Total Fund” terms, consistent with the approach taken in the

¹ The “Senior Investment Officer” classification is now known as the “Managing Investment Director” classification.

² [CalPERS Investment Committee Meeting Archive, December 14, 2015](#)

³ [CalPERS Investment Committee Meeting Archive, September 19, 2016](#)

Real Assets Program Policy, which expresses staff’s authority limits in terms of set dollar thresholds. This change is expected to provide several benefits:

- i. It is generally more intuitive to use and easier to read and interpret.
 - ii. It eliminates the “moving target” aspect of staff’s authority created by fluctuations in the day-to-day size of the Total Fund.
- b. As an additional control point, the proposed table on page 6 of 8 of the Policy also includes a new, cumulative fiscal-year limit for the Managing Investment Director, which is consistent with the structure used for the Real Assets Program.
- c. Staff proposes further simplification in the form of 1) a reduction in the number of investment categories assigned authority sub-limits, and 2) deletion of the “Direct Investment” category. These changes are summarized in Table 1 below.
- i. This change aligns with CalPERS’ initiative to reduce the number of external managers (from over 300 to 100 across the Total Fund), and is more compatible with a shift toward fewer, potentially larger commitments overall.
 - ii. Additionally, while the new “funds” grouping eliminates the “top quartile/second quartile” distinction and associated sub-limits, the proposed reformulation of staff’s authority limits remains fully consistent with the Private Equity Program strategic plan and business model. The focus on fewer, high-quality managers will continue, and performance will remain a key consideration for the Program.

Table 1: Investment Category Consolidation

Prior grouping/types	Proposed groupings/types
Top quartile funds	Funds
Second quartile funds	
Emerging manager funds	
Customized Investment Accounts	<i>No change</i>
Co-investments	<i>No change</i>
Direct investments	<i>Strike/Remove</i>
Secondary market purchases	Secondary

Proposed Changes – Dollar Terms vs. Percentage Terms

The changes proposed on pages 6 and 7 (of 8) are not anticipated to increase portfolio risk.

- The proposed expression of staff’s authority in dollar terms does not expand staff’s authority limits, and
- For “fund” investments, staff is recommending that the per-commitment limits be reduced for both the Managing Investment Director and Chief Investment Officer.

Revised Private Equity Business Model Implications

It should be noted that upon the Committee's approval of any Private Equity Program business model alternatives, staff expects to return with changes to the Policy for consideration by the Committee.

Budget and Fiscal Impacts

Not Applicable.

Benefits and Risks

Staff does not anticipate any risks associated with the proposed policy revisions. As discussed in the sections above, the proposed changes are anticipated to provide a number of benefits, including:

- Reducing complexity within the document
- Improving the "ease of use" of the document in reflecting staff authority limits
- Updating ranges and limits to reflect the current Private Equity Program strategic plan and business model

Attachments

Attachment 1 – Revised Private Equity Program Policy – Clean Version

Attachment 2 – Revised Private Equity Program Policy – Mark-up Version

Attachment 3 – Board Investment Consultant Opinion Letter – Meketa Investment Group

Katherine H. Crocker

Investment Director

Investment Compliance & Operational Risk

Elisabeth Bourqui

Chief Operating Investment Officer

**California Public Employees' Retirement System
Investment Policy for
Private Equity Program**

Effective Date [Month, DD, YYYY]

This policy is effective immediately upon adoption and supersedes all previous Private Equity Program policies.

Introduction

The California Public Employees' Retirement System (CalPERS) Total Fund Investment Policy, adopted by the CalPERS Investment Committee (Committee), sets forth the CalPERS investment beliefs and overarching investment purposes and objectives with respect to its investment programs. The CalPERS Total Fund Investment Policy specifically covers key areas of investment strategy, including performance objectives, asset allocation strategies, benchmark selection, investment risk management, and derivatives, leverage, and divestment policies, among other elements that are applicable to all asset classes and programs at CalPERS.

This document sets forth the investment policy (Policy) for the Private Equity (PE) Program (Program). The design of this Policy ensures that Staff, investors, managers, consultants, and other participants selected by CalPERS take prudent and careful action while managing the Program. Additionally, use of this policy assures sufficient flexibility in managing investment risks and returns associated with the Program.

This Policy should be read in conjunction with and is subject to conditions contained within the CalPERS [Total Fund Investment Policy](#). This Policy shall also be managed to comply with all applicable Investment Office policies.

