

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Audit Committee Meeting
Minutes

September 25, 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
 George Masten

Committee Members Absent: Jeff Hanna
 Bob Nakahara

Others Present: Joe Dear
 Gary Bruebaker
 Theresa Whitmarsh
 Renee Long
 Alicia Markoff
 Beth Vandehey
 Kristi Walters

Paul Silver, Office of the Attorney General

[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.

REVIEW AND APPROVAL OF MINUTES – JUNE 4, 2003

Mr. Masten moved to approve the June 4, 2003, Audit Committee meeting minutes. Chair Murphy seconded and the motion passed unanimously.

INTERNAL AUDITOR REPORT

Audit Recommendations Status Report

Ms. Vandehey reported that two audit recommendations remain outstanding.

It was determined that State Street Bank's (SSB) compliance monitoring system cannot perform fixed income duration, permissible investments, and asset allocation testing. Workaround solutions were developed by SSB for other compliance monitoring tests and staff is verifying that those methods provide accurate results. Ms. Vandehey said that the new deputy director for operations is leading the research effort for alternate information technology systems to perform the desired testing. The goal is to have a system by year-end. In response to a question from Chair Murphy, Ms. Vandehey advised that staff had consulted with staff from the Office of the State Treasurer, but their compliance monitoring differs from what is needed for WSIB fixed income.

Ms. Vandehey introduced Ms. Markoff to report on the outstanding real estate consultant item. Ms. Markoff referenced the Courtland Partners (Courtland) report on reconciliation items. Staff and Courtland had focused their effort on resolving the largest dollar amount discrepancies involving Lone Star Opportunity Fund, Union Square, and Lowe NW partnerships. Ms. Markoff reported that, as a result of these efforts, the net affect difference was reduced by approximately 50 percent of the amount originally reported. All remaining discrepancies are still being researched.

Chair Murphy questioned the stated percentage on page two of Courtland's report relating to Union Square interest. The report indicates that the WSIB had a 99 percent interest, but also references an 85 percent interest within the same paragraph. Ms. Markoff responded that this was due to a change in management of the property and the creation of a limited liability corporation, Heritage Tree. Ms. Markoff added that Steve Draper had verified that the paragraph was accurate. Ms. Markoff reported that when the account had changed, it created a large reconciling item.

Chair Murphy raised a concern with language Courtland used in its report concerning their role with WSIB capital calls. Chair Murphy directed Ms. Markoff to have Courtland Partners change wording within their report from "approve" to "recommends approval." Ms. Markoff agreed that the requested change in wording accurately reflects Courtland's role and will follow-up on the correction.

Internal Audit 2004-01, Private Equity

Ms. Vandehey introduced the private equity audit report. Ms. Vandehey said that one audit objective was to review internal monitoring of the private equity unit, which was last audited in 1998. Since that time, the senior investment officer changed twice and unit staff more than doubled in size.

Ms. Vandehey reported that another objective was to review activities of the general partners. Specifically, to look at compliance with the partnership agreement and determine if internal processes were adequate and operating in the best interest of limited partners. Ms. Vandehey said that she looked at best practices within the industry as part of this process.

Ms. Vandehey said that the WSIB had 87 general partnership relationships as of June 30, 2003.

Ms. Vandehey reported that the private equity unit had improved its due diligence since the 1998 audit and formalized a partnership review process. Staff increased its attendance at annual and advisory board meetings. Ms. Vandehey said that the previous audit revealed that staff had attended only 10 percent of annual meetings; Mr. Bruebaker stated that attendance is now 80 percent or better.

Ms. Vandehey described other unit improvements, which included: creation of three management tiers of general partners with assigned investment officers; standardized summaries for all investment recommendations; monitoring reports on a quarterly basis; and annual strategy planning with the private equity consultant.

Ms. Vandehey discussed electronic data management techniques she observed during the audit. Ms. Vandehey recommended that staff look into such systems for managing partnerships' terms and conditions. Ms. Vandehey reported that Pathway has its own database for data management, and Invesco uses LOTUS Notes. Ms. Vandehey added that something as simple as a Microsoft Word document containing meetings notes could provide a good history of partnership communications, which is useful when staff turnover occurs. Mr. Dear stated that the deputy director for operations is taking this into consideration in reviewing information systems.

In response to questions from Mr. Masten, Ms. Vandehey said that six partnerships and two discretionary managers were visited during the audit and she received cooperation from internal auditor peers at the California State Teachers Retirement System (CalSTRS). Ms. Vandehey stated that internal auditors at pension funds in Los Angeles and Colorado had also done partnership audits in September in New York and that, between all of the pension funds, a total of 13-14 general partners were reviewed. Ms. Vandehey stated that she had a positive reaction from WSIB investment staff regarding information sharing, but some of her peers did not have the same experience. Chair Murphy asked if there was anything the Board or executive management could do to support these efforts. Ms. Vandehey responded that making it known that information sharing between general funds with common general partners benefits everyone. Mr. Bruebaker stated that he and Mr. Dear could solicit support at the upcoming NASIO conference, which is attended by chief investment officers from throughout the United States.

Ms. Vandehey reported on issues discovered during the partnership audits. One general partner will be reissuing a report to correct an error discovered during WSIB's audit. Ms. Vandehey noted that the financial statements were correct; the error was contained in the footnotes.

