

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
June 2, 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 McIntire, Chair
Marcie Frost
Arlista Holman
Bill Longbrake
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
Susan Parsons, Internal Auditor
Dino Patiag, Investment Accounting Analyst
Kris Logan, Investment Accounting Controller
Cathy Nielsen, Administrative Assistant

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

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

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

ADOPTION OF THE MARCH 3, 2015, MINUTES

Mr. Masten moved to adopt the March 3, 2015, Audit Committee meeting minutes. Mr. Sacks seconded, and the motion carried unanimously.

EXTERNAL AUDIT

Calendar Year 2014 Conflict of Interest Policy Compliance Review Report

Ms. Steffen explained the Washington State Investment Board (WSIB) Conflict of Interest Policy requires an annual review of Board and staff compliance with the policy, to be conducted by an external CPA firm. Ms. Steffen said the Board contracted with Peterson Sullivan LLP in March 2014 to perform the reviews through calendar year 2016. Ms. Steffen introduced Mr. Mark Raker from Peterson Sullivan LLP and said he would discuss the work performed.

Mr. Raker stated Peterson Sullivan completed the Conflict of Interest policy review for the year ended December 31, 2014, and issued a letter of findings, dated May 15, 2015.

Mr. Raker explained the audit project involved reporting on four specific areas: gift and Public Disclosure Commission (PDC) form reporting, travel expenses paid by a source other than the State of Washington, personal investments, and training on the Conflict of Interest policy itself.

Mr. Raker stated there were no findings related to personal investments, travel, or gift reporting; there were a few findings under PDC reporting and training. Mr. Raker said there was one board member who did not submit a PDC report by the April 15 deadline, and for training, there was one new employee and two new Board members who did not submit an acknowledgement form indicating that they had read and understood the Conflict of Interest policy prior to the due date. For new employees, those forms are due within 1 week from the start of employment. For Board members the forms are due prior to their first Board meeting. In addition, there was one employee who did not receive training on ethics and public service laws.

Ms. Frost asked if the level of activity in the report was similar to the past. Mr. Raker said yes, with the exception of an increase in the number of travel expenses that were tested.

Mr. Nakahara questioned the consequences of not filing PDC reports with the WSIB. Mr. Raker stated he was unsure of consequences, but said in the case when a form was not filed timely, it was eventually filed.

[Treasurer McIntire arrived at 9:06 a.m.]

INTERNAL AUDIT

Internal Audit Report – Outsourced Internal Audits

Ms. Steffen introduced Ms. Melissa Bartenbach from Peterson Sullivan LLP, who joined Mr. Raker in presenting the results from the outsourced internal audits. Ms. Steffen explained the Board contracted with Peterson Sullivan LLP to conduct a review of three areas of WSIB operations to supplement the internal audit resources and to ensure completion of the Board-approved Fiscal Year 2015 Internal Audit Plan. Mr. Raker stated the audit areas were asset allocation and rebalancing, travel expenses, and commingled fund monthly pricing and unitization. Mr. Raker said the audit period covered was July 1, 2013, through September 30, 2014. Peterson Sullivan issued a letter outlining the audit procedures and findings, dated May 12, 2015.

Ms. Bartenbach detailed the results of the asset allocation and rebalancing review and noted that, in funds with assets under management, the asset allocation reviews were performed timely, in accordance with Board policy, and that staff were actively monitoring asset allocation targets. Ms. Bartenbach noted there were no instances where rebalancing was required as a result of assets outside of targeted ranges or instances of non-compliance; however, there were instances where rebalancing was completed to maintain asset allocation mixes through various buy/sell activity. She went on to say there were no exceptions within the rebalancing testing.

Mr. Raker discussed the travel expenditure review and stated the testing focused on whether there was advance approval for travel and whether the rates for lodging, meals, and airfare complied with allowable rates. Auditors tested 75 transactions and found the expenditures were allowable according to state regulations and WSIB policies, with the exception of one overpaid meal per diem.

Mr. Nakahara asked about total number of transactions. Mr. Raker stated there were approximately 2,200 transactions, and the testing was completely random.

Ms. Bartenbach discussed the review of calculations for the commingled fund monthly pricing and utilization, stating she reviewed the calculations for the retirement and permanent funds in detail, including supporting data which was directly tied to State Street Bank's (SSB) official book of record. Ms. Bartenbach found there were no exceptions in pricing and unitization testing.

Mr. Sacks questioned the degree of specificity of the Board policies. Ms. Bartenbach stated the policies are very specific.

Audit Recommendations Status Report

Ms. Parsons discussed the Audit Recommendation Status Report and said there was one recommendation relating to the Custody Bank audit presented in March of this year. Ms. Parsons said the first part of the recommendation was that SSB ensure accurate information is entered into SSB's payment platform system. Ms. Parsons noted that Internal Audit selected six wire transfers from WSIB's documentation and verified the appropriate information was entered into SSB's system. The second part of the recommendation was for the WSIB and SSB to clarify and document the various roles and responsibilities with regard to the wire transfer approvals and call back procedures. Ms. Parsons stated there have been informal discussions between the two parties, and management said they were in the process of updating the procedures and will be meeting with SSB to ensure there is full understanding of the various roles and responsibilities. This is expected take place by June 30, 2015.

