

**WASHINGTON STATE INVESTMENT BOARD**  
**Audit Committee Meeting Minutes**  
**September 6, 2006**

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  
Charlie Kaminski  
George Masten  
Bob Nakahara  
Dave Scott

Others Present:                         Joe Dear, Executive Director  
Theresa Whitmarsh, Chief Operating Officer  
Gary Bruebaker, Chief Investment Officer  
Liz Mendizabal, Public Affairs Director  
Jim Lee, Information Systems Manager  
James Mackison, Information Systems Manager  
Shawna Killman, Internal Auditor  
Beth Vandehey, Risk and Compliance Director  
Kate Sandboe, Corporate Governance Policy Analyst  
Rita Wineinger, Administrative Assistant  
Paul Silver, Assistant Attorney General

Steve Weil, Seitel Leeds & Associates

[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.

**ADOPTION OF THE MAY 31, 2006, MINUTES**

**Mr. Masten moved to approve the May 31, 2006, Audit Committee meeting minutes. Mr. Scott seconded the motion.**

Mr. Kaminski asked to have the word “including” inserted in the first paragraph on page 6.

**The above motion carried unanimously.**

**INTERNAL AUDITOR REPORT**

**Information Services Network Security Review Results**

Chair Murphy called the Audit Committee into executive session at 9:04 a.m. to review and discuss information concerning potential information technology vulnerabilities and the action taken to resolve potential vulnerabilities, the public discussion of which would result in loss to the funds

managed by the WSIB. He indicated that the executive session was expected to last about 15 minutes, at which time the Audit Committee would reconvene in open session.

Chair Murphy asked Mr. Silver to confirm that this executive session was appropriate. Mr. Silver confirmed that if there is a risk that the discussion being public would pose a loss to the funds managed by WSIB, it is appropriate to go into executive session.

[The executive session concluded at 9:30 a.m. and the open session reconvened immediately thereafter.]

### **Audit Report 2006-03, Private Equity Consultant**

Ms. Killman presented Internal Audit Report 2006-03, Private Equity Consultant. Ms. Killman began with a brief discussion of the contract itself, the consultant, and a summary of the audit and risks identified. The WSIB has a consulting contract in place to obtain creative, non-conflicted private equity consulting services to complement staff's due diligence, provide monitoring services, as well as performance reporting and back-office accounting services. Strategically, this relationship is very important to the WSIB, given that private equity returns are based on and correlated so much with general partner (GP) selection and the consultant plays a large role in selecting the GPs.

The new private equity consultant, Capital Dynamics, replaced Pacific Corporate Group (PCG), and has a 5-year contract with the WSIB. The overall assessment of Capital Dynamics was good. Capital Dynamics is headquartered in Zug, Switzerland, and has four other branches worldwide. Capital Dynamics has accomplished much in the past year and a half, including dramatic company growth. The company increased from 15 to 76 employees since early 2005. During this same time staff implemented a new accounting system and the WSIB data was the first to be loaded. Its quality management system also received ISO 9000 certification, which includes defining and documenting their processes.

Ms. Killman explained that the audit objectives were to determine whether the consultant has internal governance, ethics, compliance, and risk management programs in place and operating; is meeting the scope of services required under the contract; and has adequate internal controls in place to ensure an accurate accounting of WSIB financial data and transactions is maintained. During the audit, Ms. Killman visited both the Switzerland office, where back office accounting takes place, and the New York office.

Ms. Killman reported that Capital Dynamics has a strong internal governance program in place, Code of Ethics, Compliance/Internal Audit and Risk Management functions, staff training, and documented control procedures were established during the ISO certification process. During the audit, four risks were identified in this area: (1) human resource risk due to the considerable growth in Capital Dynamic's client base and staffing; (2) processing risk, as Capital Dynamics has not received a SAS 70 review; (3) missing process/policy risk, as the risk management process has not yet been formalized and documented; and (4) operational inefficiency risk due to the location of the contract manager assigned to the WSIB account in New York, and those located at the headquarters office in Zug.

Chair Murphy asked Ms. Killman to explain the communication issue. She indicated staff has had questions that the Capital Dynamics liaison was not able to answer without consulting with the Zug office. Ms. Killman suggested one way to resolve the issue noted during the audit would be to ensure our liaison at Capital Dynamics has the authority to answer questions in a timely manner. Mr. Bruebaker indicated the time difference has been both positive and negative in that often times WSIB staff asks questions of the liaison at the end of our day and due to the time difference we usually receive an answer by the beginning of the next working day. Mr. Bruebaker further indicated that staff receives responses from Capital Dynamics very quickly. Mr. Dear indicated that there has not been a problem with service delivery.

