OFFICE OF

THE CITY ATTORNEY

CITY OF SAN DIEGO

MICHAEL J. AGUIRRE

CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1100
SAN DIEGO, CALIFORNIA 92101-4100
TELEPHONE (619) 533-5800
FAX (619) 533-5856

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James Godsey
Anthony Neequaye
Macias, Gini & O'Connell LLP
402 West Broadway, Suite 400
San Diego, California 92101

Dear Mssrs. Godsey and Neequaye:

City of San Diego's FY 2005 Comprehensive Annual Financial Report

As admitted at the Audit Committee hearing on Monday SDCERS officials have been making payments to participants in the City of San Diego's Internal Revenue Code (IRC) 401(a) plan in violation of IRC 415 limits. This issue came to the attention of the City Attorney's office during a review of page 19 of the draft transmittal letter for the draft of the City of San Diego's 2005 Comprehensive Annual Financial Report (2005 Financial Statement), several days before you issued your opinion on the City's 2005 financial statements.

Specifically, page 19 of the draft transmittal letter for the 2005 Financial Statement that brought the IRC 415 payments to light read: "The benefits awarded to some plan participants exceed the amount permitted for Internal Revenue Code (IRC) 401(a) pension plans such as SDCERS." After reading this sentence the City Attorney's office interviewed you and asked if the amount paid in violation of IRC 415 was known and the names of those receiving the payments in excess of IRC 415.

After our inquiry, you informed the City Attorney's office that there were approximately 11 individuals who received payments above the IRC limits. Again, this information was provided before you issued your opinion for the City's 2005 Financial Statement. The City Attorney's office over the course of the next several days made inquiries of SDCERS and of your firm to find out who had received the payments. No names were produced for the 11 individuals.

However, from a review of documents made available to us by Council Member Donna Frye and SDCERS we learned that 29 individuals had received payments in excess of the IRC 415 limits from SDCERS. We made further inquiry and identified the 29 by name. We urged you not to issue your opinion on the 2005 Financial Statement before the excess benefit issue was resolved before the San Diego City Council. We also advised that it was our opinion that the explanation that the excess benefits could be covered by a Preservation of Benefits Plan adopted by the City

Council in March 2001 was not viable because the Preservation of Benefits Plan was a new pension system that would require a vote of the people of San Diego before it could be adopted.

After we learned you issued your opinion on the City's 2005 Financial Statement we discovered that SDCERS had reported to the Internal Revenue Service through SDCERS' actuary Cheiron payments in excess of the IRC 415 limit had been made to 102 individuals over a 6 year period. We learned that the amount paid exceeded $8 million. We brought these facts to your attention as soon as we discovered them.

Yesterday, you informed us you issued your opinion for the SDCERS 2005 Financial Statement on 29 June 2007. You told us yesterday that SDCERS' 2005 Financial Statement states in pertinent part with regard to the payments made in excess of the IRC 415 limits:

> "(4) $2,837,874 for plan benefits that were paid from the SDCERS Trust Fund that exceed IRC Section 415(b) limits, rather than from a separate Qualified Excess Benefits Arrangement (QEBA) plan, between fiscal years 1995 through 2006 ($2,266,162 for benefits plus $517,712 in interest through fiscal year 2006)." (emphasis added)

The $2,837,874 in excess IRC 415 payments reported in the SDCERS 2005 Financial Statement your firm certified was not reported in the City's 2005 Financial Statement certified by your firm on 26 October 2007 four months after your firm gave its opinion on SDCERS 2005 Financial Statement. Rather, the City's 2005 Financial Statement stated with regard to the excess IRC 415 payments:

> "Additionally, on March 19, 2001, the City Council adopted Ordinance 0-18930, adding SDMC sections 24.1601 through 24.1608, establishing the Preservation of Benefit Plan (POB Plan). The POB Plan is a qualified governmental excess benefit arrangement (QEBA) under Internal Revenue Code (IRC) section 415(m), which was created by Congress to allow the payment of promised pension benefits that exceed the IRC section 415(b) limits (and therefore cannot be paid from a qualified retirement plan). The POB Plan is administered by the SDCERS Board as a separate trust from the City's pension plan. On February 16, 2007, the SDCERS Board adopted the Preservation of Benefit Plan and Trust to carry out the intent of SDMC section 24.1601 et seq. As provided, in SDMC section 24.1606, and required by federal law tax, the POB Plan is unfunded within the meaning of the federal tax laws. The City may not pre-fund the POB Plan to cover future liabilities beyond the current year as it can with IRC section 401(a) pension plan, and is therefore in the process of establishing a mechanism to pay for these benefits on a pay-as-you-go basis. Currently, activities related to the POB Plan are included in the RSI for the City's pension plan using actuarial assumptions consistent with those used to perform actuarial valuations for the City's core pension plan."

What is of more concern is the statement in the transmittal letter for the City's 2005 Financial Statement suggesting the amount of IRC 415 excess payments was unknown. Specifically, the transmittal letter stated: "The estimated liabilities for retired members of the Preservation of Benefit Plan have not yet been provided to the City by SDCERS as a separate amount distinct from the City's core 410(a) pension plan." Two months before you issued your opinion on the City's 2005 Financial Statement SDCERS had sent to the Internal Revenue Service a report that

stated that 102 individuals had been paid over $8 million of payments in excess of IRC 415. Again, this information was available for two months before you issued your opinion and the information was not provided in the City's 2005 Financial Statement.

> This office has previously advised your firm about the appropriate course of action that must be taken to resolve the restatements of the related disclosures in the City's 2005 Financial Statement. Further, our office is requesting a meeting with you, Mr. Macias, and your managing partner so we can resolve all outstanding issues.

As you are aware, on November 14, 2006, the City entered into a cease-and-desist order with the Securities and Exchange Commission (Commission) relating to violations of the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 in connection with the offer and sale of municipal securities in 2002 and 2003, and other related public financial disclosures. The Commission concluded that 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 Commission further concluded that "[t]he City, through its officials, acted with scienter."

The cease-and-desist order also imposed certain remedial sanctions, including the retention of an independent consultant to review and assess its policies, procedures and internal controls with respect to bond offerings, including disclosures made in its financial statements. On January 16, 2007, the City retained the law firm of Edwards Angell Palmer & Dodge, LLP to serve as Independent Consultant. The independent consultant is required to conduct annual reviews of the City's policies, procedures and internal controls for a three year period.

I include all of the above simply to reiterate that it is imperative that the City make sure that its financial statements are accurate in all material respects. The City's activities continue to be under scrutiny by the Commission and it would be in violation of the Order if the City did not take measures to ensure that the FY 2005 CAFR was corrected. But in order to obtain a complete picture of the potential exposure it will be necessary to obtain the services of an actuary in order to determine the amount of the liability represented by the illegal excess benefit payments, and the potential growth rate of this liability.

Please let us know at your earliest convenience when we can hold our meeting. Should you have any additional questions, or if you should obtain additional information that you would like to discuss with our office please feel free to contact me.

Very truly yours,

MICHAEL J. AGUIRRE, City Attorney

By

Michael J. Aguirre
City Attorney

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