

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Audit Committee Meeting
Minutes

November 2, 2004

The Audit Committee met in open public session at 9:01 A.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: John Charles, Chair
 Debbie Brookman
 Charlie Kaminski
 George Masten
 Mike Murphy
 Bob Nakahara
 Dave Scott

Other Committee Members Present: Glenn Gorton

Others Present: Joe Dear, Executive Director
 Gary Bruebaker, Chief Investment Officer
 Theresa Whitmarsh, Deputy Director for Operations
 Beth Vandehey, Internal Auditor
 Alicia Markoff, Portfolio Administrator
 Erwin Vidallon, Finance and Budget Manager
 Nancy Calkins, Senior Investment Officer – Public Equity
 Christina Blue, Administrative Assistant
 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 Charles called the meeting to order at 9:01 A.M., and identified Committee members present.

ADOPTION OF MINUTES – AUGUST 3, 2004

Mr. Masten moved to approve the August 3, 2004, Audit Committee meeting minutes. Ms. Brookman seconded and the motion passed unanimously.

CONFLICT OF INTEREST COMPLIANCE REVIEW

Mr. Silver presented his review of reports and documents filed by WSIB members and employees, for compliance with the WSIB's Conflict of Interest policy. This review covered travel, gifts and other activity for calendar year 2003, applying the requirements of the Board's Conflict of Interest Policy as it existed in 2003. Mr. Silver concluded that for the activity reported, the requirements of the WSIB's Conflict of Interest Policy were satisfied.

Treasurer Murphy moved that the Audit Committee accept the Conflict of Interest Compliance Review for 2003 and forward it to the Board. Ms. Brookman seconded and the motion passed unanimously.

INTERNAL AUDITOR REPORT

Audit Recommendations Status Report

Ms. Vandehey introduced the quarterly report of outstanding audit recommendations. Seven of eight Partnership recommendations were completed since the last report in August 2004 from the Real Estate Audit. There are fifteen remaining items from previous audits. Chair Charles asked about items that have been extended six months since the last report. Mr. Dear responded that these were management decisions. Mr. Silver stated that the real estate agreements have been completed and summarized. Due to other project deadlines there has not been enough time to work as originally anticipated. Ms. Whitmarsh said the Financial Control Systems (FCS) audit findings work was pushed back due to lack of capacity by FCS. Treasurer Murphy asked how long has FCS been working for the WSIB. Ms. Vandehey responded that they have been working for WSIB for 6-7 years. Treasurer Murphy asked why documentation hadn't been completed. Ms. Vandehey responded that FCS had developed the system in house, as their business grew. Treasurer Murphy questioned why. Ms. Whitmarsh responded that since the company doesn't place their software offsite and it is maintained at their own facility, they never made technical manuals a priority until we asked them to produce them. Mr. Dear emphasized that the priority of the work FCS currently provides is driven by the WSIB based on the need to automate reports for the investment officers

especially the Fixed Income staff. The expectation was for this work to satisfy the audit finding to be completed this year; however FCS asked for more time. Ms. Vandehey also stated the FCS was heavily involved in the recently completed Portfolio Order Management System (POMS) implementation. Treasurer Murphy stated that the Treasurer's Office is completing a major renovation to the Treasury Management System and one of its requirements was that the programmers document along the way. Mr. Nakahara asked about the severity of outstanding items in the past, where is the FCS item as far as "must haves" and "nice to haves." Ms. Vandehey stated that FCS falls in as nice to have. Mr. Dear addressed the schedule adjustments, and in particular discussed the investment reporting recommendation, noting that the delay has been gaining the approval of the State Auditor. He noted that this year we will publish the annual report with no changes to the reporting period for real estate and private equity. Chair Charles asked about increasing the use of outside consultants to assist with the auditing functions. He asked if a policy will be developed regarding when and how outside auditors will be utilized. Mr. Dear's response is under the Investment Accounting Consulting Services agenda item.

