# Report on Investigation

**The City of San Diego, California's**

**Disclosures of Obligation to Fund the**

**San Diego City Employees' Retirement System**

**and Related Disclosure Practices**

**1996-2004**

**with**

**Recommended Procedures and Changes to the Municipal Code**

**September 16, 2004**

**Paul S. Maco**
**Richard C. Sauer**
**Vinson & Elkins L.L.P.**
**Washington, D.C.**

# TABLE OF CONTENTS

# Introduction and Executive Summary

## I. Introduction

"The Most Efficiently Run Big City in the State of California…." So reads the banner on the website for the City of San Diego (the "City"). This has not been a frivolous claim. The City was rated "high" in Financial Management, Capital Management, and Managing for Results in a survey conducted by *Governing Magazine* and has received Certificates of Achievement for Excellence in Financial Reporting for many consecutive years from the Government Finance Officers Association of the United States and Canada ("GFOA"), and Certificates of Award for Outstanding Financial Reporting from the California Society of Municipal Finance Officers. Historically, it has been distinguished by its low outstanding indebtedness and high credit ratings.

Recently, however, the City's image as a model of fiscal responsibility has been seriously tarnished. On January 27, 2004, the City of San Diego, California made a voluntary disclosure filing with the four Nationally Recognized Municipal Securities Information Repositories recognized by the U.S. Securities and Exchange Commission ("SEC"). The filing was in two parts. The first provided a description of the unfunded accrued actuarial liability ("UAAL") of the San Diego City Employees' Retirement System ("SDCERS" or the "System"), together with projections anticipating the growth in the liability[1], an estimate of the accrued liability for post-retirement health care benefits conferred on the City's retired workers, as well as a description of the mechanics by which the City funded SDCERS. The second described numerous errors discovered in the footnotes of the City's audited annual financial statements. Subsequent discovery of an additional error, while $6 million in the City's favor, was noted in a later filing but added to uncertainty about release of the City's 2003 financial statements without review by a second audit firm.

The voluntary filing was an unusual event in the municipal securities market, as well as for the City and its staff. Even when significant events occur affecting a city, such filings are typically not required under federal securities law, which regulates the municipal securities market much more loosely than the markets for corporate securities, as described in this Report. The voluntary disclosure was the result of months of dogged effort by the City's disclosure counsel with assistance from the offices of the City Manager, City Treasurer, City Attorney, and the City Auditor and Comptroller. When the voluntary filing was made, investors in the City's

[1] Forward projections of the SDCERS Actuary estimated a UAAL for SDCERS of $2.4 billion in the fiscal year ending June 30, 2011, assuming no action is taken by the City to alter the contribution mechanics.

securities, for the first time, could read in one place an outline of the complex manner by which the City funds SDCERS and grasp the extent of the burden pension and retirement health care benefits place on the City budget. A cold reality began to form, as we describe in this Report: for years, the City had balanced its budget by transferring the burden of its labor settlements to a misconstrued surplus in its pension system – a short-term solution to a budget squeeze that grew into a long-term problem through added contingent benefits, legal settlements and agreed-upon underfundings. Like the unanticipated consequences of a complex derivative contract, the result includes a sizeable pension gap projected to grow in orders of magnitude over the coming decade that the City must now address.

On February 2, 2004, eight days after release of the Voluntary Reports of Information, Moody's Investors Service ("Moody's") changed the outlook on the City's General Obligation Bonds and General Fund Obligations to negative from stable.[2] The other rating agencies followed suit. On February 23, 2004, Standard & Poor's Rating Services ("S&P") lowered the credit rating on the City's general obligation bonds from "AA" to "AA-," citing "increasing fiscal pressures relating to the city's burgeoning unfunded pension liability." On February 27, 2004, Fitch lowered the credit rating on the City's general obligations from "AAA" to "AA."

The drumbeat of negative information also resulted in law enforcement inquiries that remain pending. On February 13, 2004, soon after the release of the Voluntary Reports, the SEC requested voluntary production of certain documents in connection with an informal inquiry into the City's disclosure practices relating to its funding of SDCERS. On the same day, the United States Attorney for the Southern District of California initiated an investigation that appears to overlap in subject matter the SEC inquiry. This law enforcement interest, in turn, increased the level of concern of the rating agencies. Standard and Poor's stated that its February 23, 2004: "negative action reflects the uncertainty related to the recently commenced investigation by the [SEC] and U.S. Attorney of city financial disclosures, practices, and other documents dating back to 1996." The government investigations have also figured prominently in local political contests, including the primary elections in early March 2004 and the approach to the general election in November 2004.

On February 11, 2004, prior to being contacted by the SEC, the San Diego City Council commissioned Vinson & Elkins to review the City's disclosure practices from January 1996 through February 2004 and investigate whether the City has failed to meet disclosure obligations concerning its funding of SDCERS.[3] No limitations were placed on whom we could speak with

---

[2] On April 8, 2004, Moody's placed the same obligations on a watchlist for possible downgrade. On August 10, 2004, Moody's downgraded the City's general obligation bonds to Aa3 from Aa1, changing the outlook from negative to stable.

[3] At that time, Vinson & Elkins partner Paul Maco had provided legal advice to the City on various securities law issues, including issues related to the placement of information on its web page. Vinson & Elkins did not serve as bond or disclosure counsel on any of the offerings or reports at issue in this Report. Further we declined an invitation to be considered for an ongoing engagement to serve as San Diego disclosure counsel out of concern that such an engagement

or the documents we could review, and the scope of the content of the Report was left entirely to our discretion. The Mayor and City Council indicated a desire that the Report be as inclusive as possible: a blueprint for best practices going forward, rather than merely an analysis of whether past disclosure had been adequate.[4]

This Report represents the culmination of a six month investigation. To prepare this Report, we conducted interviews with current and former City officials and employees, including the Mayor and many members of the City Council, outside counsel for the City, the City's former outside auditors, SDCERS Trustees and administrators, the SDCERS actuary and a third-party actuary with knowledge of SDCERS.[5] We reviewed City disclosure documents, reports and memoranda, and paper and electronic files of present and former City employees, including many thousands of e-mail messages. We also reviewed audio tapes and video tapes of City Council and committee meetings, as well as minutes of SDCERS Board meetings, and other documents SDCERS, its Trustees and staff made available to us. In addition, we have reviewed historical media coverage of the City's relationship to its pension system. In fashioning proposed enhancements to the City's disclosure and financial reporting controls, we used as guides, among other things, provisions of the Sarbanes-Oxley Act of 2002 and relevant SEC regulations and pronouncements, while acknowledging that in most instances there exists no legal requirement that these standards be adopted for municipalities. Our findings and recommendations set out below rest on this foundation.

As we describe in this Report, the seeds for both the pension and the accounting problems were planted years ago and grew over time. The story told in this Report raises issues of importance for investors in municipal securities beyond San Diego, but involves complex matters of accounting and actuary practice and arcane areas of pension funding and municipal securities regulation. So that the story may be as understandable as possible, we include in Appendices to this Report a glossary of pension and other terms we use, an overview of pension regulation, and a chronology of City disclosures and relevant events contemporaneous to the disclosures. Finally, we recommend changes to the City's Municipal Code to create an

---

would present a conflict with our responsibilities in connection with this Report. Vinson & Elkins , however, has represented and continues to represent the City in responding to the pending SEC inquiry.

[4] In addition, although it had previously received a "clean" audit report on its fiscal year 2003 financial statements from the auditing firm of Caporicci & Larson, the Council commissioned KPMG to re-audit those statements. That engagement is on-going. During the course of our investigation we have spoken with KPMG personnel on numerous occasions and shared with them information from our investigation, including a preliminary draft of certain sections of this Report.

