UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8751 / November 14, 2006

SECURITIES EXCHANGE ACT OF 1934
Release No. 54745 / November 14, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12478

In the Matter of City of San Diego, California, Respondent.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against the City of San Diego, California (the "City" or "Respondent").

II.

In anticipation of the institution of these proceedings, the City has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, the City consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and the City's Offer, the Commission finds that:[1]

A. SUMMARY

This matter involves the City of San Diego's violations of the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut. The City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003.

Despite the magnitude of the problems the City faced in funding its future pension and retiree health care obligations, the City conducted five separate municipal bond offerings, raising more than $260 million, without disclosing these problems to the investing public. In each of these offerings, the City prepared disclosure documents that are used with municipal securities offerings—that is, preliminary official statements and official statements—and made presentations to rating agencies.[2] In addition, in 2003 it prepared and filed information pursuant to continuing disclosure agreements under Exchange Act Rule 15c2-12 with respect to $2.29 billion in outstanding City bonds and notes.[3] Although the City provided some disclosure about its pension and retiree health care obligations, it did not reveal the gravity of the City's financial problems, including that:

- The City's unfunded liability to its pension plan was expected to dramatically increase, growing from $284 million at the beginning of fiscal year 2002 and $720

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[1] The findings herein are made pursuant to the City's offer of settlement and are not binding on any other person or entity in this or any other proceeding.

[2] An official statement is a document prepared by an issuer of municipal bonds that discloses material information regarding the issuer and the particular offering. A preliminary official statement is a preliminary version of the official statement that is used to describe the proposed new issue of municipal securities prior to the determination of the interest rate(s) and offering price(s). The preliminary official statement may be used to gauge interest in an issue and is often relied upon by potential purchasers in making their investment decisions.

[3] Continuing disclosures are disclosures of material information relating to prior years' municipal bond offerings that are periodically provided to the marketplace by the bonds' issuer pursuant to contractual agreements and Exchange Act Rule 15c2-12.

million at the beginning of fiscal year 2003 to an estimated $2 billion at the beginning of fiscal year 2009;

- The City's total under-funding of the pension plan was also expected to increase dramatically, growing tenfold from $39.2 million in fiscal year 2002 to an estimated $320 to $446 million in fiscal year 2009;
- The City's projected annual pension contribution would continue to grow, from $51 million in 2002 to $248 million in 2009; and
- The estimated present value of the City's liability for retiree health benefits was $1.1 billion.

The City's enormous pension and retiree health liabilities and failure to disclose those liabilities placed the City in serious financial straits. When the City eventually disclosed its pension and retiree health care issues in fiscal year 2004, the credit rating agencies lowered the City's credit rating. The City also has not obtained audited financial statements for fiscal years 2003, 2004, and 2005.

Consequently, the City violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities.[4]

B. THE RESPONDENT

City of San Diego, California is a California municipal corporation with all municipal powers, functions, rights, privileges, and immunities authorized by the California Constitution and laws, including the power to issue debt. The City is the seventh most populous city in the country, with approximately 1.3 million residents.

C. RELATED PARTY

San Diego City Employees' Retirement System ("CERS") is a defined benefit plan[5] established by the City to provide retirement, disability, death, and retiree benefits to its members,

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[4] The Commission acknowledges that in the City's offering documents for sewer revenue bonds issued in 1995, 1997, and 1999 and sewer revenue bonds that were offered but not issued in 2003, in its continuing disclosures, and in its communications with rating agencies, the City failed to disclose that the City's wastewater fee rate structure did not comply with certain federal and state clean water laws, that the City was not in compliance with the terms of certain government grants and loans, and that the City could have been required to repay those grants and loans due to such non-compliance. The offerings in the 1990s, however, predate the offerings that are the subject of this Order, and the City did not consummate the 2003 offering because issues arose regarding the adequacy of its pension disclosure. In addition, in 2004, the City came into compliance with the federal and state clean water laws and the grant and loan covenants by adopting a new fee rate structure. The City thereby avoided having immediately to repay the government grants and loans.

[5] A defined benefit plan is a traditional pension plan under which pre-determined retirement benefits are based on a formula established by factors such as age, years of service, and

i.e., City employees and their beneficiaries. CERS is administered by the CERS Board, which during the relevant period included eight City employees, including the City Treasurer and the Assistant City Auditor and Comptroller, one retiree, and three non-employee City citizens appointed by the City Council as CERS Board members.

D. FACTS

1. Background

a. Structure of the City's Government

Until January 2006, the City's form of government was a city manager system.[6] Legislative powers of the City were vested in the City Council ("Council"), which made policies and appointed a professional city manager to carry out those policies. The Council was composed of nine full-time Council members who served for staggered four-year terms. Eight of the Council members represented the City's eight districts. The Mayor, who was elected at large, presided at the meetings of the Council and served as the official head of the City for ceremonial purposes. The Mayor and each Council member had one vote; the Mayor had no veto power.

Prior to 2006, the City Manager ("Manager") was the City's chief administrative officer and had substantial control over local government decisions. The Manager, appointed by the Mayor and Council, advised the Council of the City's present and projected financial condition, appointed and removed all city department heads (except the City Auditor and Comptroller ("City Auditor"), City Attorney, and City Clerk), prepared the City's budget, and carried out the Council's budget plan. During the relevant time period, the City's general fund budget was less than $900 million. The City Manager had several Deputy City Managers, one of whom was in charge of the Financing Services Department, which had responsibility for overseeing the City's issuance of municipal securities.

Prior to 2006, the City Auditor was also appointed by the Council, and was required to file at least monthly with the City Manager and Council a summary statement of revenues and expenses for the preceding accounting period.[7] The Auditor was the City's chief financial officer and was responsible for the preparation and issuance of the City's Comprehensive Annual Financial Reports, also referred to as CAFRs. The City's Comprehensive Annual Financial Reports included audited financial statements prepared pursuant to standards established by the

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compensation, and in which the employer bears risk if the employer and employee contributions and the investment return on those contributions are not sufficient to fund the pension benefits.

