

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
December 2, 2008

The Audit Committee met in open public session at 9:05 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Mason Petit, Chair
 Charles Kaminski (via telephone)
 George Masten
 Sandra Matheson
 Bob Nakahara (via telephone)

Absent: Lisa Brown

Others Present: Joe Dear, Executive Director
 Theresa Whitmarsh, Chief Operating Officer
 Gary Bruebaker, Chief Investment Officer
 Liz Mendizabal, Public Affairs Director
 Shawna Killman, Internal Audit Director
 James Mackison, Innovation and Technology Director
 Alicia Markoff, Portfolio Administrator
 Carmen Matsumoto, Compliance Officer
 Rodney Reynolds, Internal Auditor
 Kate Sandboe, Corporate Governance Officer
 Beth Vandehey, Risk and Compliance Director
 Celina Verme, Finance and Administrative Services Director
 Rita Wineinger, Administrative Assistant

 Brian Buchholz, Assistant Attorney General
 Jim Brownell, State Auditor's Office
 Ray Holmdahl, Peterson Sullivan
 Mark Raker, Peterson Sullivan

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

Chair Petit called the meeting to order and roll call was taken.

EXTERNAL AUDIT

Fiscal Year 2008 Independent Auditors' Report

Ms. Vandehey presented the 2008 financial statements. Ms. Vandehey explained the process for completion of the financial statements and thanked staff for the hard work involved in this project. Ms. Vandehey introduced Mr. Holmdahl and Mr. Raker who presented the independent audit report of the 2008 financial statements.

[Ms. Matheson arrived at 9:08a.m.]

The auditor concluded in each case that the financial statements were presented fairly, in all material respects. The auditor did not issue a management letter for new or repeat deficiencies in internal control and did not propose any adjustments to the 2008 financial statements. The auditor did provide a verbal recommendation to increase the content of the financial information included in management's discussion and analysis.

Mr. Nakahara commended staff for doing an excellent job during the transition between custodian banks and investment accounting controllers. In response to an inquiry from Mr. Nakahara, Mr. Raker indicated there will be a new GASB pronouncement related to derivatives that will affect the financial statements effective for the fiscal year ending 2010. The WSIB is currently discussing the implications of this pronouncement. Mr. Raker also assured Mr. Nakahara and the Committee that management is adequately addressing FASB Statements 157 and 159 as they apply to the WSIB.

Chair Petit thanked Ms. Vandehey for her hard work on the 2008 financial statements.

Chair Petit moved to approve the Fiscal Year 2008 Independent Auditors' Report. Ms. Matheson seconded, and the motion carried unanimously.

ADOPTION OF THE SEPTEMBER 9, 2008, MINUTES

Ms. Matheson moved to approve the September 9, 2008, Audit Committee meeting minutes. Mr. Masten seconded, and the motion carried unanimously.

EXTERNAL AUDIT

State Auditor's Office Fiscal Year 2008 Accountability Audit Report

Mr. Brownell presented the results of the 2008 Accountability Audit Report, which covered the period beginning July 1, 2007, and ending June 30, 2008. The audit was planned and conducted using a risk-based approach to review the WSIB's accountability for public resources, compliance with state laws and regulations and its own agency policies and procedures. The following areas were reviewed during the audit: asset custodian conversion, investment manager contracts, real estate investments, investment holdings, conflict of interest, travel, payroll, AFRS access, disbursements/use of 03K funds, and year-end transactions. Mr. Brownell also explained that the Board has several accounts material to the state's basic financial statements. Rather than performing tests of these accounts, the state auditor relied upon the certified public accountants' audit of the Board's account balances and financial activities. In response to an inquiry from Chair Petit, Mr. Brownell indicated that this year did provide an opportunity for a deeper look into the WSIB's processes. Mr. Brownell reported no audit recommendations for the fiscal year 2008 audit. He indicated that this is the seventeenth consecutive year that the WSIB has had no audit findings.

Mr. Masten moved to recommend that the Committee approve the 2007-2008 State Auditors' Office Accountability Audit Report. Ms. Matheson seconded, and the motion carried unanimously.

INTERNAL AUDIT

Audit Recommendations Status Report

Ms. Killman presented the Audit Recommendation Status Report. At the beginning of the quarter, there were 21 outstanding audit recommendations. Since then, staff has resolved nine

recommendations relating to the financial statement audit, contract compliance monitoring, and Financial Control Systems. Ms. Whitmarsh, Ms. Verme, and Mr. Mackison provided updates on progress made on outstanding audit recommendations.

