

**WASHINGTON STATE INVESTMENT BOARD**  
**Audit Committee Meeting Minutes**  
**December 4, 2012**

The Audit Committee met in open public session at 9:00 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Committee Members Present: Steve Hill, Chair  
Senator Lisa Brown (teleconferenced)  
Bill Longbrake  
George Masten  
Treasurer James McIntire  
Bob Nakahara  
Natasha Williams (teleconferenced)

Other Members Present: David Nierenberg (teleconferenced)  
Judi Owens

Others Present: Theresa Whitmarsh, Executive Director  
Victor Moore, Chief Operating Officer  
Gary Bruebaker, Chief Investment Officer  
Liz Mendizabal, Institutional Relations Director  
Shawna Killman, Audit Director  
Rodney Reynolds, Internal Auditor  
Kate Sandboe, Corporate Governance Officer  
Kris Logan, Investment Accounting Controller  
James Mackison, Innovation and Technology Director  
Phil Paroian, Senior Investment Officer  
Patty Davis, Administrative Assistant

Steve Dietrich, Attorney General's Office  
Bob McCormick, Glass Lewis & Company  
Martha Carter, Institutional Shareholder Services  
David Larsen, Duff and Phelps  
Steve Nebb, Duff and Phelps  
Mark Raker, Peterson Sullivan LLP  
Ray Holmdahl, Peterson Sullivan LLP

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

Chair Hill called the meeting to order and took roll call.

**ADOPTION OF THE SEPTEMBER 20, 2012, MINUTES**

**Mr. Masten moved to approve the September 20, 2012, minutes.  
Ms. Williams seconded, and the motion carried unanimously.**

## **AUDIT RECOMMENDATIONS STATUS REPORT**

Mr. Reynolds presented the Audit Recommendations Status Report. All items have been resolved, and there are no outstanding audit recommendations.

Ms. Whitmarsh commended staff as this was the first time that all outstanding audit items were completed. Chair Hill requested Mr. Mackison explain the vulnerabilities of the South Carolina system as they relate to security. He responded the breach began with phishing emails that were improperly responded to by staff. The WSIB continues preventative diligence and training to protect the WSIB's systems. There are no absolutes in preventative measures.

[Treasurer McIntire arrived at 9:33 a.m.]

Mr. Nakahara inquired about the cycle of required testing. Mr. Mackison replied the requirement was for an independent audit and vulnerability assessment every three years. He explained there was a benefit to perform these on a more frequent cycle. Mr. Mackison stated that he intends to manage the program on an ongoing basis. Mr. Longbrake suggested that annual testing is considered best practice.

## **INTERNAL AUDIT REPORT #2013-02 BUDGET MANAGEMENT AND REVENUE TRANSFERS-IN**

Mr. Reynolds presented the Budget Management and Revenue Transfers-in audit report. Internal Audit concluded expenditures are properly classified as appropriated or non-appropriated, revenue transfers-in covering WSIB monthly operating costs are properly allocated across stakeholder accounts, budget-to-actual reports provided to the Administrative Committee and executive management are accurate, and concerns of budget overspending are identified in a timely manner. The audit report contains no recommendations.

## **INTERNAL AUDIT REPORT-2013-01 PUBLIC EQUITY MANAGER MONITORING**

Ms. Killman presented the Public Equity Manager Monitoring audit report. Internal Audit found that policies and procedures established by the WSIB to monitor the performance of external managers hired to invest public equity assets on behalf of the Board are in place, operating, and considered adequate to ensure investment managers are monitored in accordance with applicable WSIB policies; and the report contains no recommendations.

Ms. Williams inquired about the review process for underperforming managers and follow-up review of action taken for consistency and appropriateness. Ms. Killman indicated that Board policy dictates action by staff, and manager termination is approved by the Board. Mr. Paroian added that staff is not authorized to terminate independently, and all decisions are thoroughly evaluated.

Mr. Longbrake inquired whether staff reviews investment manager procedures, or their independent auditor's reports. Ms. Killman indicated that prior to hiring a manager the WSIB Investment Accounting Controller and Public Equity staff review the investment manager operations to assure controls are adequate. Ms. Whitmarsh added that on an ongoing basis audit reports on control procedures at the managers are submitted to WSIB and reviewed by Portfolio Administration staff. Mr. Paroian explained that annual financial statement audit reports and management letters regarding controls are considered by many managers as proprietary.

## **ANNUAL PLAN STATUS REPORT**

Ms. Killman presented the status update on the Audit Annual Plan. The Trade Processing, Confirmation, and Settlement audit was moved back one quarter, to accommodate resource needs as liaison on the Conflict of Interest policy compliance review.