[6] In January 2006, the City transitioned from a City Manager / Council form of government to a strong Mayor form of government. Under the new system, the Mayor became the City's chief executive officer and the City Manager's position was eliminated. The Council continues to act as the legislative body. City of San Diego City Charter, Article XV.

[7] City of San Diego City Charter, Article V, Section 39.

Government Accounting Standards Board ("GASB")[8] and various statistical, financial, and other information about the City. Portions of the Comprehensive Annual Financial Reports for the years ended June 30, 2001, and June 30, 2002 were attached as appendix B to the preliminary official statements and the official statements. The Comprehensive Annual Financial Reports for 2001 and 2002 were also filed as continuing disclosures.

The elected City Attorney served as the chief legal officer for the City. The City Attorney's office advised the Council, City Manager, and all City departments on legal matters, including disclosure in the City's securities offerings. The City Attorney was responsible for preparing all ordinances, resolutions, contracts, and other legal documents.

b. The City's Pension Plan

The City provided a defined benefit pension plan and retiree health care benefits to its employees through CERS. CERS functioned as a trust for the benefit of its members (i.e., approximately 18,500 current and former City employees and officials). The City was the creator of the trust and determined its terms, including the members' required contributions and the levels of benefits. CERS was administered by a Board of Administration, which controlled the investment of CERS's funds and which owed fiduciary duties to CERS members. CERS's assets consisted of past contributions by the City and CERS members and investment earnings on those funds. CERS's liabilities consisted of operating expenses and the future pension benefits that were owed to members.

Each year, CERS hired an actuary to determine the value of the plan's assets and liabilities based on certain actuarial assumptions and the amount that needed to be contributed to the plan so that the plan accumulated sufficient assets to pay pension (but not health care) benefits when due.[9] Pursuant to the City Charter, the City was to contribute half of that amount, which was expressed in terms of a percentage of payroll expenses, with the other half to be contributed by the employees, which amount was determined as a percentage of compensation based on the employee's age upon entry into CERS.

At least three concepts were particularly important in the disclosure to the public of the City's pension obligations and funding of those obligations: (1) CERS's funded ratio; (2) the

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[8] GASB is the organization that establishes standards of state and local governmental accounting and financial reporting.

[9] An actuarial valuation is a determination by an actuary, as of a specified date, of the normal cost, actuarial accrued liability, actuarial value of the assets, and other relevant values for a pension plan based on certain actuarial assumptions. The actuarial value of assets refers to the value of cash, investments, and other property belonging to a pension plan as used by the actuary for the purpose of preparing the actuarial valuation for the pension plan. The actuarial accrued liabilities are what is owed in connection with past services, as determined by one of the actuarial cost methods. Actuarial assumptions are estimates of future events with respect to certain factors affecting pension costs, including rates of mortality, disability, employee turnover, retirement, rates of investment income, and salary increases. Actuarial assumptions are generally based on past experience, often modified for projected changes in conditions.

City's unfunded liability to CERS; and (3) the City's net pension obligation, also called the NPO. CERS's funded ratio was the ratio of its assets to liabilities. The City's unfunded liability to CERS was the dollar shortfall between CERS's assets and liabilities. The City's net pension obligation was the cumulative difference between what the City actually contributed to CERS and the amount that the City would have contributed had it conformed to a funding method recognized by GASB.

2. The City's Pension and Retiree Health Care Benefits and Funding of CERS

The City failed to disclose material information regarding substantial and growing liabilities for its pension plan and retiree health care and its ability to pay those obligations in the future in the disclosure documents for its 2002 and 2003 offerings, in its continuing disclosures filed in 2003, and in its presentations to the rating agencies. As more fully described below, the City's substantial and growing pension and retiree health care liabilities resulted from several factors, including: (1) the City's intentional under-funding of its annual pension contribution; (2) the City's granting of new retroactive pension benefits; (3) the City's use of certain CERS earnings to pay for various additional pension and retiree health care benefits and to pay a portion of employees' pension contributions; and (4) CERS's earning less than anticipated returns on its investments.

a. The City's Historical Practice of Using "Surplus Earnings" to Fund Pension and Retiree Health Care Benefits

In fiscal year 1980, the City began instructing CERS to use "surplus earnings"—i.e., earnings above the actuarially projected 8% return rate[10]—to fund an ever-increasing amount of additional benefits for CERS members. Pension plans typically retain surplus earnings to support the plan's financial soundness and to make up for years in which earnings fall short of the assumed return rate. Rather than retaining its surplus earnings, the City began using surplus earnings in fiscal year 1980 to fund an annual extra or "13th check" to retirees. The City continued using surplus earnings to pay for retiree health care benefits in fiscal year 1982 and to pay an ever-increasing amount of the employees' CERS contributions in fiscal year 1998.[11]

In total, the City used surplus earnings to pay pension benefits and employees' contributions totaling $150 million as of the end of fiscal year 2001 and an additional $25 million as of the end of fiscal year 2002. According to a 2005 CERS audit, the City's use of surplus

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[10] Without regard to its actual historical rate of return on investments, the CERS Board assumed an annual rate of investment return of 8%, which the actuary incorporated into his calculations. CERS defined surplus earnings as the amount of realized investment earnings in excess of the actuarially projected 8% return rate.

[11] In fiscal years 2003 and 2004, the City used CERS's surplus earnings from prior years to pay up to 27% of the employees' contributions.

earnings accounted for 17% of the increase in the City's unfunded liability to CERS from fiscal year 1997 through fiscal year 2003.

b. Manager's Proposal 1: The City Proposes Additional Benefits in Exchange for Contribution Relief

In fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City therefore made the pension benefit increases contingent on CERS's agreement to the City's under-funding of its annual contribution to CERS.

In fiscal year 1997, the City and CERS entered into an agreement, which was referred to as Manager's Proposal 1, that set the City's annual contribution at gradually increasing rates through fiscal year 2008. This funding method, which the City termed "Corridor" funding, was not recognized by GASB and set annual funding rates that were not actuarially determined and were projected to be below GASB-recognized funding rates through fiscal year 2006. In other words, under Corridor funding, the City would be intentionally under-funding its annual liability to CERS in fiscal years 1997 through 2006.[12] After fiscal year 2006, it was estimated that the funding rate of Manager's Proposal 1 would equal a GASB-accepted rate. Manager's Proposal 1 also contained a provision intended to protect CERS's financial soundness. Specifically, if CERS's funded ratio fell below 82.3%, the City would have to increase its CERS contribution rate.

