WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
November 1, 2006

The Audit Committee met in open public session at 9:04 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 Gary Bruebaker, Chief Investment Officer Liz Mendizabal, Public Affairs Director Steve Verschoor, Investment Accounting Controller Shawna Killman, Internal Auditor Beth Vandehey, Risk and Compliance Director Kate Sandboe, Corporate Governance Policy Analyst Rita Wineinger, Administrative Assistant James Mackison, Information Systems Manager Paul Silver, Assistant Attorney General Bob McCormick, Glass Lewis & Co

[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 9:04 a.m.

INTERNAL AUDITOR REPORT

2006 – 2007 Audit Plan Update

Ms. Killman provided an update to the 2006 – 2007 Audit Plan. The due date for the cash overlay program manager audit was changed to accommodate the schedules of Frank Russell (FR). FR could not entertain an audit during the month of September 2006, thus, the cash overlay manager audit report due date has been moved to the next Audit Committee meeting. Chair Murphy asked if the audit was done, but the report was not written. Ms. Killman indicated that the field work is scheduled for next week.

Audit Recommendations Status Report

Ms. Killman presented the Audit Recommendation Status Report. Since the last status report in September 2006, the one remaining item is on schedule for completion. The expected completion date for the summarization of partnership agreement terms under Private Equity Audit 2004-01, item 1a recommendation remains November 30, 2006.

Peterson Sullivan Update
Mr. Verschoor presented an interim report on 2006 Fiscal Year Financial Statements Audit. The Audit Committee assigned this audit to Peterson Sullivan at the May 31, 2006 Audit Committee meeting. At this time, the financial statements are in the final stages of audit and review. Peterson Sullivan has informed us there will be no restatements of financials, but they will have some suggestions for control improvements. The 2006 Annual Report will be published in January 2007. Chair Murphy asked if there were any findings or recommendations. Mr. Verschoor indicated that no findings are expected but there may be recommendations. Mr. Nakahara asked if a summary of reconciling items that were noted during the audit could be made available for the committee to review. Mr. Verschoor indicated that he was not aware of any, but he will check with Peterson Sullivan and forward that information, if available.

[Sandy Matheson arrived at 9:07]

Internal Audit's Role in Enterprise Risk Management
Ms. Killman provided an education session on Internal Audit's role in Enterprise Risk Management (ERM). This session is in response to the concerns expressed by Audit Committee members at the February 2006 meeting regarding the Internal Auditor participating as a member of the WSIB's ERM team and the need to ensure internal audit's independence is maintained while acting in this capacity.

Ms. Killman reviewed the guidance provided by the Institute of Internal Auditors (IIA) regarding appropriate roles for Internal Auditors. The IIA categorized appropriate Internal Audit roles to include: Core internal roles in regard to ERM, legitimate Internal Audit roles with, and those roles Internal Audit should avoid.

Core internal roles with regard to ERM include: reviewing the management of key risks; evaluating the reporting of key risks; evaluating risk management processes, and giving assurance that risks are correctly evaluated; and giving assurance on the risk management processes. Legitimate internal audit roles include: developing risk management strategy for Board approval; championing establishment of ERM; maintaining and developing the ERM framework; consolidated reporting on risks; coordinating ERM activities; coaching management in responding to risks; and facilitating identification and evaluation of risks. Roles internal audit should not undertake include: setting the risk appetite; imposing risk management processes; managing assurance on risks; taking decisions on risk responses; implementing risk responses on management's behalf; and accountability for risk management.

Mr. Nakahara asked if Internal Audit is not responsible for those roles the IIA indicate should not be taken on by this position, who is? Ms. Killman responded that the Risk and Compliance Director, who is part of the management team, is responsible for those areas.

<u>RISK & COMPLIANCE REPORT</u>

Risk Report
Ms. Vandehey provided an overview of the agency's Enterprise Risk Management (ERM) program. She provided a key risk analysis document, as well as a copy of the publication "Spotlight", which highlights the WSIB ERM Program. Ms. Vandehey explained that the WSIB ERM team consists of 12 members that represent a cross section of the agency. She further explained that the ERM team is

comprised of line staff, who feed information to Executive Management based on the risk levels identified. Many of the risks are low risks that are resolved by staff.

Mr. Kaminski asked, based on the flow chart provided, how risks are reported to the Board. Ms. Vandehey explained that the ERM team reports medium and high level risks to Executive Management. Those risks flow through Executive Management to the Board. Mr. Kaminski asked who the Executive Management Team consists of. Ms. Vandehey responded that the Executive Management Team is comprised of Gary Bruebaker, Theresa Whitmarsh, Liz Mendizabal, and Joe Dear. Mr. Kaminski asked if there were a significant exposure to risk identified, how those would be communicated to the Board. Ms. Vandehey responded that the Internal Auditor is also on the ERM Team and she reports directly to the Audit Committee. Mr. Nakahara asked if there are minutes available from the ERM Team meetings. Ms. Vandehey explained that there is an ERM page on the agency intranet that contains very detailed information regarding the ERM Team's work. Mr. Nakahara requested to see that intranet site.