[5] All present City employees with whom we requested interviews agreed to speak with us – some on multiple occasions. This was also true with respect to San Diego elected officials, with the exception of Councilmembers Ralph Inzunza, Donna Frye, and the late Charles Lewis. Certain other individuals declined to provide information to assist our investigation, including former City Auditor and Controller Edward Ryan and SDCERS Trustee Ronald Saathoff. We received no response to our requests for an interview from SDCERS Trustee Diann Shipione and former Mayor Susan Golding. Obviously, this was a choice fully within these individuals' discretion in each case.

independent Financial Reporting Oversight Board to oversee the City's financial reporting and disclosure practices, amendments to Code sections relating to duties of the City Manager, the City Auditor and Comptroller, and the City Attorney, and direction to those offices to work together through a Disclosure Practices Working Group to ensure the compliance of the City, the City Council, and City Officers and staff with federal and state securities laws and to promote the highest standards of accuracy in disclosures relating to securities issued by the City. These recommendations are specific actions the City can take to substantially reduce the chances such errors occur again.

## II. Executive Summary

This Report addresses whether from 1996 to 2004 the City of San Diego made adequate disclosure of its obligations to fund its retirement system, and of all reasonably related matters. This inquiry involves very different issues than it would if it concerned a business corporation with publicly traded securities. As a governmental issuer of debt securities, San Diego is subject to less defined disclosure requirements than are private issuers. For example, its public disclosure is not subject to SEC regulations that: (1) require companies with SEC-registered securities to file annual and periodic reports with the SEC, (2) provide detailed guidance as to the format and content of financial statement and other disclosure in such periodic reports and in securities offering documents, (3) require the preparation of financial reports in accordance with SEC accounting standards, and (4) require the implementation of effective internal controls.[6] Neither is the City subject to the Sarbanes-Oxley Act of 2002. Indeed, the only provisions of the federal securities laws directly relevant to it disclosure obligations are general prohibitions against material misstatements and omissions.[7] Although the SEC has brought a significant number of enforcement actions against municipal issuers, they have been based solely on this general provision and, in no case filed to date, have addressed issues of pension disclosure. Further, the City's pension system – the San Diego City Employee's Retirement System ("SDCERS") – is not subject to the elaborate requirements of ERISA, but rather to more general requirements applicable to public entity fiduciaries.

For purposes of this Report, we take a broad view of the information that might be of interest to City policy-makers, its legal and accounting professionals, and investors in the City's securities. Rather than look only to what the law specifically requires, we have attempted to present as much as may be determined of the history of the City's unique and highly complex relationship to its retirement system, and the public face that has been put on that relationship. In sum, we find that through the cumulative effect of various measures designed to minimize the

---

6 *See* the Securities Exchange Act of 1933 ("Securities Act"), §§ 13(a) and 13(b), and SEC Regulations S-X and S-K.

7 Securities Act, §17(a), and the Securities Exchange Act of 1934, §10(b), and Rule 10b-5 thereunder. These are commonly referred to as the anti-fraud provisions of the federal securities laws, but §17(a)(2) and (3) of the Securities Act can be violated through negligent conduct.

City's near-term contributions to SDCERS, a funding mechanism of exceptional complexity was created that failed to make proper provision for the System's future liabilities, involved significant financial risk to the City, and presented the City with disclosure challenges that it did not meet.[8]

The City of San Diego has developed an expensive retirement system for its municipal workers that it has failed to fully fund under the actuarial principal that pension liabilities generated today should be funded today, not passed off onto future generations of taxpayers. This situation evolved in piecemeal fashion through trade-offs between City management and its municipal unions, in each instance reflecting the short-term time horizon of the City's budgetary process. The most significant measures required the acquiescence of the SDCERS Board. SDCERS is formally independent of the City but a majority of its trustees are either City administrators or union officials.

As a result of its historically strong anti-tax attitudes, San Diego is a low-revenue city. Like other local governments in California, San Diego's budget is affected from time to time by reductions in funds received from the State. The costs of providing public safety and maintaining quality of life increase with the costs of providing its workforce with a compensation package competitive with that of other communities. San Diego is also a city with strong municipal unions. These factors have repeatedly combined to place the City's budget under significant strain. When City management cannot escape making concessions to the municipal unions but finds the larder of its operating funds bare, the easy solution has been to grant additional retirement benefits, rather than salary increases, thus avoiding the need for layoffs and cuts in services. On two occasions, moreover, the City made the provision of substantial benefit improvements contingent upon the agreement of the SDCERS Board that the City's contributions to the System would be at negotiated rates lower than the actuarially calculated rates. From July 1, 1997, through July 1, 2004, the City under-funded SDCERS pursuant to those agreements. Thus at the same time the City was agreeing to additional benefits for retirees, it was arranging to reduce its contributions to the System. This allowed the City, in effect, to finance the cost of the concessions over a multi-year period. Moreover, the City took advantage of certain vagaries of "actuarial science" and pension accounting to further minimize its contributions to SDCERS.

Many of the measures used to shift City liabilities to SDCERS into the future applied the dangerous and widely misused concept of "surplus earnings."[9] Surplus earnings are defined under the Municipal Code as the realized returns on SDCERS assets above the rate projected by

---

[8] SDCERS has been described to Vinson & Elkins by informed parties as the most financially complex system in the country.

[9] As described below, many other governmental entities have used surplus earnings from their retirement systems to fund a variety of benefits. San Diego, however, appears to be among the more aggressive and creative in this regard.

its actuary as necessary to pay its future liabilities when due. The view that whenever cash returns exceed the long-term actuarial benchmark the result is "free money" violates another actuarial principal. Returns on assets are projected as averages over decades. It is assumed that returns will fluctuate over time, with strong returns in some years offsetting weak returns in others. When, instead, above-average returns are defined as "surplus" and siphoned off for other uses, the result may be the depletion of the system's financial strength.

Nevertheless, in the early 1980s the results coming out of San Diego's "meet and confer" (labor negotiation) process began to treat surplus earnings as available for a variety of uses other than to support the underlying soundness of the retirement system. Initially, surplus earnings were used to improve the lot of retirees who had seen the buying power of their pension checks dissipate with the severe inflation of the late 1970s. Soon after, the City granted healthcare benefits to retirees as an incident of withdrawing from the Social Security System. Rather than paying the premium cost of the healthcare policies from its operating funds, it dedicated SDCERS surplus earnings for this purpose. To this day, all costs of health insurance for City retirees has come from this source.

In 1996 labor negotiations, the City acceded to a significant package of pension benefit enhancements. Together with certain negative changes in actuarial assumptions then pending, this threatened to significantly and immediately increase the City's required contributions to the System. Instead, the City prevailed upon the SDCERS Board to grant it a lengthy period to ramp-up to the higher contribution levels. At that time, investment returns had exceeded actuarial projections over many years and SDCERS had run record surpluses. Fiduciary counsel for SDCERS and the City, and the SDCERS Actuary, gave their approval to the agreement, which came to be known as Manager's Proposal 1 (or "MP1"). Actuarial projections showed that the contribution shortfall from the agreement would approximately equal the unallocated surplus accumulated to that time. Thus there existed reasonable, if ultimately misplaced, cause for optimism that this departure from strict actuarial funding would not undermine the soundness of the System.

After the adoption of MP1, the City's public disclosure concerning its retirement system began to exhibit significant inaccuracies and omissions. In the main, this appears to be the result of a failure of City personnel to understand the increasing complexities of SDCERS funding, poor communications with outside professionals and an unsophisticated view, going to the highest levels of City administration, of the demands of adequate disclosure. Although it cannot be said with certainty that no one in City administration recognized inadequacies in the City's disclosure and consciously declined to remedy them, there is no evidence of affirmative deception, and the individuals responsible for the City's disclosure lacked both motive and opportunity to mislead. We found no evidence that any City employees were personally enriched as a result of disclosure decisions in which they participated. None appear to have felt

their careers would be advanced by concealing negative information. Every element of the City's disclosure was created and reviewed by a number of people, both inside and outside the City, reducing the possibility that any could have engineered a deception. Further, much of the information at issue was available from other public sources, including the Municipal Code, SDCERS publications and local newspaper articles. Nevertheless, the disclosure problems should not be understated.