In fiscal years 1996 and 1997, the City estimated that under Manager's Proposal 1, by the end of fiscal year 2008, the City's net pension obligation would be $110.35 million. Because the City's Corridor funding method was not GASB-recognized, GASB required that the City disclose its net pension obligation in its annual financial statements.

c. The *Corbett* Litigation Requires the City to Fund Additional Retroactive Benefits

In March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with *Corbett* as the named class plaintiff.[13] Under the *Corbett* settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities. Under

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[12] Manager's Proposal 1 was viewed skeptically by some members of the CERS Board who were not City employees. The majority of the CERS Board, however, consisted of City officials who received benefit increases that were contingent on the Board's approval of Manager's Proposal 1. Moreover, CERS's actuary informed the CERS Board that Manager's Proposal 1 was a sound proposal and CERS's fiduciary counsel opined that the Board would be acting within the ambit of its fiduciary discretion in approving Manager's Proposal 1.

[13] The *Corbett* plaintiffs raised various claims based on a 1997 California Supreme Court decision which held that an employee's salary for purposes of calculating basic pension benefits included the value of overtime and accrued leave.

Manager's Proposal 1, however, the City's contributions to CERS did not increase. As a result, the City's unfunded liability to CERS increased by $185 million.

In negotiating the *Corbett* settlement, however, the City purposefully structured certain of the increased *Corbett* benefits to avoid having those benefits adversely affect CERS's reported funded ratio and the City's reported unfunded liability to CERS. Specifically, the City structured the *Corbett* settlement so that the increased benefits for retired CERS members were to be paid in a given year only if there were sufficient surplus earnings from that year to pay the benefit. If there were insufficient surplus earnings in a given year to pay the increased benefit, then the cost of the increased benefit would become CERS's liability and would eventually be paid from future years' surplus earnings. The City and CERS treated the increased benefits to retired CERS members as contingent liabilities that were not taken into account in determining CERS's funded ratio or the City's unfunded liability to CERS. As of June 30, 2001, according to CERS's actuary, if the contingent portion of the *Corbett* settlement had been included in CERS's valuation, the City's unfunded liability to CERS would have increased by $70 to $76 million and CERS's funded ratio would have decreased by 2% to 2 ½ % from what was actually reported by the City. Thus, the City's pension situation was even more dire than the numbers, as they were reported by the City, indicated.

d. CERS's Actuary Report for Fiscal Year 2001 Shows a Dramatic Increase in the City's Pension Liabilities

In fiscal year 2001, CERS's investment return began to fall short of its anticipated 8% annual return. The City was informed of CERS's declining performance in February 2002, when it received CERS's annual actuarial valuation for fiscal year 2001. This report stated that as of the end of fiscal year 2001, CERS's funded ratio was 89.9% and the City's unfunded liability to CERS was $284 million, as compared to a funded ratio of 97.3% and an unfunded liability of $69 million only one year earlier. Moreover, the report noted that if the *Corbett* contingent benefit to CERS retired members were included, the City's unfunded liability to CERS would have increased to at least $354 million and CERS's funded ratio would have fallen to at least 87.9%.

CERS's actuary attributed these changes to a number of factors, including CERS's actuarial investment losses[14] of $95.6 million (and warned that there would be further actuarial investment losses in fiscal year 2002 unless the markets improved during the remaining five months of the fiscal year). In his report, CERS's actuary also warned that "all parties" should be "acutely aware that the current practice of paying less than the [actuarial] computed rate of contribution ... will help foster an environment of additional declines in the funded ratio in absence of healthy investment returns."

In May 2002, the City learned that CERS would likely not have any surplus earnings from fiscal year 2002 to pay for the contingent benefits—specifically, retiree health care benefits, the 13th check, and the *Corbett* increase to retirees.

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[14] Actuarial investment losses are the difference between the assumed investment rate, which in the City's case was 8% annually, and the actual investment results.

e. The Blue Ribbon Committee Report Puts the City on Notice about its Growing Pension and Retiree Health Care Liabilities

In April 2002, the City received a warning that the City's pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities. This came in the form of a report from the City's Blue Ribbon Committee to the City Council.[15] The report stated that the Blue Ribbon Committee had three principal concerns regarding CERS. First, the City was granting retroactive retirement benefit increases but pushing the cost of those benefit increases into the future, long after the individuals involved in the decisions were gone. Second, the City's budgetary process did not adequately comprehend the steadily growing annual expense of the pension contribution, "particularly given the uncontrollable and non-discretionary nature of this liability." The Committee stated that the City's pension contribution would substantially increase and warned that any future benefit increases, particularly retroactive increases, would "significantly exacerbate this problem." Third, the City's budgetary process did not recognize that retiree health care costs were a non-discretionary expense that would grow at an increasing rate and that the City was not paying out of its current year's budget the full cost for their future retiree health benefits. This report thus squarely put the City on notice that it had substantial future pension and healthcare liabilities it would probably be unable to pay under the current system.

f. Manager's Proposal 2: The City Again Proposes Additional Pension Benefits in Exchange for Relief from an Impending Lump Sum Payment

In fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased portion of the employees' contribution, and obtained additional time to under-fund its annual CERS contribution.

In the second half of fiscal year 2002, the City agreed to increase pension benefits for fiscal year 2003. From as early as October 2001, however, the City was concerned that CERS's funded ratio would fall below the 82.3% floor established by Manager's Proposal 1, which would require the City, at the very least, to increase its contributions to CERS by at least $25 million to be at a higher GASB-accepted rate.

Concerned about having to pay the additional $25 million, the City sought to condition the pension benefit increases on the City's obtaining from CERS relief from the floor of Manager's Proposal 1. In November 2002, the City and CERS agreed to Manager's Proposal 2 and the City

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[15] In April 2001, the Mayor had appointed a nine-member committee of San Diego citizens, known as the Mayor's Blue Ribbon Committee on City Finances, to independently evaluate the City's fiscal health and make any appropriate recommendations. In February 2002, the Blue Ribbon Committee presented its report to the Council's Rules Committee, identifying nine areas of concern, two of which related to the City's pension fund. The same report was made to the full Council in April 2002.