INVESTMENT ACCOUNTING CONSULTING SERVICES

Mr. Dear updated the Committee on efforts to obtain investment accounting consulting services. An RFP was issued for investment accounting services, with the desire to sign up one of the big four accounting firms, but none chose to bid because they are so busy with Sarbanes-Oxley work for existing clients. However, a good proposal was received from Peterson & Sullivan, a Seattle based firm that provides auditing services to the Department of Retirement Systems and the Office of the State Treasurer. Mr. Dear said staff felt very comfortable with the firm due to their work with Retirement Systems, that they would understand WSIB accounting issues very well. In addition, the firm has substantive real estate accounting experience and expertise. Staff will be requesting the vendor, upon contract execution, to review up to three real estate managers identified by Steve Draper. Mr. Draper had recommended Ms. Vandehey review these partnerships but her workload has not permitted her to conduct these reviews. Mr. Dear noted we still have the option of tasking Courtland Partners for additional auditing services under the arrangement we have. Treasurer Murphy spoke to the Treasurer Office's work with Peterson & Sullivan and their thoroughness. Chair Charles spoke to DRS's satisfaction with the services provided. Discussion ensued about the

accounting services firm also providing enough resources for Ms. Vandehey to receive assistance with other investment review needs as they arise.

[Mr. Scott was in attendance at 9:15 A.M.]

INTERNAL AUDITOR REPORT

Internal Audit 2005-02, Bloomberg Portfolio Order Management System (POMS)

Ms. Vandehey introduced the 2005-02 audit of the Bloomberg Portfolio Order Management System (POMS). The purpose of the audit was to evaluate the controls related to the manual and automated processes of the Bloomberg Trading System necessary to ensure authorization, completeness, and accuracy of processed information; to evaluate the access controls necessary to ensure access to information is restricted to specific personnel needed to perform job duties and provide adequate separation of duties; and to evaluate the fixed income compliance module to ensure staff research, follow-up on, and report compliance exceptions in a timely manner. The POMS system allows fixed income trades to be entered in POMS by investment officers, where it flows electronically to accountants who verbally confirm with the broker. Accountants then release the trades electronically to the custodian bank where they are uploaded to the accounting system and then electronically settled at the custodian bank. POMS was a significant enhancement for the agency and provides linkage to other vendor systems, accurate straight through processing, improved control and accuracy of the trading process, pre-trade compliance checks and warning messages, and a post compliance tool.

The first recommendation in the POMS audit is to better define access privileges. POMS has 66 special privileges that can be assigned to each user. Currently the WSIB is only using nine. Management will define the nine privileges currently being used by year end.

The second recommendation is to update the Business Continuity Plan (BCP) to account for the new POMS system by end of November 2004. Specifically, on how we get the short term manual trade processing information back into the POMS system for long term restoration. In response to a

question from Mr. Nakahara, Ms. Whitmarsh stated that we will be conducting a BCP test on November 5. This will include testing communications between the WSIB and its accounting vendor, the custodial bank and Bloomberg.

The third recommendation is to obtain legal advice before moving to end the paper ticket audit trail. There are legal, regulatory and control requirements regarding electronic transactions. Management will meet with our Assistant Attorney General to develop a policy before eliminating the paper trade tickets. Mr. Charles asked that staff also work with the State Auditor. This is scheduled for completion by June 30, 2005.

The fourth recommendation is to have reconciliations consistently reviewed and procedures clearly documented. Management will assign more staff to ensure reconciliation is done consistently and written operational procedures will be established by year-end.

The final recommendation is that staff ensure all compliance tests are done either in POMS or utilizing FCS for those that have not been set up in POMS. Two tests are still not being done: permissible investments and 3 percent of cost. Also the compliance tests have not been consistently reviewed and procedures are not clearly documented. By the year-end management has committed that if POMS cannot implement all required tests then FCS capabilities will be used. Treasurer Murphy asked for clarification on the 3 percent of cost law. Ms. Vandehey responded that the understanding of the test was 3 percent of the cost of the portfolio; however, we have contacted the Assistant Attorney General to get a clear interpretation. Treasurer Murphy stated that his interpretation was that buying something today means that the cost cannot be more than 3 percent of the market value of the fund versus an amortized cost. Mr. Silver stated that Treasurer Murphy's interpretation is correct. Ms. Vandehey stated that reason it has not been done to date is based on the difference in interpretation of staff. Chair Charles asked if we were all in agreement. Treasurer Murphy asked if the permissible investment compliance control is done on an exception or an approval basis. Ms. Vandehey responded that it is done on an exception basis. Mr. Dear responded that we staff would look into the issue of a positive test instead of a negative test with Bloomberg.