First, the City contended in public disclosure that remained current until January 2004 that the cost of MP1 was covered in reserves established from surplus earnings. This assertion, however, was based on a misunderstanding of the nature and function of those reserves. More generally, the City's public disclosure concerning MP 1 did not convey the risks inherent in departing from actuarially determined contribution rates. These risks were exacerbated by the inclusion in the agreement of a mechanism with the potential to trigger a massive payment from the City to SDCERS. This, too, was not adequately disclosed.

From 1998 to 2000, additional uses were found for SDCERS surplus earnings. They went to fund certain cost of living increases for retirees and to underwrite the cost of employee contributions to SDCERS. In addition, when its members sued the System over the way in which benefits were calculated, a provision of the resulting settlement committed surplus earnings to fatten checks to current retirees. That settlement also provided for substantially increased benefits for future retirees and thereby elevated the System's total projected liabilities. The City described the suit in only one instance in its public disclosure and did so inadequately. Altogether, the various uses of surplus earnings added over time have been arranged by relative priority in a Municipal Code provision commonly known as "the waterfall."

The effects on SDCERS' funding of this history of increased benefits, under-funding and inadequately addressed changes in actuarial assumptions were masked for years by rich investment returns from the bull market of the 1990s, and by the time lag built into actuarial calculations of asset values. Nor did City disclosure during this period – aside from mandated disclosure of the amount of its existing contribution shortfall – draw attention to potential problems with the retirement system. By early 2002, however, it became apparent that SDCERS' funding level had gone into a slump, implicating the trigger mechanism built into the 1996 agreement between the City and SDCERS. The City responded by seeking another accommodation from the SDCERS Board. This time it requested, and was granted, relief from the trigger mechanism in exchange for stepped-up contributions to the System that still did not achieve the actuarial rate. The deal, known as Manager's Proposal 2 ("MP2") also granted various benefit enhancements, adding significantly to the overhead cost of the System. Again fiduciary counsel and the System actuary acquiesced in this arrangement, although expressing concerns about the general direction of the City's relationship to SDCERS, particularly as it affected future funding levels.

This agreement spawned a lawsuit on behalf of SDCERS members, claiming that both the 1996 and 2002 agreements violated applicable legal standards. Moreover, beginning in early 2003, projections of the System's unfunded liabilities for pension and healthcare benefits showed massive increases by 2011, absent remedial action. Mounting criticism from the local press and a dissident member of the SDCERS Board, as well as inquiries from a committee of the City Council, added impetus to confronting previously evaded problems, but not in an immediate expansion in the public disclosure provided by the City to the municipal debt markets.

Matters came to a head in the fall of 2003, when disclosure counsel on a scheduled offering for one of the City's enterprise funds became aware of the inclusion in the City's annual financial report of stale information concerning the views of the SDCERS actuary on the novel approach adopted for System funding. Counsel insisted on additional due diligence before approving the offering. In the resulting review, the City's internal and external auditors discovered errors throughout the footnotes to the City's financial statements for fiscal year 2002. Although there is no reason to believe that any of these largely random and (judged from their effect on the City's balance sheet) immaterial errors were intentional, the volume of mistakes raised serious questions about the efficacy of the City's internal controls for financial reporting. As noted above, on January 27, 2004, the City provided detailed public disclosure of these errors and an exposition on the funded status of SDCERS, correcting certain omissions in the City's previous disclosure.

Based upon our investigation, we conclude that the City's procedures, policies and practices for disclosure and financial reporting are inadequate in major respects. Undermining the reliability of its public disclosure have been, among other factors, the City's excessive reliance on outside professionals to generate its disclosure documents, its lack of procedures to verify the accuracy of those documents and the absence of high-level oversight to judge the clarity and completeness of information provided to the investment markets. More generally, City administration had adopted a minimalist approach to public disclosure, providing the public with negative information only when it has felt legally required to do so. The result has been a series of damaging revelations, made without advance warning and in a manner allowing the City to have limited control over the way in which the information is interpreted. This, in turn, has led to a decline in trust between the City and the investment markets that must be carefully addressed to restore to the City its former reputation as among the most financially solid and reliable of California municipalities.

# Part I

# The City of San Diego

## I. The City of San Diego and the Related Authorities

### A. The City of San Diego

The City of San Diego (the "City") is a municipal corporation with all municipal powers, functions, rights, privileges and immunities authorized by the Constitution and laws of the State of California, including the power to issue debt.[10]

The City is a "charter city" under Article XI of the California Constitution, which authorizes the organization of municipal corporations (cities) as either "general law cities" or "charter cities."[11] The powers of general law cities are fixed by the state legislature and their ordinances and regulations may be preempted by state statutes.[12] Charter cities, on the other hand, exercise exclusive authority over all municipal affairs, with such authority limited only to the extent provided in the city's charter.[13]

Under Article XI of the California Constitution, a charter city has the power to make and enforce all ordinances and regulations with respect to municipal affairs.[14] Charter provisions have the effect of legislative enactments and become the law of the state, and charter city ordinances and regulations regarding municipal affairs prevail over state laws covering the same

---

[10] City of San Diego City Charter ("Charter") art. I, § I; art VII, § 90.

[11] Cal. Const. art. XI, §§ 2(a), 3(a); *Johnson v. Bradley*, 841 P.2d 990, 993-97 (Cal. 1992) (describing rationale behind the California Constitution's charter city provision and the powers of charter cities); *City of Costa Mesa v. McKenzie*, 106 Cal. Rptr. 569, 574-75 (Cal. Ct. App. 1973) (describing authority of general law city); *Ex parte Braun*, 74 P. 780, 781 (Cal. 1903) (recognizing the California Constitution's distinction between general law cities and charter cities). Of the 478 cities in California, 371 are general law cities and 107 are charter cities. League of California Cities, Fast Facts At A Glance (July 16, 2004), *at* http://www.cacities.org/index.jsp.

[12] Cal. Const. art. XI, §§ 2(a), 7; League of California Cities, Types of Cities (July 16, 2004), *at* http://www.cacities.org.

[13] Cal. Const. art. XI, § 5(a). *See also* California Constitution Revision Commission, Final Report and Recommendations to the Governor and the Legislature, at 72 (1996), http://www.library.ca.gov/CCRC/pdfs/finalrpt.pdf ("Constitution Revision Report"). The California Constitution was amended in 1896 to enable municipalities to adopt charters, conduct local business, and control local affairs under the rationale that "the municipality itself knew better what it wanted and needed than did the state at large, and to give that municipality the exclusive privilege and right to enact direct legislation which would carry out and satisfy its wants and needs." *Johnson*, 841 P.2d at 993-94; *see also Fragley v. Phelan*, 58 P. 923, 925 (Cal. 1899). The amendment was intended to "deprive the legislature of the power, by laws general in form, to interfere in the government and management of the municipality." *Ex parte Braun*, 74 P. at 782.

[14] Cal. Const. art. XI, § 5(a). Charter cities may adopt a portion of a general law in an ordinance governing a municipal affair without binding the city to all the provisions of that general law. *Bellus v. City of Eureka*, 444 P.2d 711, 716 (Cal. 1968).

issues.[15] The provisions of a city's charter are only subject to state law with respect to matters of statewide concern.[16]

The charter represents the supreme law of the city, and a city cannot act in conflict with its charter.[17] A legislative act by a city council that violates or is not in compliance with that city's charter is void, but the actions of the individual members of the city council in taking such action generally are not open to challenge in the courts, and where the enactment of legislation is challenged as resulting from improper or fraudulent motives, the law may not be voided on such grounds.[18]

B. Organization and Structure of the City

All legislative powers of the City (except those reserved to the people by the Charter and the California Constitution) are vested in the City Council (the "Council").[19] The Council is composed of nine full-time Council members who serve for staggered four-year terms: eight Council members who represent the City's eight districts and the Mayor, who presides at the meetings of the Council and serves as the official head of the City for ceremonial purposes.[20] The Mayor has no veto power but votes as a member of the Council.[21]

The chief administrative officer of the City is the City Manager, who is appointed by the Council for an indefinite term.[22] The Manager's duties include (among other things) keeping the Council advised of the financial condition and future needs of the City, preparing and submitting

---

15 Cal. Const. art. XI, §§ 3(a), 5(a); *see also Baggett v. Gates*, 649 P.2d 874, 878, 881 (Cal. 1982); Constitution Revision Report at 72.