The investment management area of Capital Dynamics has well-defined, template-driven procedures that, if followed consistently, ensure due diligence and investment analyses are thorough and adequately documented. During the audit, three risks were identified in this area: (1) operational inefficiency risk due to errors contained in two investment recommendation reports; (2) control failure risk, as the due diligence files did not contain the specific documentation identified in Capital Dynamics documented process; and (3) inadequate information system risk due to various quantitative analyses and monitoring models maintained in spreadsheet files, which increases the risk of human errors or inadvertent corruption of the files.

Chair Murphy asked if the due diligence files in Zug were appropriate, if the Zug office retains a copy of the due diligence files on all deals or just those handled at that office, and if there were due diligence files kept by the consultant that the WSIB does not have access to. Ms. Killman indicated that the hardcopy files in New York were not in compliance with the processes and checklist that Capital Dynamics has in place, which made it more cumbersome to locate documentation, and that each office has hardcopy of the files they handled. Mr. Bruebaker indicated the WSIB has internal due diligence files that staff complete. Ms. Killman noted that the files in Zug were better organized, but that documentation was located in both offices.

Ms. Killman relayed that the portfolio review, monitoring and performance reporting were not reviewed in detail, as the majority of the work related to these services takes place as part of the quarterly report preparation which will not be completed until September. Capital Dynamics has established a process to perform compliance testing beginning in September 2006. Capital Dynamics has developed a process to test compliance and has done an excellent job in getting that up and running.

The transaction management staffing is appropriate and processes are detailed and documented. The transaction management and back-office were tested and the following risks were identified: (1) human resource risk, due to the changes in key staff; (2) bad information risk, as the data transition was more problematic than Capital Dynamics expected and required more time and resources than expected; (3) processing risk, as a number of the portfolio servicing processes are more manual than expected; and (4) control failure risks due to access to electronic signatures not being adequately restricted, the portfolio servicing supervisor over the WSIB account having both input and approval capabilities within the accounting system, and inconsistency in the documentation of confirmation of wire instructions with WSIB's general partners. Ms. Killman indicated that the use of electronic signatures has been discontinued.

Mr. Kaminski requested clarification regarding the data transition, asking why historical data would be changed by PCG and how this was missed when PCG was WSIB's private equity consultant. Ms. Markoff, Portfolio Administrator, indicated that because PCG was only required to do an annual reconciliation, the corrections to data made by PCG were occurring during the time that data was being uploaded to Capital Dynamics. Capital Dynamics provides quarterly reconciliation and were not aware that corrections would be taking place in the data they were receiving and their system was engineered to preclude changes to historical data. Capital Dynamics believed it would be receiving clean, audited information on the first upload, which is why the company set up its system to not allow changes. Ms. Killman said that Capital Dynamics has spent a significant amount of resources to ensure their information is accurate.

In summary, Ms. Killman indicated that no audit recommendations were noted and the overall audit assessment of the private equity consultant was good. The risk observations identified are intended to increase the awareness of management and discussion of controls and governance with the consultant. These are not requirements for implementation of new processes. In response to the report, Ms. Killman indicated that Capital Dynamics has responded saying that they understand and are receptive to the commentary provided in the audit report; and senior management at Capital Dynamics is fully committed to addressing the issues raised.

Mr. Nakahara asked for clarification regarding the overall assessment. Ms. Killman replied that it was better than expected based on her discussions with Ms. Vandehey regarding previous consultant audits. There were no huge risks identified that needed to be dealt with immediately. Mr. Nakahara observed that the issues seem to be related to rapid growth and that during acquisitions perhaps the processes were not as clean. He also asked if the organization is audited by anyone else and if any internal control issues were noted. Ms. Killman said that annual financial audits of both the parent and the subsidiary were conducted for calendar 2005, she reviewed both reports and no internal control issues were identified. Ms. Killman further also noted that in the U.K. the Financial Services Authority reviewed the company that was acquired and there were no internal control weaknesses noted.

**Mr. Scott moved that Audit Committee accept the Internal Audit Report 2006-03, Private Equity Consultant and forward it to the Board for approval. Mr. Masten seconded and the motion passed unanimously.**

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

Ms. Killman presented the Audit Recommendation Status Report. Since the last status report in May 2006, recommendations 2004-01, item 1b and 2005-01, item 1b were resolved with the implementation of the Goldmine Contact Management System. The private equity and real estate staff has been trained on the use of the new system. In addition, procedures were established to monitor compliance with the WSIB Savings Pool guidelines, independent of the fixed income unit. There is one remaining audit recommendation item since last quarter. The expected completion date for the summarization of partnership agreement terms under Private Equity Audit 2004-01, item 1a recommendation remains November 30, 2006.

