

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
March 2, 2010

The Audit Committee met in open public session at 9:03 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Steve Hill, Chair
Bill Longbrake
George Masten
Treasurer Jim McIntire (Acting Chair)
Bob Nakahara
Mason Petit

Committee Members Absent: Senator Lisa Brown

Others Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Shawna Killman, Internal Audit Director
James Mackison, Director of Technology and Innovation
Alicia Markoff, Portfolio Administrator
Beth Vandehey, Risk and Compliance Director
Carmen Matsumoto, Compliance Officer
Rodney Reynolds, Internal Auditor
Kristi Haines, Executive Assistant

Steve Dietrich, Assistant Attorney General
Chuck Callahan, JPMorgan
John Geronimo, JPMorgan
Kevin Garrity, JPMorgan

[Names of other individuals attending the meeting are listed in the permanent record.]

Mr. Masten called the meeting to order and took roll call. A quorum was not present, so he elected to take the agenda out of order.

MANAGEMENT

Investment Compliance Report

Ms. Vandehey reported the compliance program is managed by two internal staff and covers 80 percent of assets under management. The remaining assets are commingled or indexed, for which compliance activities are not possible. The program relies on support from external managers, including JPMorgan, Capital Dynamics, and a pool of vendors for Real Assets.

Ms. Vandehey said JPMorgan assists with compliance of approximately 50 percent of assets covering Public Equity, Fixed Income, Asset Allocation, Securities Lending, and Cash Overlay. There is a variety of tests run across multiple funds each day. During 2009, compliance was 100 percent within Fixed Income, 99.7 percent within Public Equity, and 93.33 percent within Asset Allocation. She added that Securities Lending and Cash Overlay compliance activities began mid-year 2009.

[Treasurer McIntire arrived at 9:05 a.m.]

Mr. Nakahara commented on the rate of compliance with Asset Allocation rules. Mr. Bruebaker said staff reported monthly to the Board on issues stemming from the market downturn. The compliance matter cleared in August 2009.

Ms. Matsumoto reported on Private Equity and Real Assets compliance. During 2009, 60 Private Equity funds were tested and all found in compliance. Capital Dynamics has dedicated staff to assist WSIB with Private Equity compliance. Within Real Assets, all six funds were tested and full compliance achieved after some issues were worked through. She reported that Real Assets compliance has been monitored in-house, but will be expanded in 2010 to include compliance testing by a pool of five firms individually contracted by the WSIB. She listed program testing areas performed in 2009, and plans for 2010.

Mr. Petit said it is good to resolve issues, but he is concerned it takes staff contact to ensure compliance. In response to Treasurer McIntire's question, Mr. Bruebaker said staff reviews and tracks contract expectations with relationships. Mr. Petit asked if staff had found any contract terms the WSIB had not complied with. Ms. Whitmarsh said issues are occasionally identified by compliance staff and immediately addressed. Mr. Petit said the compliance program is valuable and he appreciates staff's work.

Enterprise Risk Management Report

Ms. Vandehey introduced the 2010 risk management report. The WSIB began building its enterprise risk management (ERM) program over six years ago—long before it became a focus for most organizations. She said one of the primary focuses is to create a culture within the agency where risk discussion is safe. Ms. Vandehey reports annually to the Audit Committee as it has assigned responsibility for risk oversight.

Ms. Vandehey reviewed the evolution of risk management. The WSIB defines risk as the effect of uncertainty on objectives, and risk management is the coordinated activities to direct and control an organization with regard to risk—to make sure bad things do not happen and ensure good things do happen. While risk management has evolved over the last 30 years, the development of assessing and managing risks agency-wide came under development about 7 years ago. This approach assists with consideration of potential impact of all types of process, activity, stakeholder, service, and reputation risks. The WSIB has been very strategic in its risk management and is a leader among other public funds.

Ms. Vandehey described the WSIB's risk governance structure and framework. There is a separation between those who manage and measure risk. She detailed Board and executive management oversight, portfolio risk, risk management and reporting areas, and tools. One important tool is the ERM team itself, which is comprised of senior representatives of each asset class and Operations division. The ERM team developed a framework of key risk categories through outlining agency activities to manage assets, manage the organization, and safeguard its reputation. Risk areas in managing assets are fiduciary and investment risk; organizational managements risk include strategic, governmental and environmental, and operational risks; and safeguarding reputation combines all risk areas and WSIB's success in managing those. She then described tactical risk management activities in the front and middle office.

One of the most effective risk tools used by risk management last year was Rick Funston's Enterprise Survival and "Thrival"[™] Skills. Ms. Vandehey presented discussion and analysis

examples of how WSIB incorporated Mr. Funston's steps into its risk management processes. Another risk tool used annually to analyze operational activities is the heat map. She described the heat map tool which helps to define focus areas, with areas of most concern falling within the upper right quadrant where management effort is essential. She reported the highest scoring core business processes are investment reporting and portfolio management; and highest scoring risks are third-party vendor and information. Ms. Vandehey said the ERM team also conducts scenario analysis, and discusses and compares WSIB's situation with current risk issues.