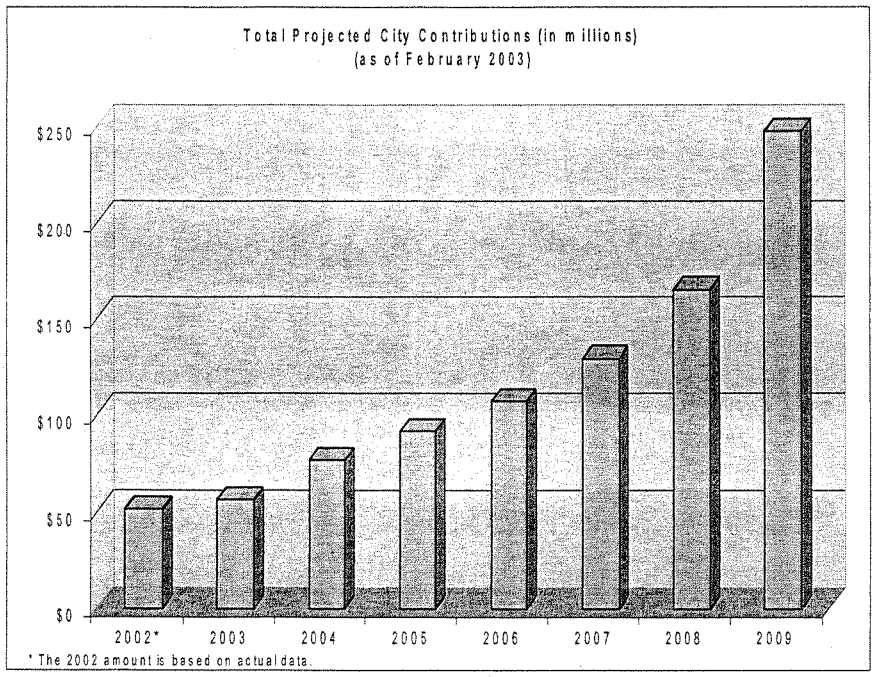
adopted the increased pension benefits as of July 2002. Under Manager's Proposal 2, once CERS's funded ratio fell below 82.3%, the City would have five years to increase its contributions to CERS to reach a GASB-recognized funding rate.

As a result of CERS's actuarial losses in fiscal year 2002, CERS did not have surplus earnings to pay the 13th check, the cost of retiree health care, and the *Corbett* benefit increase to retired CERS members. In conjunction with Manager's Proposal 2, however, the City directed CERS to use certain of its reserve accounts to pay the 13th check and the retiree health care benefits, and to pay an increased portion of certain City employees' CERS contributions. The reserve funds could have been used to increase CERS's funded ratio and decrease the City's unfunded liability to CERS; instead, the City directed that CERS use the reserve funds to pay additional benefits.

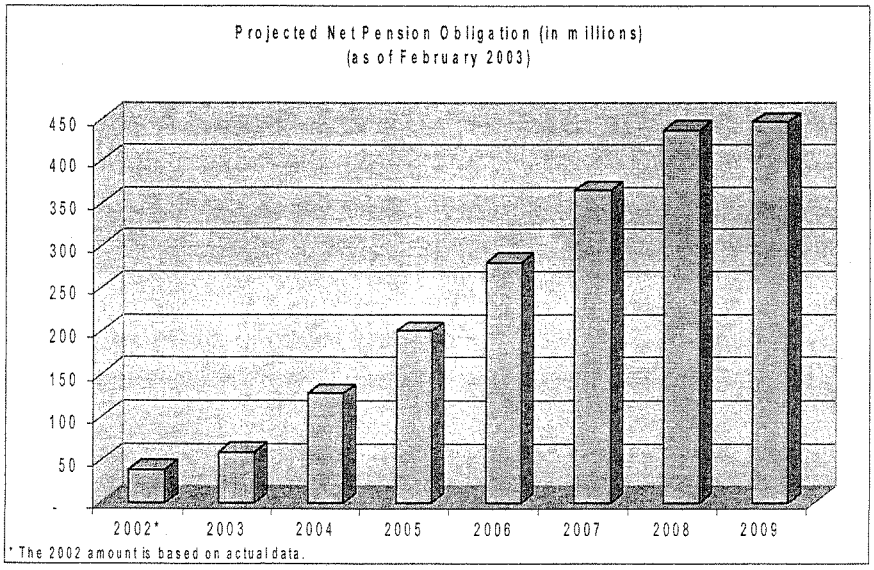
g. CERS's Actuary Report for Fiscal Year 2002 and Projections for the Future Show that the City Faces Substantial Problems Funding its Pension and Retiree Health Care Liabilities

In early 2003, the City received two reports from CERS's actuary. These reports provided the City with negative information regarding the present and projected status of CERS's funded ratio and the City's unfunded liability to CERS. First, in January 2003, the City received CERS's actuary report for fiscal year 2002. This report stated that during fiscal year 2002, CERS suffered an actuarial loss of $364.8 million and that as of the end of fiscal year 2002, CERS's funded ratio was 77.3% and the City's unfunded liability to CERS was $720 million, as compared to a funded ratio of 89.9% and unfunded liability of $284 million only one year earlier. The actuary's report further stated that if the *Corbett* contingent benefit to CERS retired members had been included, the City's unfunded liability to CERS would have been at least $790 million, and CERS's funded ratio would have been approximately 75.3%. In the concluding comment, the actuary stated that CERS was "in adequate condition," which was the first time that the actuary had not described CERS as "actuarially sound."

