

The SBCERA-KM Operational Due Diligence Program



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

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:
 - Visit to an investment manager to address trade allocation errors.
 - KM worked with an investment manager to enhance its controls surrounding cash, fee calculations and rebates.
 - KM monitors fee calculations and works with investment managers to resolve discrepancies.
 - Procedures designed to test the transfer of the Gold Coast/Kneiff Tower funds to onshore custody.
 - 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

2020 Due Diligence – By The Numbers

- Completed 7 on site visits and 3 virtual operational due diligence visits
 - 5 Credit Managers
 - 1 Fixed Income Manager
 - 1 Fund of Funds Manager
 - 1 Hedge Fund Manager
 - 1 Private Equity Manager
 - 1 Real Estate Manager
- Reasons for Visit
 - Normal 4 year rotational visits
 - Gold Coast and Kneiff Tower transition
 - Pre-hire Visit
 - Pre-hire revisit
 - Observations noted during 2019 remote procedures
- 6 Visits to be scheduled through the end of June 30, 2021
 - Pre-hire revisit
 - 4 year rotational visits
 - Observations noted during 2020 remote procedures

Operational Due Diligence Visits

Gold Coast and Kneiff Tower Transition

- Four Gold Coast and Two Kneiff Tower funds moved from offshore platforms to onshore
- KM visited the Investment Managers responsible for the accounts, completing the following:
 - Review transition of assets
 - Review reconciliation procedures
 - Review set up of fee calculation models

COVID-19 and its Impact to SBCERA Investment Managers

KM requested information pertaining to COVID-19 and the impact to SBCERA's investment managers as part of remote and fee recalculation procedures

- Most managers reported 100% of their employees were working from home.
- Impact to the investment process
 - Most managers reported no significant impact to the investment process.
 - Most managers with strategies that require travel reported a slowdown in activity
 - 1 manager reported no secondary deals were transacted. 1 manager reported all transactions in progress were halted and focus was shifted to monitoring existing assets.

Operational Due Diligence Visits

COVID-19 and its Impact to SBCERA Investment Managers, continued

- Changes in Processes or Controls
 - 1 manager reported it shifted ½ of its assets, for several of its Funds, in custody at Cantor to Pershing to mitigate risk.
 - Several managers indicated changes to allow electronic signatures due to the inability to obtain “wet” signatures
- Impact to Service Providers
 - All managers indicated no significant impact to its service providers
 - 1 manager reported it requested business continuity plans from all service providers
- Cyber Security Threats
 - Most managers indicated no cybersecurity issues other than the normal risk of cybersecurity threats

Operational Due Diligence Visits

SEC Examinations

- 1 investment manager had undergone an SEC examination since the time of KM's last site visit.
- 1 pre-hire investment manager had undergone 2 SEC examinations since the inception of the firm.
- Comments focused on
 - Enhanced disclosures related to Cross Trades
 - Enhanced disclosures related to investment allocations to ramping accounts
 - Enhanced valuation policies and ADV disclosures related to third party pricing agents
 - Enhancements to the Best Execution Policy to include the review of cross trades
 - Footnote disclosures regarding the use and effect of leverage on a fund's returns in marketing materials
- Investment Managers indicated all changes requested by the SEC were implemented.

Operational Due Diligence Visits

Investment in Systems

- 5 investment managers had implemented or were in the process of implementing new systems relevant to the trading process. KM will schedule a visit once the implementation is complete.

Changes in Key Personnel

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

Annual Review of Compliance Policies and Procedures

- 4 investment managers did not have a formal policy to review compliance policies and procedures. KM recommended that investment managers implement a formal review process. KM will follow up as part of the remote procedures.

Operational Due Diligence Visits

Opportunities to Strengthen Due Diligence

- 2 investment managers had opportunities to strengthen its due diligence procedures and the documentation of those procedures.

Strengthening Controls Around Cash

- 2 investment manager had opportunities to strengthen controls around cash movement and overdrafts.

Outsource of Back Office Operations

- 1 investment manager was in the process of outsourcing its back office operations

Cybersecurity Policies and Procedures and training

- 1 investment managers did not have formal cybersecurity training.

Operational Due Diligence Visits

Pending Litigation

- 1 investment manager noted it was currently going through a work-out process with two investments which may involve formal proceedings to seek recovery.

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

2020 Remote Due Diligence - By The Numbers

Remotely Applied Due Diligence Procedures

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

Observations

- Regulatory Examinations
 - 5 investment managers reported undergoing routine regulatory examinations. KM is currently in the process of scheduling video conference calls to read the letters.
 - Investment Managers indicated comments were resolved by the Investment Managers
- Changes in Systems, Controls and Resources
 - 6 investment managers implemented or are in the process of implementing new systems
 - 2 investment managers implemented new order management systems
 - Other system changes included implementation of research tools, new accounting systems and reporting systems. KM will observe new systems during the next ODD visit.

2020 Remote Due Diligence - By The Numbers

Remotely Applied Due Diligence Procedures

Observations, continued

- Changes in Service Providers
 - 1 investment manager reported a change in its fund administrator as well as a third party compliance provider.
- Changes to Key Personnel
 - 4 investment managers indicated changes to key personnel

2020 Due Diligence - By The Numbers

Recalculation of Management and Incentive Fees

- Investment Managers representing over 80 mandates and 11 MCA structures
- KM is currently in the process of recalculating fees including the testing of rebates and expense offsets through December 31, 2019.

Testing Includes:

- Management Fee Recalculations
 - Management fees, based on commitments or market values, are typically charged by the investment manager, or general partner, under the terms of the MCA, IMA or LPA
- Completeness of Expense Offsets
 - Many private equity investment managers charge fees to their portfolio companies. These fees may include, but are not limited to, advisory fees, monitoring fees, recapitalization fees, consulting fees and board participation fees. These fees charged by the investment manager are often offset against the management fees charged to the investor.
- Testing of Rebates
 - MCA agreements include provisions for management and incentive fee offsets for the fees paid to an underlying fund held within the MCA. Generally, rebates are in place to avoid duplication of fees.

2020 Due Diligence - By The Numbers

Recalculation of Management and Incentive Fees, continued

- Incentive Fee (Carried Interest) Recalculations
 - Incentive fees are charged by an investment manager based on a fund's performance over a given period. Can be subject to a hurdle rate and a high water mark.
 - Carried interest relates to the allocation of profits to the general partner and limited partners of a private equity fund, often allocated based on a waterfall structure
 - Carried interest calculations often included a waterfall structure comprised of multiple tiers that involve preferred returns (the hurdle rate), catch-up provisions and clawback provisions

Potential Enhancements to the Fee Recalculation Program:

- Working with the investment team to develop a process which will allow KM to identify new investments and possible changes to fee structures on a timely basis.
- Revised request for information lists sent to investment managers, including questions to identify all other products managed that include embedded fees charged by the investment manager.
- Increase fee recalculation review for the first visit after a manager pre-hire visit. KM and manager to agree on model for the first quarter invoice.

Questions?



Thank You For Your Time



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

215.441.4600
tpeters@kmco.com



Todd E. Crouthamel, CPA
Director, Audit & Accounting

215.441.4600
tcrouthamel@kmco.com