Strategic Objective

The Program's strategic objective is to maximize risk-adjusted rates of return and enhance the equity return to the Fund.

Responsibilities

Details regarding various levels of responsibility for this Program are provided in Appendix 1, Reporting to the Investment Committee, and Appendix 2, Investment Responsibilities.

**California Public Employees' Retirement System
Investment Policy for
Private Equity (PE) Program**

**Investment
Approaches
& Parameters**

A. Approach

1. Staff shall manage the Program as a whole with specific criteria appropriate to partnership investments, co- investments, and ***Customized Investment Accounts***.
2. Top down strategic assessments shall identify portfolio weightings and identify the most attractive segments of the market for investing.

B. Specific Risk Parameters

There are specific risks associated with private equity investments that shall be monitored and mitigated by CalPERS commensurate with the expected return as each investment proposal is considered, including but not limited to the following major risk categories:

1. Leverage: The increased volatility risk posed by the existence of non-recourse debt at the underlying investment level.
2. Operating and Business: The potential for certain investments to entail exceptional operating and business risks.
3. Liquidity: The liquidity risks inherent in private equity, given typical time horizons of 5-10 years and generally limited opportunities for sale in the secondary market.
4. Structural: The risks arising from a potential misalignment of interests between the general partner and the limited partners, which may be mitigated by, among other things, structuring fees and incentive payments and other key aspects of the business relationship so as to better align the interests of the partners.
5. Valuation: The risks associated with the valuation process for partnerships and co-investments, including whether the general partner employs an appropriate valuation discipline.

The investment approach for the portfolio shall seek to reduce risk through appropriate diversification by geography, industry, ***Vintage Year*** and investment strategy.

**California Public Employees' Retirement System
Investment Policy for
Private Equity (PE) Program**

**Investment
Approaches
& Parameters
(continued)**

C. Investment Vehicle Parameters

Investments vehicles may take the form of limited partnerships, limited liability companies (LLCs), or other similar limited liability legal structures.

**Investment
Constraints/
Limitations**

See Appendix 3 for program investment constraints.

**Glossary of
CalPERS
Specific
Terms**

Italicized terms appearing in the Policy are CalPERS specific in nature and are defined in the [CalPERS Specific Glossary of Terms](#).

**Policy
Document**

History See Appendix 4 for historical details of Committee adoption and revisions of this policy.

California Public Employees' Retirement System
Private Equity Program Policy Appendices

See the [Total Fund Investment Policy](#) appendices for overarching reporting requirements and responsibilities for Investment Committee, Staff, **General Pension Consultant, and Private Asset Class Board Investment Consultant.**

<p>Appendix 1 Reporting to the Investment Committee (IC)</p>
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The following tables provide details regarding reporting to the Investment Committee:

- Investment Office Staff
- General Pension Consultant

Investment Office Staff	
Report Content	Frequency
1. Staff shall provide an Annual Program Review that will include a program overview, investment review, and business review in general conformance with the Annual Program Review Template.	No less than annually
2. Staff shall report concerns, problems, material changes, and all violations of the Policy. These reports shall include explanations of any violations and appropriate recommendations for corrective action.	At next Committee meeting, or sooner if deemed necessary
3. Staff shall report regarding investment proposals it has received, the stage they are at in the pipeline, and their ultimate disposition.	Monthly

General Pension Consultant	
Report Content	Frequency
1. The Consultant shall monitor, evaluate, and report on the performance of the Program relative to the benchmarks and this Policy and other applicable CalPERS Policies.	No less than annually

California Public Employees' Retirement System
Private Equity Program Policy Appendices

**Appendix 2
Investment Responsibilities**

The following tables provide details regarding investment related responsibilities for the:

- Investment Office Staff
- Private Asset Class Board Investment Consultant
- General Partner

Investment Office Staff Responsibilities
1. All aspects of program portfolio management, including monitoring, analyzing, evaluating performance relative to the appropriate benchmark, selecting investments, and contracting with general partners.
2. Monitor general partners in the implementation of, and compliance with, the Policy.
3. Develop and maintain selection guidelines for private equity investments.
4. Develop and maintain investment procedures, program guidelines, and sub-program guidelines.
5. Monitor non-recourse debt as a risk factor.