16 Cal. Const. art. XI, § 5(a); *see also DeVita v. County of Napa*, 889 P.2d 1019, 1032 (Cal. 1995); *Bellus*, 444 P.2d at 717 (holding that State Pension Act was not intended to preempt field of pensions for municipal employees). Courts determine whether an issue or activity is a municipal affair or a statewide concern through an ad hoc inquiry in light of the facts and circumstances surrounding each case. *Baggett*, 640 P.2d at 878; *Johnson*, 841 P.2d at 999-1000.

17 *See Domar Elec., Inc. v. City of Los Angeles*, 9 Cal. 4th 161, 170-71 (Cal. 1994).

18 *Id*. at 171; *see, e.g., City and County of San Francisco v. Cooper*, 13 Cal. 3d 898, 914 (1975), and ("[W]e do not inquire into the knowledge, negligence, methods, or motives of the legislature if, as in this case, the [act] was passed in due form" (quoting Justice Holmes in *Calder v. Michigan*, 218 U.S. 591, 598 (1910)) (citing *Fletcher v. Peck*, 10 U.S. 87 (1810)). One leading treatise on municipal law sums up the law as follows:

> Except as they may be disclosed on the face of the act or are inferrible from its operation, the courts will not inquire into the motives of legislators in passing or doing an act, where the legislators possess the power to pass or do the act and where they exercise that power in a mode prescribed or authorized by the organic law…. In such case, the doctrine is that the legislators are responsible only to the people who elect them.

McQuillin, *Law of Municipal Corporations* § 16:89 (3d ed.), West MUNICORP § 16:89 (2004) (citations omitted).

19 Charter art. III, § 11.

20 Charter art. III, § 12.

21 Charter art. IV, § 24.

22 Charter art. V, § 27.

to the Council the annual budget estimate, and ensuring that the ordinances of the City and the laws of the State are enforced. The Manager is responsible for developing the annual financial plan for the City and may hire experts or consultants as necessary to assist with its preparation.[23] Reporting to the Manager is the Treasurer, who is appointed by the Mayor and confirmed by the Council and who maintains custody of City funds and books.[24] The Financing Services Department of the Office of the City Treasurer oversees the debt issuance process.

The elected City Attorney serves as the chief legal officer for the City. The City Attorney's Office advises the Council, its Committees, the Manager, and all City Departments and Offices on legal matters. The City Attorney is responsible for preparing all ordinances, resolutions, contracts, bonds, and other instruments in which the City is concerned, and endorsing on each such document his or her approval of its form or correctness.[25]

Internal auditing and accounting is the responsibility of the City Auditor and Comptroller, who is elected by the Council and the Mayor and who serves as the chief fiscal officer for the City of San Diego.[26]

In 1992, a new provision was added to the Charter specifically requiring the City Manager and all non-managerial officers of the City to inform the Council of all material facts or significant developments relating to all matters under the jurisdiction of the Council as provided under the Charter, except as otherwise controlled by the laws and regulations of the United States or the State of California, and to comply promptly with all lawful requests for information by the Council.[27]

### C. The Related Authorities

Due to constitutional and statutory limits on the authority of local governments to increase property tax rates and raise revenue, many California localities no longer directly access the capital markets except for short-term cash-flow borrowings.[28] Instead, local governments in

---

[23] Charter art. V, § 28.

[24] Charter art. V, § 45.

[25] Charter art. V, § 40.

[26] Charter art. V, § 39.

[27] Section 32.1, Responsibility of Manager and Non-Managerial Officers to Report to Council.

[28] Propositions 13, 62, and 218 restricted the ability of local governments to raise revenue. Proposition 13, which was enacted in 1978, amended the state constitution to limit the maximum amount of real property taxes and to require approval of two-thirds of the voters for special taxes. Cal. Const. art. XIIIA. Proposition 62, which was enacted as a statutory initiative in 1986, requires majority voter approval for general taxes and prohibits the imposition of certain taxes by local governments. Cal. Gov't Code §§ 53720 *et seq*. (West 2004). Proposition 218, which was enacted in 1996, amended the state constitution to provide for majority voter approval for general taxes and made other changes relating to taxes, fees, and assessments. Cal. Const. arts. XIIIC and XIIIB. *See generally* Institute for Local Self Government, *The Fiscal Condition of California Cities* (2003); League of California Cities, *Financing Cities: City Financing in the Decades After Proposition 13*.

California rely on a variety of authorities, agencies, public corporations, districts, and similar instrumentalities to issue debt to finance infrastructure improvements.

Entities controlled at least in part by the City that have issued debt in recent years include the Public Facilities Financing Authority of the City of San Diego, the San Diego Facilities and Equipment Leasing Corporation, the City of San Diego/Metropolitan Transit Development Board Authority, the Convention Center Expansion Financing Authority, the Redevelopment Agency of the City of San Diego, the Open Space Park Facilities District, and several Community Facilities Districts and Special Assessment Districts.

*The Public Facilities Financing Authority*. The Public Facilities Financing Authority of the City of San Diego (the "PFFA") is a joint powers authority formed between the City of San Diego and the Redevelopment Agency of the City of San Diego to assist the City with financing public improvements pursuant to a joint exercise of powers agreement authorized by the Joint Exercise of Powers Act.[29] Bonds issued by the PFFA are secured by revenues consisting largely of lease payments and/or installment payments made by the City. Pursuant to the Marks-Roos Local Bond Pooling Act of 1985, the PFFA also issues revenue bonds secured by certain unpaid reassessments against properties located in a reassessment district and from other specified sources. The PFFA is governed by a board of commissioners consisting of five members: three members of the public appointed by the Mayor and confirmed by the Council, the City Treasurer, and the Assistant Executive Director of the Redevelopment Agency of the City of San Diego. The Mayor appoints the members of the board, subject to confirmation by the Council and the Redevelopment Agency.

*The San Diego Facilities and Equipment Leasing Corporation.* The San Diego Facilities and Equipment Leasing Corporation (the "Corporation") is a nonprofit public benefit corporation that was established to acquire and lease and/or sell to the City of San Diego real and personal property to be used in the municipal operations of the City and for the financing of municipal construction projects. Certificates of participation and other securities issued by the Corporation are supported by a variety of revenues and taxes, depending on each issue. The City Manager, the City Auditor and Comptroller, and the City Attorney comprise the board of the Corporation.

*The MTDB Authority.* The City of San Diego/Metropolitan Transit Development Board Authority (the "MTDB Authority") is a joint powers authority formed by the City and the San Diego Metropolitan Transit Development Board. The MTDB Authority was created to acquire, construct, maintain, repair, manage, operate and control facilities to provide public capital improvements including public mass transit and related transportation facilities primarily benefiting the City. The City appoints two members of the public to the MTDB Authority's

[29] Cal. Gov't Code § 6500 (West 2004).

governing board and the San Diego Metropolitan Transit Development Board appoints one. Bonds issued by the MTDB Authority are secured by revenues consisting of lease payments made by the City.

*The Convention Center Expansion Financing Authority.* The Convention Center Expansion Financing Authority is a joint powers authority formed by the City of San Diego and the San Diego Unified Port District to assist with the financing, acquisition, and construction of convention center facilities. The City Manager, the Mayor, the Executive Director of the Port District, and the Chair of the Port District Board comprise the board of the Convention Center Expansion Financing Authority. The bonds issued by the Convention Center Expansion Financing Authority are secured by revenues consisting primarily of lease payments made by the City.

*The Redevelopment Agency.* The Redevelopment Agency of the City of San Diego (the "Redevelopment Agency") was activated by action of the Council pursuant to the Community Redevelopment Law of the State of California; at the same time, the City declared itself to be the Redevelopment Agency. The bonds issued by the Redevelopment Agency are secured principally by certain pledged tax revenues. The Mayor and the members of the Council serve as the governing board of the Redevelopment Agency, although the Redevelopment Agency is a separate, legally constituted body operating under the Community Redevelopment Law.[30] The City Manager and City Attorney serve as the Redevelopment Agency's Executive Director and General Counsel, respectively.