## **CONFLICT OF INTEREST POLICY 2.00.100 REVISION**

Staff implemented a recommendation made by the State Auditor's Office that Board members and staff certify in writing, upon appointment and annually thereafter, that they have read and will comply with the Board's Conflict of Interest Policy 2.00.100. The proposed revisions to the policy reflect this current practice.

**Mr. Masten moved to recommend the Board adopt the proposed revisions to the Conflict of Interest Policy 2.00.100. Treasurer McIntire seconded, and the motion carried unanimously.**

## **2012 PROXY SEASON VOTING UPDATE**

Ms. Sandboe introduced Mr. McCormick, Glass Lewis & Company, and Ms. Carter, Institutional Shareholder Services (ISS). Ms. Sandboe presented an overview of the WSIB's U.S. voting record for the 2012 proxy voting season.

Between January 1, 2012, and October 31, 2012, the WSIB voted a total of 3,307 proxy ballots. Proxy votes were cast on a total of 28,724 individual proxy proposals dealing primarily with election of directors, ratification of auditor, compensation plans, and shareholder proposals.

For the upcoming proxy voting season, the WSIB's top priority issues will be monitoring executive compensation, primarily through advisory votes on compensation plans, supporting shareholder proposals on proxy access, annual election of directors, and encouraging greater board diversity.

Mr. McCormick discussed corporate governance trends and "hot button" issues for the 2013 U.S. proxy voting season. The big issues for 2013 are director compensation (say on pay), proxy access, political contributions, greater Board diversity, separating the roles of CEO and Chairman, and majority voting.

Discussion ensued around Board turnover and concern was voiced about director and member tenure. Mr. McCormick indicated that very few directors fail to get a majority vote. Long-term shareholder definition was discussed, and many studies of that issue and its impacts are ongoing. Mr. Masten expressed concern regarding money managers that trade frequently, effectively making them short-term investors. This creates conflict with our position of being a long-term investor.

Mr. McCormick noted that proposals allowing shareholders to nominate candidates to serve on Boards, commonly referred to as proxy access, was a new governance trend in 2012 and that we will likely see an increase in proposals next year. Mr. Longbrake inquired of Ms. Sandboe what guidelines are in place regarding proxy access. Ms. Sandboe indicated that she reviews those ballots and generally supports shareholder access to the ballot, following the guidance of Glass Lewis and ISS.

Mr. Masten inquired if this has an impact on public companies going private. Mr. McCormick stated that it may affect the way they go public, so that it preserves their control.

### Global Equity Proxy Voting

Ms. Sandboe explained that staff had initially explored different options for voting international proxies, but determined that due to limited funding and staffing resources, it was too complex and difficult to manage. That resulted in retaining ISS to perform a proxy voting audit to review how global equity fund managers voted on our behalf and compare their votes with the WSIB's guidelines on international proxy issues. This is their first report on that effort.

Ms. Carter related that there are four primary proxy issues. They are Board independence, Board diversity, compensation, and related party transactions. Those priorities in the WSIB's guidelines are consistent with global trends. The key takeaways are to try to manage and reduce voting conflicts, refine voting policy, and look ahead with a strategy to develop relationships within the WSIB's existing global network for collective action.

There was discussion about the amount of voting conflict between the WSIB's managers. Ms. Sandboe responded this might be a subject worth discussing with fund managers. She indicated that she would be doing further research into the matter. Ms. Whitmarsh indicated the audit was requested as a way to gain information for the Committee and to hear feedback from members on next steps.

Ms. Mendizabal clarified for members that WSIB's global equity fund managers are not required to vote the WSIB's non-U.S. proxies according to the WSIB's international proxy voting guidelines. When the guidelines were adopted in 2011, the Board agreed to allow fund managers to vote per *their* guidelines. This audit was to compare *their* votes to *our* guidelines. The information gives staff the detail they need to determine what, if any, follow-up is needed with fund managers.

[The Committee recessed at 10:48 a.m., and reconvened in open session at 10:58 a.m.]

### **ALTERNATIVE ASSET VALUATION POLICY REVIEW**

Ms. Logan introduced Messrs. Larsen and Nebb, Duff and Phelps. Ms. Logan informed members the WSIB hired Duff and Phelps through a competitive selection process to provide consulting services for alternative asset valuation.

Mr. Larsen reviewed the projects included in the review. Project 1 was to review and document WSIB alternative asset valuation policies and procedures and provide recommendations for improvement. Project 2 was to review general partner valuation policies and procedures to determine the overall quality of the valuations received by the WSIB.