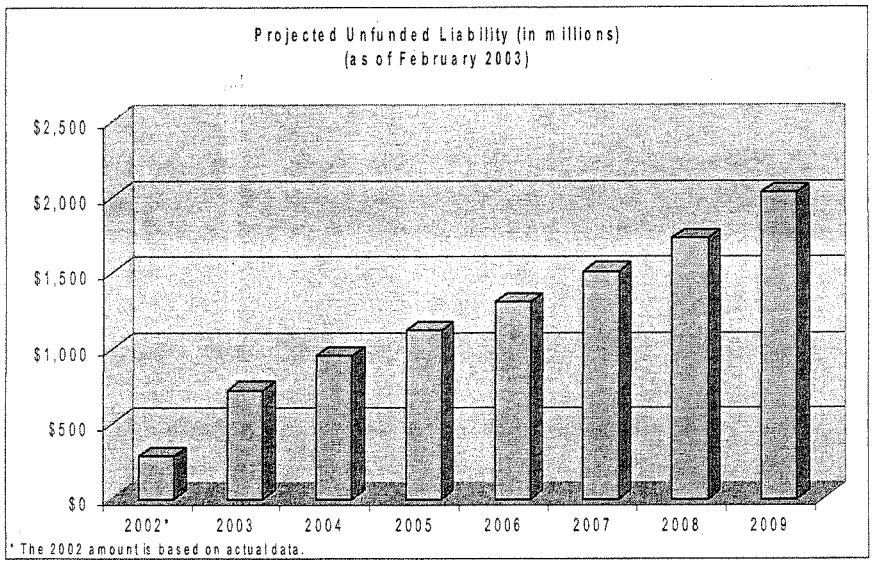
Second, in February 2003, CERS's actuary provided to the City projections of the City's contributions under Manager's Proposal 2, the City's net pension obligation, the City's unfunded liability to CERS, and CERS's unfunded ratio. Specifically, the City's contribution rate was projected to more than quadruple—from 9.83% of payroll in fiscal year 2002 ($51 million) to 35.27% of payroll in fiscal year 2009 ($248 million). The following chart illustrates the growth in the City's projected annual contribution to CERS:



The City's net pension obligation was projected to grow by tenfold—from $39.23 million in fiscal year 2002 to as much as $446 million in fiscal year 2009. The following chart illustrates the growth in the City's projected net pension obligation:



The City's unfunded liability was projected to increase more than seven fold—from $284 million at the beginning of fiscal year 2002 to $2 billion at the beginning of fiscal year 2009. CERS's funded ratio was projected to continue to fall—from 77.3% at the beginning of fiscal year 2003 to 65.6% at the beginning of fiscal year 2009. The following chart illustrates this dramatic increase in the City's projected unfunded liability to CERS:



The City had knowledge of these projections prior to all of its 2003 municipal securities offerings.

h. The *Gleason* Litigation: CERS Members Challenge Manager's Proposal 1 and Manager's Proposal 2

Further evidence that the City's under-funding of CERS was potentially threatening the City's future fiscal health came in January 2003, when CERS members filed a class action, with *Gleason* as the named class plaintiff, against the City and CERS alleging breaches in connection with the City's under-funding of CERS under Manager's Proposal 1 and Manager's Proposal 2. Among other things, the *Gleason* complaint alleged that by 2009, the City would owe approximately $2.8 billion to CERS, with an annual City budget expense of more than $250 million. In March 2003, the CERS attorney in the *Gleason* litigation advised CERS that (1) certain CERS Board members had breached their fiduciary duty by adopting Manager's Proposal 2; and (2) CERS should exercise its right to nullify Manager's Proposal 2. The CERS Board, which included the City Treasurer and the Assistant City Auditor and Comptroller, rejected this advice. If Manager's Proposal 2 had been nullified, the City would have been required to make an immediate potential payment to CERS of up to $159 million.

i. CERS's Response to the Blue Ribbon Committee Report Advises the City's Officials of the Growing Pension and Retiree Health Care Crisis.

In February 2003, additional detailed information about the City's pension funding crisis was presented to City officials when CERS responded to the Blue Ribbon Committee's report.[16] In its response, CERS advised the City that as of June 30, 2002, CERS's funded ratio had fallen to 77.3% and the City's unfunded liability to CERS had increased to $720 million. The response also stated that the falling funded ratio and the increasing unfunded liability resulted from three factors: a dramatic decline in CERS's investment performance in fiscal years 2001 and 2002; the City's granting of increased benefits; and the City's contributions to CERS at less than a GASB-recognized rate.

With respect to the City's under-funding, the response stated that the annual amount of the City's under-funding of CERS continued to increase in fiscal years 2002 and 2003, which was contrary to the initial projections from Manager's Proposal 1 that the annual amount of under-funding would decline beginning in fiscal year 2001. The response further stated that the City's net pension obligation would reach $102 million by the end of fiscal year 2003 and $423 million by the end of fiscal year 2009.

The response also discussed the City's future liability for retiree health care. CERS's actuary had estimated that the present value of the City's liability for future retiree health care was in excess of $1.1 billion. The response further stated that the City was not making any contributions to CERS to pay for this liability, that CERS had been paying for this liability with money in a reserve funded with CERS's surplus earnings from prior years, that the reserve would be depleted in fiscal year 2006, and that in fiscal year 2006, the City would have to pay an estimated $15 million for retiree health care. The response warned that absent a change in the benefit and a dramatic decrease in future health care costs, the City could be facing significant future funding obligations. The response recommended that the City consider funding this future health care liability as part of its annual contribution to CERS.

j. The City's Study of Its Pension Obligations Concludes that the City's Pension Liabilities Could Negatively Impact the City's Credit Rating

In April 2003, the City received additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City's credit rating and ability to issue municipal securities. In February 2003, the City hired a financial adviser to analyze CERS's funding and to develop potential solutions. On April 16,

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[16] From February 9 through 13, 2003, the local newspaper wrote three front page, above-the-fold articles about the City's under-funded pension system and the CERS response. The newspaper articles explained that (1) by the end of FY 2009 the City's unfunded liability to CERS was projected to increase to almost $2 billion; and (2) the City's unfunded liability for retiree health care was estimated to be $1.1 billion.

2003, the financial adviser provided to the City a preliminary pension analysis. In its analysis, the financial adviser stated that because of the City's under-funding, the City's unfunded liability would continue to grow and CERS's funded ratio would continue to fall through fiscal year 2021 regardless of actuarial gains or losses. The financial adviser estimated that under Manager's Proposal 2, the City's unfunded liability to CERS would grow to $1.9 billion at the end of fiscal year 2009 and to $2.9 billion at the end of fiscal year 2021, and CERS's funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021.

