

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
March 3, 2015

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 SW, Olympia, Washington.

Committee Members Present: Treasurer Jim McIntire, Chair
 Marcie Frost (teleconferenced)
 Arlista Holman
 Bill Longbrake (teleconferenced)
 George Masten
 Bob Nakahara
 Joel Sacks

Also Present: Theresa Whitmarsh, Executive Director
 Victor Moore, Chief Operating Officer
 Liz Mendizabal, Institutional Relations Director
 Marie Steffen, Audit Director
 James Mackison, Director of Innovation and Technology
 Phil Paroian, Senior Investment Officer – Public Equity
 Kate Sandboe, Corporate Governance Officer
 Jen Edwards, Compliance Officer
 Shawna Killman, Operational Due Diligence Analyst
 Alicia Markoff, Portfolio Administrator
 Kris Logan, Investment Accounting Controller
 Beth Vandehey, Risk and Compliance Director
 Cathy Nielsen, Administrative Assistant

 Mary Lobdell, Attorney General’s Office
 Lealan Miller, Eide Baily LLP
 Stephen Heath, Intrinium
 Nolan Garrett, Intrinium
 Steven Glass, Zeno
 Paul Whitehead, BlackRock
 Nathaniel Evarts, State Street Global Advisors
 Karl Schneider, State Street Global Advisors
 Edward Kamonjoh, Institutional Shareholder Services
 Bob McCormick, Glass Lewis & Company

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

Acting Chair Masten called the meeting to order and took roll call.

Ms. Lobdell introduced Tor Jernudd, a new attorney with the Attorney General’s office.

ADOPTION OF THE DECEMBER 2, 2014, MINUTES

Ms. Holman moved to adopt the December 2, 2014, meeting minutes.
Mr. Masten seconded, and the motion carried unanimously.

EXTERNAL AUDIT

Fiscal Year 2015 Independent Financial Auditor – Scope of Work and Auditor Appointment

Ms. Steffen stated the WSIB contracts with an independent auditor to review the Board-prepared annual financial statements. In December 2014, the WSIB refreshed the prequalified pool of independent audit service providers, which included the financial statement auditor. Ms. Logan and Ms. Steffen reviewed materials submitted by six firms, and selected Eide Bailly LLP to recommend to the Board to perform the Fiscal Year 2015 audit of the Board-prepared financial statements. Eide Bailly provided a letter to the Audit Committee certifying the firm's independence from WSIB. Ms. Steffen stated Eide Bailly LLP has not provided any services to the WSIB in this fiscal year-to-date.

Ms. Steffen introduced Mr. Lealan Miller, Eide Bailly, who gave a brief overview of the firm; Eide Bailly is a full service accounting firm.

Mr. Nakahara asked about the firm's expertise in private equity and real estate. Mr. Miller responded that Eide Bailly has fairly significant expertise both areas. Mr. Nakahara questioned the references given relating to their level of exposure and complexity and how expertise will be gained. Mr. Miller explained staff member Mr. Chad Flannigan has real estate experience and, for alternative investments, Eide Bailly focuses on the process, polices, and procedures the WSIB's uses for due diligence. If something is identified that has not been dealt with before, Eide Bailly will consult with Mr. Flannigan and Mr. Eric Bergman for their expertise on the subject. Mr. Flannigan will observe initially, until needed. Mr. Nakahara commented that the firm is probably the best-kept secret in the industry, and went on to say that he was impressed with Eide Bailly's background.

[Treasurer McIntire arrived at 9:15 a.m.]

Ms. Holman moved that the Audit Committee recommend the Board appoint Eide Bailly LLP to perform the Fiscal Year 2015 independent financial audits. Mr. Masten seconded, and the motion carried unanimously.

IT Security and Data Warehouse Auditor – Scope of Work and Auditor Appointment

Ms. Steffen introduced Mr. Mackison and Messrs. Stephen Heath and Nolan Garrett of Intrinium. She stated that as part of the Fiscal Year 2015 Internal Audit Plan approved by the Board, the IT Security and Data Warehouse audits will be performed by an external, experienced audit consultant. Mr. Mackison and Ms. Steffen reviewed the materials submitted by five firms and selected Intrinium to recommend to the Board to conduct a comprehensive IT security review, perform penetration testing, and conduct an application controls review of the WSIB's data warehouse and performance systems. Intrinium has certified the firm's independence from the WSIB, no potential conflicts of interest exist, and assigned staff are free from personal and external impairments to independence. Intrinium has not provided any services to the Board in this fiscal year-to-date.