#### **NONVOTING BOARD MEMBERS TERM EXPIRATIONS**

Chair Murphy discussed the upcoming term expirations of nonvoting Board members Charlie Kaminski and John Magnuson. Mr. Kaminski indicated that he was interested in continuing to serve on the Board. Mr. Dear advised that he spoke with Mr. Magnuson who would also like to continue as a nonvoting Board member. Chair Murphy asked that both members submit a letter of interest to the Audit Committee

**Mr. Masten moved that the Audit Committee re-appoint the existing members for another three-year term and forward to Board for approval upon the receipt of letters from both members. Chair Murphy seconded and the motion passed unanimously.**

### **CORPORATE GOVERNANCE CORRESPONDENCE**

Ms. Sandboe, Corporate Governance Policy Analyst, presented an update on WSIB's corporate governance correspondence. When the Board amended the Proxy Voting Guidelines in support of a majority vote standard, Ms. Sandboe corresponded with the top 25 companies in which the WSIB is invested to inform corporate leaders of the Board's action. Of those companies, 10 had already adopted a form of majority voting. For the remaining 15 companies, letters were sent to the chair of the nominating and governance committee or to the board.

Chair Murphy requested clarification regarding IBM, as it appears it had a failed majority vote. Ms. Sandboe indicated that many companies have adopted a majority vote standard or a director resignation policy during this proxy season, either as a result of shareholder proposals or voluntarily, such as IBM. She further indicated that many companies are choosing to voluntarily adopt a less restrictive policy. The Committee discussed the outcomes of the majority vote proposals for Amgem (47% favorable), Johnson & Johnson (39% favorable), and Walmart (22% favorable).

Ms. Sandboe reported that, earlier this year, letters were sent to the private equity fund managers requesting information about the WSIB's investments in companies doing business in Sudan. Chair Murphy asked if no responses were received, did the WSIB send follow-up requests for this information. Ms. Sandboe indicated that additional letters were sent and responses are still being received. Chair Murphy requested a list of those companies that have not responded.

Mr. Masten asked for clarification regarding the William Blair letter. Does this reference to .53% interest refer to the overall Hyundai Motor Company? Mr. Bruebaker explained that this references .53% of our portfolio managed by William Blair. Mr. Masten asked how much money that equates to, what is the total dollar amount we have in William Blair?

Mr. Kaminski asked where the managers obtain information that indicates a company is operating in the Sudan. Ms. Sandboe indicated that most of the companies subscribe to services to provide that information.

The last item of corporate governance was the letter sent to the U.S. Securities and Exchange Commission (SEC) supporting the proposed rules requiring greater disclosure of executive pay. The SEC unanimously adopted the new rules on July 26, 2006. The new rules require companies to disclose the dollar value of stock options; disclosure of severance and change-in-control agreements, including the specific circumstances in which payments may be triggered; disclosure of retirement

and post-employment benefits; disclosure of compensation for the principal executive officer, the principal financial officer, and the three most highly compensated executive officers.

**Sarbanes Oxely (SOX) SECTION 404 – INTERNAL CONTROL REVIEW SCOPE OF WORK**

Ms. Whitmarsh reported that the Audit Committee had previously been presented with a plan of how the WSIB may become a voluntary complier in SOX Section 404. The first step of that plan is to have an investment accounting firm review internal controls in relation to the requirements of SOX Section 404. Peterson Sullivan, the firm retained to conduct the Fiscal Year 2006 Financial Statement Audit, has agreed to conduct this review while it is on site conducting the financial audit. The firm has performed these types of reviews for other clients. Peterson Sullivan will prepare a separate letter to management outlining our strengths and weaknesses and a cost benefit analysis of what it would take to become a voluntary complier. The full report will not be completed for the November Audit Committee meeting, but will be presented in February 2007.

Chair Murphy asked who from Peterson Sullivan will do the work. Ms. Whitmarsh indicated that no specific person had been identified, but usually two or three people are assigned and Peterson Sullivan anticipates the review will require an additional week of work and approximately \$7,500.

**Mr. Masten moved that the Audit Committee accept the Internal Control Review Scope of Work. Mr. Scott seconded and the motion passed unanimously.**

Mr. Nakahara requested that if significant internal control issues are found that they be presented at the November meeting. Ms. Whitmarsh indicated a preliminary report would be available at that time.

**OTHER ITEMS**

Mr. Kaminski suggested that the Committee request to have Seattle University Law School provide a follow-up to its Board governance presentation at the July Board meeting. Chair Murphy agreed and requested the follow-up take place with the entire Board.

Mr. Bruebaker addressed Mr. Masten's earlier question regarding how much money the WSIB has invested with William Blair. He indicated the investment was \$1.6 million.

There was no further business to come before the Committee and the meeting adjourned 10:42 a.m.