

The SBCERA-KM Operational Due Diligence Program



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Overall Investment Program

SBCERA's investment process focuses on three types of risk. These include:

1. Investment Risk – The risk that actual returns may be lower than expectations. Generally, investors take on more investment risk in hopes of achieving higher returns. SBCERA manages these risks with its Staff and NEPC.
2. Legal Risk – The risk of financial and reputational loss that can result from a lack of awareness or misunderstanding of how laws and regulations impact SBCERA's portfolio. SBCERA manages these risks through its internal and external legal counsel.
3. Operational Risk – The risk of financial and reputational loss that can result from managers' internal controls, design and implementation and oversight of its employees while investing for SBCERA. Taking on additional operational risks is never expected to increase returns. SBCERA manages these risks through the Kreischer Miller – SBCERA Operational Due Diligence Program.

Objectives of Operational Due Diligence

1. **For all** - Reaffirm the details of investment mandates to the investment managers' teams, the necessity for adhering to them, and the Plan's desire to minimize operational risks.
2. **For those with less sophisticated internal support** - Create an opportunity for strengthening internal systems, procedures, and safeguards that preserve the investment mandate and minimize operational risks.
3. **For those who operate outside of their investment mandate in a transparent manner or have systems and processes that expose the Plan to unnecessary risks** - Create an opportunity for constructive redirection of any internal systems, procedures, and personnel.
4. **For those who are covering up an overt disregard of their investment mandate or an overt disregard for systems and processes to reduce risk** - Create a potential deterrent, as the process increases their risk of being discovered.

Objectives of Operational Due Diligence

5. **For the Plan's Staff/Board** - Provide feedback to the Plan's Staff and Board that strengthens its understanding of operational risks associated with investment managers and provides increased manager accountability for maintaining the investment mandate and reducing operational risks.
6. **For All Managers and the Plan's Staff / Board** – Process improvement: the focus of our due diligence process is on understanding what can go wrong and working with each investment manager to strengthen their controls.

Key Elements of a Strong Due Diligence Process

- **Field work** – A short meeting is not enough
- **Targeted** – Right areas; your account
- **Actual Testing** – More than just listening to a well-rehearsed story by a polished investment professional
- **Deep industry knowledge** – Should be conducted by senior individuals who know the inner workings of investment managers
- **Collaboration** – Should work with manager to discuss observations, ways to improve systems and controls, and items for follow-up
- **Closing loops** – Visits, calls, or remote update procedures to follow up on points raised in closing meetings
- **Meaningful feedback** – Reporting should be transparent and provide a broad overview as well as sufficient detail
- **Independence** – No conflicts of interest

Operational Due Diligence Process

The Process – The process is customized to fit SBCERA’s specific needs. Elements of the process include:

1. Pre-hire visits
2. New (Initial) Manager visits
3. Repeat visits
4. Remotely applied procedures
5. Fee recalculations
6. Other procedures (addressing specific concerns of the Staff/Board)

Operational Due Diligence Process

1. **Pre-hire visits** – Assess operational risks before the Plan has committed any capital to the investment manager. Similar in scope to the new manager visit. These are important when there are investment lockups for long-term investments
2. **New (initial) manager visits** – Assess operational risks relating to the Plan’s existing investment managers. Begins with a discussion with the portfolio manager to understand the strategy, then an understanding of processes and systems. Concludes with a wrap-up meeting to discuss findings and recommendations.
 - Traditional Managers (such as equity and fixed income), including but not limited to:
 - Attempting to bypass system controls (such as entering inappropriate trades into the portfolio system)
 - A day in the life of a trade

Operational Due Diligence Process (cont.)

2. New (initial) manager visits, continued

- Non-Traditional Managers (such as real estate, PE, FOFs), including but not limited to:
 - Focus on Manager's due diligence for accepted investments
 - How does this manager screen potential investments?
 - Due diligence binders
 - Ongoing monitoring
 - Cash movements
 - What investments were rejected because of the manager's due diligence process?
 - Procedures performed at each manager are customized to address the risks specific to that manager's asset class. The procedures performed on a fund of fund manager are much different than those performed on an international equity manager.

Operational Due Diligence Process (cont.)

3. Repeat visits

- Repeat visits in response to issues noted in new manager visits.
- Repeat visits in response to issues noted as part of remote procedures.
- Normal repeat visits based on a rotational basis.

4. **Remotely applied procedures** – Provide ongoing monitoring of managers and potential risks, recalculate investment management and performance fees, serve as an indicator of changes in operational risk, and reinforce SBCERA's desire to minimize operational risks. Results of remote procedures are discussed with SBCERA staff and follow-up visit timing is modified as needed to address any additional operational risks.