Mr. Mackison said, in addition to the extensive scope of the last audit, the WSIB expanded the review to include a data risk assessment to address the WSIB's target profile and the potential impacts of a breach, and to evaluate monitoring of third-party security. He said the WSIB has a unique set of risks as a global institutional investor, and staff felt Intrinium brought knowledge of that unique environment, along with strong technical expertise in security practices and hacking approaches. Mr. Mackison noted that Intrinium had favorable references.

[Mr. Longbrake joined via conference call at 9:20 a.m.]

Mr. Heath introduced Mr. Nolan Garrett, founder of Intrinium, as well as Ms. Kylie Martonik, Information Security Consultant. Mr. Heath gave a brief overview of the company and work it has performed for other companies and other state agencies. He discussed Intrinium's project plan and philosophy, stating Intrinium works hard to have an expedited and concise plan in order to offer services for significantly less than competitors.

Mr. Heath described the processes Intrinium will review relating to internet targeting and potential weaknesses in the environment. Intrinium will eventually come on-site to perform the technical and penetration testing of the organization. The final stage is the audit, where the company gains full access to work their way through the project. It will be based on industry standards and organizational needs, which includes a review of WSIB policy and how it matches to what Intrinium sees in other places. Work is scheduled to begin on April 20, with final reports issued by the end of June. A presentation of the final findings is planned for the September 1 Audit Committee meeting.

[Mr. Sacks arrived at 9:29 a.m.]

Mr. Heath responded to Board member questions about Intrinium's ability to avoid using information from their last audit, and specific data that would be reviewed during the audit. He said Intrinium would look at the due diligence of the agency and what controls are in place, emphasizing the scope of work is very detailed. He further stated if areas of risk are identified, Intrinium will work with the WSIB staff on testing.

Chair McIntire inquired about a communication plan for when the WSIB gets hacked, not if. Mr. Mackison acknowledged that staff does think about that and said, depending on the impact and type of breach, there are disclosure processes in place for notifying staff, management, and the State Chief Information Security Officer. Because the WSIB does not have personally identifiable information, no public disclosure is required, but communicating with business partners who are impacted by a breach is part of the disclosure process.

Mr. Masten questioned if Intrinium ever had a client they were unable to penetrate. Mr. Heath replied that yes, Intrinium does run into some they are not able to gain full access to, but there is always some area in which data is leaked.

Mr. Masten moved that the Audit Committee recommend the Board appoint Intrinium to conduct a comprehensive IT security review, perform penetration testing, and conduct an application controls review of the WSIB's Data Warehouse and Performance System. Ms. Holman seconded, and the motion passed unanimously.

INTERNAL AUDIT

Audit Recommendations Status Report

Ms. Steffen introduced Ms. Susan Parsons, WSIB internal auditor, and provided a review of her background and experience.

Ms. Steffen stated the Audit Recommendation Status Report is a standing agenda item. As noted on the report, the recommendation regarding the Department of Retirement Systems (DRS) third-party service organization's control has been resolved. Internal Audit verified the report was received and no issues were noted, and they confirmed there was language added to the contract going forward. Ms. Steffen commended DRS for working to get this recommendation cleared earlier than expected.

Internal Audit Report – Custody Bank

Ms. Steffen presented the results of the Custody Bank audit. She introduced Ms. Cala Risse, the WSIB's on-site State Street Bank (SSB) representative, who provided assistance throughout the audit.

Overall, the audit of SSB, as the global custodian, was very positive. SSB has adequate processes and controls in place to ensure the Board's financial and operating information is accurate, and the assets in their custody are adequately safeguarded.

Ms. Steffen discussed audit planning; which included meeting with Board staff, reviewing contract documentation, and reviewing SSB's service organization control reports (SOC 1 Reports), which were rendered by Ernst and Young. She explained that based on planning, a review of controls, and a risk assessment, audit objectives were developed.

