

**WASHINGTON STATE INVESTMENT BOARD**  
**Audit Committee Meeting Minutes**  
**March 3, 2009**

The Audit Committee met in open public session at 9:02 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present:           Mason Petit, Chair  
Steve Hill  
George Masten  
Jim McIntire  
Bob Nakahara

Other Members Present:               David Nierenberg (via telephone)

Absent:                                   Lisa Brown

Others Present:                       Theresa Whitmarsh, Acting Executive Director  
Gary Bruebaker, Chief Investment Officer  
Liz Mendizabal, Public Affairs Director  
Chris Green, Risk Analyst  
Shawna Killman, Internal Audit Director  
Carmen Matsumoto, Compliance Officer  
Rodney Reynolds, Internal Auditor  
Kate Sandboe, Corporate Governance Officer  
Beth Vandehey, Risk and Compliance Director  
Rita Wineinger, Administrative Assistant  
  
Brian Buchholz, Assistant Attorney General  
Jim Brownell, State Auditor's Office  
Warren Chen, Glass Lewis & Company

[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.

**ADOPTION OF THE DECEMBER 2, 2008, MINUTES**

**Mr. Masten moved to approve the December 2, 2008, Audit Committee meeting minutes. Mr. Hill seconded, and the motion carried unanimously.**

**EXTERNAL AUDITS**

**State Auditor's Office Fiscal Year 2009 Accountability Audit – Entrance Conference**

Mr. Brownell introduced Sarah Mahugh, who will be the auditor-in-charge of the Washington State Investment Board (WSIB) Fiscal Year 2009 Accountability Audit performed by the State Auditor's Office (SAO). Mr. Brownell indicated the audit will cover the period beginning July 1, 2008, and ending June 30, 2009. The audit was planned using a risk based audit approach and will cover the following areas: contracts, investment manager fees, securities lending, fixed income, private equity,

permanent funds, disbursements, and conflict of interest. For the statewide financial statements, the State Auditor will place reliance on the independent certified public accounting firm's audit of the WSIB prepared financial statements. Mr. Brownell indicated the Board has not had a finding from the SAO in 17 consecutive years. In response to Mr. Hill's inquiry, Mr. Brownell indicated the report will be presented to the WSIB in November or December of 2009.

### **Conflict of Interest Policy Update**

Ms. Whitmarsh explained staff undertook a review of the Conflict of Interest Policy with input from the Assistant Attorney General and is recommending revisions to the policy. Ms. Whitmarsh explained revisions include a transfer of duty for review of Board and staff adherence to the policy from the Attorney General's Office (AGO) to the SAO; clarifying language around guidelines for gifts, meals, and entertainment based on feedback received in annual ethics training sessions to Board and staff; and an update of the definition of "immediate family" as it pertains to PDC filing requirements and permissible investments to reflect societal changes and provide clarity to Board and staff. Mr. Dietrich further explained that conflict of interest review is a task that the AGO does not provide for any other agency and that although they will continue to provide legal advice through the review as necessary, this change will provide a more independent review.

[Treasurer McIntire arrived at 9:12 a.m.]

[Treasurer McIntire left the meeting at 9:14 a.m.]

**Mr. Masten moved to recommend that the Board adopt the proposed changes to Policy 2.00.100, Conflict of Interest. Mr. Hill seconded, and the motion carried unanimously.**

[Treasurer McIntire returned to the meeting at 9:20 a.m.]

### **INTERNAL AUDIT**

#### **Internal Audit Report 2009-02 – Trade Processing, Confirmation, and Settlement**

Mr. Reynolds presented the results of Internal Audit's review of trade processing, confirmation, and settlement at the WSIB. Mr. Reynolds indicated the overall assessment is good; procedures that ensure trades are processed, confirmed, and settled appropriately are strong; and there are no recommendations to report as a result of this audit.

Mr. Nakahara asked staff if a back-up plan is in place to continue business processes seamlessly if the custody bank were to fail. Ms. Killman replied that JPMorgan certifies their business continuance plan annually, the WSIB has a plan in place to address continuance in the event of an emergency, and the WSIB is better positioned to deal with this than other public pension funds given that the Board's investment accounting system also records investment transactions, independent of the custody bank.