5. **Fee Recalculations** – KM independently calculates investment management and performance fees based upon the supporting documentation.

Operational Due Diligence Process (cont.)

6. **Other Procedures** (addressing specific concerns of the Staff/Board)

- Procedures are developed in response to concerns raised by the Staff/Board or in response to issues noted by KM through ongoing monitoring and have included:
 - Inquiring of investment managers whether they had Russian investments and how they planned to dispose of any.
 - Worked with an investment manager to enhance its controls surrounding cash disbursements.
 - Working with an investment manager to understand enhancements made to improve cybersecurity training and readiness.
 - Visit to an investment manager to understand trade errors and controls implemented to reduce errors in the future.
 - KM monitors fee calculations and works with investment managers to resolve discrepancies.
 - Assistance with plan auditor requests.

Core Areas of Focus

- Operational Due Diligence is constantly evolving and each site visit is customized to the investment manager and asset class.
- Each site visit begins with an understanding of both the corporate and organizational structure as well as key person exposure and succession planning.
- Each visit generally focuses on the following key areas:
 - A. Identification and understanding of systems, controls, and resources impacting portfolio management
 - B. Assessment of compliance with the investment mandate and effective portfolio risk management
 - C. Understanding of an investment manager's trade and transaction execution and allocation
 - D. Valuation and Counterparty Risk
 - E. Performance measurement and review

Core Areas of Focus (cont.)

- F. Effective and timely trade reconciliation procedures
- G. Cash management flows and controls over cash
- H. Effective procedures to maintain confidentiality of transactions and portfolio details
- I. Appropriately skilled personnel with relevant training and development programs
- J. Effective and independent compliance functions ensuring, in particular, compliance with relevant regulatory requirements (including review of recent regulatory examinations)
- K. Adequate financial strength and insurance arrangements of investment manager
- L. SEC search
- M. Technology, Disaster Recovery and Business Continuity, Cybersecurity
- N. Compliance with key elements of SBCERA's contract, such as investment guidelines, keyman notification, and insurance requirements.

Other Areas of Focus

- Manager fee recalculations – Challenges to the fee recalculation process include:
 - Changing agreements
 - Differing formulas
 - Complex formulas for investment fees
 - Differing investment vehicle structures
 - Differing custodians and administrators
 - Lags in market values
 - Complex hurdle calculations
 - Complex waterfall structures, some requiring deal-by-deal analysis



Operational Due Diligence Visits

2023 Due Diligence – By The Numbers

- Completed 9 operational due diligence visits – all on-site
 - 5 Credit Managers
 - 1 Custodian
 - 2 Emerging Market Fixed Income
 - 1 Private Equity
- Reasons for Visit
 - Normal 4-year rotational visits
 - 1 pre-hire visit
 - 1 pre-hire revisit
 - Observations noted during remote procedures

Operational Due Diligence Visits

Mergers/Sale of Business/New Manager

- 1 investment manager merged with another firm of similar size since the time of KM's last site visit. The investment teams for the strategies in which SBCERA invests have not changed, but more resources are available to the team for research.
- 1 investment manager sold the business associated with a strategy in which SBCERA did not invest. The SBCERA investment team was not affected, but overall headcount dropped at the firm.
- 1 investment manager was newly formed in 2023.

Change in Ownership

- The founders of 1 investment manager diluted their ownership to below 50%. Current leaders of the firm increased their ownership.

Operational Due Diligence Visits

SEC Examinations

- KM read two SEC letters on examination as part of site visits. The first resulted in a clean closing letter. The second had comments on cross-trades and the investment manager updated their policies as a result.

Changes in Key Personnel

- 4 investment managers had noted the retirement and/or turnover of key personnel. SBCERA's investment team was notified of turnover changes.

Service Organization Control (SOC 1) Report

- 2 investment managers, one of whom acts at the administrator of the funds in which SBCERA invests, obtained a SOC 1 report on their own controls over administration services, asset management services and advisory services. No exceptions were noted in the testing of effectiveness of the controls in either case.

Operational Due Diligence Visits

Investment in Systems

- 5 investment managers implemented new systems or invested in significant upgrades to existing systems. 2 of the managers updated their trading and order management systems. 1 implemented new systems across order management, compliance and accounting in 2023 and another will do the same in early 2024. The fifth investment manager implemented a new data warehouse and expense allocation system.
- The custodian implemented new systems for document retention and performance reporting.