Chair McIntire asked about the securities lending process. Ms. Steffen said there is a separate contract for securities lending with SSB. This will be an area considered during the annual planning process. Foreign exchange pricing will also be considered in future audits.

The report contained one recommendation relating to outgoing wire payments. Internal Audit recommends SSB ensure accurate information is entered into their payment system to document the telephone call back and ensure appropriate security procedures are followed to authenticate the wire payments. Additionally, the WSIB and SSB should clarify the various roles and responsibilities of the WSIB staff with regard to the approval and callback procedures.

WSIB management and SSB agree with the recommendation. The WSIB and SSB have initiated dialog to clarify the roles, and the WSIB staff will add written procedures to the Master Custody Trading Authority. SSB will ensure correct information is entered into their payment system to document the telephone confirmation.

Internal audit will follow up and report on the status of correction action at the next Audit Committee meeting.

Audit Plan Quarterly Status Report – Fiscal Year 2015

Ms. Steffen presented the Audit Plan Quarterly Status Report. She highlighted the areas of change since last quarter and said the IT Security and Data Warehouse Audit and Public Market Investment Compliance Audit reports will be presented at the September 2015 Audit Committee meeting. Peterson Sullivan is performing these audits.

Ms. Steffen also noted the Conflict of Interest Policy Review will be performed over the next quarter and presented at the June Audit Committee.

[The Committee recessed at 10:23 a.m. and reconvened in open session at 10:40 a.m.]

EDUCATION

High Frequency Trading and Dark Pools

Mr. Paroian introduced four panelists who represented three of the WSIB's partners; Zeno, which does third party execution analysis, and BlackRock and SSGA, which are passive managers.

Mr. Glass of Zeno Consulting discussed the services the group provides to the WSIB, providing quarterly analysis of equity separate accounts. Mr. Glass explained that High Frequency Trading (HFT) is generally defined as the use of very sophisticated computer algorithms, high-speed communication components, and geographic proximity to trading centers in order to implement trading strategies as quickly as possible.

Mr. Glass stressed that most HFT strategies are legitimate, quasi market-making trading activities that actually help make the market cheaper and more efficient, and not all are predatory. A majority of studies are suggesting that on balance HFT helps more than it hurts, but there needs to be more empirical data on the actual impact that HFT has on the market, and the Securities and Exchange Commission (SEC) agrees. Mr. Glass recommended the WSIB continue doing exactly as they have been, including talking to the managers to ensure they are on top of this issue. Mr. Paroian added that staff is meeting quarterly with managers and discussing these issues.

Mr. Nakahara asked if the frequency of HFT is like a 21st century arbitrage. Mr. Glass said that in some ways it is.

Mr. Whitehead gave an overview of BlackRock and said fragmentation in the U.S. securities market allows for HFT and for off-exchange trading and trading in dark pools, which can be 25 percent of market volume. He explained trading in dark pools has anonymity as a feature, along with better pricing.

Mr. Evarts, SSGA, agreed with the others' comments, stating there are two types of impact: realized (cost to transact) impact and implied (opportunity cost) impact. He said there is a debate about the difference between volume and liquidity. Volume is what you see on the screen; liquidity is the ability to transact. In summary, Mr. Evarts stated discussions at SSGA are around price, not venue.

Chair McIntire questioned both firms on dark pools, managing conflicts of interest, and transparency. Mr. Whitehead stated dark pools are operated by broker/dealers. Messrs. Evarts and Whitehead stated their companies do not direct transactions or orders to a specific venue. Mr. Schneider added they have the ability to internally cross securities, which is not a dark pool.

Mr. Whitehead said managing conflict is at the core of all of they do. The broker/dealers manage conflict on a daily basis. BlackRock uses transaction cost analysis and manages their ability to meet forecasted costs, as well as tracking benchmarks.

Mr. Glass stated that disclosure will be what the regulators work on this year.

Mr. Nakahara asked whether similar trading happens in international markets. Mr. Whitehead noted that fragmentation is unique to the U.S. Mr. Glass added that while Canada, Germany, Australia, and the U.S. are looking for ways to curb HFT, other countries are looking to attract HFT. He said developed markets such as Singapore and Japan are exploring regulations designed to attract HFT.

