

# The SBCERA-KM Operational Due Diligence Program



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Thomas A. Peters, Director  
Todd E. Crouthamel, Director  
Jennifer Kreischer, Director  
Investment Industry Group  
Kreischer Miller  
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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.

## 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

### **2025 (through 7/31) Due Diligence – By The Numbers**

- Completed 9 operational due diligence visits – one remote, rest on-site
  - 2 Credit Managers
  - 2 Real Estate Managers
  - 4 Private Equity Managers
  - 1 Other
- Reasons for Visit
  - 1 initial visit
  - 1 pre-hire revisit
  - Rest normal 4-year rotational visits

## Operational Due Diligence Visits

### **Mergers/Sale of Business/New Manager**

- 1 firm merged with a larger firm in the last year. The firm noted existing ownership retained control over their operating budget and that they believe they can continue to operate largely as done before the transaction. They also note that they will be able to provide more opportunities for advancement for their team members.

### **Changes in Key Personnel**

- The president/CFO retired at one firm. He remains involved as a senior advisor. His duties as president were split between the Chief Executive Officer, the Chief Operating Officer and the General Counsel. No CFO was named and the Global Controller has taken more finance duties.

### **Cybersecurity Incident**

- One investment manager noted that one of their email addresses had been compromised, but they stated that no personally identifiable information was compromised and there was no financial impact.

## Operational Due Diligence Visits

### SEC Examinations

- 4 of the investment managers KM visited were subject to SEC fines in 2024 related to examinations previously disclosed to the SBCERA Staff and Audit Committee.
- One of the investment managers KM visited was subject to and SEC examination that was completed in 2025.
  - The manager had previously found that an employee was in violation of expense report policies and reimbursed any funds that incurred expenses in excess of the policies. KM notes that the reimbursement impacted one fund in which SBCERA is invested (owning approximately 11% of the fund). The fund was reimbursed approximately \$71,000.
  - The SEC found that the investment manager did not sufficiently disclose the impact of overcharging expenses to investors and did not have sufficient controls over expenses. The manager noted that they have updated the relevant policies and procedures.
- One of the investment managers KM visited started an SEC examination in 2025. As of October 2025, the exam has not yet been completed.

## Operational Due Diligence Visits

### **Service Organization Control (SOC 1) Report/Administration of Funds**

- 2 investment managers, both of which act as 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.
- 1 of the investment managers that KM visited in 2025 is in the process of transitioning from self-administering all funds to using a third-party administrator

## Operational Due Diligence Visits

### Investment in Systems

- One of the managers plans to implement a new accounting system in 2026. KM will follow up and obtain an understanding of the new system when it is implemented.
- One investment manager is planning to upgrade the systems used for calculating management fees. KM will follow up and obtain an understanding of the new system when it is implemented.

### Other

- For one manager, KM provided an overview of the allocation of investment opportunities, capacity for new opportunities and new funds that might impact this capacity.

**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.**

## 2025 Remote Due Diligence - By The Numbers

### **Remotely Applied Due Diligence Procedures**

- 23 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 Administrative Proceedings
  - KM and SBCERA staff noted decreased SEC Administrative Proceeding (i.e. settlements) activity compared to September 2024.
- SEC Examinations – 5 investment managers reported SEC examinations. Four of those exams have been completed and KM was permitted to read the correspondence with the SEC. The topics covered include expenses charged to the funds, disclosure of services provided by related parties and related fees, and recommendations for improvement of other disclosure and administrative matters. One of those closed exams was reported to the SBCERA Audit Committee and Staff in 2024. One SEC exam remains open.

## 2025 Remote Due Diligence - By The Numbers

### Remotely Applied Due Diligence Procedures

#### Observations, continued

##### Other Regulatory Examinations

- 2 investment managers reported having undergone other regulatory interactions. The first was an examination by the Financial Conduct Authority (FCA) in the UK. The FCA does not permit anyone outside the firm to have access to their correspondence, but the manager noted that the correspondence with the FCA related to the FCA gathering more information about CLOs and that no further information was required from them. The second manager noted examinations by the Small Business Administration (an annual exam related to SBA loans) and by FINRA. They stated that there were no findings or instances of non-compliance and KM was permitted to read the correspondence with the SBA and FINRA.

## 2025 Remote Due Diligence - By The Numbers

### Remotely Applied Due Diligence Procedures

#### Observations, continued

#### Changes in Systems, Controls and Resources

- 1 investment managers has implemented a new system. They implemented software to assist in analyzing investments, managing workflow related to the underwriting, allocation and execution of investments. They are also in the process of transitioning to using the software for analysis of returns and cash flows on all investments. KM received a demonstration of the system as used now and will follow up in future site visits on new functionality as the manager's transitions continue.

## 2025 Remote Due Diligence - By The Numbers

### Remotely Applied Due Diligence Procedures

#### Observations, continued

- Trade Error – 1 investment managers reported a trade error. The error occurred at their middle office service provider resulting in an inaccurate share count with respect to an equity investment. As a result of the error, certain funds oversold shares. The error was corrected the following day, resulting in a gain which was retained by the funds per the manager's trade error policy.
- Change in Service Providers - 2 investment managers reported a change in their legal service providers. One noted that retirements at the prior law firm degraded service and they switched to two additional firms. The other firm added a law firm to their service providers.

# 2025 Remote Due Diligence - By The Numbers

## Remotely Applied Due Diligence Procedures

### Observations, continued

- Changes in Key Personnel - KM inquired of turnover of key personnel and 11 investment managers indicated changes to key personnel. KM performed procedures to determine that SBCERA staff had been informed of the changes in accordance with the respective contracts.
- Pending/Threatened Litigation
  - 2 Investment Managers disclosed pending or threatened litigation
    - 1 Investment Manager potential litigation related to an employee during his tenure at another firm. This matter has been disclosed to the SBCERA Staff and Audit Committee in prior years.
    - 1 Investment Manager noted lawsuits against the firm that “allege violations of ERISA’s fiduciary and prohibited transaction rules against plan sponsor, the manager and others.” KM will continue to follow up with the manager for future updates on the complaints that have been filed.

Questions?



## Thank You For Your Time



**Thomas A. Peters, CPA, CIPM**  
Director, Audit & Accounting  
Investment Industry Group Leader

**215.441.4600**  
**[tpeters@kmco.com](mailto:tpeters@kmco.com)**



**Todd E. Crouthamel, CPA**  
Director, Audit & Accounting

**215.441.4600**  
**[tcrouthamel@kmco.com](mailto:tcrouthamel@kmco.com)**



**Jennifer Kreischer, CPA**  
Director, Audit & Accounting

**215.441.4600**  
**[jlkreischer@kmco.com](mailto:jlkreischer@kmco.com)**