

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Audit Committee Meeting
Minutes

March 12, 2003

The Audit Committee met in open public session at 9:02 A.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Mike Murphy, Chair
 Jeff Hanna (teleconference)
 George Masten
 Bob Nakahara

Committee Members Absent: Lee Ann Prielipp

Others Present: Joe Dear
 Gary Bruebaker
 Les Brodie
 Beth Vandehey
 Alicia Markoff
 Linda Lester
 Kristi Walters

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

Chair Murphy called the meeting to order at 9:02 A.M., and identified members present.

ADOPTION OF MINUTES – FEBRUARY 4, 2003

**Mr. Masten moved to adopt the February 4, 2003, Audit Committee minutes.
Chair Murphy seconded and the motion passed unanimously.**

INTERNAL AUDITOR REPORT

Audit Recommendations Status Report

Ms. Vandehey reported that three audit recommendations were completed since December 2002: the Portfolio Administration staff completed unit desk manuals; Business Continuance Plan testing occurred; and Courtland Partners replaced staff in valuing the monthly real estate portfolio.

Ms. Vandehey introduced Ms. Markoff who spoke to the outstanding fixed income compliance oversight audit recommendation. Ms. Markoff reported that State Street Bank's (SSB) IPR system is incapable of running WSIB's compliance testing and SSB proposed creating exception reports through the use of Excel spreadsheets. Ms. Markoff stated that SSB is sensitive to the additional staff time required for this work-around solution, and noted that SSB estimates it will take less than one hour per week to analyze these reports. SSB is currently creating macros and expects to have the spreadsheet available for download by mid-April. Ms. Markoff recommended that the WSIB try the exception reporting method on a six-month trial basis.

Ms. Markoff said there is one remaining test that the IPR system is incapable of producing, relating to permissible investments. SSB has yet to propose a solution.

Chair Murphy asked if a weekly compliance review is sufficient and noted that the Office of the State Treasurer (OST) runs daily checks. Ms. Markoff responded that compliance is checked daily by a WSIB fixed income investment officer, but the recommendation was for it to be done externally from the unit. Chair Murphy reiterated that he is dissatisfied with fixed income running their own compliance checks and uncomfortable without daily testing, as errors can compound before they are discovered. Mr. Bruebaker said he wants better compliance tools, and plans to examine this area in the future. Ms. Markoff stressed that SSB is well aware of the WSIB's concerns.

Ms. Vandehey reported that Courtland Partners is reconciling their data against the real estate partnerships to determine why there are differences, but the project is taking longer than expected. Courtland created spreadsheets showing contributions and distributions and is contacting the partnerships regarding the discrepancies. Ms. Vandehey confirmed that she received a progress report from Courtland, but has yet to analyze their information. Courtland anticipates completion by April 30. Mr. Nakahara asked if there is a potential to affect the returns of the WSIB. Ms. Vandehey stated that it is too early to tell. Chair Murphy asked that Ms. Vandehey provide a follow-up report at the next meeting.

Internal Audit 2003-03, Custodian Bank

Ms. Vandehey introduced her internal audit report of SSB, which has been the WSIB's custodian bank since 1996. The SSB contract was renewed in October 2002. Ms. Vandehey said that long-standing vendor relationships, like the one with SSB, are positive, as they allow more time to work out problems and establish controls, which reduces the potential for errors.

Ms. Vandehey presented an analysis of areas audited at SSB since 1998. Ms. Vandehey reported that the 2003 audit included a review of bank records from January to December 2002, and an on-site visit in November. There were no audit findings.

Ms. Vandehey said she wanted to ensure that recommendations made during the 1999 audit were implemented. One of these recommendations was to collect \$650,000 in outstanding tax reclaims from the previous custodian bank, The Bank of New York (BoNY). WSIB staff worked diligently with both SSB and BoNY and reduced the outstanding balance to approximately \$50,000. The remaining balance is attributed to incorrect claim filing by BoNY. BoNY has re-filed for these claims, and the taxes should be received in a timely manner. In response to a question from Chair Murphy, Ms. Vandehey stated that there are tax reclaims aside from those leftover by BoNY, but SSB has tracked those all along as part of their own tax reclaim program. The SSB tax reclaim unit was reviewed during the prior audit in 1999 and no problems were noted at that time.