Ms. Vandehey discussed the primary goal of the ERM Team: to create a risk aware culture. The ERM Team encourages managers to embed risk management into their division, engaging in risk discussions within their units, identifying key risks being taken and the key risks faced in their divisions, owning the management of those risks, and to share key risks with other business units to enhance understanding and help deal with the unexpected. The ERM Team developed annual risk assessment questionnaires that analyze the likelihood and impact of each of the core business processes within the agency. The likelihood and impacts are analyzed using a scale of 1-5, with 1 being low and 5 being high on the rating scale.

Chair Murphy asked if the Pricing & Unit6izaiton of the CTF and Daily Valued Funds methodology modeling error was scored a 3, was this methodology reviewed further based on that score. Ms. Vandehey indicated that it was reviewed.

The core business processes analyses were then plotted on a heat map. The results indicated that the WSIB core business processes have high impact items but with low likelihood of occurrence.

In response to Ms. Matheson's earlier question regarding agency risks, Ms. Vandehey explained that the agency risk document identifies fiduciary risk, market risk, strategic risk, government environment risk, operation risk, and reputation risk as the key risks.

Mr. Kaminski asked where implementation risk of the investment program would show up. Does this get folded into one of these six categories? Ms. Vandehey responded that these types of risks would not be included at this time as the ERM is focused on the operational risk of the agency. However, the staff intends to expand the program to include investment risks over the next few years.

Mr. Nakahara commented that he applauds Ms. Vandehey and the ERM team for taking this very seriously, because it should be. Mr. Nakahara would like the ERM Team and senior management to explore the investment risk area. In light of the Board embarking on defining and unifying investment beliefs, the ERM Team could do a good job of understanding that and become a great safety net for the Board. If the Board is responsible as fiduciaries for ERM, we need to know what it is and its strengths and weaknesses. Mr. Nakahara further commented that he would like the full

Board to understand ERM. Mr. Bruebaker indicated that an education session for the Board would be included in a future Board agenda.

Compliance Report
Ms. Vandehey presented the second compliance report for this year; the first was on Board policy compliance. Over the past three year, operational staff have made significant headway in compliance outside of the investment. The first system operational staff implemented was the Bloomberg POMs system, which tested compliance on pre-settled trades against the fixed income securities. The next year, operational staff chose the Charles River Compliance system, which tested compliance on post trade public equity securities managed by our active international managers. The Charles River also does some additional tests for fixed income.

This year, we have turned our attention to the Private Equity asset class, working with the new consultant, Capital Dynamics to begin an annual compliance review of all partnership relationships. The first compliance reports have been received this month and the Compliance Officer will be responsible for reviewing the test results, evaluating if further testing needs to be completed, follow up on the test results with the Private Equity staff or the partners, help resolve any issues, and provide a report on the compliance results to management.

ADOPTION OF THE SEPTEMBER 6, 2006, MINUTES

> **Ms. Matheson moved to approve the September 6, 2006, Audit Committee meeting minutes. Mr. Masten seconded the motion.**
>
> **The above motion carried unanimously.**

DIRECTED BROKERAGE ANNUAL REPORT
Mr. Donovan presented the Directed Brokerage Annual Report. The beginning balance for fiscal year 2006 was $244,255. Total credits earned for the year were $1,448,864 with the major portion generated by non-U.S. active equity managers. Credits have increased from fiscal year 2005 by $667,108 or 85 percent. The total payments for services for fiscal year 2006 were $4,250.

For fiscal year 2007, the projections are for $950,000 in total credits earned, which is approximately $350,000 more than the prior fiscal year. No future projected expenditures are forecasted for FY 2007. Beginning July 1, 2005, all credits are being wired to the custodial bank to be placed in the commingled trust fund.

Chair Murphy noted that Frank Russell is the only company noted on the report, and asked were there no other commissions paid to others? Mr. Donovan indicated that Frank Russell is the firm that handles the commissions.

2007 MEETING DATES

Mr. Dear presented the proposed Audit Committee meeting schedule for 2007. The dates selected are the last day of the last month of each quarter and include: January 31st, April 30th, July 24th (tentative), and October 31st.