Private Asset Class Board Investment Consultant Responsibilities
1. Provide independent perspective and counsel to the Committee, to include routine communication with the Investment Office Staff and periodic reviews of processes and procedures.

General Partner Responsibilities
1. All aspects of portfolio management as set forth in each general partner's limited partnership agreement or contract with CalPERS and the Policy.
2. Communicate and cooperate with Investment Office Staff and authorized third parties regarding the management of the fund.

California Public Employees' Retirement System
Private Equity Program Policy Appendices

Appendix 3
Investment Constraints/Limitations

A. Strategy Allocation Targets & Ranges:

Strategy	Target	Range
Buyouts	65%	55% - 75%
Credit Related	10%	0% - 15%
Venture Capital	1%	0% - 7%
Growth/Expansion	15%	5% - 20%
Opportunistic	10%	0% - 15%

B. Investment Parameters:

Staff Authority Limits
Net Asset Value (NAV) in billions

The Managing Investment Director (MID) and Chief Investment Officer (CIO) limits apply per commitment.	Funds	Co-Investments	Customized Investment Account	Secondary
MID	\$0.5	\$0.3	\$1.3	\$0.9
CIO	\$1	\$0.6	\$1.9	\$1.7
Fiscal Year Limit applies to cumulative commitments.				
MID Fiscal Year Limit	\$10	\$3	\$5	\$3

1. Committee approval will be required for commitments beyond those authorized for the CIO. If there is a vacancy in the CIO position, Committee approval will be required for commitment authority otherwise delegated to the CIO.
2. The aggregate **Net Committed Capital** to any one general partner is limited to 10% or less of PE's total Net Committed Capital. Any exceptions to this must be specifically approved by the Committee. On August 18, 2014, the Committee approved three exceptions, increasing the maximum exposure from 10% to 15% for the following general partners; Blackstone, Carlyle and Apollo.
3. Co-Investments are subject to the further restriction that the co-investment must be made alongside a firm with which the PE Program has an active commitment.
4. Fund Investment Limitation - CalPERS commitments to any one fund cannot exceed 25% of the fund.

California Public Employees' Retirement System
Private Equity Program Policy Appendices

Appendix 4
Private Equity Program Policy Document History

Date	Detail
1997-04-04 1997-04-14	Approved by the Policy Subcommittee Adopted by the Investment Committee
2005-03-11 2005-04-18	Revised by the Policy Subcommittee Approved by the Investment Committee
2005-09-16 2005-10-17	Revised by the Policy Subcommittee Approved by the Investment Committee
2006-04-14 2006-05-15	Revised by the Policy Subcommittee Approved by the Investment Committee
2008-08-18 2008-09-15	Revised by the Policy Subcommittee Approved by the Investment Committee
2009-06-16	Administrative changes made to align with Policy Review Project
2009-12-14 2010-02-16	Revised by the Policy Subcommittee Approved by the Investment Committee
2011-10-17 2011-11-14	Revised by the Policy Subcommittee Approved by the Investment Committee
2012-05-14	Administrative changes made to reflect Delegation revisions
2013-06-12	Administrative changes made to reflect Private Asset Class Board Consultant Policy revisions
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5. Valuation: The risks associated with the valuation process for partnerships and co-investments, including whether the general partner employs an appropriate valuation discipline, ~~and, for direct investments, whether the valuations are reasonable.~~

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**California Public Employees' Retirement System
Investment Policy for
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California Public Employees' Retirement System
Private Equity (PE) Program Policy Appendices

**Appendix 3
Investment Constraints/Limitations**

A. ~~Sub-Asset-Class~~ Strategy Allocation Targets & Ranges:
The targets and ranges are effective November 14, 2011.

Strategy	Target	Range
Buyouts	<u>65</u> 60%	<u>55</u> 50% - <u>75</u> 70%
Credit Related	<u>10</u> 15%	<u>0</u> 10% - <u>15</u> 25%
Venture Capital	1%	0% - 7%
Growth/Expansion	15%	5% - 20%
Opportunistic	10%	0% - 15%

B. ~~Fund~~ Investment Parameters:

	Top Quartile	Second Quartile	Emerging Manager Teams	Customized Investment Account	Secondary Market Purchases
Staff Level Authority	Limit Commitment to ≤ 25% of the fund				
Managing Investment Director (MID) approval for amounts of PE Policy Target up to	4%	0.75%	0.75%	3%	2%
Chief Investment Officer (CIO) approval for amounts of PE Policy Target up to	8%	1.5%	1.5%	4.5%	4%