Mr. Nakahara questioned pushing this back four months from February to June. Ms. Steffen stated they are transitioning to a new independent accounting verification system. Mr. Moore added that it would have been cleared up had the WSIB not been transitioning to a new verification system.

Internal Audit Report – Tangible Assets Investments

Ms. Parsons said the Tangible Assets Investments Audit has been completed. Ms. Parsons said the audit objectives were to determine whether the investments were prudently invested, properly authorized, and adequately monitored by the WSIB. The audit also included a review of compliance with Board and investment policies, and whether internal controls, responsibilities, and staff experience adequately address key person risk. Ms. Parson identified six investments for testing, attempting to get diversification in sector, investment officers, and commitment size.

Ms. Parsons noted Internal Audit is recommending the Tangible Assets unit develop written procedures defining the level and types of documentation to be maintained

and where the documentation should reside on the network. Ms. Parsons said management is in agreement with the recommendation and will update the policy to include expectations for due diligence. In regards to the documentation, management believes this should be addressed from an agency-wide perspective and will initiate discussion at the executive level.

Mr. Longbrake questioned if Internal Audit would review the updated policy for adequacy. Ms. Parsons confirmed the policy would be reviewed when revisions have been made.

Mr. Sacks asked whether Ms. Parsons looked at a variety of different investment vehicles as part of the audit. Ms. Parsons stated that, while each deal is different, the monitoring documentation is very similar in the sense that there should be reviews of reports, agreements, and correspondence documentation.

Mr. Sacks asked if the same criteria would be applied to a review of any of the asset classes. Ms. Whitmarsh asked Mr. Sacks if he was referring to operational complexity in terms of oversight of the various deal structures. Mr. Sacks said he was referring more to the diversity of the deal structures than the complexity and, after hearing Ms. Parsons, he understood deal structure may be different but, from the audit perspective the monitoring of the investment would be similar regardless of the structure.

Mr. McIntire stated part of the concern is that some of these are indefinite contracts and maybe the WSIB has to monitor differently for different types of product.

Audit Plan Quarterly Status Report:

Ms. Steffen said the Audit Plan Quarterly Status Report covers the status of the Fiscal Year 2015 Internal Audit Plan and the audit areas approved by the Board in June 2014. Ms. Steffen reviewed the audits and their completion status. Ms. Steffen said the IT Security and Data Warehouse Audit, performed by Intrinium, is on track to have the completed report to WSIB management by June 30 and the results presented to the Audit Committee at the September meeting. Ms. Steffen reported the Public Market Investment Compliance Monitoring Audit has been moved to the Fiscal Year 2016 Audit Plan. Ms. Steffen noted there is one month left in the fiscal year, and Internal Audit will report on the full year as part of the review of performance measures at the September Audit Committee meeting.

Fiscal Year 2016 Annual Internal Audit Plan

Ms. Steffen presented the Fiscal Year 2016 Internal Audit Plan, which was developed using a rigorous risk assessment using both quantitative and qualitative methods. Ms. Steffen confirmed the independence of the Internal Audit function at the WSIB and noted Internal Audit has been free from interference in determining the scope of the work, the performance of the work, and reporting the results to management and the Board. Ms. Steffen reviewed the planning process used to select the proposed audit areas, including the risk assessment tool, interviews conducted, and analysis of the cycle plan.

Using the process described, the six audit areas selected for the Fiscal Year 2016 Audit Plan were Private Equity; Investment Accounting Verification System; Trade Processing, Confirmation, and Settlement; Contracts Management; Public Equity

(includes Compliance Monitoring); and Cash Daily Wire and Monthly Cash Movements.

Ms. Holman asked how the risk ratings are determined for the potential audit areas during the quantitative risk assessment. Ms. Steffen said that it is based on auditor judgement and discussions with the unit managers.

Mr. Longbrake asked if the scope of the private equity audit will include a verification valuation of procedures and timeliness. Ms. Steffen said the valuation process is reviewed by external auditors as part of the CPA audit of the WSIB's financial statements.

Ms. Whitmarsh stated Duff & Phelps came in 3 years ago to present on the subject, and added there is an education session today on valuation practices.

Chair McIntire talked about the issue of fee structures in the news and requested an overview of what has happened here with WSIB's general partners, as well as on a global basis. Ms. Whitmarsh will add this update to the Executive Director's report for the June Board meeting. Chair McIntire requested an understanding of what controls the WSIB has from an audit perspective, and what our contracts look like in terms of capacity to actually go back in and review. Ms. Whitmarsh will work with Compliance team on that.

Ms. Frost asked about the intersection of the Enterprise Risk Management (ERM) team and the Internal Audit group and if risk areas are being identified through that forum and incorporated into the audit plan. Ms. Steffen stated she participates on the ERM team as a consultant, and the risks discussed throughout the year can be incorporated during the risk assessment discussions during the planning meetings.