*The San Diego Open Space Park Facilities District.* The City of San Diego formed the San Diego Open Space Park Facilities District No.1 (the "District"), for which the Council serves as the governing body. The District has the power and is obligated to cause the City of San Diego to levy ad valorem taxes on all secured property in the District, subject to taxation, without limitation as to rate or amount (except in the case of certain personal property, which is taxable at limited rates) for the payment of principal and interest on bonds issued by the District.

*The Reassessment Districts and Community Facilities Districts.* The City has provided for the issuance of bonds by certain other special districts to finance improvements that benefit those districts. The City established two reassessment districts that have issued bonds, which are payable primarily from certain special assessments collected from the owners of assessed land within those reassessment districts. The City has also established several community facilities districts that issue bonds under the Mello-Roos Community Facilities Act of 1982, which are

[30] According to the League of California Cities, most redevelopment agency boards are made up of the members of the local city council. League of California Cities, *Financing Cities: City Financing in the Decades After Proposition 13*, at 17.

payable primarily from certain special taxes collected from the owners of certain taxable land within those districts. The Council serves as the legislative body of each district.

## II. The Issuance Process

The Financing Services division of the Office of the City Treasurer is responsible for overseeing the issuance of debt by the City and related entities such as the PFFA. As is customary for the issuance of municipal securities, the City and the related authorities rely on outside bond counsel to assist with debt issuances and tax analysis of the proposed financing and on outside disclosure counsel to help them meet their disclosure obligations relating to such debt under the federal securities laws. In connection with a debt issuance, the City also retains an outside financial advisor to analyze and evaluate different financing options. The staff of the Financing Services division works with the City Attorney's Office, bond counsel, disclosure counsel, and the financial advisor to organize the financing and draft the necessary documents. The Financing Services staff also assists the City Treasurer and the City Manager to guide the proposed financing through the process of obtaining Council approval.

Bond counsel and disclosure counsel are selected and retained (but not paid) by the City Attorney's Office. Typically, bond counsel and disclosure counsel are chosen based upon their responses to a Request for Proposals ("RFP"). In some circumstances, they may be selected by the City without an RFP process; for instance, in connection with past issuances of refunding bonds, the City has engaged the same bond counsel firm that participated in the issuance of the original bonds. The same firm that serves as bond counsel may also serve as disclosure counsel, or another firm may provide disclosure counsel services. The City has relied on a limited number of firms to serve as bond counsel and disclosure counsel in recent years.

Disclosure counsel assists the City in producing the preliminary and final official statements describing the proposed debt issuance, which are used in marketing the bonds. The City's official statement consists of the main body (which provides details relating to the debt to be issued, the use of proceeds, current litigation, the continuing disclosure obligations relating to such debt, and related matters) and a number of appendices, including Appendix A, which contains financial and demographic information relating to the City, and Appendix B, which includes the City's general purpose financial statements. Other appendices can include such items as a copy of bond counsel's proposed opinion, a description of the book-entry system, the continuing disclosure agreement relating to the bonds, and a description of applicable bond insurance.

The main body, or "front part," of the official statement is drafted by disclosure counsel, with the assistance of members of the Financing Services staff, using a previous official statement as their template. Disclosure counsel outlines the issues for which more information is

needed, and the Financing Services staff assembles that information and provides it to disclosure counsel for inclusion in the initial draft. Different City departments may participate in the process depending upon the nature of the financing. Disclosure counsel then circulates that draft to a working group that includes Financing Services managers and staff, a representative of the City Attorney's Office, bond counsel, and the financial advisor for their review. Subsequent drafts are also reviewed by the Treasurer and the Deputy City Manager and may be reviewed by other City officials as well, depending on the nature of the financing.

Another group of Financing Services staff, under the direction of Financing Services Manager Lakshmi Kommi, is primarily responsible for maintaining Appendix A. Throughout the year, they regularly update the financial and demographic information included in Appendix A for use with different debt issuances and for continuing disclosure purposes. As part of the preparation of a new draft official statement, they review Appendix A and provide a current version to disclosure counsel for inclusion in the official statement. Appendix A is also circulated for review by the working group and the Auditor and Comptroller, the Treasurer, and the Deputy City Manager.

For Appendix B to the official statement, the Financing Services staff obtains the City's general purpose financial statements, which consist largely of excerpts from the City's Comprehensive Annual Financial Report ("CAFR"), from the Auditor's office. Appendix B is typically not included in the form of the official statement that is submitted to the Council for approval, however. Instead, it is inserted into the final version before the official statement is printed and distributed.

The working group typically holds a number of meetings and conference calls to discuss the draft official statement. In addition to the working group, representatives of other City departments also review portions of the draft relating to their areas of responsibility and provide comments in an internal review process that is coordinated by a representative of the City Treasurer's Office or Financing Services who serves as project manager for the proposed issuance. Participating reviewers may submit their comments to the project manager or may provide them to disclosure counsel. The working group conducts a page-by-page review of the draft in order to confirm that it is accurate and that all comments have been incorporated, and disclosure counsel conducts due diligence. At the conclusion of this drafting process, substantially final drafts of the preliminary or final official statement and the other necessary financing documents are ready for circulation to City officials for their formal approval and submission to the Council for approval pursuant to an ordinance or a resolution.

A bond document with a revenue or general fund liability of more than five years (such as an indenture, a lease, or a purchase installment contract) must be approved by ordinance of the Council, while a document that does not carry its own financial obligation (such as a preliminary

official statement) may be approved by the Council by a resolution rather than an ordinance. Bond counsel prepares the necessary ordinances and resolutions for review by the City Attorney's Office. In issuances where a preliminary official statement is provided, it may be submitted for Council approval in advance of the rest of the documents for the financing so that it can be used to market the bonds prior to the closing.

The official statement and other bond documents, together with their requisite ordinance and/or resolution, are assembled under the cover of a Form 1472 "Request for Council Action" ("Form 1472"). The Form 1472 provides accounting details for the offering as well as an explanation of all documents submitted to the Council for approval. Also included with the Form 1472 is a description of the financing in an attachment called the "A Page" or the "Manager's report," which also contains the City Manager's recommendation that the Council approve the ordinance or resolution being presented. These materials are circulated for approval by the City Auditor and Comptroller, the City Attorney, a representative of the City Manager's office, a representative responsible for environmental review, and other City officials depending on the nature of the financing. They indicate their approval of the issuance and the documents by signing the Form 1472.

When all the necessary signatures have been received, the Form 1472, together with the ordinance and supporting documents, is sent to the Council's docketing coordinator, who collects the documents that are to be submitted to the Council for approval and files them with the City Clerk's office. The City Clerk distributes all of the materials relating to the agenda for the next meeting of the Council to the Council members for their review. Before the Council meeting, separate briefings on the agenda items are held for Council staff and the City Manager's office; the City Attorney's Office may also conduct an internal briefing regarding any legal issues that may be implicated by the docketed items. For some issuances, particularly those that are subject to greater scrutiny, representatives of the City Manager and the City Auditor may brief the Council members individually.

Bond ordinances and resolutions are addressed by the Council in open session and must be read into the record twice. A representative of the City Manager's office makes a presentation to the Council regarding the issuance. Under California law and the City Charter, approval by the Council of a bond ordinance in most cases requires further voter approval.[31] No public referendum is required for documents that may be approved by the Council by resolution.

[31] An ordinance or resolution determining that the public interest or necessity demands a municipal improvement to be financed by the issuance of debt may be adopted only by a vote of five members of the Council, and a vote of two-thirds of the electors voting on each proposition at a regular or special election for the issuance of such bonds is required before such indebtedness may be incurred, except for ordinances authorizing such short-term debt issuances as are permitted by Section 92 of Article VII of the Charter. Charter art. VII, § 90.