Change of Service Providers

- 1 investment manager noted it had changed its Third-Party Administrator, primarily due to service issues and control deficiencies with the prior administrator.
- 1 investment manager switched Third-Party Administrators to take advantage of a deeper team and technology at the new service provider in their asset class.

Operational Due Diligence Visits

Outsourced accounting to a joint venture in India

- The custodian that KM visited in 2023 has outsourced their accounting function to a joint venture in India. The custodian provided a SOC 1 report on their internal controls to us and the controls at the joint venture were included in the SOC 1 report.

Planned Change in Service Providers

- The investment manager that is implementing all new systems in early 2024 is also planning to change many related processes. These include performing middle and back-office functions and IT support with their own teams, rather than outsourcing them. This investment manager will continue to use a third-party administrator.

Kreischer Miller routinely follows up with investment managers who are in the process of implementing our recommended changes to consider the impact on SBCERA's operational risks.

2023 Remote Due Diligence - By The Numbers

Remotely Applied Due Diligence Procedures

- 25 Investment Managers reviewed through remotely applied procedures.
- Investment Managers are selected based on normal rotations, changes noted and discussions with SBCERA Investment Staff.

Observations

- SEC Examinations
 - 8 investment managers reported having undergone or were currently undergoing SEC examinations.
 - 1 was focused on question about the transition from LIBOR rates
 - 3 managers changed disclosures in the Form ADV and changes to various policies to clarify current procedures
 - 2 examinations with no follow-up required
 - 1 where the SEC raised concerns that a fund owned 100% by the investment manager's staff did not meet the custody rule
 - 1 where the SEC asked questions about disclosures and commission rates related to use of an affiliated broker-dealer and about the new SEC rules on advertising. This examination is still in process, but KM was permitted to read the Investment Manager's response to the SEC on the questions raised. The response documented analysis of industry rates on commissions, showing that the manager was below industry averages. The response also noted changes in disclosures that the manager will make to address the SEC questions in both areas.

2023 Remote Due Diligence - By The Numbers

Remotely Applied Due Diligence Procedures

Observations, continued

Other Regulatory Examinations

- 2 investment managers reported having undergone or were currently undergoing other regulatory examinations.
 - 1 investment manager has had interactions with the Financial Conduct Authority (FCA) in the UK and the Monetary Authority of Singapore (MAS). No action was required as a result of either the FCA or the MAS interactions.
 - 1 investment manager reported having undergone an examination with the CSSF (Luxembourg regulator), who expressed a concern regarding the delegation of authority. As a result, the investment manager hired a new officer.

Changes in Systems, Controls and Resources

- 4 investment managers are in the process of implementing new systems. When the systems have been implemented, KM will observe the new systems either during the next ODD visit for 3 and remotely for 1.
- 1 investment manager implemented new pre-trade rules for their compliance system after KM recommendations from their 2022 site visit.

2023 Remote Due Diligence - By The Numbers

Remotely Applied Due Diligence Procedures

Observations, continued

- Trade Errors
 - 1 investment manager reported a trade error in which they executed a sale instead of a purchase. The investment manager indicated that they corrected the error by purchasing shares the next day at a lower price, resulting in a small gain for SBCERA. The investment manager also noted that, should the error have resulted in a loss, the loss would have been born by the investment manager.
- Changes in Service Providers
 - 1 investment manager reported a change in its administrator and its custodian to a well-known administrator and a well-known custodian.
 - 1 investment manager reported a change in its external auditor as they consolidated service providers after it had been acquired by a larger investment manager.

2022 Remote Due Diligence - By The Numbers

Remotely Applied Due Diligence Procedures

Observations, continued

- Changes to Key Personnel
 - 7 investment managers indicated changes to key personnel.
 - 1 investment manager combined investment teams for two strategies after a merger and the Chief Executive Officer, Chief Commercial Officer, Chief Compliance Officer and the Chief Investment Officer of one investment strategy left.
 - 1 investment manager saw a portfolio manager and a managing director of research leave and be replaced in one strategy. In another of their strategies, 2 partners and 5 managing directors left and were replaced.
 - The Chief Risk Officer at 1 investment manager announced he would retire in a year and stepped back into an advisory role as his successor took over the CRO role.
 - 1 investment manager hired a new managing director.
 - 1 investment manager saw turnover where 6 managing directors left and 8 were hired.
 - 1 investment manager saw turnover of the portfolio manager and assistance portfolio manager in one strategy
 - The portfolio manager at 1 investment manager moved from one strategy to another

Questions?



Thank You For Your Time



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