

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
March 4, 2014

The Audit Committee met in open public session at 9:01 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Committee Members Present: Joel Sacks, Chair
Arlista Holman
Bill Longbrake
George Masten
Bob Nakahara

Members Absent: Treasurer James McIntire
Senator Sharon Nelson

Others Present: Victor Moore, Chief Operating Officer
Gary Bruebaker, Chief Investment Officer
Liz Mendizabal, Institutional Relations Director
Shawna Killman, Audit Director
Rodney Reynolds, Internal Auditor
Alicia Markoff, Portfolio Administrator
Kate Sandboe, Corporate Governance Officer
Beth Vandehey, Risk and Compliance Director
Jen Edwards, Compliance Officer
Mary Hougan, Administrative Assistant

Mary Lobdell, Attorney General's Office
Jonathan Floyd, Hamilton Lane
Yovanka Bylander Arroy, Institutional Shareholder Services Inc.
Edward Kamonjoh, Institutional Shareholder Services Inc.
Bob McCormick, Glass Lewis & Co.

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

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

Chair Sacks began the meeting by recognizing Joe Dear's contribution to public service, as well as his time at the WSIB as a member and Executive Director. Chair Sacks stated Mr. Dear was an excellent leader, mentor, role model, and friend. He will be greatly missed. A moment of silence was taken in Mr. Dear's memory.

ADOPTION OF THE DECEMBER 3, 2013, MEETING MINUTES

Mr. Masten moved to approve December 3, 2013, Audit Committee meeting minutes. Ms. Holman seconded, and the motion carried unanimously.

INTERNAL AUDIT

Internal Audit Report 2014-06 Stakeholder Reporting

Mr. Reynolds presented the results of the Board's stakeholder reporting audit. Overall results showed stakeholder reports are accurately presented and adequately supported, related control procedures are in place and operating as intended and reports required by state statute and Board policy are prepared timely.

The report contained one audit recommendation to expand the quarterly investment performance report review process to include independent verification of information obtained from investment staff. Management agrees with the recommendation and procedures will be implemented to address concerns raised by April 30, 2014. Internal audit will follow-up and report the status of corrective action at the next quarterly Audit Committee meeting.

Chair Sacks asked about the reporting level of the recommendation. Mr. Reynolds explained the investment performance information identified as not independently verified was isolated, resulting in a lower level recommendation.

[Mr. Longbrake arrived at 9:07 a.m.]

Audit Recommendation Status Report

Ms. Killman reported the status of follow-up activities related to prior audit recommendations. Over the last quarter, one of three recommendations was resolved. Hamilton Lane received an independent review of information technology (IT) system controls the WSIB is relying upon, with no relevant exceptions noted. Hamilton Lane will continue to have the independent review of IT controls, with results reported to the WSIB on a biennial basis.

Two recommendations in progress from the Real Estate Intermediaries and Operating Companies audit were summarized, along with expected completion dates.

Mr. Nakahara asked about the level of control WSIB will have in the back-office reviews conducted at the intermediaries. Ms. Killman indicated the Compliance unit will establish a program and monitor results.

Chair Sacks asked how the back-office recommendation will be implemented and followed-up on once the corrective action has been implemented. Ms. Killman informed the Committee the ongoing monitoring program implemented by staff will be reviewed by her area when real estate audited, the current cycle is once every three years unless a need arises to review sooner.

Audit Plan Quarterly Status Report

Ms. Killman presented the Audit Plan Quarterly Status Report. She reported the investment performance and stakeholder reporting audits were combined, and presented earlier today by Mr. Reynolds. The custody bank audit has been moved back one quarter, due to preparation for the peer review, as well as the strategic project on real estate governance.

MANAGEMENT

Investment Compliance Overview and Results for 2013

Mdmes. Vandehey and Edwards presented the annual Investment Compliance Report. Ms. Vandehey stated the Public Asset compliance results, which include public equity and fixed income for 2013 were positive. Compliance with investment policy and investment manager contract guidelines had a few minor exceptions in fixed income and securities lending.

Chair Sacks asked how contract guidelines are determined. Ms. Vandehey said investment staff negotiates the guidelines and the compliance unit monitors the restrictions through the on-line daily compliance tool.

Ms. Edwards reported on WSIB's Federal Compliance Reporting. Compliance serves as a central location in the WSIB for applicability and oversight of filings to ensure consistent and accurate reports. The WSIB has filed quarterly holdings of listed securities to the Securities and Exchange Commission (SEC) since third quarter in 2011. The SEC collects information to protect investors and maintain efficient markets.

The Federal Reserve Bank collects information to carry out monetary policy and protect consumers' rights. The WSIB files two monthly and one annual filing that report foreign purchases, sales and holdings of short and long-term securities by asset class to the Federal Reserve Bank.

