

**STATE OF WASHINGTON  
STATE INVESTMENT BOARD**

Audit Committee Meeting  
Minutes

November 1, 2005

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:           Treasurer Michael Murphy, Chair  
Debbie Brookman  
Charlie Kaminski  
George Masten  
Sandra Matheson  
Bob Nakahara  
Dave Scott

Other Members Present:               Pat McElligott, Board Chair

Others Present:                         Joe Dear, Executive Director  
Gary Bruebaker, Chief Investment Officer  
Theresa Whitmarsh, Deputy Director for Operations  
Shawna Killman, Internal Auditor  
Beth Vandehey, Compliance Director  
Steve Verschoor, Investment Accounting Controller  
Kristi Walters, Executive Assistant  
Paul Silver, Assistant 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., and identified Committee members present.

**ADOPTION OF MINUTES – MAY 10, 2005**

**Ms. Brookman moved to approve the May 10, 2005, Audit Committee meeting minutes. Mr. Masten seconded and the motion carried unanimously.**

## **NONVOTING BOARD MEMBER CANDIDATE INTERVIEWS**

Chair Murphy directed the members to the proposed interview questions and described the nonvoting Board member selection process. The vacancy will occur when Jeff Hanna leaves the Board in November. Chair Murphy said that the Committee would go into executive session following the three candidate interviews to discuss their qualifications.

[Mr. Kaminski was in attendance at 9:15 a.m.]

The Committee interviewed David Nierenberg, Al Symington, and Joseph A. Sasenick.

Chair Murphy called the Committee into executive session at 9:50 a.m. He said that the purpose of the session is to evaluate the qualifications of an applicant for public employment. He estimated that the executive session would last approximately 15 minutes. Chair Murphy said that, after completion of the executive session, the Committee would resume its open public session.

[The executive session concluded at 10:12 a.m. and the Committee reconvened in open session.]

**Mr. Masten moved that the Audit Committee forward a recommendation to the Board nominating David Nierenberg to fill the remaining term of the vacant nonvoting Board member position until December 31, 2005, and for a three-year term ending December 31, 2008. Mr. Scott seconded and the motion carried unanimously.**

## **INTERNAL AUDITOR REPORT**

### **Internal Audit Report 2005-04 – Public Equity International Managers**

Ms. Killman reported on the internal audit of public equity international managers. She said that Ms. Vandehey did the audit planning and made some initial visits in March. Ms. Killman visited managers in September, and then she and Ms. Vandehey worked together on audit results.

Ms. Killman reported that \$7.8 billion is invested through international equity external managers. Ninety-four percent of that is invested in developed markets and six percent is with emerging

markets. Within developed markets, 60 percent of the money is actively managed and 40 percent is managed passively. The initial risk assessment assessed active management as a higher risk.

The audit objectives were to determine if adequate controls exist and WSIB funds are safeguarded; determine whether the manager's internal corporate governance, ethic, compliance and risk management are in place and operating; determine if investment orders are followed; ensure accurate accounting of investment data and transactions; and ensure compliance with the terms of the contract.

The WSIB has seven active developed markets managers, which can be split out by portfolio type. One manager from each portfolio type was selected for audit: Capital Guardian Trust (core), William Blair & Company (growth), and LSV Asset Management (value).

Ms. Killman said that the overall assessment of the managers was good, with no recommendations to report. During the audit, best practices were also considered. The following observations were made within operations that managers may want to consider improving to meet industry best practices.

In summary, Capital Guardian has no internal audit department and no compliance testing for state banking and SEC regulations, William Blair has only one pricing feed and no SAS 70 audit, and LSV's controls were not tested in their most recent SAS 70. Additionally, none of the companies has formal processes in place to review firm-wide risks.

In response to questions from the Committee, Ms. Killman said that trade transactions and disaster recovery plans were reviewed during the audit. She said that Capital Guardian uses Deloitte & Touche as its external auditor. Mr. Nakahara suggested that staff should check for corporate governance issues as part of the RFP process. He further suggested that audit observations should be reinforced by the executive director and chief investment officer with top management of the firms.

In response to Mr. McElligott's comments about the lack of an internal auditor at Capital Guardian, Ms. Vandehey came forward and described the self-assessment group the company she observed was in place to review controls and implement improvements. While this is similar to what internal audit does, the responsibility is within the unit and individual members of the unit to implement proper controls and processing and to ensure they are in compliance with the SEC. Capital Guardian does not believe that an internal audit program would add value. Mr. Bruebaker said that Capital Guardian has one of the best pre-trade compliance systems that he has seen and he does not expect that the company will change its current practice. Mr. McElligott said that the Board should continue to recommend an internal audit program.

**Ms. Brookman moved that the Audit Committee accept the Internal Audit Report 2005-04, Public Equity International Managers and forward it to the Board for approval. Mr. Masten seconded and the motion passed unanimously.**

#### **Audit Recommendations Status Report**

Mr. Bruebaker commented on the change in expected completion date for the summarization of partnership agreements under Private Equity Audit 2004-01 recommendations. He said that the entire partnership agreement must be reviewed in order to document requirements, as the agreements are not uniform. Capital Dynamics, who is our new private equity consultant has a system in place that may collect the information needed by staff. Mr. Bruebaker said that a definitive plan will be ready by March 31, 2006.

