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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**Date Issued:** March 2, 2010

**IBA Report Number:** 10-19

**Audit Committee and City Council Docket Date:** March 8, 2010

**Item Number:** AC # 2 & CC # 201

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# Third Annual and Final Report of Independent Consultant to the City of San Diego

## OVERVIEW

On February 24, 2010, Stanley Keller (the City's Independent Consultant since January 2007) issued his Third Annual and Final Report to the City in accordance with the Cease-And-Desist Order (Order) of the United States Securities and Exchange Commission (SEC) dated November 14, 2006. Mr. Keller will be presenting his Third and Final Annual Report to the Audit Committee and the City Council on March 8, 2010. This report provides background with respect to the SEC Order, recaps reports issued to date by the Independent Consultant, highlights noteworthy excerpts from the Third Annual and Final Report, discusses City correspondence to the SEC following receipt of the Third Annual and Final Report, and discusses whether the City has complied with the SEC Order.

## FISCAL/POLICY DISCUSSION

### SEC Cease-And-Desist Order

In November 2006, the SEC entered an Order sanctioning the City for committing securities fraud by failing to disclose to the investing public important information about its pension and retire health care obligations in the sale of municipal bonds in 2002 and 2003. To settle the action, the City agreed to cease and desist from future securities fraud violations and to retain an independent consultant for three years to foster compliance with its disclosure obligations under the federal securities laws. The City consented to the issuance of the Order without admitting or denying the findings of the Order.

## Requirements and Reports of the Independent Consultant

The Order required the City to hire an Independent Consultant within 60 days. The City entered into an Agreement with the firm of Edwards Angell Palmer & Dodge LLP for independent consultant services on January 16, 2007. The Agreement designated Stanley Keller as having lead and principal responsibility for Independent Consultant services. The Agreement will terminate in March of 2010.

The Order and the Agreement required the Independent Consultant to provide an Initial Report (within 120 days after the date of engagement) and three Annual Reports to the City. To date, the Independent Consultant has provided the City and the SEC with the following reports in compliance with the Order:

June 7, 2007:	Initial Report of Independent Consultant
March 25, 2008:	First Annual Report of Independent Consultant
April 24, 2009:	Second Annual Report of Independent Consultant
February 24, 2010:	Third and Final Annual Report of Independent Consultant

## Noteworthy Excerpts from the Third and Final Report

The IBA has reviewed the Third and Final Annual Report of Independent Consultant and finds Mr. Keller's analysis/assessment to be comprehensive and thorough. The Report contains 22 concluding recommendations and offers some concluding thoughts and statements. The IBA finds the following excerpts from the report to be noteworthy:

- “The City has made dramatic progress over the last several years in a number of areas to create a "culture of compliance" to replace the "culture of expediency" described in the Kroll Report. This progress has included putting in place a strong Mayor form of government with centralized responsibility and accountability, an effective Audit Committee to provide independent oversight, an independent and professional internal audit function and a smoothly functioning DPWG (Disclosure Practices Working Group). These and other measures, including a diligent IBA office and a professional City Attorney Office, produce an effective disclosure and control environment.”
- “The DPWG process has been thorough and extensive. That process cannot guarantee the accuracy of the City’s disclosure, but it does provide appropriate controls and procedures designed to ensure that necessary information is included in the disclosure material and that such information is consistent with other City disclosures and information ... it is important that the DPWG function on an independent, non-political basis with only the accuracy and completeness of the City’s disclosure as the focus.”
- “The one area where progress has lagged has been implementation of the City’s ICOFR (Internal Controls over Financial Reporting) remediation. Although significant steps have been taken, particularly recently, much more remains to be done if the City is to have the assurance of an effective internal control system. This is the last significant action necessary to complete, and indeed go beyond, the Kroll report recommendations.

A strong commitment and concerted effort will be required if this is to be successfully accomplished.”

- “Because of the requirements of the SEC, San Diego has been a pacesetter among municipal issuers in terms of the disclosure processes and controls that it has put in place. As stated in my Prior Reports, and as confirmed by the Mayor and other City officials, the actions taken by San Diego are intended not just to comply with the requirements of the SEC Order but are designed to create a model for others to follow.”