Another 1999 recommendation related to an incomplete audit review of the sub-custodian bank network. A full examination could not be performed previously due to SSB limitations on what Ms. Vandehey was allowed to review. During this year's audit, Ms. Vandehey looked at redacted documentation and spoke directly with staff. Ms. Vandehey found good controls and monitoring in place.

Ms. Vandehey said that much of this year's audit focused on the Financial Information Services (FIS) accounting services team. Ms. Vandehey listed the services performed by FIS on behalf of the WSIB. Ms. Vandehey reported that financial data from the FIS team is used to calculate WSIB performance returns, review asset allocation, and perform compliance testing. Initially, Ms. Vandehey rated the unit as high risk, but dropped it to low risk following the audit. Ms. Vandehey said that the unit performs financial review through automated systems, manual processes, and the use of Excel spreadsheets. Ms. Vandehey examined automated exception reporting and found that reconciliations were timely, proper reviews occurred, and source documentation was maintained.

Ms. Vandehey examined the manual processes, which include services such as: wire/trade instructions, price overrides, valuation entry, and off-line Excel spreadsheets used to validate various financial information. Ms. Vandehey reported that policies and procedures were established and good compensating controls are in place. She said that operating standards were recently updated, which ensure consistency between clients and among the FIS team.

Ms. Vandehey reported that the best control point in place with the FIS team is the Financial Control Systems (FCS) investment accounting system that WSIB staff uses to ensure the accuracy of SSB's data. Ms. Vandehey said that records close simultaneously each month at FCS and SSB on 46 funds. Exceptions are reported, which WSIB staff research and clear. Ms. Vandehey provided the Committee with a summary of all exceptions over the past year, their dollar amount, and explained why they occurred. Ms. Vandehey stated that the WSIB does rely on the bank's information for performance reporting. Mr. Nakahara asked if the SSB systems would detect errors if the WSIB did not have the FCS system in place. Ms. Vandehey said that the WSIB's use of the FCS system is similar to using a personal checkbook to reconcile against a bank's monthly statement.

Ms. Vandehey described the global pricing service (GPS) unit's processes for calculating the fixed income and international active manager portfolios. The FIS unit receives valuations from WSIB's consultants and the external manager for real estate, private equity, and public equity commingled fund managers. Ms. Vandehey explained the manual price overrides process established in each of these units. Chair Murphy asked if WSIB's consultants evaluate the information prior to sending it to SSB. Ms. Vandehey stated that she was unsure, but did not believe they did. Chair Murphy expressed his concerns with this practice, specifically when publicly-traded companies are involved for which pricing should be checked against the market. Ms. Vandehey explained that a monthly comparison is done of the last quarterly market value and recent distributions are taken into consideration. Ms. Markoff commented that the senior investment officer in real estate examines their monthly valuations and speaks with the partnerships on any questionable item. Chair Murphy asked what private equity does, to which Mr. Bruebaker stated the he did not believe the unit checks public companies within the portfolio. Chair Murphy directed that staff pursue this further with Pacific Corporate Group given the volatility of the marketplace.

Mr. Hanna commented on the various policies among the general partnerships, and said that staff would need to be familiar with all of those in order to value the portfolio. Mr. Bruebaker stated that PCG should know the policies and promised to report back to Chair Murphy on discussions with PCG prior to the next Audit Committee meeting.

Ms. Vandehey stated that there were no exceptions found in her examination of the GPS unit's manual pricing procedures. There is a high level of compliance. Written policies and procedures are in place for price overrides with checks performed prior to release, and source documentation is maintained. The GPS unit does not change prices after release. Ms. Vandehey noted that the FIS accounting team performs the tolerance level check to plus or minus three percent of Bloomberg. If a price falls out of tolerance, the FIS accounting team submits it back to GPS and, if after research a difference remains, a manual price change occurs. Ms. Vandehey reported that all documentation she examined was supported, appropriate supervisory review occurred, and the area was rated low risk following the audit.

Ms. Vandehey examined the PricewaterhouseCoopers SAS 70 review of the bank's disaster recovery plan. SSB tests the plan twice a year on different areas. The WSIB experienced no problems with SSB during the events of September 11.