Staff Authority Limits
Net Asset Value (NAV) in billions

<u>The Managing Investment Director (MID) and Chief Investment Officer (CIO) limits apply per commitment.</u>	<u>Funds</u>	<u>Co- Investments</u>	<u>Customized Investment Account</u>	<u>Secondary</u>
<u>MID</u>	<u>\$0.5</u>	<u>\$0.3</u>	<u>\$1.3</u>	<u>\$0.9</u>
<u>CIO</u>	<u>\$1</u>	<u>\$0.6</u>	<u>\$1.9</u>	<u>\$1.7</u>
<u>Fiscal Year Limit applies to cumulative commitments.</u>				
<u>MID Fiscal Year Limit</u>	<u>\$10</u>	<u>\$3</u>	<u>\$5</u>	<u>\$3</u>

1. Committee approval will be required for commitments beyond those authorized for the ~~MID-PE or the CIO~~. If there is a vacancy in the CIO position, Committee approval will be required for commitment authority otherwise delegated to the CIO.

2. The aggregate **Net Committed Capital** to any one general partner is limited to ~~no~~

California Public Employees' Retirement System
Private Equity (PE) Program Policy Appendices

~~more than 10% or less~~ of PE's total Net Committed Capital. Any exceptions to this must be specifically approved by the Committee. On August 18, 2014, the Committee approved three exceptions, increasing the maximum exposure from 10% to 15% for the following general partners; Blackstone, Carlyle and Apollo.

- ~~1.3. Co-Investments are subject to the further restriction that the co-investment must be made alongside a firm with which the PE Program has an active commitment.~~
- ~~2.4. Fund Investment Limitation - CalPERS commitments to any one fund cannot exceed 25% of the fund.~~
- ~~3. The CIO may approve an increase in committed capital to an existing Customized Investment Account with Top-Quartile performance by up to 20%.~~

~~C. Co-Investment and Direct Investment Parameters:~~

Staff Level Authority	Co-Investments	Direct Investments
Managing Investment Director (MID) approval for amounts of PE Policy Target up to	0.75%	0.5%
Chief Investment Officer (CIO) approval for amounts of PE Policy Target up to	1.5%	0.5%

- ~~1. Committee approval will be required for commitments beyond those authorized for the MID-PE or the CIO. If there is a vacancy in the CIO position, Committee approval will be required for commitment authority otherwise delegated to the CIO.~~
- ~~2. Co-Investments are subject to the further conditions that (a) the investment in the co-investment by the funds managed by the general partner shall equal or exceed the CalPERS investment in the co-investment, and (b) the amount committed by CalPERS to the co-investment shall be smaller than the CalPERS commitment to the fund.~~

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Private Equity (PE) Program Policy Appendices

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M E K E T A I N V E S T M E N T G R O U P

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CHICAGO IL

MIAMI FL

PORTLAND OR

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LONDON UK

July 23, 2018

Mr. Henry Jones
Chair, Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

**RE: REVISION OF THE PRIVATE EQUITY INVESTMENT POLICY – SECOND
READING**

Dear Mr. Jones:

Meketa Investment Group (“Meketa”) has been asked in its capacity as Board Consultant for the Private Equity Program (the “Program”) to opine on the revisions of the CalPERS’ Private Equity Investment Policy (the “PE Policy”) submitted to the Investment Committee for a first reading on June 18, 2018. The revisions to the Policy are described in Item 6a. There has been no revisions to the PE Policy since the first reading, however the Total Fund Policy has been revised since the first reading.

As we described in our letter for the first reading, there are a number of changes to the PE Policy, as described below.

Transition to “dollar-oriented” authority on its per-investment limits. Staff has proposed moving to “dollar-oriented” authority limits, from “percent of Total Fund” limits. A benefit of dollar limits is that they are clear and do not fluctuate based on changes to the size of the Total Plan. Staff has proposed limits that are comparable to what would be allowed under the existing PE Policy, as calculated for a Total Plan value of approximately \$356 billion. Staff has maintained the concept of separate authorization limits for the MID and the CIO.

- The appropriate delegation limits under a “dollar-oriented” framework may change should the size of the Total Fund change dramatically.