Mr. Sacks asked which external auditor will be performing the Daily Valued Transaction Processes. Ms. Steffen replied the review will be incorporated in the audit of the WSIB-prepared financial statements performed by Eide Bailly.

Mr. Sacks questioned the WSIB's assessment and prioritization of risk, ranking the three sub-categories of strategic, control, and financial risk equally. Ms. Steffen said that, from the perspective of looking at the three different areas, one does not outweigh the other, they are equally weighted.

Mr. Nakahara referenced the audit cycle history and asked about rethinking the timing of the Human Resource Management audit. Ms. Steffen noted the previous audit covered compliance with policies, training, and personnel files, and that WSIB's Human Resources unit had satisfactorily implement the recommendations from the prior audit.

Ms. Frost moved that the Audit Committee recommend the Board adopt the Fiscal Year 2016 Internal Audit Plan. Ms. Homan seconded, and the motion carried unanimously.

MANAGEMENT

Investment Referral Quarterly Report

Mr. Moore discussed the investment referral log, noting there was one additional referral since the last Board meeting from Bank of America Merrill Lynch. Mr. Moore stated this was followed up by Mr. Bruebaker.

EDUCATION

WSIB Alternative Asset Valuation Practices

Mr. Patiag presented on the valuation practices and procedures of alternative assets that the WSIB invests in, namely private equity, real estate, and tangibles.

Mr. Patiag said alternative assets do not have published market prices and, while alternatives comprise 40 percent of the retirement portfolio, the WSIB relies on the general partners for a large portion of the valuation.

Mr. Patiag said the WSIB engaged Duff & Phelps to conduct an analysis of the valuation policies and practices of the general partners, discussed Duff and Phelps' ratings of green, yellow, and red, depending on whether the valuation policies and practices will result in an appropriate fair value. Mr. Patiag said, by definition, fair value is the amount which an asset could be exchanged between willing parties, but not in a forced or liquidation sale.

Mr. Patiag said almost all partners were rated green, with a very few rated yellow or red, resulting as insignificant in terms of market value and impact to the retirement portfolio. Mr. Patiag said, with the help of Hamilton Lane, the WSIB reviews the audited financial statements of each partner for the types of audit opinions, whether the valuation in the financial statements agree with those in the capital account statements, if events subsequent to the issuance of financial statement affected valuation, and whether the auditor changed from the previous year.

Mr. Patiag said each partner is required to respond to a questionnaire that covers whether significant changes in the valuation policy has occurred, their use of third party valuation experts, and whether audited financials from underlying companies are received.

Mr. Patiag said each quarter a cross-company and realization analysis is performed, and valuation changes outside certain criteria are investigated. Mr. Patiag explained that anomalies identified in the annual and quarterly reviews are discussed at the quarterly meeting of the Valuation Committee.

Mr. Nakahara asked about any biases. Mr. Patiag stated that any strong biases would be tabulated. Mr. Patiag added that, as it gets closer to the sale, the valuation gets closer to the actual sale price.

Mr. Nakahara referenced transactional events and the heightening up process, and asked if there are learning opportunities. Ms. Logan stated staff are looking at trying to correlate the portfolio to some sort of benchmark, so it could be used at year end or even in the monthly TAP price. Ms. Logan added that, in the year end audited financial statements, the WSIB holds the books open and books June values in June, so projecting out at year end is not necessary.

Chair McIntire said the WSIB has some investment assets for 10 years or more, and questioned if they were inherently less liquid assets and whether their values reflect their age. Mr. Patiag stated the valuation policies and practices would have been examined by Duff & Phelps. Chair McIntire stated his concern of holding aged investments on the books too long. Ms. Logan stated the WSIB has to look at materiality as well.

Ms. Will stated most of the funds invested in tangible assets do not have a performance track record for the WSIB to look at the valuations. Ms. Will added that Hamilton Lane looks at that type of information for private equity. Ms. Logan stated that Duff & Phelps looked at the valuation policies of the general partners and the valuation of the WSIB policies to see if there was adequate due diligence in place. Ms. Logan added that Duff & Phelps documented the WSIB's entire process and stated the WSIB had top tier practices when it came to due diligence, operational reviews, and oversight and monitoring.

Mr. Masten commented that due diligence on new relationships is really a question for the Chief Investment Officer.

OTHER ITEMS

Fiscal Year 2015 Independent Financial Statement Audits – Engagement Terms Letter

Ms. Steffen said, in April 2015, the WSIB engaged Eide Bailly to conduct the independent audit of the Fiscal Year 2015 financial statements, prepared by the WSIB. Ms. Steffen stated that auditing standards require that the auditor communicate the terms of the audit engagement with management, in the form of an engagement letter, and to "those charged with governance." The Audit Committee is responsible for the oversight of financial reporting, and therefore the recipient of the communication to "those charged with governance." The communication includes the responsibilities of the auditor and the planned scope and timing of the audit.

EXECUTIVE SESSION

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

[The Committee went into executive session at 10:24 a.m., and reconvened in open session at 10:40 a.m.]

There was no further business to come before the Committee, and the meeting adjourned at 10:40 a.m.