The preliminary pension analysis also stated that the City's large unfunded liability to CERS would cause the City's contribution to CERS to increase dramatically. The analysis estimated that the City's contribution rate to CERS would more than double—from 18.87% of payroll (or $107.5 million) in fiscal year 2004 to 40.9% of payroll ($286.9 million) in fiscal year 2009.

The preliminary pension analysis also discussed the effect that the City's unfunded liability would have on the City's credit rating. The financial adviser stated that the City's current unfunded liability would not only trigger an adverse credit event but that the rating agencies would expect the City to develop a plan to reduce its unfunded liability by increasing its annual contributions and/or funding the unfunded liability by issuing bonds. The financial adviser further stated that if the City did not develop and implement such a plan, the City's unfunded liability could cause the City "significant credit and legal challenges." The City's disclosures in 2003 failed to inform investors of the financial adviser's analysis.

3. The Offerings, Continuing Disclosures, and Rating Agency Presentations

a. The Bond Offerings and the City's Preparation of the Offerings' Disclosure Documents

During 2002 and 2003, the City conducted the following five municipal securities offerings totaling $261,850,000 in par value:

- $25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002B (Fire and Safety Project) (June 2002)
- $93,200,000 City of San Diego, 2002-03 Tax Anticipation Notes Series A (July 2002)
- $15,255,000 City of San Diego/Metropolitan Transit Development Board Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding (April 2003)
- $17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding) (May 2003)
- $110,900,000 City of San Diego 2003-04 Tax Anticipation Notes Series A (July 2003)

A transactional financing team prepared the offering documents, that is, the preliminary official statement and the official statement, for each of the five municipal bond offerings. The

financing team consisted of outside consultants and officials from the City Manager's office (financing services division), Auditor and Comptroller's office, and the City Attorney's office. The outside consultants included, among others, bond counsel, disclosure counsel, and underwriters. The preliminary official statement and the official statement for each of the five offerings consisted of a description of the offering, a general description of the City, including financial, economic, statistical, and other information in appendix A, and audited annual financial statements from the City's Comprehensive Annual Financial Reports in appendix B. Information regarding its pension and retiree health care obligations was provided in both appendices A and B.

The outside consultants took the lead in drafting the description of the bond offerings. City officials in the financing services division were responsible for drafting appendix A. The financing services division updated Appendix A on an ongoing basis and at the time of a bond offering, forwarded the latest version of Appendix A to the entire financing team. The team met several times to review, comment on, and ultimately finalize the preliminary official statements and official statements at "page-turner meetings." Appendix B was prepared by the Auditor's office and the City's outside auditor. The Council approved all of the 2002 and 2003 offerings at open session meetings.

b. The Continuing Disclosures

During the relevant period, the City also filed annual continuing disclosures relating to its $2.29 billion in outstanding bonds for the purpose of updating investors on the state of the City's finances.[17] City officials in the financing services division coordinated, reviewed, and filed the 2002 and 2003 continuing disclosures. Almost all of these continuing disclosures included appendix A and portions of the City's Comprehensive Annual Financial Reports. The financing services division was responsible for ensuring that the most updated and accurate version of appendix A was attached to the continuing disclosures before they were filed.

c. The 2003 Rating Agency Presentations

The City made presentations to the rating agencies on a yearly basis, both in connection with specific bond offerings and to update the rating agencies on the City's general credit. The presentations were made orally with PowerPoints in meetings with representatives from Fitch Ratings, Moody's Investors Service, and Standard and Poor's. In 2003, the rating agencies specifically asked the City to address the pension plan as part of its annual presentations. These presentations were important because they directly affected the City's bond ratings. The 2003

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[17] An underwriter of municipal securities covered by Exchange Act Rule 15c2-12 may not purchase or sell municipal securities in connection with an offering unless the issuer has undertaken in a written agreement or contract for the benefit of the bondholders to provide its audited annual financial statements and certain other annual financial and operating information, to nationally recognized municipal securities information repositories and state information depositories designated by the Commission and to provide notices of certain material events and notices of any failures to file on the nationally recognized municipal securities information repositories or the Municipal Securities Rulemaking Board and state information depositories.

PowerPoint presentations were prepared and presented by officials from the City Manager's office, including the financing services division, and the City Auditor and Comptroller's office. The financing services division drafted the pension portion of the 2003 PowerPoint presentation. Officials from the City Auditor's office made the oral presentation on the pension plan and fielded numerous questions on that topic from the rating agencies.

4. The False and Misleading Disclosures

In the preliminary official statement and the official statements for the 2002 and 2003 offerings, the 2003 presentations to the rating agencies, and the 2003 continuing disclosures, the City made substantial disclosures regarding (1) the City's policies for funding CERS; and (2) the status of CERS's funding and the City's liability to CERS. Additionally, in the preliminary official statements, the official statements, and continuing disclosures, the City made certain representations regarding its retiree health care obligations. The disclosures (collectively "Disclosures"), however, were misleading because the City failed to include material information regarding the City's current funding of its pension and retiree health care obligations, the City's future pension and retiree health care obligations, and the City's ability to pay those future obligations.

First, with respect to the pension issues, the City failed in the Disclosures to reveal several material facts, including that (1) the City was intentionally under-funding its pension obligations so that it could increase pension benefits but push off the costs associated with those increases into the future; (2) because of the City's under-funding of its pension plan, its net pension obligation was expected to continue to grow at an increasing rate, reaching from $320 million to $446 million by the end of fiscal year 2009; (3) the City's unfunded liability was expected to continue to grow at a substantial rate, reaching approximately $2 billion by fiscal year 2009; (4) this growth in the City's unfunded liability resulted from the City's intentional under-funding of its pension plan, the City's granting of new retroactive pension benefits, the City's use of pension plan earnings to pay additional benefits, and the pension plan's less than anticipated investment return; (5) the City's annual pension contribution was expected to more than quadruple by fiscal year 2009; and (6) the City would have difficulty funding its future annual pension contributions unless it obtained new revenues, reduced pension benefits, or reduced City services. Moreover, the City falsely disclosed in Appendix B to its preliminary official statements and its official statements that its net pension obligation was funded in a reserve.

