

**WASHINGTON STATE INVESTMENT BOARD**  
**Audit Committee Meeting Minutes**  
**March 1, 2016**

The Audit Committee met in open public session at 8:57 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Joel Sacks, Acting Chair  
Marcie Frost  
Bill Longbrake (teleconferenced)  
George Masten  
Bob Nakahara

Absent: Treasurer Jim McIntire, Chair  
Arlista Holman

Also Present: Theresa Whitmarsh, Executive Director  
Ian Cameron, Chief Operating Officer  
Gary Bruebaker, Chief Investment Officer  
Chris Phillips, Institutional Relations Director  
Marie Steffen, Audit Director  
Susan Parsons, Internal Auditor  
Kate Sandboe, Legislative Relations and Corporate Governance Officer  
Jen Edwards, Compliance Officer  
Shawna Killman, Operational Due Diligence Analyst  
Phil Paroian, Senior Investment Officer – Public Equity  
Alicia Markoff, Portfolio Administrator  
Kris Logan, Investment Accounting Controller  
Beth Vandehey, Risk and Compliance Director  
Cathy Nielsen, Administrative Assistant

Tor Jernudd, Attorney General's Office  
Lealan Miller, Eide Bailly LLP  
Brad Berls, Eide Bailly LLP  
Lillian McDonell, Watson McDonell  
David Hammond, Watson McDonell  
Fassil Michael, ISS  
Bob McCormick, Glass Lewis & Company  
Richard Young, State Street Bank  
Brenda Dulger-Sheikin, State Street Bank

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

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

**ADOPTION OF THE DECEMBER 1, 2015, MINUTES**

**Mr. Masten moved to adopt the December 1, 2015, meeting minutes.**  
**Ms. Frost seconded, and the motion carried unanimously.**

## **EXTERNAL AUDIT**

### **Financial Statement Auditor – Scope of Services and Auditor Appointment**

Ms. Steffen stated the WSIB contracts for an independent audit of the Board-prepared annual financial statements. She stated staff recommends the Board appoint Eide Bailly to perform the audits of the Board-prepared financial statements for Fiscal Years 2016 through 2019.

Ms. Steffen introduced Messrs. Miller and Berls of Eide Bailly, who gave a brief overview of the firm and audit plan.

Mr. Sacks asked about the rotation of auditors during the 4 years. Mr. Miller stated new staff will be added to the team every year and will work alongside experienced staff.

Mr. Miller gave an overview of the Governmental Accounting Standards Board (GASB) Statement No. 72 and described the fair value measurement and application, stating it will be effective during Fiscal Year 2016. The WSIB will not see a change except for an additional footnote disclosure.

**Ms. Frost moved that the Audit Committee recommend the Board appoint Eide Bailly LLP to perform the Fiscal Years 2016, 2017, 2018, and 2019 independent financial statement audits. Mr. Masten seconded, and the motion carried unanimously.**

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

Ms. Steffen stated the WSIB contracts for an independent annual review of compliance with the Board's Conflict of Interest Policy. This is an agreed-upon procedures review for which the scope of the services is defined and follows the monitoring protocols laid out in the Board's policy. She said staff recommends Watson McDonnell LLP to perform the annual Conflict of Interest Policy Compliance Reviews for calendar years 2015 through 2018.

Ms. Steffen introduced Ms. McDonnell and Mr. Hammond of Watson McDonnell, who gave a brief overview of the company. Mr. Hammond stated the work plan will cover disclosure, travel paid by outside sources, and certifications and training. When asked, Mr. Hammond stated the review is done yearly.

**Ms. Frost moved that the Audit Committee recommend the Board appoint Watson McDonnell to perform the calendar years 2015, 2016, 2017, and 2018 Conflict of Interest Policy Compliance reviews. Mr. Masten seconded, and the motion carried unanimously.**

## **INTERNAL AUDIT**

### **Audit Recommendation Status Report**

Mdmes. Steffen and Parsons provided an overview of the eight recommendations on this quarter's Audit Recommendation Status Report, along with staff's follow-up activities regarding the recommendations. Seven recommendations were resolved over the quarter.

Acting Chair Sacks questioned the public equity external investment manager termination process with respect to delegation of signing the termination letter. Ms. Whitmarsh suggested reporting back at the June Audit Committee meeting.

### **Internal Audit Report – Investment Accounting Verification System**

Ms. Parsons presented the results of the Investment Accounting Verification System internal audit. She noted that during 2015, the WSIB transitioned investment accounting verification systems. The WSIB had adequate processes and controls over the transition between investment accounting verification systems to ensure the WSIB's data was properly recorded in the new system. Also, the WSIB has processes and controls in place, implemented through

the system, to ensure the official investment accounting book of record is complete and accurate. There were no audit recommendations.

### **Internal Audit Report – Trade Processing, Confirmation, and Settlement**

Ms. Steffen presented the results of the Trade Processing, Confirmation, and Settlement internal audit. Overall, the WSIB had adequate processes and controls in place to ensure trades and private market cash flow transactions are processed, confirmed, and settled in an accurate, complete, and timely manner. The WSIB has internal controls in place to ensure the WSIB's assets are properly safeguarded.