By its terms, an ordinance approving bond documents typically will authorize the City Manager to make necessary, non-substantive changes to the bond documents even after the ordinance has been approved. A resolution approving an official statement also will authorize the City Manager, City Attorney, or bond counsel to make such changes as are needed, which allows for updates to the official statement and the insertion of Appendix B when the official statement is finalized. Following the approval of all bond documents, the bonds are priced, and the closing (at which the necessary agreements, certificates, and legal opinions are signed or presented and the bonds are issued) occurs shortly thereafter.

Council approval of the issuance by ordinance (or in some cases, by resolution) may also be required in the case of bonds issued by one of the related authorities, depending upon the entity involved and the nature of the issuance, and the process of obtaining such approval is similar to the process described above. For instance, in connection with debt issuances by the PFFA, a representative of the City Attorney's Office provides the members of the PFFA's board with the same documents that were submitted for approval by the Council. After the Council has approved the bond documents, the PFFA reviews them in a public meeting at City Hall, or in some instances at the offices of the Centre City Development Corporation, at which representatives of Financing Services and other relevant departments make presentations to the PFFA board on the proposed financing and answer any questions. These presentations are substantially similar to those provided to the Council. The PFFA board approves an issuance and official statement by resolution. Like the Council resolutions, the PFFA resolutions generally authorize certain changes to the documents by the City Manager, City Attorney, or bond counsel after approval. Voter approval of PFFA issuances is not required, although as discussed above it may be required for any related Council ordinances.

# Organization and Structure of the San Diego City Employees' Retirement System

## I. History and structure

SDCERS is a multiple-employer, defined benefit plan established in 1927 by the City of San Diego (the "City") to provide retirement, disability, death, and retiree health benefits to its members and their beneficiaries.

### A. Participating employers

SDCERS members currently include the employees of the three participating employers in SDCERS: the City, the Unified Port of San Diego (the "Port"), and the San Diego Regional County Airport Authority (the "Airport"). The Port became a participating employer of SDCERS in 1963 through an agreement with the City. The Airport entered into an agreement with SDCERS in 2003 to become a participating employer. While SDCERS is a common administrative and investment agent for the City, Port, and Airport, each respective employer adopts its own level of benefits and vesting schedule for its employees through its own plan. The funding status and required contributions are then determined separately for each employer plan.

### B. Role of the City in SDCERS

SDCERS functions, at a basic level, as a trust.[32] The City established the trust and, as the settlor of the trust, can determine and amend its terms, including the levels of benefits and required contributions for its members, through City ordinances.[33] This trust, however, is administered by the Board of Administration (the "Board") and not by the City or its Council.[34] The Board is a fiduciary as to the beneficiaries of SDCERS (i.e. its members), and its duties towards these beneficiaries in carrying out its administrative functions take precedence over any other duties that the Board may have to other entities involved in SDCERS, including the City.[35]

---

[32] *See* Charter art. IX, § 145. Although the SDCERS fund is described as a trust fund in the City Charter, there does not appear to be a separate trust agreement.

[33] *See* Charter art. IX, § 141.

[34] *See* Charter art. IX, § 144.

[35] *See* Cal. Const. art. XVI, § 17 and discussion in Section III(C) below.

Monies of SDCERS are held in a retirement trust fund in the City Treasury that is separate from the funds of the City and controlled by the Board.[36] The SDCERS fund may be used only for the purposes of SDCERS.[37] Payments from the fund may only be made by order of the Board; the Council cannot order payments from the fund.[38]

## II. Applicable law

The organization and operations of SDCERS are governed by California State Constitution Article XVI, Section 17; the San Diego City Charter Article IX, Sections 141 through 148.1 and Article X, Section 1; and the San Diego Municipal Code Chapter 2, Article IV, Sections 24.0100 *et seq.* SDCERS is intended to be a qualified plan under the Internal Revenue Code and, as a result, is subject to certain Internal Revenue Code requirements.[39] However, because SDCERS is a governmental plan, it is exempt from the Employee Retirement Income Security Act and from certain qualification requirements under the Internal Revenue Code, including the nondiscrimination rules applicable to the participation of highly compensated employees.[40]

## III. Board of Administration

SDCERS is administered by the Board of Administration (the "Board"), which is composed of thirteen members. The members of the Board are (1) the City Manager, (2) the City Auditor and Comptroller, (3) the City Treasurer, (4-6) three members of SDCERS who are elected by the general members, (7) one member elected by the fire safety members, (8) one member elected by the police safety members, (9) one retired member of SDCERS elected by the retired membership, (10) an officer of a local bank appointed by the City Council, and (11-13) three other San Diego citizens appointed by the City Council. Board members serve 6-year terms, with one term expiring each year. Ex-officio members of the Board serve for the period of their respective positions with the City.[41]

### A. Administrative functions

The Board performs a variety of administrative functions. The Board determines who the members of SDCERS are and is charged with being the sole authority and judge, under general

---

[36] *See* Charter art. IX, § 145.

[37] *Id.*

[38] *Id.*

[39] *See* San Diego Municipal Code ch. 2, art. IV, div. 10, § 24.1010 and div. 14, § 24.1408.

[40] *See* I.R.C. §§ 401(a)(5)(G), 410(c)(1)(A).

[41] *See* Charter art. IX, § 144.

ordinances adopted by the City Council, as to the conditions under which persons may be admitted to benefits of any sort under SDCERS.[42] The Board employs an actuary to make an annual valuation of SDCERS' assets and liabilities and, at least once every five years, employs an actuary to perform a thorough investigation of the mortality, service, and compensation experience of members and other persons receiving benefits, along with an actuarial valuation of assets and liabilities.[43] Based on the work and recommendations of the actuary, the Board adopts contribution rates for the various classes of members for each employer and adopts actuarial assumptions (mortality and service tables and rates, assumed rate of investment return, etc.) as it deems necessary to provide benefits.[44] The Board is also responsible for crediting appropriate interest to member and employer contribution accounts and transferring amounts from such accounts to a reserve in order to fund retiree benefits.[45] The Board must also prepare an annual administrative budget for SDCERS and is responsible for the preparation of an annual report.[46]

B. Investments

The Board has exclusive control over the investment of SDCERS funds.[47] The Board may employ independent investment counselors as needed to provide professional services to support the Board's investment responsibilities.[48] The Board is permitted to invest the funds in any bonds or securities that are authorized by law for savings banks and in any additional classes or types of investments that are approved by resolution of the City Council, except that individual investments within the approved classes or types must be approved by independent investment counsel.[49]

C. Fiduciary duties

In its administration of SDCERS, the Board is subject to the fiduciary duties set forth in Article XVI, Section 17 of the California Constitution. Under these constitutional provisions, the Board must administer its system in a manner that will assure prompt delivery of benefits and

---

[42] *Id.* Nevertheless, the City Auditor and Comptroller must refuse to allow any payment of a retirement allowance if, in the opinion of the Auditor and Comptroller, the retirement allowance has been granted in contravention of the Charter or any ordinances passed under the authority granted in the Charter.

[43] *See* Municipal Code ch. 2, art. 4, div. 9, § 24.0901.

[44] *See id.*, § 24.0902.

[45] *See id.*, §§ 24.0903 and 24.0904.

[46] *See id.*, §§ 24.0906 and 24.0911.

[47] *See* Charter art. IX, § 145; Cal. Const. art. XVI, § 17. The California Pension Protection Act of 1992 (Proposition 162), approved by the electorate in November 1992, strictly limited the Legislature's power over public pension funds by charging public retirement boards with the sole and exclusive power over the investment of public retirement system assets and the administration of the public retirement systems.

[48] *See* Municipal Code ch. 2, art. 4, div. 9, § 24.0901.