In response to a question posed by Treasurer McIntire, staff will research what protection the WSIB has regarding any overnight monies with JPMorgan, as it is not a qualified public depository in the state of Washington, as well as if there is an exception to the public depository law that allows the WSIB to use JPMorgan.

**Mr. Hill moved to recommend to the Board approval of Internal Audit Report 2009-02, Trade Processing, Confirmation, and Settlement. Mr. Masten seconded, and the motion carried unanimously.**

## **Audit Recommendations Status Report**

Ms. Killman presented the Audit Recommendations Status Report. Since the last quarterly status report in December, five audit recommendations were resolved relating to the valuation of alternative investments, contract compliance monitoring, and Financial Control Systems. Staff continues to work on seven remaining audit recommendations.

## **MANAGEMENT**

Ms. Whitmarsh introduced the Risk and Compliance staff, who presented the following three agenda items.

### **Enterprise Risk Management Report**

Ms. Vandehey provided an overview of the agency's Enterprise Risk Management (ERM) program and key risk results for 2008. The ERM program includes a written framework, tools to capture risks, and a process for assessment, mitigation, and reporting. Ms. Vandehey described the 2008 accomplishments of the ERM team, which included an operational risk review and benchmark project. In 2009, the risk unit will primarily focus on establishing a framework for measuring risk for the total portfolio. Ms. Vandehey described the development process of the heat map in response to a question from Chair Petit. She explained that this process involves focus groups that are a representation of staff across the agency. She further explained the ERM team is made up of representatives from nearly every unit in the agency, the team meets regularly, and minutes are available on the intranet. The Committee discussed the tangible examples of how the organization has benefited from the ERM program.

### **Investment Risk Report**

Mr. Green presented the investment risk report. He described the types of risks to which the agency's portfolios are exposed, possible ways the risks can be quantified, the current and ideal level of understanding we would like to have on each risk and the plan for providing regular measurement and reporting going forward.

There are two primary challenges in implementing the quantitative risk program. First, all risks will require a transparent and clean portfolio-level data set. This challenge is being worked on by the data warehouse team with assistance from the risk and research units. The second challenge is staff and time. The WSIB only has one risk analyst at this time working with the larger risk team. This will limit the speed at which the program can report on all the risks. In 2009, the risk unit will focus most of its effort on quantifying market risk through calculating Value at Risk and providing concentration analyses.

The Committee discussed the resources dedicated to investment risk analysis; the current status of the data warehouse; and, the timing of the completion of data population in the warehouse.

### **Compliance Report**

Ms. Vandehey provided an introductory overview of the compliance program and explained that she oversees the public equity, fixed income, and asset allocation compliance program while Ms. Matsumoto is the compliance officer over the private equity and real estate compliance programs. In 2008 the fixed income portfolio was 100 percent in compliance with internal policies, the public equity active manager portfolios were 97.7 percent compliant, and the asset allocation was 90.9 percent compliant. The asset allocation breaches started around October 2008 during the market turndown.

All breaches are tracked on the JP Morgan on-line system and the Board has been made aware of the primary alerts during separate executive session meetings over the last few months. Ms. Vandehey then introduced Ms. Matsumoto. Ms. Matsumoto provided an update of the progress of the WSIB's private equity and real estate compliance programs. In 2008, 136 funds were tested, 133 of were found to be in compliance with the ten areas tested. Three general partners did not respond to inquiries. Testing areas for Private Equity included: capital calls, distributions, profit and loss allocation, management fees, valuations, investment restrictions, bridge financing, clawback liability, reinvestment of income, and cross-fund investing. Testing has been completed on our largest Real Estate investment and was found to be in compliance. Testing areas for Real Estate included capital calls, distributions, acquisitions, dispositions, profit and loss allocation, management fees, valuations, investment restrictions, clawback liability, and carried interest. The 2009 testing schedule includes testing of all active core portfolio funds for Private Equity, excluding funds with minimal or no activity; non-core portfolio funds if the investment team plans to continue a future investment relationship with them; and two Real Estate relationships.