The report contains two audit recommendations. One to enhance controls over system access report reviews and one to reinforce controls over monitoring of unfunded commitments of private market investments. Management agrees with the recommendations. Procedures have been put into place to obtain and review access reports. Management will be reviewing the procedures surrounding private market transactions, and will consider this recommendation when applying any procedural changes. Internal audit will follow up and report the status of corrective action at the next quarterly Audit Committee meeting.

### **Audit Plan Quarterly Status Report – Fiscal Year 2016**

Ms. Steffen reported on the Fiscal Year 2016 Internal Audit Plan, noting that four of the audits have been completed. Due to an overlap of an audit performed by the State Auditor's Office, Ms. Steffen proposed adding the audit of the Private Equity and Real Estate Back Office Consultant; with the report presented at the September Audit Committee meeting. There was no objection to the change in the Audit Plan.

### **IT Audit Frequency**

Ms. Steffen said the Audit Committee previously inquired about the frequency of IT audits, in relation to general cybersecurity concerns and IT environment changes. She said these areas have been audited on a 3-year rotational basis. Mr. Cameron added that the IT environment is constantly changing, and management is proposing interval reviews on a targeted level.

Mr. Longbrake added that anytime a significant change happens, the testing process should be accelerated. Ms. Frost agreed and added the organization should not be limited to the state's standards.

When asked, Mr. Cameron said a third party would provide the interval reviews.

Mr. Sacks asked if there is an expectation for WSIB partners as it relates to the kind of reviews they're doing for cybersecurity risk – in particular, within real estate. Mr. Cameron stated the vendors are required to comply with security protocol and may provide Service Organization Control reports annually. In terms of the real estate environment, the Risk and Compliance unit engages with third parties to evaluate those control environments to assess risk and evaluate weaknesses.

## **EXECUTIVE SESSION**

Acting Chair Sacks 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 5 minutes, at which time the Committee would reconvene in open session.

[The Committee went into executive session at 10:20 a.m. and reconvened in open session at 10:27 a.m.]

## **MANAGEMENT**

### **Annual Enterprise Risk Management Update**

Ms. Vandehey provided a brief overview of the risk management framework and discussed the two case studies from 2015. She identified two instances over the last year where the

WSIB was recognized as a leader in risk management. When asked about operational risk measurements, Ms. Vandehey stated the three key operational risks are recruitment of and retention of employees, the risk that manager/vendor transitions create operating challenges, and the risk that budgetary constraints create an ongoing, long-term impact on the agency during the climate of expanded investment opportunities.

Ms. Whitmarsh said that every year in the fall, Enterprise Risk Management work is rolled into the Strategic Plan development.

Acting Chair Sacks asked about new employees providing observations and feedback on possible risk. Ms. Vandehey said that information is brought to the Enterprise Risk Management team for review. She added that an agency-wide risk assessment will be performed this year.

### **Risk Appetite Statements Review**

Ms. Vandehey provided a review of the updated Risk Appetite Statements, noting the last Board approval of these statements was September 2011.

Ms. Frost suggested the section on Empowering Staff to Identify Operational Efficiencies may be a place to recognize Lean and work on standardizing processes.

**Ms. Frost moved that the Audit Committee recommend the Board approve the Risk Appetite Statements as presented. Mr. Masten seconded, and the motion carried unanimously.**

### **2015 Year-End Proxy Voting Reports and 2016 Preview**

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

Ms. Sandboe reported that in 2015, the WSIB voted 3,153 proxy ballots, and those ballots contained 27,966 individual proxy issues. The greatest number of votes cast was in the election of directors, followed by ratification of auditor, and advisory votes on executive compensation or "say-on-pay." Ms. Sandboe said that companies are now required to ask for an advisory vote on their executive compensation plans, so-called "say-on-pay" proposals. Of the 2,038 proposals presented, the WSIB voted against 355, primarily due to the companies' failure to align pay with performance.

Ms. Sandboe reported that 2015 was the first year the WSIB manually voted environmental shareholder proposals, instead of relying on Glass Lewis' voting recommendation. She stated the WSIB voted 88 shareholder proposals on climate change and risk, approving 47 proposals and rejecting 41. She compared this to the year before, when the WSIB voted on 75 environmental shareholder proposals, approving only 3 and rejecting 72 proposals.

Mr. Sacks asked about the number of companies doing a yearly "say-on-pay" vote. Mr. McCormick answered that most companies have adopted this.

Mr. Michael presented a review of how the WSIB's global equity fund managers voted the WSIB's non-U.S. proxy ballots. He discussed the methodology for the proxy voting review and reported that the WSIB's managers are not consistently voting with management and appear to be employing a measure of discernment when making corporate governance-related voting decisions. Mr. Michael also discussed notable changes from 2014 to 2015, and the WSIB's policy and global governance trends.