MANAGEMENT

2008 Proxy Season Voting Report and 2009 Proxy Voting Preview

Ms. Sandboe presented WSIB's voting record for the first 10 months of the 2008 proxy voting season. Between January 1, 2008 and November 17, 2008, the WSIB voted a total of 3,677 proxies. Proxy votes were cast on a total of 25,533 individual proxy proposals dealing primarily with election of directors, ratification of auditor, compensation plans, and shareholder proposals. The WSIB withheld votes from approximately 3,730 of the 19,031 directors nominated for election, which represents almost 20 percent of the total director votes. Consistent with our proxy voting guidelines, the WSIB voted against 291 of 1,106 proposed executive compensation packages this year. The WSIB policy states that executive compensation should be directly aligned with performance and for that reason, the WSIB voted "against" about 26 percent of the time. This year the WSIB also voted in favor of 80 "say on pay" proposals, which would allow shareholders an advisory vote on executive compensation plans.

For the upcoming proxy voting season, Glass Lewis & Company identified three top trends: 1) a greater emphasis on controlling executive compensation, primarily through shareholders proposals for "say on pay," clawbacks, and limits on golden parachutes; 2) majority voting reaching a broader group of companies through shareholder proposals targeted at smaller (outside the S&P 500) companies; and 3) a call for stronger risk controls in the form of establishing risk committees and disclosing risk management structures and procedures.

The Committee discussed the active proxy voting season and Ms. Sandboe predicted that the activity level will increase in the coming year. The Committee also discussed questions posed to Barclays Global Investors (BGI) for additional analysis of the cost to the WSIB's securities lending program to have the unrestricted ability to recall shares out on loan. Staff will continue to research this topic and revisit the issue at the next Committee meeting.

Compliance Report

Ms. Matsumoto provided an overview of the WSIB's investment compliance program. Ms. Matsumoto explained that a compliance program has been established for the WSIB in Fixed Income, Public Equity, Private Equity, and Real Estate asset classes. A compliance program for Tangible Assets will begin to be developed in 2009. Fixed Income and Public Equity investments are monitored through JPMorgan's online compliance system. The system runs daily post-trade tests on our investments to ensure that they are in compliance. The WSIB compliance staff and Capital Dynamics staff conduct annual compliance testing on all Private Equity funds. She further indicated that the compliance testing is underway for Real Estate investments. In response to Chair Petit's inquiry, Ms. Matsumoto explained that the Compliance Unit is on track to complete planned testing in accordance with its 2008 testing schedule.

[The Audit Committee recessed at 10:20 a.m. and reconvened in open session at 10:36 a.m.]

Ms. Markoff provided an update to the Committee regarding a pricing error that occurred in the Bond Fund Friday, November 28. One of the bonds had an identifier (CUSIP) change occur due to a corporate action. The bond dropped from the pricing file for the day and was incorrectly priced at the issuance price. The pricing error was 2.7 cents per share. WSIB is analyzing the problem and will

implement corrective action to ensure the error does not occur in the future. This was the first time the WSIB had a material discrepancy in pricing of the Bond Fund.

Limited Liability Company (LLC) Structure Education Session

Ms. Whitmarsh introduced the LLC Structure Education Session, explaining that this overview is to provide the Audit Committee with an understanding of the LLC structure and controls. Ms. Markoff said that the LLCs provide a liability shield for the other assets managed by the WSIB, as well as the assets of the state, and are completely separate entities. The Board has authorized four LLCs during the past two years. These include the Global Co-Investment, LLC, Emerging Markets Fund-of-Funds, LLC, PBSC Holdings, LLC, and Tangible Co-Investments, LLC. The LLCs were formed as “single member” LLCs. Staff established procedures for the LLCs to ensure adequate oversight and controls are in place. All capital calls and distributions for the LLCs follow a similar process as other investments and are authorized by staff in accordance with the master custody trading authority. The Portfolio Administrator oversees the process, with the investment memorandum approved by the Executive Director, Chief Investment Officer, and Real Assets Senior Investment Officer. Expenses incurred by the LLCs are processed separately to maintain legal separation, but follow the same internal control structure as other investment expenses.

The Committee discussed the structure and controls in place for the LLCs. Mr. Dear emphasized that the Board approves each LLC and current compliance and control structures apply to the LLC activities once approved. Ms. Killman indicated this is an area that Internal Audit will be evaluating in the coming audit cycle.

Private Market Valuation Education Session

This agenda item will be addressed at the March 2009 meeting.

OTHER ITEMS

The Committee further discussed questions regarding the cost benefit the securities lending program in relation to having the ability to recall those shares to vote. Staff will continue to research this topic and revisit it at the next Committee meeting.

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