

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
December 1, 2009

The Audit Committee met in open public session at 9:04 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Mason Petit, Chair (via teleconference)
Steve Hill (via teleconference)
George Masten
Treasurer Jim McIntire (via teleconference)
Bob Nakahara

Other Board Members Present: David Nierenberg (via teleconference)
Judi Owens

Absent: Senator Lisa Brown

Others Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Shawna Killman, Internal Audit Director
Kris Logan, Investment Accounting Controller
James Mackison, Director of Technology and Innovation
Kate Sandboe, Corporate Governance Officer
Rita Wineinger, Administrative Assistant
Marie Repcik, Administrative Assistant

Steve Dietrich, Assistant Attorney General
Jim Brownell, State Auditor's Office
Ray Holmdahl, Peterson Sullivan PLLC
Sarah Mahugh, State Auditor's Office
Bob McCormick, Glass Lewis & Company (via teleconference)
Mark Raker, Peterson Sullivan PLLC
Jeff Thompson, Glass Lewis & Company

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

Mr. Masten, Acting Chair, called the meeting to order at 9:04 a.m. and roll was taken.

APPROVAL OF THE SEPTEMBER 1, 2009, AND NOVEMBER 19, 2009, MINUTES
Chair Petit moved to approve the September 1, 2009, Audit Committee meeting minutes. Mr. Masten seconded, and the motion carried unanimously.
Chair Petit moved to approve the November 19, 2009, Audit Committee meeting minutes. Mr. Hill seconded, and the motion carried unanimously.

[Treasurer McIntire joined the meeting via teleconference at 9:07 a.m.]

EXTERNAL AUDITS

State Auditor's Office Fiscal Year 2009 Accountability Audit Report

Ms. Mahugh presented the 2009 Accountability Audit Report for the WSIB, which covered the period beginning July 1, 2008, and ended June 30, 2009. The areas examined included contracts, investment manager fees, securities lending, fixed income, private equity, permanent funds, disbursements, and agreed upon procedures for Conflict of Interest Policy compliance.

Ms. Mahugh also explained that the Board has several accounts material to the state's basic financial statements, and the state auditor relied upon the certified public accountants' audit of the Board's account balances and financial activities. No audit findings were reported for the Fiscal Year 2009 audit, marking the eighteenth consecutive year that the WSIB has had no audit findings.

Mr. Masten moved to recommend Board approval of the WSIB July 1, 2008 – June 30, 2009, State Auditor's Office Accountability Audit Report. Mr. Petit seconded, and the motion carried unanimously.

Conflict of Interest Compliance Review and Personal Investment Reports

Ms. Mahugh presented the results of the 2008 Conflict of Interest Policy compliance review. This was the first year that the State Auditor's Office performed the annual review, which was previously performed by the Attorney General's Office. Exceptions were identified where travel requests did not have prior approval, or were not properly dated; and three approved purchase of investments reports filed by Board members were not reported on the members' respective annual F-1 reports. Ms. Whitmarsh indicated that steps have already been taken to ensure these types of exceptions were not noted in the future.

Fiscal Year 2009 Independent Financial Auditors' Reports

Ms. Logan presented the Fiscal Year 2009 financial statements, which were prepared by staff in the Investment Accounting unit and are the ultimate responsibility of WSIB management. Ms. Logan explained the process for completion of the financial statements and the recent procedural changes. Based on prior year auditor recommendations, the management discussion and analysis (MD&A) sections were expanded to provide more detail on material balance changes, and valuation procedures over private equity and real estate were improved.

Ms. Logan introduced Mr. Holmdahl and Mr. Raker who presented the independent audit reports of the Fiscal Year 2009 financial statements. Mr. Raker and Mr. Holmdahl provided an overview of Peterson Sullivan's experience, explaining that this year marks the fourth year they have audited the WSIB financial statements. Mr. Holmdahl discussed new accounting pronouncement FAS157, regarding how fair value should be determined, but explained that this is not a requirement of the WSIB. He opined that in the next year there may be additional requirements related to FAS157 for the WSIB.

