

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 through 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:
 - Assist staff in understanding implications of SEC examination and administrative proceeding activity in September sweep.
 - 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, AI
- N. Compliance with key elements of SBCERA's contract, such as investment guidelines, keyman notification, and insurance requirements.

Operational Due Diligence Visits

Due Diligence (August 2025 – January 2026) – By The Numbers

- Completed 6 operational due diligence visits – all on-site
 - 5 Credit Managers
 - 1 Real Estate Managers
- Reasons for Visit
 - 4 initial visits
 - 2 normal 4-year rotational visits

Operational Due Diligence Visits

SBCERA's Access to Key Information

- 2 of the investment managers visited in initial, pre-hire visits stated that they did not make certain information that SBCERA considers critical available to investors (or not in a timely basis). In each case, the Staff and KM were able to work with the investment manager to structure a process whereby either the Staff and/or KM will have access to the information going forward.

Growth of the Investment Manager/Changes in Ownership

- Two investment managers that received an initial visit and one with a rotational visit noted changes in key systems or processes as a result of changes in ownership. The operational due diligence was performed on the new processes and systems.

Operational Due Diligence Visits

Discussions Regarding Allocations

- The nature of SBCERA's investment with many investment managers is such that the managers' approach to allocating investment opportunities is particularly important. When SBCERA has a fund of one or makes co-investments, there is a risk that the best investments will be allocated to comingled funds and/or other investors before SBCERA. In two of the managers subject to initial visits, the detail of the allocation policy was discussed both with the investment manager and with the Staff as part of the ODD so that the Staff has a full understanding of the process.

No Full Shadow Accounting

- For investment managers that use a third-party administrator (TPA), their maintenance of a full shadow set of books and records can serve as a key control. As it also increases costs, many investment managers have scaled back their reperformance of certain accounting and record-keeping performed by the TPA. One of the investment managers subject to an initial visit and one with a rotational visit do not maintain full shadow books and record. Each provided KM with a discussion of their key controls and the process they use to oversee the work of the TPA.

Operational Due Diligence Visits

Use of Third-Party Administrator

- One of the investment managers subject to an initial visit administers private credit funds internally. They are in the process of preparing to have a SOC 1 report on internal controls prepared and plan to have the Type 1 report, which outlines their controls in detail, but does not test the execution of the controls, by December 31, 2027. In the following year, they plan to issue a Type 2 SOC 1 report, which would include testing of the operation of the controls. The manager noted that they plan to have the related fund of one audited, which provide assurance that a third party is also looking at the holdings and results of operations of the funds and the related annual reporting.

Operational Due Diligence Visits

Preventive Pre-Trade Compliance v. Detective Post-Trade

- Generally, a control that prevents inappropriate trades from being made is preferred compared to controls that detect any errors, no matter how quickly the detection happens. For one of the investment managers subject to a rotational visit, their systems have been updated to allow use of preventive controls in pre-trade compliance. The operational due diligence was performed on these new systems and processes.

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.

Questions?



Thank You For Your Time



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