

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
September 9, 2014

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 Southwest, Olympia, Washington.

Committee Members Present: Joel Sacks, Chair
Arlista Holman
Bill Longbrake
Treasurer James McIntire (teleconference)
Bob Nakahara
Senator Sharon Nelson

Members Absent: George Masten

Others Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Victor Moore, Chief Operating Officer
Liz Mendizabal, Institutional Relations Director
Shawna Killman, Audit Director
Ashley Lillie, Audit Intern
Kate Sandboe, Corporate Governance Officer
Phil Paroian, Senior Investment Officer – Public Equity
Mary Hougan, Administrative Assistant

Mary Lobdell, Attorney General's Office
Mark Raker, Peterson Sullivan LLP

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

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

ADOPTION OF THE JUNE 10, 2014, MINUTES

Senator Nelson moved to adopt the June 10, 2014, meeting minutes.
Ms. Holman seconded, and the motion carried unanimously.

EXTERNAL AUDIT

Fiscal Year 2015 External Accountability and Compliance Audit Services - Scope of Work and Auditor Appointment

Noting the turnover experienced in the Internal Audit function, Ms. Killman indicated the WSIB would like to augment internal audit resources by having an external audit service provider complete three internal audits included in the Fiscal Year 2015 Internal Audit Plan approved by the Board in June. Staff would like to hire Peterson Sullivan LLP to perform reviews of the Board's Asset Allocation and Rebalancing, Travel Expenditures, and Commingled Fund Monthly Pricing and Unitization.

Chair Sacks asked what considerations went into selecting the internal audits to outsource. Ms. Killman indicated she considered how compliance-focused each area to be reviewed was, noting those tend to be easier to contract out, while also paying attention to the added benefit of having the new internal auditors review the area.

Ms. Holman moved that the Audit Committee recommend the Board approve the scope of services and appoint Peterson Sullivan LLP to perform a review of three areas of WSIB operations included in the Fiscal Year 2015 Internal Audit Plan: Asset Allocation and Rebalancing, Travel Expenditures, and Commingled Fund Monthly Pricing and Unitization. Senator Nelson seconded, and the motion carried unanimously.

INTERNAL AUDIT

Audit Recommendation Status Report

Ms. Killman reported on the status of staff's follow-up activities related to prior audit recommendations. Over the last quarter, one of three recommendations was resolved by management, when all compliance exceptions from the Board's Conflict of Interest Policy Review were addressed. Two recommendations in the Board's Real Estate area are in progress related to External Auditor Communications and Investment Back-Office Monitoring and Ongoing Due Diligence of the Board's Intermediaries and Real Estate Operating Companies, with completion dates next quarter.

Audit Recommendation Follow-Up Project

Ms. Lillie presented the results of the Board's Audit Recommendation Follow-Up Project. Overall results showed WSIB is maintaining controls established in response to prior audit recommendations. Portfolio Administration, Human Resources, Risk and Compliance, Investment Accounting, and Real Estate staff have taken actions to address 20 prior audit recommendations and have made significant improvements in each area.

The report contained one repeat audit recommendation, which was to request and review the independent service organization control reports of the Department of Retirement System's (DRS) third-party record keepers to ensure tests of controls related to trade execution activities are included in the reviews, and any issues identified are followed-up on in a timely manner. It was noted during this review that one of the two record keeper's biennial service organization control reports have not included the required investment-related control testing. As such, controls over the investment activities of the record keeper responsible for the retirement plan 3s have not been independently reviewed since December 31, 2007. Management agrees with the recommendation and has contacted DRS to request both record keepers include investment-related control testing in their service organization control reviews. DRS also ordered a review of the record keeper in question's investment-related activities from 2008 forward. Follow-up status will be reported to the Board at the next quarterly meeting.

Mr. Longbrake suggested this recommendation be put on the tracking list and be reviewed biennially.

Senator Nelson commented on Ms. Lillie's exceptional written materials and said her oral presentation was superb.

External Quality Assessment Follow-Up

Ms. Killman provided responses to the six recommended improvements included in the External Quality Assessment Review Report of WSIB Internal Audit received in June. One revision to the Audit Committee Charter Policy resulted, adding termination oversight of the Audit Director as an Audit Committee responsibility.

[Treasurer McIntire was in attendance via teleconference at 9:32 a.m.]

Ms. Holman moved that the Audit Committee recommend the Board approve the proposed revision to the Audit Committee Charter Policy 1.00.130. Senator Nelson seconded, and the motion carried unanimously.

Audit Plan Quarterly Status Report – Fiscal Year 2015

Ms. Killman presented the Audit Plan Quarterly Status Report. She reported 11 audit projects are scheduled for Fiscal Year 2015, with four of them being outsourced. A status update will be reported at each quarterly meeting.