The scope of the review for Project 1 included the following tasks:

- Read, studied, and commented on the existing WSIB valuation policy;
- Interviewed key members of WSIB investment, internal audit, and operation teams concerning valuation policy, procedures and processes;

- Interviewed key members of third-parties engaged by WSIB to perform reporting, due diligence, audit, and compliance functions;
- Reviewed documentation relevant to WSIB valuation process and procedures;
- Documented existing WSIB valuation process and procedures; and
- Provided WSIB management with suggested policy, procedure, and process enhancements to improve best practice.

Mr. Larsen reported that the WSIB is considered within the top-tier of limited partnerships (LP). He presented several recommendations for improvements for both Projects 1 and 2.

## Project 1

### *Private Equity*

In future LP agreements, consider including a requirement for general partners (GPs) to comply with IPEV Valuation and Investor Reporting Guidelines. Formalize a process whereby private equity staff report to the WSIB Valuation Committee significant valuation matters identified from participation on advisory committees, other meetings, discussions and correspondence. Finally, enhance current processes by monitoring significant underlying holdings for publically disclosed transactions. Document the results and incorporate into the monthly valuation process. Holdings deemed “significant” will be determined by WSIB staff, but could potentially include the Top 20 holdings by GP reported fair market value. Currently, initial public offerings and bankruptcies are reviewed on a passive basis. GPs could be asked to provide transaction information on significant transactions on a timelier basis; i.e. throughout the quarter as opposed to quarter end.

### *Real Estate*

Review GP quarterly correspondence and reporting ensuring that investment managers report quarterly fair value information. Ensure that appraisal values, if used, represent fair value. If Real Estate staff does not agree that recent appraisals are representative of fair value, these appraisals should not be utilized. Real Estate staff should be involved in the appraisal process, and WSIB management should provide oversight. WSIB should consider selecting an independent third-party appraiser to supplement appraisals contracted by GPs if manager provided appraisals do not represent fair value. To the extent practical, standardize valuation templates and methodologies provided and used by managers of real estate operating companies.

Mr. Larsen suggested that the need for an independent real estate appraisal is dependent on the quality of the investment manager valuation process and the availability of objective valuation inputs. If the investment manager’s process is dynamic and effective, appraisals may be redundant and may not add value. If the investment manager’s valuation process is not deemed sufficient or the investment is complex and fair value is difficult to determine, appraisals or independent assessments of value may provide additional insight and would be recommended on a periodic basis (potentially annually). Mr. Larsen explained other WSIB functions and third-party roles.

### *Investment Manager Valuation Policy Review*

Mr. Larsen suggested that compliance should review investment manager valuation policies for consistently determined fair value of investments. Knowledge and expertise of external third-parties will be utilized as appropriate.

Mr. Larsen also had suggested improvements for directional benchmarking of private equity cross-holdings. When investment manager reported values are directionally inconsistent, inquiries should be made to determine the basis for these inconsistencies, and WSIB should document why or why not the reported value requires adjustment. He suggested that Hamilton Lane perform an analysis and report on the materiality of cross-holdings going forward. Hamilton Lane may use expected value benchmarks to test the reasonableness of GP valuations and to ensure directional consistency. These benchmarks will also be used to determine, where appropriate, potential in-phase adjustments.

Mr. Larsen felt that for an exit value comparison analysis, the WSIB should request fund managers provide an analysis of last reported fair value compared to exit value on a regular basis. Alternatively, the WSIB alternative investment teams should develop a process to actively track individual portfolio company realizations and compare realized values to last reported fair value estimates. Back testing provides additional evidence about the robustness of the managers fair value estimates. He further suggested that GPs managing existing investments could be asked to provide this information. It could also be requested in future partnership agreements. Hamilton Lane has indicated that this analysis will be performed going forward.

### PROJECT 2

The scope of the review for Project 2 included the following tasks:

- Read, studied, and commented on the existing valuation policy for WSIB's investment managers for fair value compliance;
- Interviewed key members of investment, finance, and operation teams for a sample of WSIB's investment managers concerning valuation policy, procedures and processes; and
- Provided WSIB's management with feedback concerning the degree to which each of the investment managers interviewed by Duff and Phelps implement their stated valuation policies and demonstrate that they report fair value in accordance with Accounting Standards Codification (ASC) 820.

Mr. Larsen explained the review of valuation policies and investment manager interviews.

For 88 investment managers, Duff and Phelps reviewed the documentation provided by investment managers to WSIB to understand each investment manager's policies and procedures for determining fair value. As part of this process, they considered relevant topics, including, but not limited to: quality and involvement of the investment manager's audit firm; use of a third-party reviewer in the valuation process; frequency of valuations; the valuation methods and inputs considered and utilized; valuation standard with which the investment manager complies (ASC 820, International Private Equity and Venture Capital Valuation Guidelines (IPEV), Private Equity Industry Guidelines Group (PEIGG), etc.); and the role of each investment manager's internal staff within the valuation process.