Mr. Sacks asked what risks the WSIB should be concerned with as long-term investors. Messrs. Glass, Whitehead, and Evarts discussed how a public plan sponsor can monitor their external managers' trading and Mr. Paroian confirmed that WSIB staff are doing so.

Mr. Masten asked if HFT traders were seeking business from pension funds. Mr. Glass stated he was not aware of any.

Ms. Holman asked if the Board could see who the HFT traders were. Mr. Whitehead responded that market participants do not currently have transparency on what party is taking the other side of the trade.

Chair McIntire thanked group for their time, discussion, and education.

MANAGEMENT

2014 Year-End Proxy Voting Reports and 2015 Preview

Ms. Sandboe introduced Mr. Kamonjoh from Institutional Shareholder Services (ISS) and Mr. McCormick from Glass Lewis & Co.

Ms. Sandboe reported that, in 2014, the WSIB voted 3,505 proxy ballots and those ballots contained 31,741 individual proxy proposal issues. The greatest number of votes cast was in the election of directors, followed by ratification of auditor and advisory votes on executive compensation.

She said the WSIB's key issues in the 2015 proxy voting season will be trying to control executive compensation through "Say on Pay" votes, shareholder proposals regarding climate risk, annual election of directors, and Board responsiveness to 2014 shareholder proposals.

Mr. Sacks asked about the volume of votes the WSIB would cast on climate change proposals in 2015. Ms. Sandboe said there would likely be about 70 proposals in that category that the WSIB would vote. Mr. Sacks asked about the times the WSIB voted against management, and if those negative votes resulted in any changes. Ms. Sandboe explained that many times it doesn't happen right away; it takes a few months to realize changes.

Chair McIntire asked for an illustration of a climate change proposal the WSIB might vote for and one the WSIB would vote against. Ms. Sandboe reported that Emerson Electric was a favorable vote; the proposal asked the company to generate a report that more comprehensively described what they see as the climate change risks or opportunities, and what steps they were taking to prepare themselves to mitigate that risk for the company. She said the WSIB had recently voted against a climate change proposal at Apple. The shareholder proposal asked the company to put together a report that would give greater disclosure of climate change risk that would impact their business and what they were doing to mitigate it. Both ISS and Glass Lewis recommended voting against the proposal because Apple was already providing excellent disclosure. Chair McIntire asked if, in both cases, management was in opposition to the shareholder proposal. Ms. Sandboe said yes.

Chair McIntire asked about disclosure of political contributions proposals and if any of those have been voted on. Ms. Sandboe stated the WSIB usually votes in favor of those proposals, and added they have increased dramatically in the last couple years.

Mr. Kamonjoh reported on the results of a review ISS performed on how the WSIB's global equity fund managers voted the WSIB's non-U.S. ballots. He explained the investment manager's vote records were benchmarked against company management recommendations, as well as the ISS standard benchmark policy and, to the degree possible, the WSIB's own proxy voting guidelines.

In looking at the WSIB's voting guidelines on the specific governance issues analyzed in the review, Mr. Kamonjoh said managers are largely voting with the WSIB. Alignment with ISS policy suggests some opposition to management, but divergence from ISS policy does not necessarily mean the manager is voting in lock step with management recommendations.

Mr. Kamonjoh discussed some of the notable trends and developments in global markets that have a bearing on the WSIB policies, saying that for the 2015 proxy voting season, shareholders are seeking the ability to nominate their own representative to companies' boards.

Mr. Sacks asked about the WSIB's position on proxy voting. Ms. Sandboe replied that the WSIB usually prefers proposals requiring holding 3 percent of the company's shares for 3 years and to be able to nominate director candidates.

[The Committee recessed at 12:45 p.m., and reconvened in open session at 1:05 p.m.]

Investment Compliance Report

Ms. Edwards gave an overview of the Investment Compliance program, which covers approximately 83 percent of the total assets under management as of December 31, 2014.

Ms. Edwards went over the details of the compliance results from public assets and stated SSB has a daily compliance system that tests 61 accounts every day, which includes testing of 418 rules. The only two areas with non-compliance this year were public equity and securities lending, due to a few minor instances of non-compliance against the policies, which were resolved quickly.