Mr. Raker concluded in each case that the financial statements were presented fairly, in all material respects. The auditor found that recommendations from the prior year were implemented and the financial data was complete and disclosures were written with much more clarity. The auditor did not issue a management letter for new or repeat deficiencies in internal control and did not propose

any adjustments to the 2009 financial statements. Mr. Nakahara asked why the MD&A addresses two years but the audit itself covers only one. Mr. Holmdahl explained that in order to address both years in the audit report would have been cumbersome in that both sets of financial statements would have been included.

Mr. Masten moved that the Committee recommend Board approval of the Fiscal Year 2009 Independent Financial Auditors' Reports. Mr. Hill seconded, and the motion carried unanimously.

INTERNAL AUDIT

Internal Audit Report 2010-01 – Custody Bank Operations

Ms. Killman presented the Custody Bank Operations internal audit report. This is the first audit of JPMorgan Chase Bank (JPM) since the WSIB transitioned from State Street Bank in October 2007. The audit covered three cities and 15 audit areas. The overall audit assessment was good, and the report contains five recommendations to strengthen controls.

1. **JPM Communications:** JPM should continue to work to provide more timely responses to the inquiries of WSIB staff.
JPM Response: JPM acknowledged that the WSIB experience with their operating model has been difficult and cumbersome. JPM has presented a new client service model which includes additional staff with a comprehensive understanding of JPM's organizational structure
2. **Scope Limitation:** JPM should allow WSIB access to records for audit purposes in accordance with the custody contract agreement, specifically in the areas of corporate audit, subcustodian network management and business continuance planning.
JPM Response: JPM acknowledged that contract language allows WSIB staff and auditors access to JPM's systems pertaining to services utilized by WSIB, and they will work with internal partners to afford access for future audits. JPM will follow-up with a letter outlining what accommodations can be made to meet this contractual obligation.
- 3a. **Master Custody Trade Authority:** JPM staff responsible for signature authentication and call-backs for WSIB trades submitted via FAX should be adequately trained on the proper use of the WSIB's Master Custody Trading Authority
JPM Response: JPM agrees and will ensure staff responsible for signature authentication and call-backs are adequately trained.
- 3b. **Master Custody Trade Authority:** WSIB staff should monitor JPM SAS 70 audit reports to identify risks for follow-up as necessary.
WSIB Management Response: This recommendation will be implemented.
4. **JPM SAS 70 Audit Coverage:** JPM should work with its external auditors to ensure that the unique processes followed in providing services to the WSIB are tested as part of their SAS 70 reports.
JPM Response: JPM Pricing Unit will explore having the BGI pricing input process included in their SAS 70 objectives in the upcoming audit period, and the Private Equity Fund Services is looking to provide a SAS 70 specific to their line of business by March 2010.

[David Nierenberg joined the meeting via teleconference at 9:55 a.m.]

5. Fixed Income Trade Affirmation: The WSIB should ensure fixed income trades are affirmed.

WSIB Management Response: Once made aware that JPM was not affirming fixed income trades, staff began work to determine which trade affirmation process would be most efficient. A decision will be made and implemented by June 30, 2010.

Committee and staff discussion ensued regarding the audit recommendations. Mr. Nakahara asked if the internal business units at the WSIB were having similar communication problems with JPM. Ms. Killman explained that this has been an ongoing since the contract outset. Ms. Whitmarsh asked Mr. Mackison to speak to this question, as he has taken over this relationship monitoring. Mr. Mackison explained that this has been an ongoing problem and he believes communication has improved gradually and monthly meetings to identify issues and then escalate to appropriate levels have been established. The Committee discussed the communication issues in more detail and the alignment of incentives. Ms. Whitmarsh explained the compensation associated with the custody bank contract is through securities lending. Mr. Bruebaker added that JPM also receives fees from any of the WSIB partners that elect to use their services for foreign exchange, as well as cash management fees. The Committee discussed other ways to pursue communication improvements with JPM, including discussions at a higher level within the organization.