[49] *See* Charter art. IX, § 145.

related services to the participants and their beneficiaries.[50] The members of the Board are to discharge their duties with respect to the system solely in the interest of, and for the exclusive purpose of (1) providing benefits to participants and their beneficiaries, (2) minimizing employer contributions, and (3) defraying reasonable expenses of administering the system. The Board's duty to its participants and their beneficiaries takes precedence over any other duty,[51] and each Board member must act prudently and diligently in the discharge of his or her duties to SDCERS.[52]

## IV. Members and benefits

### A. Members

SDCERS members include employees and former employees of the three participating employers: the City, the Port, and the Airport. Generally, membership in SDCERS is mandatory and a condition of employment for all salaried employees in the classified service[53] and all employees in the unclassified service who are employed one-half, three-quarters, or full-time.[54]

For purposes of benefits, there are three classes of members: general members, safety members, and elected officers.[55] The different classes of members and benefits resulted from the inclusion of different groups of employees in SDCERS. In 1955, the Police and Fire Systems were merged into SDCERS to create a second class of members, while in 1971, elected officials became eligible for membership, creating the third class of members.[56] Safety members include City police officers, firefighters, full-time life guards, and police department recruits in the City's Police Academy.[57] Elected officers include the Mayor, members of the City Council, and the City Attorney.[58] General members are members not otherwise classified as safety members or elected officers.[59] Notably, elected officers are not required to become members of SDCERS

---

[50] *See* California Pension Protection Act of 1992 (Proposition 162) (amending Article XVI, Section 17 of the California Constitution to increase and clarify the fiduciary duties of public retirement boards).

[51] *Id.*

[52] Specifically, the California Constitution requires that the Board discharge its duty in accordance with the "prudent expert" standard, the same standard imposed under ERISA. *See also* SDCERS *Comprehensive Annual Financial Report* for the year ending June 30, 2003 (the "2003 CAFR"), *Financial Section*, p.45, *at* http://www.sdcers.org/images/pdf/sdcers_fy2003_cafr_2_ financial_section.pdf.

[53] Employment in the City is divided into the classified and unclassified service. *See* Charter art. VIII, § 117.

[54] *See* Municipal Code ch. 2, art. 4, div. 1, § 24.0104.

[55] *See id.*, § 24.0103.

[56] *See* 2003 CAFR, *Actuarial Section*, at 125, *at* http://www.sdcers.org/images/pdf/sdcers_fy2003_cafr_4_ actuarial_section.pdf.

[57] *Id.*

[58] *Id.*

[59] *Id.*

but may file a written election to become a member.[60] The City has all three classes of members. The Port only has general and safety members, and the Airport only has general members.[61]

B. Benefits

Benefits available to members of SDCERS include service retirement, disability, death, retiree health, and other related benefits. The discussion below generally describes these benefits. The specific features of the benefits vary from employer-to-employer and member-to member. The different features of these benefits for various members are summarized in a table set forth in the Actuarial Section of the Comprehensive Annual Financial Report for SDCERS for the year ending June 30, 2003 (the "Benefit Summary Table").

1. Service retirement

a. Eligibility. A member is eligible for service retirement benefits upon retiring from his or her respective employer provided he or she has satisfied certain age and service requirements. For example, a general member employed by the City is eligible for service retirement benefits upon the earlier of: (1) reaching age 62 and performing 10 years of service, or (2) reaching age 55 and performing 20 years of service. The age and service requirements for service retirement vary from employer-to-employer and among the different classes of members.[62]

b. Calculation of benefit. A member's service retirement benefit is calculated by multiplying three factors: (1) a member's number of years of creditable service, (2) the member's "Final Compensation," which generally is the member's highest rate of compensation during a one year period of membership and (3) a retirement factor or multiplier.[63] The retirement factor is a set percentage that is determined based on the age at which the member retires, the member's class (i.e. general, safety, or elected officer), and the member's employer.[64] A member may also have a choice as to which set of retirement factors apply to the calculation of his benefit, and depending on the member's

---

60 Municipal Code ch. 2, art. 4, div. 17, § 24.1702.

61 Note also that general and safety members who are serving as duly elected presidents of a recognized employee labor organization may continue to participate in SDCERS in accordance with a Memorandum of Understanding between the City and the Member's employee organization. *See* Municipal Code ch. 2, art. 4, div. 2, § 24.0201(b) and Municipal Code ch. 2, art. 4, div. 3, § 24.0301(b).

62 For a summary of these different requirements, see the Benefit Summary Table, *Exhibit A*.

63 *See* Municipal Code ch. 2, art. 4, div. 4, §§ 24.0402(d) (general members) and 24.0403(d) (safety members).

64 *See, e.g., id.*, §§ 24.0402 and 24.0403, Table 1.

choice of retirement factors, the Final Compensation amount used in the benefit calculation may be adjusted (i.e. reduced or increased by 10%).[65] The calculation of a member's benefit may also be subject to a cap of 90% of Final Compensation, depending on the member's class and employer and the set of retirement factors selected by the member to be used in the benefit calculation.[66]

c. Payment of benefit. Generally, the service retirement benefit calculated above provides an amount to be paid to a member on a monthly basis until the member's death. However, a member may elect various optional benefit forms that provide different levels of benefits to the member's beneficiary upon the member's death.[67] Election of an optional benefit will reduce the amount of the member's monthly service retirement benefit.[68] The amount of a retired member's monthly retirement benefit is also subject to a cost-of-living adjustment (or COLA) as determined annually by the Board.[69] The COLA may not increase a member's benefit by more than 2% per year or reduce the benefit below the amount received by a member on the effective date of his or her retirement.[70] In addition to the monthly payment, a retired member may also be entitled to a supplemental benefit or "13th check" each year, depending upon the overall performance of SDCERS.[71]

2. Disability

In the event a general or service member retires from service due to a disability, the member is eligible for a disability benefit. The level of a member's disability benefit is dependent upon whether the disability was suffered in the course of employment. Generally, the monthly disability benefit is the greater of: (1) monthly installment payments equal to a percentage of Final Compensation plus an annuity purchased with the member's accumulated contributions or (2) if eligible for service retirement, the

---

65 *See, e.g., id.*, § 24.0402(e) (general members) and § 24.0403(d) (safety members).

66 *See, e.g., id.*, § 24.0402(g) (general members) and § 24.0403(e) (safety members).

67 *See id.*, §§ 24.0602 through 24.0607.

68 *See id.*, §§ 24.0402(i) and 24.0403, Table 1

69 *See id.*, § 24.1505. The Board determines, before each July 1, whether a COLA is warranted based on the increase or decrease in the annual cost of living which occurred in the previous calendar year, as shown by the Bureau of Labor Statistics Consumer Price Index—All Items.

70 Municipal Code ch. 2, art. 4, div. 15, § 24.1505.

71 *See, e.g., id.*, § 24.1502(a)(6).

member's monthly service retirement benefit.[72] Elected officer members are only eligible for a normal service retirement benefit upon disability.[73]

3. Death

In the event of the death of an active member, the member's surviving spouse (or, if there is no surviving spouse, the member's dependent children) is eligible to receive a death benefit. The form of these benefits varies depending on whether the member dies of industrial (i.e. work-related) causes and on whether the member was eligible to retire at the time of death. Generally, if a member dies from industrial causes and/or while eligible to retire, the member's surviving spouse (or dependent children) will receive a certain monthly benefit to be paid over the surviving spouse's life (or until all the dependent children reach age 18).[74] If a member dies from non-industrial causes before he or she is eligible to retire, the member's surviving spouse (or dependent children) will receive a certain lump-sum benefit.[75] In the event of the death of a retired member, the retired member's designated beneficiary is entitled to receive $2,000 upon the member's death. The beneficiary is also entitled to continued benefits to the extent provided under the optional form of benefit elected by the member.[76]

4. Retiree health

A member eligible for retiree health benefits is eligible to obtain health coverage under any City-sponsored plan and will have his or her health insurance premiums paid or reimbursed, subject to certain limitations.[77] The retiree health benefit is funded by the City either directly or through a separate account maintained under SDCERS called the "401(h) Fund."[78] All amounts in the 401(h) fund can only be used to pay for retiree health benefits and, although the amounts may be pooled with other SDCERS funds for investment purposes, the 401(h) Fund may not be used to fund retirement or other benefits under SDCERS. [79]

---

[72] *See* Municipal Code, ch. 2, art. 4, div. 5, §§ 24.0503 through 24.0506.

[73] *See* Municipal Code, ch. 2, art. 4, div. 17, §§ 24.1707.

[74] *See* Municipal Code, ch. 2, art. 4, div. 7, §§ 24.0704 and 24.0705.