After consultation with WSIB, Duff and Phelps interviewed 33 Investment Managers (representing 39.9 percent of portfolio assets as of second quarter 2012) to verify that documented valuation policies and procedures were being followed. During these interviews, they discussed relevant topics with each manager's valuation team such as the description of the manager's valuation process, the role of auditors and third-party reviewers, the use of a third-party reviewer in the valuation process, the valuation methodology of any non-standard instruments (such as derivatives), and documentation provided to LPs.

Mr. Larsen described the review and assessment of the underlying managers' valuation policies. The policies fell into three categories: 1) Policies that, if followed as stated, should result in ASC 820 compliant fair value; 2) Policies that, if followed as stated, may not be fully compliant with ASC 820; and 3) Policies that, if followed as stated, would not result in ASC 820 compliant values. The investment managers were coded green, yellow, and red accordingly.

Mr. Larsen noted that a review of the policy alone cannot determine if the underlying investment manager's fair market value based on net asset value is robustly determined. If the policy is found to be compliant with ASC 820, the procedures must also be deemed to adhere to the policy in order to produce a robust fair market value based on net asset value.

Mr. Larsen further explained that for overall investment manager ratings, 89.9 percent of WSIB's assets are invested with investment managers that received a green rating, 10.0 percent received a yellow rating; and 0.2 percent received a red rating.

Mr. Larsen described the ratings for private equity investment managers. Based on their analysis, 94.8 percent of WSIB's are invested with investment managers that received a green rating, 4.9 percent received a yellow rating, and 0.3 percent received a red rating.

Mr. Larsen described the ratings for real estate investment managers. Based on their analysis, 79.8 percent of WSIB's real estate assets under management (AUM) are invested with investment managers that received a green rating, 20.2 percent received a yellow rating, and no real estate investment managers received a red rating.

Mr. Larsen stated that all of WSIB's tangible asset AUMs are invested with investment managers who were received a green rating.

Mr. Larsen further explained that of the 88 valuation policies reviewed, the most common weaknesses were found to be (most frequent to least): a valuation on a semi-annual or annual basis rather than quarterly; limited data regarding valuation was provided to limited partners; material reliance on an advisory committee comprised of LPs as a cross check for efficacy of investment valuations could lead to trouble maintaining LP status with too much influence on valuations; investments are marked to the valuations only if there is a material change in value from the previous quarter, or are marked to a number other than estimated fair market value; data collected from portfolio companies was not thoroughly tested or

confirmed (trends versus actuals); back-testing considered but not formal or institutionalized; and having a bias toward holding at cost for a prolonged period.

Treasurer McIntire inquired about establishing fair value for the sale of limited partnerships. Mr. Larsen explained that it was very difficult to determine, given the many variables involved. Net asset value represents the exact amount of cash received on the date of a sale, and becomes a very good proxy for value on what you received.

Mr. Longbrake commented on Neil Pearson's empirical research study regarding monthly change in net asset value of alternative assets. The study suggested that there could be a systematic fudging of reporting of values. That could be an issue for the WSIB. However, you need to test the data to determine if that is occurring. Mr. Longbrake suggested the WSIB could replicate the study to see how the distribution returns appear.

Members discussed the differences between Governmental Accounting Standards Board (GASB) and Financial Accounting Standards Board (FASB) valuation definitions.

Mr. Masten suggested that fair market value is an estimate. The actual value of an asset will not be known until the asset is sold. Mr. Longbrake reiterated that the consistency of reporting was important.

Treasurer McIntire inquired if the new GASB rules on valuing pension funds affect this definition of fair market value. Mr. Larsen replied that he didn't believe it would.

Chair Hill requested that staff report back with an update at the next Committee meeting. Ms. Logan advised that responses and action plans to the recommendations presented by Duff and Phelps are available for review. Project 1 recommendations are in process. There is disagreement on real estate appraisal valuations, and the Valuation Committee will be addressing that issue. The implementation plan will be a lengthy process. Staff are developing reports to facilitate monitoring and establish benchmarks. Ms. Logan indicated that staff would report back to the Committee either annually or biannually. Full compliance is on a 2-year cycle. Chair Hill requested that the Committee be updated on the implementation during the 2-year process. Ms. Whitmarsh confirmed that an update would be given to the Committee at the June meeting.