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Elimination of First and Second Quartile fund sub-limits. The current PE Policy includes a limit for a “First Quartile” fund and a separate, lower limit for a “Second Quartile” fund. The proposed PE Policy no longer includes these sub-limits. Staff evaluates potential fund investments across a broad range of quantitative and qualitative factors. We have noted that, while important, quartile ranking of past performance is not fully indicative of the potential future performance of a private equity manager, particularly early in a fund’s life.

- The current PE Policy has large differences in delegated authority for funds depending on quartile ranking of the manager. By eliminating the sub-limits, Staff can consider a wider range of variables such as portfolio fit, investment pacing, strategic relationship, and fees in sizing the fund commitment.
- Currently, Staff needs Board approval to commit to a fund from a manager that is not at least second quartile, as defined in the CalPERS Glossary. Unless Staff requests the Board approve specific Private Equity Funds, this requirement significantly constricts the universe of investment opportunities. We note that the recently revised Total Fund Policy includes a requirement that CalPERS obtain a Prudent Person Opinion for any commitments to funds where the manager does not qualify as at least second quartile as defined in the CalPERS Glossary.
- Our understanding is that Staff will continue to include quartile ranking information on managers committed to in the fiscal year.

Elimination of sub-limit for Emerging Manager funds. The current PE Policy includes a limit for “Emerging Manager” funds that is in-line with limits to a second quartile fund manager. The proposed PE Policy will allow Staff to consider “Emerging Manager” funds on an equal basis with all fund opportunities.

- Our understanding is that Staff will continue to include descriptions of characteristics of the Emerging Manager funds that Staff commits to in the fiscal year.

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Elimination of CIO's ability to increase committed capital to an existing Customized Investment Account. Currently, the CIO has the ability to increase the commitment to an existing Customized Investment Account by 20%, provided it has top quartile performance.

- The CIO will no longer be able to add additional capital to any existing Customized Investment Account without approval from the Investment Committee. Additionally, delegated authority for Customized Investment Accounts would require a Prudent Person Opinion in the recently revised Total Fund Policy.

Elimination of Direct Investments as a transaction type. Direct Investments are those where CalPERS would invest without the participation of a general partner. Historically, Direct Investments have included CalPERS investments in private asset managers such as Apollo Group.

- We understand that authority for Direct Investments will be considered at a later date.

Modification of certain limitations for Co-investments. The current PE Policy limits the size of CalPERS Co-investment to be less than (a) the amount committed by the private equity fund, and (b) the commitment CalPERS has made to the private equity fund. The proposed PE Policy includes a dollar-based limit for individual Co-investments (\$300 million for MID and \$600 million for CIO) that generally correspond with the limits under the existing policy. Additionally, under the proposed PE Policy, CalPERS would not be restricted to Co-investments deriving from the private equity fund in which it had made a commitment, but rather CalPERS could make a Co-investment in an opportunity proposed by a manager so long as CalPERS had an active investment to any private equity fund managed by such manager.

- The elimination of these limits provides a wider set of Co-investment opportunities for Staff to consider.
- The delegated authority for Co-investments would require a Prudent Person Opinion in the recently revised Total Fund Policy.

New limit on aggregate annual investments. The proposed PE Policy includes a new limit on the MID's cumulative annual authorization across each of Funds, Co-investments, Separate Accounts, and Secondary Investments.

- The limit on commitments in a fiscal year by the MID helps protect the Fund by building vintage year diversification in the Program. We note that the Real Assets program includes similar fiscal year aggregate commitment limits on its MID.

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Strategy ranges are updated. Staff has proposed a modification to the target and ranges of the Buyouts (increase) and Credit Related (decrease) strategies. Staff has stated that certain Credit Related strategies are being invested through CalPERS Opportunistic Program, thereby reducing the investment set available under the Private Equity Program.

The proposed PE Policy includes a number of modifications to Staff delegation. Most of the modifications provide some expansion of the range of investments that Staff may consider, but remain generally in-line with current limitations for overall size of delegated authority. Meketa believes the proposed revisions are in line with CalPERS Investment Beliefs, in particular Investment Beliefs 1, 2, 5, 6, 7, and 10.

Please do not hesitate to contact us if you have questions.

Sincerely,



Stephen McCourt
Managing Principal



Steven Hartt
Principal



Hannah Schriener
Vice President

SPM/SKH/HS/nca