Additionally, with respect to retiree health care benefits, the City failed to disclose in its preliminary official statements, official statements, and continuing disclosures that[18] (1) the estimated present value of its liability for retiree health care was $1.1 billion; (2) the City had been covering the annual cost for retiree health care with pension plan earnings from prior years that were expected to be depleted in fiscal year 2006; (3) after fiscal year 2006, the City would have to pay for the retiree health care benefits from its own budget at an estimated annual cost of $15 million; and (4) the City had not planned for paying such additional costs.

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[18] The issue of retiree health care was not addressed in the rating agency presentations.

5. The City's Knowledge of the Misleading Disclosures

The City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements. The Mayor and Council delegated final approval of the official statements to the City Manager. The City Manager's office was responsible for the preparation of the preliminary official statements and the official statements, including appendix A. The City Auditor's office was responsible for the preparation of appendix B to the preliminary official statements and official statements. Through their designees on the CERS Board, among other things, both the City Manager's and the City Auditor's offices had knowledge about the City's use of CERS's surplus earnings, Manager's Proposals 1 and 2, CERS's actuary reports for fiscal years 2001 and 2002, and CERS's response to the Blue Ribbon Committee Report. Also, several representatives of the City Manager's office, City Attorney's office, and Auditor and Comptroller's office attended relevant closed session meetings of the Council where Manager's Proposals 1 and 2 and the *Corbett* and *Gleason* litigations were discussed. Moreover, the Blue Ribbon Committee Report and CERS's response to the Blue Ribbon Committee Report were both presented to a committee of the Council at which officials from the City Manager's and Auditor and Comptroller's office were present. Finally, the offices of the City Manager and the City Auditor were responsible for the City's study of its pension obligations that occurred in early 2003. Through their participation and involvement in the above-referenced matters, certain city officials knew or were reckless in not knowing that the Disclosures were false and misleading.

Specifically, by early 2002, the City, through its officials, knew, among other things, that (1) CERS's funded ratio would likely fall below the 82.3% floor set by Manager's Proposal 1; (2) the City was proposing Manager's Proposal 2 to avoid the effects of CERS's falling below the floor; (3) Manager's Proposal 2 allowed the City more time to under-fund CERS; and (4) the Blue Ribbon Committee had raised concerns about the City's under-funding of CERS and the future retiree health care liability. By early 2003, the City, through its officials, knew, among other things, that (1) the City's projected total contributions to CERS would grow from $77 million in fiscal year 2004 to $248 million in fiscal year 2009; (2) CERS had fallen below the 82.3% floor of Manager's Proposal 1; (3) the City and CERS had adopted Manager's Proposal 2 to allow the City more time to under-fund CERS; and (4) CERS was using reserved surplus earnings to pay certain benefits and to pay an increased portion of the employees' CERS contribution.

6. Materiality and the City's Voluntary Disclosure

The misleading Disclosures were material in view of the City's overall financial health. The Disclosures were also material given the magnitude of the City's projected annual CERS payments in the future and the potential consequences of those liabilities to the City, including inability to make the payments without reduction in other services.

The nature and level of under-funding brought into question the City's ability to fund the pension and health care benefits in the future as well as its ability to repay the bonds and notes. Under such a scenario, the City could be forced to choose between paying pension contributions, paying what the City owes on its bonds and notes, reducing services, and/or raising fees and taxes.

The materiality of the misleading Disclosures was demonstrated by the impact on the City's bond ratings when it finally disclosed key facts about the pension plan on January 27, 2004 in a voluntary report of information, after a non-employee CERS Board member raised concerns about the City's disclosure. The voluntary report provided information regarding (1) CERS's current and estimated future funded status; (2) the City's current and estimated future liabilities to CERS; (3) the reasons for the substantial decrease in CERS's funded ratio and increase in the City's liability to CERS; (4) the City's previous use of CERS funds to pay for retiree health care and the City's estimated future liabilities for retiree health care; and (5) the City's anticipated difficulty funding its increasing CERS contribution without new City revenues, a reduction in pension benefits, a reduction in City services, or other actions. Shortly after the disclosures in the voluntary report, the rating agencies lowered their ratings on the City's bonds and notes.

E. Legal Discussion

1. The Securities Act and Exchange Act Antifraud Provisions

State and local governments are exempt from the registration and reporting provisions of the Securities Act and the Exchange Act. Similarly, the Commission's authority to establish rules for accounting and financial reporting under Section 19 of the Securities Act and Section 13(b) of the Exchange Act does not extend to municipal securities issuers. The City and other municipal securities issuers, however, are subject to the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In addition, the Commission has promulgated a broker-dealer rule, Exchange Act Rule 15c2-12, which in general limits market access for certain municipal securities issues to those offerings in which the issuer agrees to file annual financial disclosures of specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with repositories designated by the Commission. The antifraud rules apply to such disclosure and to any other statements made to the market.

Section 17(a) of the Securities Act prohibits misrepresentations or omissions of material facts in the offer or sale of securities. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit misrepresentations or omissions of material fact in connection with the purchase or sale of any security. These provisions prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer, purchase, or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 require a showing that defendants acted with scienter. Aaron v. SEC, 446 U.S. 680, 701-02 (1980). Scienter is "a mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). In the Ninth Circuit, recklessness satisfies the scienter requirement. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc). Recklessness is "an extreme departure from the standards of ordinary care, and which presents a danger of misleading [investors] that is either known to the defendant or is so obvious

that the actor must have been aware of it." Id., 914 F.2d at 1569. Scienter, however, need not be shown to establish a violation of Section 17(a)(2) or (3). Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of these sections may be established by showing negligence. SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992).

2. The City's Violations of the Antifraud Provisions of the Securities Act and the Exchange Act

The City's public disclosures in the preliminary official statements and official statements for its 2002 and 2003 offerings, its 2003 continuing disclosures, and presentations to the rating agencies failed to disclose material information regarding the City's current funding of its pension and retiree health care obligations, the City's future pension and retiree health care obligations, and the City's ability to pay those future obligations. The omission of this information caused the information that was disclosed to be misleading.