In response to a question by Mr. Nakahara, Ms. Killman explained that the issues noted in recommendation 3a were not pervasive problems noted during the audit, but rather were isolated incidents that highlight an overall need for JPM training. Ms. Owens asked whether the signature authentication was not being completed. Ms. Killman explained that JPM staff had verified the wrong signature, although the appropriate signature was documented.

The Committee requested they receive updates on these issues at each Audit Committee meeting until adequately resolution is achieved.

Audit Recommendation Status Report

Since the last quarterly status report in September, three audit recommendations were resolved related to the Financial Control Systems and Limited Liability Company Audits. There is one recommendation remaining that is scheduled to be completed by March 31, 2010.

MANAGEMENT

2009 Proxy Voting Report and 2010 Season Preview

Ms. Sandboe introduced Mr. Thompson and Mr. McCormick, who joined the meeting via teleconference. Ms. Sandboe explained that for the first 10 months of the year the WSIB voted a total of 3,481 proxies. Proxy votes were cast on a total of 25,075 individual proxy proposals dealing primarily with election of directors, ratification of auditor, compensation plans, and shareholder proposals. In the election of directors, the WSIB withheld our vote from about 20 percent of the directors seeking re-election. The primary concerns were lack of independence; compensation practices that suggest boards are not always fulfilling fiduciary duties; and directors who sit on an excessive number of boards. This year, the WSIB also voted in favor of 75 “say on pay” proposals,

which would allow shareholders an advisory vote on executive compensation plans. Ms. Sandboe explained that for the upcoming proxy voting season, the WSIB's top priority issues continue to be majority voting for directors and controlling executive compensation, primarily through shareholder proposals for "say on pay."

Mr. McCormick discussed regulatory developments, proxy access, advisory vote on compensation, shareholder initiatives, and trends in corporate governance. Mr. McCormick indicated there are many regulatory developments that will affect the 2010 proxy season, to include: compensation restrictions for TARP companies; advisory vote on compensation; shareholder access to management proxy; elimination of broker vote; majority voting for directors; separation of chairman and CEO, declassified boards, Senator Dodd's bill, and Delaware's proposal for dual record dates. Proxy access changes proposed by the SEC would allow shareholders to nominate candidates for seats on company boards. Advisory vote on compensation was discussed, which is required now at more than 300 companies that accepted TARP funds. The results have been that no company has yet lost such a say-on-pay vote and support at certain large companies ranged from 63.5 percent of votes cast at Motorola Inc. to nearly 98 percent at Goldman Sachs Group Incorporated. Mr. McCormick also presented a list of likely 2010 shareholder initiatives, which include: vote "no" campaigns against directors, compensation, governance, environmental concerns, and social issues.

Referring to the fact that the WSIB voted against 390 proposed compensation plans, Mr. Nakahara asked whether we prevailed in any of those votes. Ms. Sandboe explained the WSIB voted against 100 more compensation plans than in the previous year. She believes that when a high number of votes are received against the compensation plans, a clear message is sent to the company management. Mr. Nierenberg and Treasurer McIntire agreed with Ms. Sandboe's assessment. On another Corporate Governance issue, Treasurer McIntire requested the WSIB's engagement efforts with companies doing business in Iran and Sudan be discussed at the January Board meeting.

OTHER ITEMS

Ms. Whitmarsh announced that Ms. Wineinger, who has staffed the Audit Committee for close to five years, is taking a new position with Employment Security. Ms. Whitmarsh said that Ms. Wineinger has done a phenomenal job of supporting this Committee and will be missed.

There was no further business to come before the Committee and the meeting adjourned at 10:51 a.m.