Ms. Edwards reported on the Private Markets compliance results for 2013. Private markets is monitored through a compliance program developed in-house by the WSIB and completed by outside consultants such as Hamilton Lane for private equity and KPM for real estate and tangible assets. Ms. Edwards stated Hamilton Lane would review the private equity results next. For the other assets, 16 investments are currently being tested. This includes 11 real estate and five tangible asset investments. She noted the only compliance issue revealed in 2013 for real estate was an annual plan that did not have written signatory approval by all board members as required by the limited liability company agreement. The WSIB staff member on the advisory board approved the plan but signatures were not available from the partner.

Hamilton Lane Private Equity Compliance Consultant Report

Mr. Floyd gave an overview of WSIB's private equity compliance program. This program includes comprehensive assessment, testing, and monitoring. It is a three-step process, beginning with risk assessment, followed by compliance analysis and testing, and concluding with ongoing monitoring of significant findings.

Mr. Floyd reported one compliance exception related to management fees discovered by WSIB. As a result of the finding, WSIB received approximately

\$5,000 back in the form of a one-time management fee credit. He stated continued areas of focus are claw-backs, valuation, and management fees.

Mr. Longbrake asked if there is a check for accuracy on valuation policies and best practices. Mr. Floyd stated a questionnaire specifically on their valuation policy is issued every year and the process is very collaborative with the partners. He also said Hamilton Lane conducts site visits.

Mr. Nakahara asked about the accountability of any reporting discovery to management and how much reliance do you place on their external auditors. Mr. Floyd said the issue was discussed with the general partners. They refunded the management fees and then discussed with their auditors.

Mr. Nakahara asked if the auditors should have discovered the management fee discrepancy. Mr. Floyd stated it comes down to materiality. Financial auditors focus their efforts on material risk and the numbers the WSIB are working on may not be material to the fund auditor.

Mr. Floyd reviewed the upcoming testing plan for 2014. He noted 100 funds in the Private Equity Portfolio were selected for testing. The funds were selected using a risk-based approach. All funds managed by general partners with compliance violations will also be tested.

Enterprise Risk Management – Annual Review and Update

Ms. Vandehey gave an overview of the WSIB Enterprise Risk Management (ERM) program. The purpose of the ERM team is to ensure WSIB has a comprehensive policy and framework for an effective risk management program.

Ms. Vandehey explained the ERM key risk framework. She noted the framework has three categories, managing the assets, managing the organization, and safeguarding our reputation. Within these categories are six key risks each with its own risk appetite statement.

Ms. Vandehey summarized the ERM teams risk activities for 2013. These included developing the ERM risk forecast and mitigation activities for 2013, conducting two scenario analysis discussions, and completing the operational heat map assessment. She explained the operational heat map review is periodically conducted to have staff assess and discuss the risks and internal controls, in 13 core process areas. She stated the results are reported to executive management and used in strategic planning.

[The Committee took a recess at 10:20 a.m., and reconvened in open session at 10:30 a.m.]

2013 Year-End Proxy Voting Report and 2014 Update

Ms. Sandboe introduced Ms. Bylander and Mr. Kamonjoh of Institutional Shareholder Services (ISS) and Robert McCormick, of Glass Lewis & Co. Ms. Bylander began the presentation by noting that ISS specializes in proxy voting, securities class actions, and protects reputational risk.

Mr. Kanonjoh reviewed the WSIB's international equity managers' proxy voting activity. He said the review was conducted using ISS' standard proxy voting guidelines as the benchmark against which to compare the voting practices of the WSIB's eight international equity managers. He noted the evaluation metrics consist of board quality, economic factors, compensation, and shareholder rights.

Mr. Kanonjoh reported the overall alignment with ISS's recommendations range from 89 percent to 100 percent and the overall alignment with company management's recommendations range from 88 percent to 97 percent. He said the voting activity of WSIB's international investment managers is generally aligned with WSIB's proxy voting policy in each of the categories reviewed. The equity managers are not uniformly voting with company management's recommendations, which suggest that equity managers are employing a measure of discernment when making corporate governance-related voting decisions. He also noted that some managers are voting more consistently with management than others.

Mr. Nakahara inquired if there is a maximum amount of boards that directors can serve on. Mr. McCormick stated full-time executives should serve on no more than three boards and part-time executives should serve on no more than six boards.

Chair Sacks asked whether ISS is driving corporate decision-making. Mr. Kanonjoh stated ISS' policy generally reflects the governance viewpoint of its clients.

Ms. Sandboe presented the voting record for the 2013 proxy voting season. She said the WSIB voted a total of 3,501 proxy ballots. Proxy votes were cast on a total of 31,073 individual proxy proposals dealing primarily with election of directors, ratification of auditor, compensation plans, and shareholder proposals. There were a total of 21,196 director votes and WSIB voted against or withheld on more than 2,480 nominees. She said WSIB took action on 54 proposals regarding the adoption of majority voting for the election of directors, and voted in favor 100 percent of the time.

