

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
June 2, 2009

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
 Steve Hill (via teleconference)
 George Masten
 Jim McIntire
 Bob Nakahara

Absent: Senator Lisa Brown

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

 Brian Buchholz, Assistant Attorney General
 Ray Holmdahl, Peterson Sullivan PLLC
 Mark Raker, Peterson Sullivan PLLC
 Bob McCormick, 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 began the meeting and acknowledged there was not a quorum present. Members present discussed topics based on a consensus approach beginning at 9:08 a.m.

INTERNAL AUDIT

Audit Recommendations Status Report

Ms. Killman presented the Audit Recommendations Status Report. Since the last report in March, one audit recommendation was resolved and three expected completion dates were revised as a result of delays reported by external parties. Mr. Nakahara asked how comfortable Ms. Killman is with the revised completion date for the record keeper audits. Ms. Killman indicated the report is due any day and that she is comfortable with that.

EXTERNAL AUDITS

Information Services Board Security Policy Compliance Audit Report

Mr. Reynolds presented the Information Services Board (ISB) Security Policy Compliance Audit Report issued by the State Auditor's Office (SAO). This audit is required of all state agencies once every three years, and the SAO concluded the WSIB has complied, in all material respects, with the ISB requirements.

The Committee discussed the security of the WSIB's information systems. Mr. Mackison indicated that while the audit report does provide comfort, staff is always looking at ways to improve. In response to a question from Chair Petit, Mr. Mackison explained the WSIB had a vulnerability assessment in 2006, based on the annual internal audit risk assessment. Mr. Nakahara asked if the scope of this audit included the data warehouse. Mr. Mackison replied an application review of the data warehouse was not conducted during this audit; however, there is constant dialogue with the ISB to ensure security and application design is an ongoing process.

Chair Petit announced that consensus of the Committee was to forward the ISB Security Policy Compliance Audit Report to the Board for approval.

Financial Statement Audit – Approval of Scope of Work

As the Audit Committee is required to approve the scope of work for all external audit-related services, Ms. Killman presented a proposed Scope of Work for an annual Financial Statement Audit for a five-year period ending June 30, 2014.

[Treasurer McIntire arrived at 9:24 a.m.]

Chair Petit moved to approve the scope of work for an annual audit of the financial statements prepared by the WSIB for the five-year period ending June 30, 2014. Treasurer McIntire seconded the motion.

Chair Petit announced that a quorum of the Committee was present at 9:29 a.m. and roll call was taken.

The above motion carried unanimously.

Mr. Nakahara asked if there could be any consideration for providing comment regarding future accounting standards to the scope of work. Ms. Killman indicated this can be covered in the current scope of work.

Financial Statement Audit – Independence Statement Review and Appointment of External Auditor (Peterson Sullivan PLLC)

Ms. Killman indicated the previous contract for annual financial audit services has expired, so a request for qualifications and quotations was issued in March 2009. The evaluation team reviewed three firms' responses and unanimously selected Peterson Sullivan PLLC to recommend for appointment to the Audit Committee. She presented a written statement from Peterson Sullivan PLLC, confirming their independence from the WSIB to the Audit Committee, along with a list of services provided to the WSIB since the last audit. In response to a question from Mr. Nakahara about auditor rotation being considered, Ms. Killman indicated that although there is no rotation requirement for the Board's auditors, Sarbanes Oxley does require mandatory rotation of audit partners within accounting firms that

audit SEC registrants. She further indicated that an assessment regarding auditor independence is required annually by Audit Committee charter, so the Committee can continue its discussion of future audit partner assignments within the selected firm, in an effort to continue to be prudent.

Ms. Killman introduced Mr. Holmdahl and Mr. Raker, who gave a brief description of the firm. Mr. Holmdahl explained they understand using partner rotation to support independence. He also explained Peterson Sullivan has a second partner review each audit; however, should the Committee request partner rotation, their fees would not be adjusted as a result. Mr. Raker provided a brief description of the audit approach used by Peterson Sullivan PLLC. Treasurer McIntire asked if they have any other contracts with investment managers. Mr. Holmdahl indicated there are none with managers doing business with the WSIB. In response to a question from Mr. Nakahara, Ms. Killman indicated the other two firms considered were BDO Seidman and Clark Nuber. In response to a question from Mr. Nakahara, Ms. Killman indicated Peterson Sullivan PLLC had been auditing the WSIB's financial statements for three years and there is no question of their independence.