Ms. Edwards said Private Markets compliance is accomplished with the help of several outside consultants. Private equity investments are monitored by the WSIB through a compliance program with Hamilton Lane, and real estate and tangible asset investments are monitored with the assistance of KPM and Associates. Results from 2014 were very positive.

Ms. Edwards responded to Board member questions on the review of funds, stating that real estate and tangible assets are reviewed rotationally and the risk-based approach for private equity ensures all funds are covered every few years.

Ms. Killman summarized the Board's expanded monitoring of the back-office operations of investments in companies where the Board has a significant ownership interest. For these investments, on-site reviews of the managers' financial controls, governance, and investment monitoring processes will be reviewed at least once every 2 years. A report will be provided next year.

Ms. Edwards finished the presentation with a discussion of the compliance testing plan for 2015 and an overview of the federal compliance reporting that is currently required of the WSIB.

Investment Referrals Quarterly Report

Mr. Moore stated there are two new referrals since the last meeting. He shared that the Executive Director and the Chief Investment Officer are meeting with Federal Way Asset Management tomorrow.

Daily Valued Funds Report

Ms. Markoff presented the annual daily value fund report, stating the WSIB manages and administers three Daily Valued Funds (DVF): the Savings Pool, the Bond Fund, and the U.S. Treasury Inflation Protected Securities (TIPS) Fund. She said the TIPS Fund is part of the fixed income allocation for the Retirement Strategy Funds (RSF), managed by Alliance Bernstein. The portfolios are managed internally by the WSIB's Fixed Income unit, and Operations is responsible for the administration of these funds.

Ms. Markoff reported that, during 2014, two material errors occurred in the TIPS Fund; however, after further analysis by the RSF manager, it was determined there was no impact to the overall unit price at the RSF level, thus no participants were harmed. Ms. Markoff said the first error was due to an incorrect Consumer Price Index factor that was used to price each of the TIPS in the portfolio.

The second error was related to a newly purchased TIPS investment that was incorrectly valued at cost instead of the closing market price, which self-corrected the next day. Ms. Markoff reiterated that both errors did not impact the participants because they were not material at the RSF level. She reported there were no other errors or issues related to the DVF to report.

Daily Valued Funds Operations Policy 2.14.300 Revision

Ms. Markoff discussed the update to the Daily Valued Funds Operations Policy 2.14.300, stating an update was made to allow the WSIB to use the custodian bank for the book of record for the daily funds and to allow the WSIB to use the prior day cash interest factor to accrue cash.

Mr. Sacks moved that the Audit Committee recommend the Board approve the proposed revisions to the Daily Valued Funds Operations Policy 2.14.300. Ms. Holman seconded, and the motion carried unanimously.

Enterprise Risk Management Board Risk Discussion

Ms. Vandehey gave an overview of the Enterprise Risk Management (ERM) Program, stating the WSIB has been engaged in ERM for over a decade.

Ms. Vandehey reviewed a list of commonly recommended practices for a healthy risk culture and said that, since the beginning of the ERM team, the WSIB has fostered an open culture, allowing any risk to be discussed. She provided an overview of the WSIB risk governance framework, which shows how the culture is strong because risk management is separate from risk measurement.

Ms. Vandehey gave a brief overview of the key risk framework, which is supported by risk discussions, key risk analysis, and risk appetite statements. She said the Board will have the opportunity to revisit each of these items at the July Board meeting.

2014 Personal Investment Report

Ms. Whitmarsh stated that the Investment Referral Process Policy 2.05.800 requires her to report to the Audit Committee on any investment approvals that she provided for Board members, as well as approvals the Board provided for Ms. Whitmarsh. She said 18 Board-member investments were approved, and none were denied. Ms. Whitmarsh said she had none herself.

EXECUTIVE SESSION

Treasurer McIntire announced the Committee would go into executive session to review the performance of a public employee. He said the executive session was expected to last approximately 8 minutes, at which time the Committee would reconvene in open session.

[The Committee went into executive session at 1:36 p.m., and reconvened in open session at 1:56 p.m.]

OTHER ITEMS

There was no further business to come before the Committee, and the meeting adjourned at 1:57 p.m.