The Committee discussed the testing levels, which include green, yellow, orange, and red. Each level requires more extensive follow-up with the general partners. Ms. Matsumoto said that as the Compliance staff delves deeper into understanding the underlying issues, additional questions arise for the general partners. Treasurer McIntire emphasized the importance of truly understanding the information and not taking the short answer. Mr. Nakahara questioned the interpretation of 98 percent compliance in Private Equity as a good result. Ms. Matsumoto explained that 98 percent was indeed a good result.

[Mr. Nierenberg joined the meeting via telephone at 10:30 a.m.]

[The Audit Committee recessed at 10:33 a.m. and reconvened in open session at 10:45 a.m.]

### **Private Market Valuation Education Session**

Ms. Whitmarsh explained that two years ago the outside auditing firm, Peterson Sullivan, recommended the WSIB become familiar with new standards for valuing alternative investments and put in place controls to ensure compliance with the new guidance from the American Institute of Certified Public Accountants. Ms. Logan provided an update to the committee on the progress of implementation of the program that meets the auditor's recommendations.

In 2006, the WSIB created a review/tracking system to ensure audited financial statements received timely reviews, and are consistent with the partner's valuation policy. The current practice documents the review and understanding of the investments, portfolio, strategy, method, and significant assumptions used to value the investments. Finally, Investment Accounting staff reviewed controls designed to ensure the alternative investment values reported in the financial statements are in accordance with accounting standards.

In 2007 and 2008, staff formed a valuation committee that meets quarterly; the Compliance Unit developed valuation policy manuals for both Real Estate and Private Equity that organize the relevant valuation documents from partnerships; general partner compliance with valuation policies tested; extensive discussions held with other limited partners to learn how they are handling valuation issues; and extensive discussions with our largest general partner to ascertain efforts towards compliance with FAS 157. A policy on Private Market Valuation was adopted on December 31, 2008. This policy indicates the WSIB relies primarily on the expertise of its investment managers to determine the fair value of their portfolios; and that the WSIB management understands that it is responsible for

reviewing and understanding the valuation framework used by general partners. Pursuant to our policy, we will adjust the valuation by our general partners if further information becomes available and it affects our TAP price.

Going forward, the auditors have recommended more documentation of oversight, review of financial information, and “challenging” values by the WSIB investment managers. The Committee discussed investment officer’s current participation in advisory committees. Mr. Bruebaker further commented that staff has actively participated in every general partner advisory committee that they will allow and have fully documented participation.

Mr. Nierenberg asked who has ultimate responsibility for making the valuation decision. Staff responded that the general partner makes the decision and the WSIB then has the role of oversight of fairness, the intelligence and consistency of the process by which the general partners do their job, rather than of the specific valuations themselves. Ms. Logan indicated staff will be exploring ways to validate the underlying assumptions that the general partners use. Mr. Bruebaker commented that the general partner is audited as well. Mr. Nierenberg opined that in the context of asset allocation responsibilities, both the Board and staff have different perspectives regarding valuation that could be acceptable. Mr. Nierenberg emphasized the need to have multiple, reasonable perspectives for different purposes in valuation.

[Mr. Nierenberg departed the meeting at 11:05 a.m.]

### **2009 Proxy Voting Season**

Ms. Sandboe introduced Mr. Chen, who provided a 2009 Proxy Voting Season preview. This preview included discussion on the credit crisis, risk management and TARP, executive compensation, and shareholder initiatives for 2009. In response to a question from Chair Petit, staff clarified that voting recommendations from Glass Lewis are based on Glass Lewis’ own guidelines and the WSIB policy guidelines.

### **OTHER ITEMS**

Chair Petit called the Audit Committee into executive session at 11:47 a.m. to review and discuss the performance of a public employee. He said the executive session was expected to last until approximately 12:05 p.m.

[The Audit Committee reconvened in open session at 11:54 a.m.]

There was no further business to come before the Committee and the meeting adjourned at 11:55 a.m.