Chair Petit moved to appoint Peterson Sullivan PLLC to perform the Fiscal Year 2009 audit of the financial statements prepared by the WSIB. Treasurer McIntire seconded, and the motion carried unanimously.

ADOPTION OF THE MARCH 3, 2009, MINUTES

Treasurer McIntire moved to approve the March 3, 2009, Audit Committee meeting minutes. Chair Petit seconded, and the motion carried unanimously.

INTERNAL AUDIT

Internal Audit Report 2009-03 – Accounting, Pricing, and Unitization of the Commingled Trust Fund and Commingled Monthly Bond Fund

Mr. Reynolds presented the results of Internal Audit's review of accounting, pricing, and unitization of the commingled trust fund and commingled monthly bond fund at the WSIB. Mr. Reynolds indicated the overall assessment is good; procedures that ensure total market value, income, and expenses are accurately allocated to the various owner accounts are strong; and there are no recommendations to report as a result of this audit.

Chair Petit moved to recommend to the Board approval of Internal Audit Report 2009-03, Accounting, Pricing, and Unitization of the CTF and CMBF. Treasurer McIntire seconded, and the motion carried unanimously.

Internal Audit Report 2009-04 – Limited Liability Company Processes

Ms. Killman presented the results of Internal Audit's review of Limited Liability Company (LLC) processes, indicating the overall assessment was good and that the report includes two audit recommendations.

Recommendation 1: Legal Counsel

If the Board wishes to enhance the barrier between the LLC and the WSIB, staff should continue pursuit of a separate LLC contract for external legal counsel. Management agrees with the recommendation, and has engaged the Attorney General's Office (AGO) to determine the correct process for hiring direct counsel for the various LLCs.

Recommendation 2: Internal Policies and Procedures – Level 3

WSIB staff should finalize the internal accounting policies and procedures for the LLCs. Management agrees with this recommendation and will finalize the policies and procedures for LLC back office activities by June 30, 2009.

The Committee discussed the governance structure of the LLCs. Mr. Dietrich indicated these LLCs are formed through the Secretary of State's Office, and each has an LLC Agreement with specific operating policies referred to that govern the LLC. Ms. Whitmarsh explained the LLCs are single member LLCs, with WSIB as the sole member. This allows the LLCs to use WSIB staff and policies to support the functions of the LLCs. She also commented this structure provides flexibility and speed to the decision making process, within the guidelines provided by the Board.

Chair Petit moved to accept the Limited Liability Company Processes Internal Audit Report 2009-04, and forward it to the Board for approval. Treasurer McIntire seconded, and the motion carried unanimously.

Fiscal Year 2009-2010 Internal Audit Plan

Ms. Killman presented Internal Audit's Fiscal Year 2009-2010 Internal Audit plan. Project selections were made using a rigorous risk assessment process. Internal Audit met with each unit and facilitated the assessment of the risk factors for each of the potential audit areas. From this process, five areas were selected: Custodian Bank Operations; Private Equity Investments; Real Assets Investments; Stakeholder Reporting and Information Requests; and Real Estate Consultant. In accordance with the Institute of Internal Audit Standards, Ms. Killman confirmed to the Committee that WSIB Internal Audit has been free from interference in determining the scope of its internal audits, performing their work, and communicating the results of their audits. A review of the Fiscal Year 2008-2009 Internal Audit results was presented and discussed. Mr. Nakahara thanked Ms. Killman and Mr. Reynolds for providing an excellent quantitative and qualitative tool.

Chair Petit moved to recommend that the Board adopt the Fiscal Year 2009-2010 Internal Audit Plan. Treasurer McIntire seconded, and the motion carried unanimously.

[The Committee recessed at 10:12 a.m. and reconvened in open session at 10:27 a.m.]

[Mr. Masten arrived at 10:27 a.m.]

MANAGEMENT

Corporate Governance Planning

Ms. Mendizabal explained that staff is planning a comprehensive review and discussion of the WSIB's Corporate Governance program at the Board's off-site planning session in July. The information presented today is intended to set the stage for that discussion by re-familiarizing the Board with the current program, and discussing how scope of the program has grown since it was created four years ago. Ms. Whitmarsh introduced staff from Glass Lewis & Co., who are available to answer questions if necessary.