This information was material to investors. The magnitude of the City's unfunded liabilities was enormous. For example, the City knew that by 2009 the unfunded liability would reach $1.9 billion and its actuarially required contribution would be approximately $240 million compared to $51 million in FY 2002. The City's under-funding of CERS and unfunded liabilities to CERS and for retiree health care were projected to continue to grow at an increasing rate. The increase in the City's under-funding and unfunded liabilities resulted, in part, from the City's decisions to increase pension and retiree health care benefits but push the costs of those increases into the future, to use CERS's prior earnings to cover additional benefits, and to pay a portion of the employees' contribution to CERS. All of this information raised a question whether the City could pay for these pension and retiree health care obligations and repay the bonds and notes issued by and on behalf of the City.

The City, through its officials, acted with scienter.[19] City officials who participated in drafting the misleading disclosure were well aware of the City's pension and retiree health care issues and the magnitude of the City's future liabilities. Moreover, even though the City officials knew that the City's pension issues were of concern to the rating agencies, they failed to disclose material information regarding the City's pension and retiree health care issues. In light of the City's officials' detailed knowledge of the magnitude of the City's pension and retiree health care liabilities and of the rating agencies' interest in those liabilities, the City officials acted recklessly in failing to disclose material information regarding those liabilities.

F. REMEDIAL EFFORTS AND UNDERTAKINGS

1. Since 2005, Respondent has implemented several remedial measures with a view to detect and prevent securities violations. Specifically, the City has terminated certain officials in the City Manager's and Auditor and Comptroller's offices or has allowed them to resign. The City has filled these positions with new employees generally having significant relevant experience with

[19] The City's scienter is based on the mental state of its officials. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n.3 (2d Cir. 1972).

other municipal governments or the private sector. The City has hired a full time municipal securities attorney who is responsible for coordinating the City's public disclosure and who has conducted continuing education for the City's deputy attorneys on the City's disclosure requirements.

2. The Mayor resigned and has been replaced by a former City police chief. In January 2006, pursuant to a public referendum, the City changed from a strong city manager form of government to a strong mayor form of government.

3. The City has hired new outside professionals including new auditors for its fiscal year audits. The City also hired individuals not affiliated with the City to act as the City's Audit Committee and charged the Committee with investigating the City's prior disclosure deficiencies and making recommendations to prevent future disclosure failures. The City has also hired new disclosure counsel for all of its future offerings, who will have better and more continuous knowledge on the City's financial affairs. This disclosure counsel has conducted seminars for City employees on their responsibilities under the federal securities laws.

4. The City has also enacted ordinances designed to change the City's disclosure environment. First, the City created a Disclosure Practices Working Group, comprised of senior City officials from across city government. The Working Group is charged with reviewing the form and content of all the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to securities issued by the City or its related entities; and conducting a full review of the City's disclosure practices and to recommend future controls and procedures. Second, the Mayor and City Attorney must now personally certify to the City Council the accuracy of the City's official statements. Third, the City Auditor must annually evaluate the City's internal financial controls and report the results to the City Council.

5. Respondent shall comply with the following undertakings to:

a. Retain, not later than 60 days after the date of this Order, at its expense, an independent consultant not unacceptable to the Commission's staff (the "Independent Consultant"). The City shall require the Independent Consultant to (a) conduct annual reviews for a three-year period of the City's policies, procedures, and internal controls regarding its disclosures for offerings, including disclosures made in its financial statements, pursuant to continuing disclosure agreements, and to rating agencies, the hiring of internal personnel and external experts for disclosure functions, and the implementation of active and ongoing training programs to educate appropriate City employees, including officials from the City Auditor and Comptroller's office, the City Attorney's office, the Mayor, and the City Council members regarding compliance with disclosure obligations; (b) make recommendations concerning these policies, procedures, and internal controls with a view to assuring compliance with the City's disclosure obligations under the federal securities laws; and (c) assess, in years two and three, whether the City is complying with its policies, procedures, and internal controls, whether the City has adopted any of the Independent Consultant's recommendations from prior year(s) concerning such policies, procedures, and internal controls for disclosures

for offerings, and whether the new policies, procedures, and internal controls were effective in achieving their stated purposes;

b. No later than 10 days following the date of the Independent Consultant's engagement, provide to the Commission staff a copy of an engagement letter detailing the Independent Consultant's responsibilities pursuant to paragraph 5(a) above;

c. Arrange for the Independent Consultant to issue its first report within 120 days after the date of the engagement and the following two reports within 60 days following each subsequent one-year period from the date of engagement. Within 10 days after the issuance of the reports, the City shall require the Independent Consultant to submit to Kelly Bowers of the Commission's Pacific Regional Office a copy of the Independent Consultant's reports. The Independent Consultant's reports shall describe the review performed and the conclusions reached and shall include any recommendations deemed necessary to make the policies, procedures, and internal controls adequate and address the deficiencies set forth in Section III.D of the Order. The City may suggest an alternative method designed to achieve the same objective or purpose as that of the recommendation of the Independent Consultant provided that the City's Mayor and City Attorney certify in writing to the Commission staff that they have a reasonable belief that the alternative method is expected to have the same objective or purpose as that of the Independent Consultant's recommendation;

d. Take all necessary and appropriate steps to adopt, implement, and employ the Independent Consultant's recommendations or the City's alternative method designed to achieve the same objective or purpose as that of the Independent Consultant's recommendation; and

e. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the City, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity; provided however, that the Independent Consultant may enter into an agreement with the City to serve as an independent monitor to oversee the City's remedial efforts with respect to enhanced accountability, greater transparency, increased fiscal responsibility, and independent oversight. Except as permitted above, the agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Pacific Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the City, or any of its present or former affiliates, directors, officers, employees, or agents acting in

their capacity as such for the period of the engagement and for a period of two years after the engagement.

6. In determining whether to accept the City's Offer, the Commission considered these undertakings and remediation measures.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the City's Offer.

Accordingly, it is hereby ORDERED that:

A. The City cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and

B. The City comply with the undertakings enumerated in paragraph 5 of Section III.F. above.

By the Commission.

Nancy M. Morris
Secretary