Performance Measure Dashboard – Fiscal Year 2014

Ms. Killman presented the Fiscal Year 2014 internal audit performance measures. Performance measure targets met included the completion of the Fiscal Year 2015 Internal Audit Plan in a timely manner, spending 77 percent of total available hours on direct assurance, consulting and advisory services, and reporting the outcome of the Fiscal Year 2014 performance measures to the Board timely. As a result of the Internal Auditor position vacancy, one auditor did not complete 40 hours of Continuing Professional Education (CPE), and five of the seven scheduled audits were completed during Fiscal Year 2014.

Chair Sacks said the commitment to the consultant role for outsourcing proved to be extremely helpful.

Internal Audit Staffing Update

Ms. Killman summarized the Internal Audit staffing updates for the Committee. Her new role with the Risk and Compliance unit is effective September 16, 2014. In August, Marie Steffen was appointed by the Board as the new Audit Director and will begin employment on September 16, 2014. Ms. Killman stated she has prepared an external training plan for the new Audit Director that includes investment and pension fund auditing.

In July 2014, the Internal Auditor resigned and the position remains unfilled until the new Audit Director is on staff. Recruiting to fill the Internal Auditor position will begin in October 2014. Internal Audit also had the assistance of an Audit Intern, Ashley Lillie this summer, who worked on a planned Internal Audit Project approved by the Board.

Ms. Holman asked how Internal Audit will stay on target with the Audit Plan without one internal auditor. Ms. Killman indicated this staffing issue has been accounted for in the 2015 audit plan, with the new internal auditor being assigned one audit during the year. The outsourcing of some audits is considered necessary for Internal Audit to accomplish the plan.

Chair Sacks inquired about the planning process for Fiscal Year 2016, and how much of it is relatively fixed. Ms. Killman said the process used for planning is very good and will enable the new Audit Director to meet with staff across the agency to discuss risk and determine a priority ranking together. Ms. Whitmarsh commented on the flexibility for conclusion of the plan and audits are often moved to meet business needs and risks.

Mr. Nakahara asked how much time Ms. Killman will have to transition. Ms. Killman indicated she will be concentrating on her new role in October, and will be available to assist the new Audit Director as needed.

Chair Sacks recognized and thanked Ms. Killman on behalf of the Committee for her nine years of outstanding work as Audit Director. He said Ms. Killman's peer review received the highest mark possible, and her professional ethics and integrity have served the Committee and Board well.

[The Committee recessed 9:55 a.m., and reconvened in open session at 10:05 a.m.]

MANAGEMENT

2015 Meeting Schedule

Mr. Moore presented the proposed 2015 meeting dates of March 3, June 2, September 1, and December 1.

Ms. Holman moved that the Audit Committee adopt the 2015 meeting dates as presented. Treasurer McIntire seconded, and the motion carried unanimously.

Investment Referral Quarterly Report

Ms. Whitmarsh offered the information for the members' reference. There were three new referrals that are under review by staff.

WSIB Public Equity Managers' Trade Execution and Broker Monitoring

Mr. Paroian presented an educational session on how public equity managers are dealing with new trading methods, particularly "dark pools" and "high frequency traders." He said consensus is that these new methods are neither all good nor all bad. The key is whether they are causing our managers to incur higher trading costs than they otherwise would. Monitoring by Zeno, an independent third-party firm that conducts execution analysis, indicates that WSIB's managers' trading costs are lower than average. Responses from the WSIB managers indicate a thoughtful and balanced approach to the challenges presented by dark pools and high frequency trading. Mr. Paroian indicated staff will continue to question the Board's public equity managers on their monitoring of brokers and execution venues to ensure that trading in our accounts is done efficiently and in the fund's best interests.

Chair Sacks asked what the biggest risk is for the public side investments. Mr. Paroian acknowledged the biggest risk is the WSIB's size, particularly in passive investments. It challenges investment managers when trading large blocks of stocks, and is one of the reasons properly managed dark pools can be useful.

Treasurer McIntire asked if the benchmarks can be influenced by these practices. Mr. Paroian said the benchmarks do not account for trading costs.

Proposed Proxy Voting Guideline on Shareholder Initiatives

Ms. Sandboe presented the proposed revisions by staff and the Board and Audit Committee Chairs. The intent of the new guideline is to provide clarity and be more expansive on the types of shareholder issues the WSIB will consider supporting. Ms. Sandboe noted a thorough review of the proxy voting guidelines will be completed next year and presented to the Committee for review.

Chair Sacks explained that in addition to clarity, the new guideline is designed to encourage disclosures on climate risk issues, mitigation plans, and actions by the companies in which the WSIB is invested. Ms. Whitmarsh said staff is comfortable with the proposed changes made by the Board and Audit Committee Chairs.

Treasurer McIntire moved that the Audit Committee recommend the Board approve the revisions to the Global Proxy Voting Guidelines Policy 2.05.200. Senator Nelson seconded, and the motion carried unanimously.

There was no further business to come before the Committee, and the meeting adjourned at 10:24 a.m.