Ms. Sandboe gave a general overview of the Corporate Governance program, including two graphs from the 2008 Proxy Voting season that showed the total number of votes cast on proxy proposals and specifically how the WSIB voted in board of director elections. In response to a question from the Chair, Bob McCormick, chief policy officer for Glass Lewis, explained the difference between a vote

“for,” a vote to “withhold,” and a vote “against” a board director. Mr. McCormick also discussed Senator Charles Schumer’s proposed “Shareholder Bill of Rights Act of 2009,” which was introduced in the Senate. Treasurer McIntire asked if the WSIB has a policy on participating with other pension funds to support these types of proposals. Ms. Sandboe indicated there is not a policy, although these are issues that are in the WSIB’s proxy voting guidelines. Staff has not, however, gone the next step in taking other action. Mr. Hill commented referred to the Target proxy fight and said this type of shareholder activism is not always without cost and may not be in the best interest of the WSIB. Ms. Sandboe explained that on the Target issue the WSIB, based on Glass-Lewis analysis, did not support the dissident view and voted with management.

Ms. Whitmarsh explained the reason this topic has been brought to the Committee is to get a sense of direction regarding the level of involvement the Committee is comfortable with. She also indicated this is an area where the WSIB should be thoughtful and careful with the good reputation that it has developed over time. Treasurer McIntire said that while we do not want to be media hounds, we should take a leadership role in shaping policy. He also asked if we are dealing only with publicly traded companies, which are one portion of our portfolio; or do we have an oversight process for Real Estate and Private Equity. Mr. Masten indicated this should happen when we are deciding to make the investment or not. Ms. Mendizabal also commented this is part of the decision to invest and the ongoing monitoring.

[Steve Hill left the teleconference at 10:57 a.m.]

Mr. Masten commented that impact on returns should be the primary consideration in considering any expansion of the Corporate Governance program.

Ms. Whitmarsh explained that the range of corporate governance activities that the WSIB is being asked to engage in is very broad. It might be useful to begin to think about bucketing activities into areas that have a short-term impact that is measurable versus a long-term impact that may have less obvious benefits and then decide where on the spectrum of activities the Board wants to engage.

Mr. Masten indicated he does not believe the WSIB should get involved in political activism.

Ms. Whitmarsh said the agenda for the July off-site planning meeting will include a presentation by the Executive Director of the Council of Institutional Investors, a panel presentation by staff and the CEO of Glass Lewis & Co., and also any input from the Audit Committee in response to this presentation. The July meeting will include a discussion on the next steps for the WSIB and its corporate governance program.

[Steve Hill rejoined the teleconference at 11:14 a.m.]

Enterprise Risk Management Scenario Analysis

Ms. Vandehey and Mr. Mackison presented a summary of staff’s risk review of the custodian bank services, as requested by the Committee during the March 3, 2009, meeting. The Public Deposit Protection Act applies to the custodian bank, but the WSIB’s assets are exempt. Except for cash waiting to be swept to the external Short Term Investment Funds and the end of day sweeps of cash, the WSIB’s assets are protected. They do not appear as assets or liabilities on the custodian’s balance sheet, are segregated from other deposit accounts, and are not subject to claims by creditors. In response to a question from Mr. Masten, Mr. Mackison indicated if the bank failed, the daily amounts to be swept to external and end of day vehicles could be at risk for loss, depending on the action of the

bank regulator. The average daily amounts swept to those vehicles were approximately \$630,000 in May 2009.

The likelihood of the custody bank failing is assessed by staff as low. The custodian bank under contract with the WSIB is one of the largest banks in the industry and it continues to have the highest credit rating among banks and the government continues to rely upon them. The highest impacted areas of WSIB operations would be custody of assets, trade processing, and investment services for active managers. Staff will research options to mitigate the risks associated with a custody bank failure.

Daily Valued Funds Annual Report

Ms. Markoff presented the daily valued funds annual report. She reported one material error on the Bond Fund Pricing and four immaterial errors in 2008. This report will continue to be brought to the Audit Committee each year. However, the Board will continue to be notified of any error that impacts the unit price by more than the tolerance level, \$0.01/unit. In response to Mr. Nakahara's question, Ms. Markoff indicated the Savings Pool error was discovered by the record-keeper.

OTHER ITEMS

Chair Petit asked the Committee to consider the idea of adding meetings to the annual schedule, as the agendas have become more robust. Treasurer McIntire and Mr. Masten indicated they would prefer to participate in additional meetings as requested by the Chair, rather than adding meetings to the annual schedule.

There was no further business to come before the Committee and the meeting adjourned at 11:26 a.m.