### City Correspondence to the SEC in Response to the Third Annual and Final Report

In his **First Annual Report**, the Independent Consultant provided the City with 36 recommendations pertaining to specific areas related to the adequacy of the City’s disclosures, financial reporting and internal control structure. On May 15, 2008, the Mayor sent correspondence to the SEC responding to each of the 36 recommendations - commenting on actions that had been taken, actions that were in progress, or plans for future action with respect to each recommendation. On May 21, 2008, the Council President sent a separate letter to the SEC, on behalf of the City Council, supplementing the Mayor’s correspondence and explaining specific actions taken by the City Council in relation to 13 of the 36 recommendations.

Following receipt of the **Second Annual Report** of Independent Consultant, the City Council and the Mayor agreed to develop a joint response to the SEC summarizing actions taken or in progress to address each of the 27 recommendations made by the Independent Consultant. The Mayor prepared a draft response and the Council directed the IBA to review and make suggestions for amendment prior to final City Council review. On September 30, 2009, the Mayor and Council President sent a letter to the SEC in response to recommendations in the Second Annual Report. As Councilmember Frye was not present for the City Council meeting approving the final version of the response, she sent a separate letter to the SEC on October 13, 2009 regarding her recommendations and observations on the Second Annual Report.

The **Third Annual and Final Report** of Independent Consultant provides 22 concluding recommendations to the City. The IBA has reviewed these recommendations and believes that most are substantially underway or already in practice; however, as discussed in the Report, there are a few (notably finishing the development of an effective internal control system) that will require additional time and resources to complete. **The IBA recommends that the City Council again consider developing a letter to the SEC in conjunction with the Mayor to detail significant actions taken or in progress to address each of the 22 concluding recommendations made by the Independent Consultant.**

### Has the City Complied with the Requirements of the SEC Order?

The IBA has reviewed the two requirements found in the SEC Order in an effort to determine if the City has satisfied the Order. The first requirement is that the City comply with the undertakings enumerated in paragraph 5 of Section III. F. This section of the Order pertains to the hiring and reporting requirements of the Independent Consultant. We believe these requirements have been substantially completed; however, sub-item d. of paragraph 5 requires that the City “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". It is anticipated that the pending letter to the SEC from the City Council and the Mayor will represent the City's 1) significant actions taken or activities in progress to date and 2) commitment to be responsive to each of the final 22 recommendations made by the Independent Consultant, including those pertaining to effective internal controls.

The second requirement of the Order directs the City be compliant with certain federal securities laws on a go-forward basis. As the Independent Consultant notes in his Report, the City has made significant progress in becoming current with its CAFR, reentering the public bond market, improving its governance oversight structure and its disclosure controls, procedures and practices. Mr. Keller further states that actions taken by the City are intended not just to comply with the requirements of the SEC Order but are designed to create a model for others to follow. The IBA agrees with the Independent Consultant and believes that the City's current disclosure review and governance oversight practices are amongst the strongest in local government. We believe that the City's current review and oversight practices help to ensure that the City will continue to be compliant with all federal securities laws on a go-forward basis.

**Based on the aforementioned statements/assumptions and the belief that the City will continue to improve on those processes identified by the Independent Consultant, the IBA believes that the City has largely satisfied the requirements of the SEC Order.** We have discussed our conclusions with the Office of the City Attorney and subject to the statements and assumptions herein they generally concur. **The IBA recommends the City Council ask the Independent Consultant for his thoughts on whether the City has satisfied the SEC Order when he presents his Third Annual and Final Report to the City Council on March 8, 2010.**

## CONCLUSION

The Independent Consultant will be presenting his Third Annual and Final Report to the Audit Committee and the City Council on March 8, 2010. The IBA has reviewed the Report and found Mr. Keller's analysis/assessment to be comprehensive and thorough. The Report provides the City with 22 concluding recommendations. As was done in response to the Second Annual Report, the IBA recommends the City Council consider developing/sending a letter to the SEC, in conjunction with the Mayor, detailing all significant actions taken or in progress to address each of the final 22 recommendations made by the Independent Consultant. The IBA stands ready to assist in the development of a final SEC response letter for City Council consideration.

The IBA appreciates the significant contributions of the Independent Consultant to help the City facilitate important fiscal reform. Based on statements/assumptions noted above and the belief that the City will continue to improve on key processes identified by the Independent Consultant, the IBA believes that the City has largely satisfied the requirements of the SEC Order.

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APPROVED: Andrea Tevlin  
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