Ms. Vandehey reported on the WSIB's new quantitative risk program. Across the industry, risk management is being redefined, similar to what WSIB is doing as an agency to improve its program and seek partners to fully integrate processes. The WSIB program reports to the Chief Operating Officer. Within the past year, WSIB has hired a quant staff member, two information technology programmers to support risk systems, and a risk analyst within the Asset Allocation unit. Staff plans to report on Market Risk (total portfolio concentration analysis) in June and, depending on risk system availability, Value at Risk (VaR) before year end.

Other goals for the risk program detailed in the 2010 Strategic Plan include Board risk education and reporting, building out the infrastructure to support the risk initiative, and continued development of the risk framework.

Mr. Mackison gave an update on the data warehouse system. He said the system is producing concentration analyses, but data is still being analyzed and scrubbed. Commingled fund data has been loaded. Ms. Whitmarsh said a real estate data integrator was just hired to collect, map, and format data from general partners for entry into the system.

Treasurer McIntire welcomed Mr. Longbrake as a new Audit Committee member.

In response to Mr. Longbrake's question, Ms. Vandehey said staff plans to conduct an analysis on the recent market crisis once data is available in the data warehouse system. Noting the quantitative risk program presentation material (page 23, second bullet point under the first sub-section) quoting the MSCI Barra survey, Mr. Longbrake suggested any plan for risk management staff to develop investment management expertise and offer "investment advice" could compromise oversight responsibilities.

Mr. Nakahara asked if the risk approach had resulted in better investment decision-making. Mr. Bruebaker pointed out the recent work on private equity concentration risk. He said staff is making good progress and getting good value from the ERM program. Ms. Whitmarsh identified Investment and Operations staff serving on the ERM team.

APPROVAL OF THE DECEMBER 1, 2009, AND DECEMBER 17, 2009, MINUTES

Mr. Masten moved to approve the December 1, 2009, and December 17, 2009, Audit Committee meeting minutes. Mr. Petit seconded, and the motion carried unanimously.

INTERNAL AUDIT

Internal Audit Report 2010-02 – Private Equity

Mr. Reynolds presented the Private Equity internal audit report. He reported the overall assessment was good. The report found that general partners have adequate procedures over deal sourcing, due diligence, monitoring and valuation; financial statements are audited by reputable firms; and a

strong framework is in place to address risks associated with use of “placement agents.” Internal Audit has one recommendation to further strengthen controls.

Mr. Reynolds said the audit included on-site visits of seven general partners, representing 33 percent of total potential exposure of the Board’s private equity portfolio. He detailed the on-site fieldwork conducted in deal sourcing, due diligence, monitoring, valuation, and audit firm areas. Internal Audit also conducted research around placement agents due to recent “pay to play” concerns in other states.

[Mr. Hill was in attendance via teleconference at 9:52 a.m.]

Mr. Reynolds said internal audit recommendations are ranked on a 1-3 scale, with 1 as the highest risk category (immediate action required) and 3 as the lowest (minor issue noted; process or control should be strengthened). Internal Audit identified a level 3 recommendation during the private equity audit relating to investment contacts and referrals. He said the Board may wish to develop a contact and referral policy or process that formalizes a consistent approach with regard to investment opportunities that come to the WSIB through a wide variety of channels. Management agreed it would perform research and bring back options for consideration if requested by the Committee.

Mr. Masten said his understanding of the current process is opportunities currently arise from staff and consultant activities researching the private equity universe, as well as some referrals from external solicitations received by Board members, which are then referred on to the Executive Director and/or Chief Investment Officer for consideration. He asked if there are issues with the current process. Mr. Reynolds said a few other funds have more consistent processes on how investments are referred, which reduces any misperception of pressure that could result from trustee follow-ups with staff. Ms. Killman said there have been no problems historically at the WSIB. The level 3 recommendation is intended to be forward-looking, in light of recent media reports in other states and questions raised by the State Auditor’s Office on WSIB practices. She believes it would well serve the Board to document and clearly communicate its referral process. Ms. Whitmarsh said the current process is any Board member referrals she receives are forwarded to Mr. Bruebaker and he ensures she is aware of any referral he receives. These are then passed onto the appropriate Senior Investment Officer for assessment.

A discussion ensued on the need for a policy, the current process, and reason. Ms. Killman said the recommendation was made in an effort to be a little more transparent. She noted some organizations track follow-up communications on referrals as well. Chair Hill said a tabulation of referrals would be a good thing to do. Mr. Masten said putting a policy into place would not change the environment. Staff would still need to make tough calls despite who initiates referrals. Mr. Longbrake pointed out the Board’s Conflict of Interest Policy is extremely thorough, and he feels it adequately covers any potential issues. He believes the recommendation was possibly made, in part, due to recent issues with other states. He suggested staff respond with how to better deal with the public relations issue. Chair Hill and Treasurer McIntire agreed. Ms. Whitmarsh said staff would document its current procedure and come back to the June Audit Committee meeting with a description of best practices. Chair Hill said the Committee would then consider whether to recommend a Board policy.