#### **2005-2006 Audit Plan Update**

Chair Murphy announced that the private equity consultant internal audit was moved from November 2005 to August 2006 due to the recent change of consultants. He said the fixed income management and information technology audits are still planned for February 2006 and May 2006 respectively. The internal audit of the custodian bank was removed from this year's audit plan. Ms. Killman said that the next risk assessment will be conducted in March 2006 and the custodian bank will be reassessed for audit at that time.

[The Committee recessed at 10:50 a.m. and reconvened in open session at 11:00 a.m.]

### **REAL ESTATE CONSULTANT WORK REVIEW**

Ms. Vandehey reported that the real estate unit internal audit resulted in a recommendation that management should increase the use of outside consultants or auditors for special projects.

Management hired Peterson Sullivan PLLC to conduct two projects over the past year. Peterson Sullivan reviewed and reported on the December 31, 2004, unfunded commitment balance of Lowe Northwest and The Campbell Group's compliance with the agreement surrounding management and advisory fee increase effective January 2003. The unfunded commitment balance as of December 31, 2004, for Lowe Northwest is now fairly stated and The Campbell Group's fee increase effective January 2003 was found to be in compliance.

### **PRELIMINARY REVIEW OF FINANCIAL REPORTS**

Ms. Whitmarsh presented staff's work on the preparation and format of this year's financial statements. She said that, while the WSIB is not required to be GASB compliant, there is an interest in having the WSIB financial statements audited. Peterson Sullivan PLLC was hired to recommend changes to financial statements to move toward that end. She introduced Steve Verschoor to review the changes and answer questions.

Mr. Verschoor noted the changes to the management discussion and analysis letter, financial statement presentation, and notes for the financial statements. He said the largest change is to the notes which were expanded, in part, to meet new requirements of GASB #40: Deposit and Investment Risk Disclosure.

Ms. Brookman and Chair Murphy complimented staff on their work. Ms. Brookman said that she found the notes to the statements very helpful and suggested that these should be shared with new Board members.

## **PROXY VOTING ANNUAL REPORT**

Mr. Bruebaker said that the calendar year 2004 proxy voting report was given at the March 17 Committee meeting. Today's report covers proxy voting for the six-month period ended June 30, 2005. He said that proxy voting will be reported on a fiscal year basis from here forward.

Mr. Bruebaker said that, at the Board's direction, staff began voting proxies in January of this year. Glass Lewis & Company was hired as the Board's proxy voting consultant and Investor Responsibility Research Center was hired to do the physical voting. Mr. Bruebaker noted the summarized voting records for indexed U.S. equity, indexed and enhanced international equity, active international developed markets core, and value and growth equity, emerging markets, and terminated portfolios. For U.S. equity, over 178 distinct issues were voted for 3184 shareholder meetings. The WSIB voted with management 79.7 percent of the time.

## **CONFLICT OF INTEREST COMPLIANCE REVIEW**

Mr. Silver reported on his review of gift, travel, personal investments, and statements of financial affairs reporting for 2004. The reports were reviewed for compliance with the Ethics in Public Service law and the Board's Conflict of Interest policy. Mr. Silver said that he found full compliance reporting of gifts, travel related expenses paid in whole or in part by external entities, and investments. He said that the statements of financial affairs were also in compliance. Mr. Silver noted that two staff had filed after the April 15 deadline. He determined that these reports contained no changes from the previous year's filings. Mr. Silver said that the Board and staff were in full compliance with the law and Board policy. Chair Murphy asked Mr. Dear to encourage staff to submit their reports on time. Mr. Dear said that a corrective action plan is in place to ensure filing by the deadline.

**Ms. Brookman moved that the Audit Committee accept the Conflict of Interest Compliance Review and forward it to the Board for further approval at the November 17, 2005, Board meeting. Mr. Scott seconded and the motion carried unanimously.**

## **DIRECTED BROKERAGE ANNUAL REPORT**

Ms. Whitmarsh presented the directed brokerage annual report for fiscal year 2005. She reported that services historically paid for under directed brokerage are now being paid for under non-appropriated funds, though staff is still reviewing which services should be paid out of directed brokerage versus non-appropriated funds. In response to Mr. Masten's questions about advantages or disadvantages of one over the other, Ms. Whitmarsh clarified that it is a matter of eligibility. Chair Murphy said that the directed brokerage balance used to be a big number that was not properly utilized and he is pleased to see it turned around.

## **2006 MEETING SCHEDULE**

Chair Murphy asked if any members had additions or deletions to the listing of tentative agenda items for 2006. None were requested.

**Mr. Scott moved that the Audit Committee accept the 2006 meeting schedule.**

**Ms. Brookman seconded and the motion carried unanimously.**

## **OTHER ITEMS**

There was no further business to come before the Committee and the meeting adjourned at 11:15 a.m.