In conclusion, Ms. Vandehey reported that prior audit exceptions were resolved, and she found adequate procedures and checks in place within the areas examined at SSB. Ms. Vandehey noted the WSIB's FCS system helps to ensure the accuracy of financial data. SSB had good controls over errors, correction procedures for price changes, and an adequate business recovery plan in place.

In response to an inquiry from Mr. Nakahara, Ms. Vandehey reported that she looked at the bank's SAS 70 report and their internal corporate audit department shares information with her during her visits.

Mr. Masten moved that the Audit Committee recommend that the Board accept Internal Audit 2003-03, Custodian Bank. Chair Murphy seconded and the motion passed unanimously.

DAILY VALUED FUNDS OPERATIONS POLICY DRAFT 2.14.300

Chair Murphy summarized the development of the Daily Valued Funds Operations Draft Policy, which stemmed from an internal audit recommendation to reduce the WSIB's potential for operational errors and liability if monies paid in error could not be recovered.

Ms. Markoff provided annual cost comparisons on: 1) the WSIB continuing its current practice of managing and pricing the daily valued funds (DVF); 2) partial outsourcing of the DVF operations to the custodian bank; and 3) complete outsourcing, which considered three cost estimates from Barclay's Global Investors (BGI), State Street Global Advisors, and The Vanguard Group. Ms. Markoff noted that partial outsourcing would not eliminate the WSIB's liability, so staff focused on either continuing the current in-house operations or complete outsourcing. Based on the cost effectiveness to participants, staff recommends that the WSIB continue its internal management of the DVFs.

The Committee recommended that specific company references be removed from the policy. Chair Murphy directed staff to strike everything on page two after the first sentence under External Managers. Ms. Markoff agreed to review the entire draft policy and delete similar references.

Mr. Masten said that he wanted the policy to retain the deleted sentence on page five, number two, related to annual Board reporting. Following a brief discussion, the Committee determined that the annual reporting should come through the Audit Committee and requested staff to retain and re-word the sentence accordingly.

Ms. Markoff said that the other additions on page five, regarding notifications when there is an inability to close, are necessary due to the contractual relationship between the Department of Retirement Systems and the record keeper.

Mr. Masten requested that staff incorporate the above-noted revisions into the draft policy prior to forwarding it to the Board, and moved that the Audit Committee recommend that the Board adopt Daily Valued Funds Operations Policy 2.14.300.

In response to a question from Mr. Nakahara, Ms. Markoff stated that one person from the Portfolio Administration unit would be eliminated if the DVF operations were outsourced. Ms. Markoff noted that some investment staff work would also become unnecessary; however, their time would be redistributed to add value in other asset classes.

Chair Murphy reiterated that, if the controls in place today fail in the future and DVF operations become a liability, the WSIB should revisit the idea of delayed payouts. Chair Murphy said that this would involve limiting payout to less than 100 percent until an account is reconciled, and then the remaining balance could be paid. Mr. Masten agreed that a delayed payment process would be the next logical step.

Chair Murphy said that he feels there are sufficient controls in place at this time.

The above motion passed unanimously.

PROXY VOTING POLICY REVISION 2.05.200

Mr. Bruebaker reported that the Proxy Voting Policy was revised to incorporate the Council of Institutional Investors (CII) principles and core policies at the Committee's request. Mr. Bruebaker stated that staff also took this opportunity to refine the policy, and noted those changes. Mr. Bruebaker said that the revised policy does not change proxy voting processes but, rather, provides more clarity. Mr. Bruebaker confirmed that BGI and all other managers are aware of the WSIB policy.

In response to an inquiry from Mr. Nakahara, Mr. Dear described the CII by-law changes approved in January. Treasurer Murphy shared information he learned at a recent conference concerning a proposal from the New York Stock Exchange regarding corporations, which the Securities Exchange Commission has not yet adopted. Treasurer Murphy said he will forward written material on this topic to staff and Committee members.

Mr. Masten moved that the Audit Committee recommend that the Board approve the revisions to Proxy Voting Policy 2.05.200. Chair Murphy seconded and the motion passed unanimously.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 10:18 A.M.