#### **INVESTMENT REFERRALS QUARTERLY REPORT**

Ms. Whitmarsh offered the information for the members' reference. There were four new referrals. One was referred to the Request for Qualifications and Quotations for Audit Service Provider Pool and the remaining four continue to be evaluated by the investment team. Ms. Whitmarsh indicated the referral process is working well and provides transparency for the WSIB.

#### **DAILY VALUED FUND POLICY REVISION**

Staff recommends that the schedule for trading and valuing the Daily Valued Funds (DVF) be moved from the New York Stock Exchange (NYSE) to the Bond Market. The NYSE was selected when the DVF included equities, and equities are

no longer part of the DVF. Short-term cash was clarified as an investment vehicle in the Savings Pool, and is not a change of asset allocation. Other minor clarifying and grammatical edits were also proposed.

**Mr. McIntire moved to recommend the Board adopt the proposed revisions to the Daily Valued Fund Policy 2.14.300. Mr. Masten seconded, and the motion carried unanimously.**

#### **FY 2012 INDEPENDENT FINANCIAL AUDITORS' REPORT**

WSIB Policy 1.00.130 states that the Audit Committee will review the results of the WSIB financial statement audit and approve the audit report. Ms. Killman introduced Messrs. Holmdahl and Raker, Peterson Sullivan LLP. The Audit Committee appointed Peterson Sullivan LLP to perform the fiscal year 2012 financial statement audit, which involves statements for each category of funds under management by the WSIB. The funds are: Retirement Funds; Labor and Industries' Funds; Permanent Funds; Other Funds; Guaranteed Education Tuition Fund; and Developmental Disabilities Endowment Trust Fund.

The independent auditors' reports, along with the respective financial statements prepared by management, were reviewed. 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 2012 financial statements.

Mr. Holmdahl informed members that they use FASB guidelines for alternative asset valuations, in the absence of guidance from the GASB.

**Mr. Masten moved that the Audit Committee recommend the Board approve the FY 2012 Independent Auditors' Reports. Mr. McIntire seconded, and the motion carried unanimously.**

#### **CONFLICT OF INTEREST POLICY COMPLIANCE REVIEW**

WSIB Conflict of Interest Policy 2.00.100 requires that an annual review of Board and staff compliance be conducted by an independent external auditor. The Board appointed Peterson Sullivan LLP to conduct the review for calendar year 2011. The review included statements of financial affairs reporting, gift reporting, travel paid for by outside sources, personal investments, and periodic training.

During 2012, Board members filed 21 approval requests for acquisition of investments reports. All requests were approved. The Executive Director had no investment purchases rising to the reporting criteria level of the Conflict of Interest Policy.

There were three findings relating to travel expenses paid for directly by outside sources. One business class flight was not allowable, the meals for one WSIB staff trip were paid by the manager and the employee was also reimbursed for the same meals, and exceptions to maximum allowable per diem lodging costs for six hotel stays were not properly documented, in accordance with the Office of Financial Management (OFM) rules.

Mr. Moore presented management's response. Management has determined that all future air travel, whether paid by WSIB or outside sources, will be booked by WSIB staff, allowing greater control and documentation of both domestic and international travel.

Management will clarify with OFM for the appropriate use of the various travel exceptions that may be required. They will instruct travelers to request travel, whenever possible, at least two weeks prior to departure. They will instruct the travel desk staff to have adequate traveler information on lodging and itineraries to determine if exceptions are necessary, or when alternative accommodations are necessary to comply with OFM policy. Finally, during annual ethics training, OFM policies regarding travel and per diem allowances will be highlighted. Mr. Moore also indicated training will stress the importance of using a check or credit card when paying for travel expenses for tracking purposes.

[Mr. Nierenberg joined by teleconference at 11:55 a.m.]

Chair Hill stated he believes the WSIB should pay directly for all travel expenses, rather than allow investment managers to pay for WSIB staff travel for those charged with monitoring the managers. This would avoid the appearance of a conflict of interest, and the WSIB should not be putting its investment officers in that position.

#### **EXECUTIVE SESSION - DISCUSSION WITH EXTERNAL AUDITORS**

Chair Hill stated the Committee would go into executive session to discuss financial and commercial information relating to an investment since public knowledge regarding the discussion would result in loss to the funds managed by the WSIB or would result in private loss to the providers of the information. The executive session was expected to last approximately 15 minutes, at which time the Committee would reconvene in open session.

[The Committee went into executive session at 12:00 p.m., and reconvened in open session at 12:15 p.m.]

Chair Hill expressed that he has enjoyed serving as the Audit Committee Chair, and commended staff for their support of him in that role.

There was no further business to come before the Committee, and the meeting adjourned at 12:16 p.m.