> **Mr. Masten moved to approve 2007 Audit Committee meeting schedule. Ms. Matheson seconded the motion.**
>
> **The above motion carried unanimously.**

PROXY VOTING

Annual Report & 2007 Proxy Voting Season Issues

Ms. Sandboe, Corporate Governance Officer, presented the Proxy Voting Annual Report. Ms. Sandboe introduced Bob McCormick Vice President of Proxy Research and Operations, from Glass Lewis & Co

Ms. Sandboe reported that so far this year, the WSIB has voted a total of 3,612 proxies. Proxy votes were cast on a total of 27,298 individual proxy proposals dealing primarily with election of directors, ratification of auditor, compensation plans, and shareholder proposals.

In a further breakdown of our proxy votes, the WSIB withheld votes from approximately 3,908 of the 17,767 director votes, which represents 22% of the total votes on this issue. Ms. Matheson asked if this was an increase over prior years. Ms. Sandboe indicated that it is approximately the same and that at the end of last year, it was 25%. Chair Murphy asked how many directors were re-elected. Mr. McCormick explained that only 0.11% of directors did not get a majority vote. Chair Murphy asked if staff had sent correspondence to some firms. Ms. Sandboe indicated that correspondence had been sent to the top companies and further indicated that this is why getting a majority voting standard is so important.

Consistent with our proxy voting guidelines, the WSIB voted against 306 of 1,458 proposed executive compensation packages last year. The WSIB policy states that executive compensation should be directly lined with performance and for that reason, the WSIB voted “against” approximately 21% of the time. Chair Murphy asked if voting “against” is different than withholding. Mr. McCormick explained that the withhold vote is unique just to the director election proposal. In that case the options are to vote for or to withhold, you cannot abstain. Chair Murphy asked if the compensation plans require a majority. Mr. McCormick explained that in general those require a majority vote of cast shares. Chair Murphy asked of the 21% we voted against, how many got it anyway? Mr. McCormick indicated he did not have that information, but would follow up with that data. He elaborated that it is a relatively small number that do not get re-elected because currently the broker votes that are un-voted end up being voted with management. Mr. McCormick said there is currently a push at the New York Stock Exchange underway to move away from broker voting.

Ms. Matheson asked if there has been any different types of compensation plans going forward in response to stockholder concerns. Mr. McCormick indicated that there is more focus on linking compensation to performance measures. This is also related to the expected the Securities and Exchange Commission (SEC) disclosure regulations. In terms of executive compensation, companies will realize that people will be shocked when the actual amount of compensation being paid is disclosed. In response to that, companies will be more forthcoming in how they got to those levels and how those amounts are tied to performance.

Mr. Nakahara asked what in the area of post employment compensation has changed. Mr. McCormick explained that there has been a recent push to reign in those post employment packages. Part of the new disclosure requirement will show actual amounts. Under current disclosure, how the payments will be based is required. Many companies have faced proposals requiring a shareholder vote on excessive executive termination clauses. The general definition is if it is greater than 3 times the annual compensation, it is a golden parachute and no longer able to take advantage of IRS deductibility and therefore, should be approved by shareholders.

Chair Murphy asked if the new disclosure requirements take place before or after the event occurs. Mr. McCormick indicated beginning next year information will be disclosed prior to the event taking place. Chair Murphy asked what the next steps should be. Ms. Sandboe indicated that more compensation plans link performance to pay and she believes we are having some effect on these companies.

Chair Murphy asked how many of the companies that are owned by WSIB have excessive compensation issues. Mr. Bruebaker explained that the private equity firms all have performance based pay.

Mr. Masten indicated we are also a member of the Council of Institutional Investors (CII), a leading forum for corporate governance activism.

Ms. Matheson asked if there are differences in European stocks and domestic stocks. Mr. McCormick explained that they have different issues. In general, with compensation in Europe, there is a lot less disclosure, however compensation is generally lower. In terms of compensation, Europe does a much better job. In the UK, there is an advisory section on every proxy to let shareholders weigh in on how they think about the compensation on an advisory basis. As a result, several UK companies have revised their compensation policies.

Mr. McCormick further explained that last year the American Federation of State, County and Municipal Employees (AFSCME) put up proposals at four companies, including Home Depot requiring an advisory vote on the compensation committee. While none of these proposals passed, they did receive on average 45% of the vote, which is an extremely high support for first year proposal. Chair Murphy asked what the big companies in our state such as Boeing and Microsoft, are doing.

[Dave Scott arrived at 10:13]

OTHER ITEMS

Mr. Bruebaker added that the New York Stock Exchange is comprised of two groups, one runs the exchange and one sets the rules. Marsh Carter is chairman of the Board that supervises the two functions.

There was no further business to come before the Committee and the meeting adjourned 10:33 a.m.