A discussion ensued regarding a general partner's practice of very limited retention of due diligence documents. The general partner felt this would become industry standard. Chair Murphy stated a concern with the practice and asked that staff discuss this with the general partner to get more depth on the matter and report back about this change in practice prior to the October Board meeting.

Ms. Vandehey continued her report, sharing with the Committee that Invesco did not appear to be verifying the management fees of partnerships in which they invest. Ms. Vandehey recommends that investment staff follow-up with Invesco to ensure compliance on this issue.

Ms. Vandehey reported on three issues raised during her examination at Joseph Littlejohn and Levy (JLL). The first issue relates to the advisory committee. It appears that the WSIB has a seat on the advisory board, but staff has not participated due to lack of JLL's notification and/or acknowledgment of the WSIB's seat. JLL has been asked to provide a list of advisory board members.

The second issue relates to verification of portfolio companies holdings against legal documents. Ms. Vandehey reported that her examination revealed that year-end holdings were materially correct, but there are unresolved accounting issues. A discussion ensued regarding the change in accounting services utilized by JLL. In response to a question from Chair Murphy, Ms. Vandehey stated that the outstanding accounting differences were immaterial and she and staff were waiting on a response from JLL. Mr. Bruebaker stated that Pacific Corporate Group is also aware and has this issue on a follow-up list. In response to a question from Mr. Masten, Ms. Vandehey stated that the WSIB was in JLL funds 1, 2, and 3, and the total investment is \$165 million.

Ms. Vandehey summarized that two recommendations resulted from her audit. The first recommendation is that the private equity unit utilize monitoring and data management techniques. The second recommendation is for investment staff to follow-up with general partners on the specific issues raised in the audit report. Ms. Vandehey concluded her report stating that the private equity unit is managing a large number of relationships and has improved processes significantly under the direction of Tom Ruggels.

Ms. Vandehey reported that the partnerships visited were helpful and were surprised that more limited partners had not taken advantage of their right to come review records. The general partners were agreeable to share results of WSIB audit with peers, provided those peers were within the partnership. Ms. Vandehey relayed that general partners would be notified prior to releasing audit material to a peer fund.

Mr. Masten moved that the Committee accept Internal Audit 2004-01 Private Equity, and forward it to the Board. Chair Murphy seconded and the motion passed unanimously.

CODE OF CONDUCT COMPLIANCE REVIEW

Mr. Silver introduced his code of conduct report memo and attachment summarizing issues identified. Mr. Silver said that there were no significant omissions discovered during his review. Mr. Silver reported that while no gifts had been reported to the Board, three were reported on financial statements. Mr. Silver said that one gift did not actually fall into the gift category, but all were properly recorded and that it was good to side on the error of reporting, versus not.

Mr. Silver reported that there were some issues in his interpretation of travel documents, but those items were resolved after staff discussions.

Mr. Silver reported there were a few investment reporting issues that he would follow-up on directly with Board members. Mr. Silver stated that there were a few technical compliance issues with the filers box on the financial filing, but this could be addressed in an educational session.

Mr. Silver concluded, stating that the level of compliance was admirable.

Mr. Masten moved that the Audit Committee accept the Code of Conduct Report for 2002 and forward it to the Board. Chair Murphy seconded and the motion passed unanimously.

DIRECTED BROKERAGE ANNUAL REPORT

Ms. Long presented the annual directed brokerage report. The 2003 fiscal year beginning balance was approximately \$227,650 and ending balance approximately \$205,170. Ms. Long said the report details commissions received by both BNY ESI and Frank Russell. There was approximately \$19,900 in commissions received from BNY ESI and no future monies are expected. Frank Russell received approximately \$715,070, most of which was from international commissions. The total income for fiscal year 2003 was \$735,034.42. Payments for services to vendors were \$757,514.53, which brings the balance on June 30, 2003, to \$205,169.81.

Ms. Long described the estimates and actuals for 2003 and forecast for 2004. Ms. Long described how carryover errors from BNY ESI affected the estimates. Ms. Long reported that the discrepancies have been corrected. Ms. Long stated that WSIB projects Frank Russell payments of \$1,137,000 for fiscal year 2004. Mr. Bruebaker stated that the overall goal is to get the most cost effective trades. There will be some transactions toward the end of this fiscal year due to restructuring of the international program.

A summary page containing monthly vendor activity was distributed to the Committee.

Mr. Masten moved that the Audit Committee accept the Directed Brokerage Annual Report and forward it to the Board. Chair Murphy seconded and the motion passed unanimously.

PROXY VOTING ANNUAL REPORT

Mr. Bruebaker briefly reviewed the annual proxy voting report. Mr. Bruebaker stated that staff had reviewed manager guidelines and activities throughout the year and found all to be in compliance. Staff had also verified that all managers had the WSIB proxy voting guidelines and had the managers state that they had no material differences between their practices and WSIB policies. The Committee report reflected each manager's activity for the year.

PROPOSED 2004 MEETING DATES

Ms. Whitmarsh reviewed the proposed Audit Committee meeting dates for 2004, which follow the past practice of meeting the first Wednesday of the last month of each quarter at 9:00 A.M. Ms. Whitmarsh noted a change in the September date to accommodate Chair Murphy's attendance at the annual State Treasurer's conference.

Mr. Masten moved that the Audit Committee accept the proposed 2004 meeting schedule. Chair Murphy seconded and the motion passed unanimously.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 10:02 A.M.