Ms. Sandboe reviewed the executive compensation proxy voting. There were a total of 780 compensation plans proposed and WSIB voted against 204. The WSIB voted against more than 357 compensation committee members for paying excessive compensation.

Ms. Sandboe noted WSIB voted against 337 of the 2,204 management proposals regarding an advisory vote on executive compensation. She stated this was primarily due to failures to align pay with performance. Ms. Sandboe reported the continued focus on key issues for 2014 will be advisory vote on executive compensation, shareholder proposals seeking to adopt majority voting for director elections and seeking board declassification, board diversity, and board responsiveness to the 2013 shareholder votes.

Mr. Longbrake asked if we are considering discussion with boards that received a negative vote on the excessive compensation pay. Ms. Sandboe said the WSIB would like to engage more with companies on this issue.

Mr. McCormick gave an overview the upcoming 2014 proxy voting season. There have been several regulatory changes since the Dodd-Frank Wall Street Reform and

Consumer Protection Act (Dodd-Frank Act) was adopted. One of the requirements pending will require companies to disclose all compensation data. He said most companies have already implemented strict independent procedures and hired independent compensation consultants.

Mr. McCormick noted a frequent shareholder proposal is on political contributions. The focus is on companies involved in trade organizations and how financial resources of trade organizations are being used.

Mr. McCormick noted shareholder activists are looking at more strategic proposals in 2014. He said engagement between companies and shareholders has increased significantly in recent years and that while there has been growth in the number of campaigns, the number of settlements with activists has increased as well.

Sudan, Iran Resolutions Update

Staff notified the Audit Committee that the Sudan and Iran investment resolutions had expired as of December 31, 2013. Staff will continue to monitor the political situation in both countries and engage with companies as necessary.

Investment Referrals Quarterly Report

Mr. Moore reported there were three new referrals, one which was deemed not a fit and two that are under review by staff.

Daily Valued Funds Annual Report

Ms. Markoff explained that the Board's Daily Valued Funds (DVF) Operation Policy requires staff to report annually to the Audit Committee all errors. She reported there were no errors above the tolerance level that impacted the Savings Pool or the WSIB Bond Fund's closing unit prices. Ms. Markoff noted there was one immaterial error that occurred in the WSIB Bond Fund's net asset value due to a corporate action. The par value was incorrectly transferred to the new notes and for one day the value of the WSIB Bond fund was undervalued by \$0.007 per unit. The error was identified and the fund was corrected the next day.

Daily Valued Funds Operations Policy 2.01.300 Revision

Ms. Markoff said the DVF policy has been updated to include the new DVF U.S. TIPS Fund, which is now being managed internally by the WSIB Fixed Income unit.

Ms. Holman moved that the Audit Committee recommend the Board approve the revisions to Policy 2.14.300. Mr. Masten seconded, and the motion carried unanimously.

EXTERNAL AUDIT

Financial Statement Audits – Scope of Services and Auditor Appointment

Ms. Killman indicated the five-year financial statement audit service contract the WSIB had with an external audit firm expired on December 31, 2013.

Management would like to engage Peterson Sullivan LLP to perform the independent audit of the Board's fiscal year 2014 financial statements. This is based on the firm's audit experience, qualifications of the proposed auditors, and quality of previous performance. She noted an additional consideration this year is the Board's transition to a new accounting book of record, effective July 1, 2013. A

competitive procurement for a multi-year financial statement audit contract will be conducted for fiscal year 2015.

The Committee discussed auditor independence, and reviewed the scope of services proposed.

Ms. Holman moved that the Audit Committee recommend the Board appoint Peterson Sullivan LLP to perform the fiscal year 2014 independent financial audits. Mr. Masten seconded, and the motion carried unanimously.

Conflict of Interest Policy Compliance Review – Scope of Services and Auditor Appointment

Ms. Killman explained the Board established an external audit service provider pool in September 2012, with three firms under optional-use contracts available to perform project work related to compliance audit services. The WSIB released a Project Work Request for this review in February 2013, with all three firms responding. Based upon an evaluation panel review of the responses and fees proposed, staff would like to hire Peterson Sullivan LLP to perform the 2013-2016 Conflict of Interest Policy Compliance Reviews.

Ms. Holman moved that the Audit Committee recommend the Board appoint Peterson Sullivan LLP to perform the calendar years 2013, 2014, 2015, and 2016 Conflict of Interest Policy Compliance Review. Mr. Masten seconded, and the motion carried unanimously.

There was no further business to come before the Committee, the meeting adjourned at 11:57.