Mr. McCormick discussed likely topical issues for the upcoming 2016 proxy voting season, including proxy access and board qualifications and tenure.

[Ms. Frost left the meeting at 11:22 a.m.]

### **Annual Investment Compliance Report**

Ms. Edwards gave an overview of the Investment Compliance program, which covers approximately 85 percent of the total assets under management, as of December 31, 2015. She stated compliance with investment policy and contract guidelines was very positive.

Ms. Killman discussed the Operational Due Diligence monitoring program and addressed a question raised earlier regarding cyber security. She stated it is an education process for small organizations and she will continue to look at this area going forward. Larger managers have required reviews by the Securities and Exchange Commission (SEC), and she reviews those reports.

Ms. Edwards discussed the compliance testing plan for 2016, stating that a testing rotation was implemented for Real Estate and Tangible Assets to ensure all investments were reviewed at least every 3 years.

Mr. Nakahara referred to compliance, internal audit, and external audit, asking about audit fatigue and how much time is being spent by staff on the investment side and the back office in supporting these audit activities. Mr. Cameron said the information is not tracked or quantified. Ms. Whitmarsh added that one of the past strategic plan projects was to figure out how to be more efficient with managers' time in responding to the multiple requests from our compliance and audit staff.

### **Daily Valued Funds Report**

Ms. Markoff presented the annual Daily Valued Funds (DVF) report, stating the WSIB manages and administers three DVFs: the Savings Pool, the Bond Fund, and the U.S. Treasury Inflation Protected Securities (TIPS) Fund. 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 calendar year 2015, there were no errors either material or immaterial related to the DVFs, and there were no instances of being unable to close the DVFs.

Ms. Logan stated the WSIB implemented QED as a verification system, so there is an independent check between two systems on a daily basis.

### **2015 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 staff and Board members, as well as approvals the Board provided for Ms. Whitmarsh. She said 24 investments were approved, and none were denied. Ms. Whitmarsh said she had none herself.

### **Investment Referrals Quarterly Report**

Mr. Cameron stated there was one new referral in January, which is still ongoing.

### **State Street Bank – Servicing of U.S. Public Retirement Plans Update**

Mr. Young and Ms. Dulger-Sheikin introduced themselves and discussed the action taken by the SEC in relation to improper conduct of one of State Street Bank's former employees, in the asset servicing business in the state of Ohio. Mr. Young reviewed the controls that State Street Bank has to ensure this does not happen again.

Acting Chair Sacks stated that one of the things that is of utmost importance to the WSIB is reputation. Most of the Audit Committee's time has been spent talking about managing reputational risk, both the work of the WSIB and the partners. Acting Chair Sacks

requested an understanding of what happened, why it happened, and what State Street Bank learned about the gaps in controls.

Mr. Young explained the findings arose out of the actions of a former employee and consultants that were retained on State Street's behalf. The conduct violated State Street Bank's Standard of Conduct and was undertaken without informing others in State Street management of the conduct. Mr. Young discussed the major process changes in third-party vendor management and said there is a team set up that has a separate reporting structure. He said when a vendor is paid now, it goes through the risk team instead of the business team, which is an important control that was missing in the past. When asked, Mr. Young stated the risk team looks at the risk of the vendor and the work performed, versus what was contracted.

Mr. Cameron asked about additional solutions that State Street Bank may be employing in other areas of the business that will detect and/or prevent something like this from happening. Mr. Young stated the culture is very different today, and the tone from the top is about risk management and risk excellence. He acknowledged that when State Street Bank's reputation is tarnished, it affects the reputation of the WSIB.

Mr. Masten asked for clarification on the consultant hired to do activity in Ohio. Mr. Young said he was a consultant with a law firm. Mr. Masten asked if State Street employees need to seek approval on political activity at the state level or federal level. Mr. Young said they must request approval for all political contributions. When asked, Mr. Young said there is no incentive plan; employees are not paid on commission, with the exception of designated business development staff who are paid on a commission basis to bring in new business.

Acting Chair Sacks asked how the incident came to light. Mr. Young referenced his presentation and stated that what the SEC has written is what he is able to discuss, noting that the investigation started with the Department of Justice.

Acting Chair Sacks spoke on behalf of Chair McIntire, stating the WSIB values the relationship with State Street Bank. Through a number of conversations with this Committee, there have been many good things said about the systems, controls, and the partnership the Board has with State Street Bank. The concern the WSIB has is that when combining this incident in Ohio with some of the interactions the WSIB had directly with State Street Bank in the past around the pricing of foreign exchange transactions, it raises two red flags. He stated the WSIB needs to be assured that 5 to 7 years from now, there will not be a third incident. Acting Chair Sacks asked State Street Bank for continued diligence in working for the WSIB's interests, with the expectation that there cannot be a third incident. Mr. Young stated he will ensure that is understood at all levels of the organization.

#### **OTHER ITEMS**

There was no further business to come before the Committee, and the meeting adjourned at 12:22 p.m.