Overall the POMS system processes trades that are authorized, complete and accurate. POMS has a sufficient audit trail, strong access controls and the appropriate information is restricted to authorized personnel.

Treasurer Murphy moved that the Audit Committee accept Internal Audit 2005-02, Bloomberg Portfolio Order Management System and forward it to the Board for approval at the November 18 meeting. Ms. Brookman seconded and the motion passed unanimously.

DIRECTED BROKERAGE ANNUAL REPORT

Mr. Vidallon presented the annual directed brokerage report. Total commissions earned for 2004 were \$833,291, adding the carry-forward balance from 2003; total revenues available for the year were \$1,038,460. Total payments for services were \$1,024,611, which gives us an ending balance of \$13,849 as of June 30, 2004. As for fiscal year 2005, the projected commissions are expected to be \$569,500, adding the 2004 carry-forward balance of \$13,849, total projected revenues will be approximately \$583,000. The total projected expenditure is estimated at \$500,000, which will give us a projected ending balance of about \$83,000. Treasurer Murphy stated that things look better than they did a few years ago.

PROXY VOTING

Proxy Voting Annual Report – Calendar Year 2003

Mr. Bruebaker presented the Committee with Proxy Voting Annual Report for calendar year 2003. Under the U.S. Equity, Barclays Global Investors (BGI) voted on 9,000 issues related to 3,621 companies. In 2003, BGI voted with management 71 percent of the time versus 79 percent in 2002. On the international side, the WSIB delegates proxy voting to investment managers. Internationally, 16,000 issues were voted related to 2,100 companies. The active

managers tend to vote with management. If investment managers disagree with the company management, they usually sell the stock.

2005 Proxy Voting Plan

Mr. Dear presented the Committee with the a plan for voting proxies in 2005. An RFP was issued for proxy research, advising and voting services. Three responses were received and evaluated, Glass Lewis & Co (GL)/Investor Responsibility Research Center (IRRC) was selected. Staff will execute the contract and meet with GL/IRRC on November 15-16 to review the current WSIB policy and develop a draft WSIB proxy voting policy. Staff recommend that the Committee have a special meeting on December 6 to review the draft policy, revise where necessary, and forward to the Board for final adoption at its December 16 meeting. This action plan and timeline will allow the WSIB to be ready to vote proxies in 2005. The original estimate of costs for proxy voting was \$237,000 and actual costs will be \$195,000. While the consultant and staff will be able to meet the requirements to vote the 2005 proxy season, Mr. Dear said that he feels the 2005-07 biennial budget request for additional staff to assist with this effort is still necessary. Chair Charles requested a copy of the current policy. Treasurer Murphy requested an electronic copy of the current policy as well as the Glass Lewis policy. Staff agreed to distribute these materials on November 24. Chair Charles clarified the materials being sent include the current policy and the staffs write up of the proposed policy. Treasurer Murphy requested a table that compares the differences in the current WSIB policy, the Glass-Lewis policy and the final staff proposed policy. Mr. Masten asked if the contract was for one year. Mr. Thatcher responded that the contract is a three year contract with options for either a one 2-year renewal or two 1-year renewals.

Mr. Masten moved that the Audit Committee schedule a special meeting on December 6, 2004, to review the draft policy and guidelines and approve a final policy for recommendation for adoption by the Board at its December 16 meeting. Mr. Scott seconded and the motion passed unanimously.

PROPOSED 2005 MEETING DATES

Mr. Charles presented the proposed 2005 Audit Committee meeting schedule for review. The proposed dates are February 1, May 10, August 2 and November 1. Treasurer Murphy asked if those dates are subject to change. Mr. Dear responded that these are published and the only change would likely be for an additional meeting date.

Treasurer Murphy moved that the Audit Committee accept the meeting schedule for 2005. Mr. Masten seconded and the motion passed unanimously.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 10:01 A.M.