Audit Recommendation Status Report

Ms. Killman presented the quarterly Audit Recommendations Status report, which includes custodian bank recommendations from December. Ms. Killman said Committee members had

expressed concerns with communications and records access issues reported during the internal audit. She said JPMorgan representatives were present to discuss resolution of outstanding issues and respond to Committee questions. Mr. Mackison, the WSIB's relationship manager for the JPMorgan contract, was also present for the discussion.

Status Update on Outstanding Recommendations for Custodian Bank Audit

In response to communications issues, Mr. Geronimo said JPMorgan had implemented a new client service model in September 2009 to add additional levels of support to the on-site representative. JPMorgan suggested this model should assist with navigating their large organization and ensure inquiries are addressed within a shorter timeframe. Mr. Callahan said the structure connects the multiple areas within JPMorgan the WSIB interacts with. A weekly inventory call among JPMorgan staff has been in place since September. Ms. Whitmarsh said quarterly meetings between staff and JPMorgan were recently re-instituted. Ms. Killman said Internal Audit would determine how well the service model is working and report back at the June Audit Committee meeting.

In response to issues with subcustodian and corporate audit access issues, Mr. Geronimo reported a recent change in process related to limited scope of the subcustodian network. JPMorgan will allow "view only" access to Internal Audit by July 2010. Ms. Killman said "view only" access is acceptable for audit purposes.

Mr. Hill noted a third internal audit recommendation relating to corporate audit information for which WSIB is seeking additional access. Mr. Geronimo said the issue remains at impasse and JPMorgan is working to find an acceptable solution for both parties. He outlined two possible scenarios to resolve the issue involving third-party confirmation. Mr. Callahan said JPMorgan acknowledges the issue must be resolved quickly and in a manner sufficient to the Committee; however, the issue involves confidentiality of proprietary information.

Treasurer McIntire read aloud from the JPMorgan contract with the Office of the State Treasurer relating to internal audit access. He noted this issue was raised last May and continues to this day. He noted similar issues in another state and their custodian bank, creating serious concerns with fiduciary responsibility. He said the WSIB has every reason to be concerned that contracts are not breached. Ms. Whitmarsh asked Mr. Callahan for JPMorgan to resolve the issue prior to the June 1 Audit Committee meeting.

Ms. Killman noted the status of additional custodian bank recommendations are detailed in the Committee materials.

MANAGEMENT

Daily Valued Funds Annual Report

Ms. Markoff presented the annual Daily Valued Funds report. There was one immaterial error occurring during 2009. She reported that a security in the Bond Fund was entered incorrectly, causing it to accrue one day less of interest (\$1,006.94) each day from February 3, 2009, to August 1, 2009. She said there was no impact to the closing unit price. Ms. Markoff said the Bond Fund has approximately \$587 million in assets.

[The Committee took a brief recess at 10:30 a.m., and reconvened in open session at 10:48 a.m.]

[Mr. Hill was no longer in attendance via teleconference at 10:48 a.m.]

OTHER ITEMS

Nonvoting Board Member Nomination Process

Ms. Whitmarsh introduced the nonvoting Board member discussion on behalf of Chair Hill. She relayed he intends to engage members in an examination of nonvoting Board member processes. Staff prepared a list of discussion items, including: (1) whether the Audit Committee is the appropriate Committee for such a discussion, (2) the role of nonvoting Board members, (3) desirable qualifications, (4) nomination and selection processes, and (5) appropriate term lengths. Treasurer McIntire invited member comments.

Mr. Petit said the outcome of the recent nonvoting Board selection process was great. He hopes that any recommended changes would not result in unnecessary steps to reach a successful outcome. Mr. Longbrake shared his perspective as the recently appointed nonvoting member. He noted the process outlined in the Committee materials from 1993 was followed for the most part, but he believes a more formalized time schedule and public notice may be worthwhile. Treasurer McIntire concurred.

Mr. Masten said he preferred the Committee not address all of the outlined issues today. He noted that fiduciary counsel's memos and legislation clearly state that voting members select nonvoting members and he believes the function should be moved to the Administrative Committee. He shared he would like the Board to closely examine the role of nonvoting Board members.

[Mr. Hill arrived at 10:58 a.m.]

Treasurer McIntire summarized the Committee discussion for Chair Hill. Chair Hill said it makes sense to move the function to the Administrative Committee and for that Committee to select which matters to address.

Mr. Masten moved the Audit Committee recommend the Board amend Audit Committee Charter 1.00.130 by striking, on page 5, “nominate candidates for the nonvoting positions of the Board” and renumber the remaining section; and move the verbiage to Administrative Committee Charter 1.00.120. Mr. Petit seconded, and the motion carried unanimously.

Internal Audit Director Annual Evaluation

Treasurer McIntire announced the Committee would go into executive session to review and discuss the performance of a public employee. He said the executive session was expected to last approximately 5 minutes, at which time the Committee would reconvene in open session and adjourn.

[The Committee went into executive session at 11:03 a.m., and reconvened in open session at 11:21 a.m.]

There was no further business to come before the Committee and the meeting adjourned at 11:21 a.m.