[75] *See id.*, § 24.0702.

[76] *See id.*, § 24.0710.

[77] *See* Municipal Code, ch. 2, art. 4, div. 12, § 24.1202.

[78] *See id.*, § 24.1203.

[79] *Id.*

5. Other related benefits

a. DROP. The Deferred Retirement Option Plan ("DROP") is a voluntary program created to provide members flexibility when planning for retirement by providing members with access to a lump-sum benefit in addition to their monthly retirement allowance. To participate in DROP, a member must be eligible for retirement, elect to begin receiving his monthly retirement benefit allowance, and forgo accrual of all other benefits under SDCERS.[80] The member's monthly retirement benefit allowance will be deposited into a DROP account, along with additional employee and employer contributions and credited interest on the account.[81] A member must designate the length of time he or she wishes to participate in DROP (up to a maximum of five years) and must agree to terminate employment following the termination of participation in DROP.[82] At the end of the DROP period, the member will be able to receive the amounts in his or her DROP account and will begin receiving the monthly retirement allowance directly.[83]

b. Withdrawal of Accumulated Contributions. If a member terminates employment prior to being eligible to apply for a service retirement benefit, the member may withdraw the member's accumulated contributions with interest upon proper application to SDCERS within six months of termination.[84] Alternatively, the member may keep the contributions with SDCERS (1) until the member satisfies the age requirements for a retirement benefit or (2) for participation purposes in the event the member is rehired by a participating employer.[85] Withdrawal of accumulated contributions, however, terminates membership in SDCERS, and the member will no longer be eligible for any SDCERS benefits, unless the member is re-employed and repays the amounts previously withdrawn.[86]

---

80 *See* Municipal Code, ch. 2, art. 4, div. 14, § 24.1402.

81 *See id.*, § 24.1404.

82 *See id.*, § 24.1402.

83 *See id.*, § 24.1407.

84 *See* Municipal Code ch. 2, art. 4, div. 2, § 24.0206 (general members) and Municipal Code ch. 2, art. 4, div. 3, § 24.0306 (safety members).

85 *Id.*

86 *See* Municipal Code ch. 2, art. 4, div. 13, § 24.1306.

## V. Contributions and Funding

Generally, with respect to the funding of defined benefit plans, assets are accumulated in order to cover current and future benefits provided by the plan. Each year the actuary selected by the Board performs an actuarial valuation of the plan to determine whether the plan currently has the funds necessary to satisfy its current and future benefit obligations. The annual actuarial valuation of a defined benefit plan is based on various actuarial assumptions, such as investment performance, employee retention rates, mortality tables, expected increases in compensation and expected cost-of-living adjustments. Since actual plan experience will never precisely equate with the actuarial assumptions, the value of the assets of most defined benefit plans will either exceed or fail to meet the amounts necessary to cover its accrued benefit liabilities.

Based on this valuation, the actuary determines the annual amount that must be contributed to the plan in order to cover the plan's annual costs. This annual cost includes the amount necessary to satisfy benefits that accrue in a given year (the "normal cost") and the amount necessary to amortize any shortfall between the assets of a plan and the accrued benefit liabilities of the plan, or the plan's unfunded actuarial accrued liability (the "UAAL"), over a certain period of time.

The following discussion addresses the contributions made by the City and its employees to satisfy this annual cost under the City's defined benefit plan within SDCERS and the overall funding status of such plan.[87]

### A. Contributions

Under SDCERS, the City and members (while actively employed) must contribute certain amounts as prescribed by the City Charter and applicable municipal statutes in order to fund the benefits as described above. For employees, these contribution rates, expressed as a percentage of compensation, are based on the age of a member upon entry into SDCERS and actuarial calculations that are approved by the Board.[88] The City may pay or "offset" a portion of the member's required contribution.

Pursuant to the City Charter, the City is to contribute annually an amount certified by the actuary that is substantially equal to that required of the employees.[89] Prior to 2002, the

---

[87] The contributions and funding status of the SDCERS plans of the Port and Airport are not relevant to the investigation at issue and beyond the scope of this discussion.

[88] With the approval of the Board, employees may contribute more than the actuarially determined contribution rate, and an employee who makes such additional contributions is entitled to receive an increased retirement benefit in proportion to the additional contributions. *See* Charter art. IX, § 143.

[89] *Id.* The City is not required to contribute in excess of such amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past service of employees.

Municipal Code provided that the City would contribute a percentage of members' earnable compensation as determined by the SDCERS's actuary pursuant to the annual actuarial valuation.[90] In November of 2002, the Municipal Code was amended to provide that the City would contribute the amounts agreed to in the governing Memorandum of Understanding between the City and the Board.[91]

Since July 1996, the City has made specified annual contributions in accordance with successive funding arrangements entered into by the City and SDCERS in 1996 and 2002 (respectively, "MP1" and "MP2"). These funding arrangements provided for a fixed annual rate of contributions expressed as percentages of payroll and were below the rates determined by the actuary during this period as necessary to cover the annual costs of the City's plan (i.e., the actuarially required rates ("ARC")).[92]

B. Funding status

As of the annual actuarial valuation as of June 30, 2003, the amount necessary to cover the accrued benefits under the City's plan, or the actuarial accrued liability (the "AAL"), was $3.533 billion, while the actuarial value of assets of the City's plan under SDCERS was $2.375 billion.[93] Accordingly, based on the actuarial valuation dated June 30, 2003, the plan has an UAAL of $1.157 billion (the difference between the AAL and the actuarial value of assets) and a funded ratio of 67.2% (the percentage of the AAL covered by the value of plan assets).[94] Since the actuarial valuation for the year ending June 30, 2002, the UAAL for the City's plan increased by $437 million and the funded ratio decreased from 77.3%.

Since the actuarial valuation ending June 30, 2000, the funding status of the City's plan under SDCERS, like many pension systems around the county, has steadily deteriorated. The City's plan has experienced actuarial losses (not investment losses) of $193.2 million, $364.8 million, and $303.7 million in 2001, 2002, and 2003 respectively for a total actuarial loss of $861.7 million during this period.[95] The City's plan has seen its funded ratio incrementally

---

90 *See* Municipal Code ch. 2, art. 4, div. 8, § 24.0801 (2000).

91 *See id.*

92 *See infra* Part II for a more detailed discussion on MP1 and MP2.

93 *See* San Diego City Employees' Retirement System Annual Actuarial Valuation for the year ending June 30, 2003 (the "2003 Actuarial Report"). The actuarial value of assets is not the market value of assets. The actuarial value "smooths" investment returns over a five year period. By utilizing this smoothed value in the actuarial valuation, the impact of the volatility of the market on actuarial valuations is softened.

94 *See* 2003 Actuarial Report, at 13.

95 *See id.*, at 10.

decrease from 97.3% in 2000 (its highest level from 1993-2003)[96] to 67.2% in 2003. These actuarial losses are due to a number of combined factors, including poor investment performance resulting from adverse market conditions.[97] As is the case with most pension plans since 2000, SDCERS failed to achieve its assumed rate of investment return of 8% in 2001 (+4.1%), 2002 (-4.1%), and 2003 (-3.4%).[98] These sub-par investment returns accounted for $695 million or 80% of the total actuarial loss for this three-year period only.[99] Other factors contributing to the decline include (1) the increase in benefits to current retirees arising from the *Corbett* litigation, (2) the City's contribution rates since 1996, which were below the actuarially required rates for the same period,[100] and (3) demographic changes. As described later in this Report, when viewed from a longer-term perspective, these other factors actually had a greater impact on the SDCERS funding status than the actuarial investment losses.[101]

C. Future of contributions and funding status

In August 2004, the City agreed to settle a class action litigation challenging MP1 and MP2.[102] The settlement requires that the City contribute at the full actuarially required rate (calculated based on the PUC method) beginning in FY 2006, contribute $130 million for its FY 2005 contribution, and provide a total of $500 million in security interests in real property to secure its required contributions to SDCERS through FY 2008. However, regardless of the City's contributions levels, the City's plan should continue to remain in a similar funding position over the next several years. Due to the smoothing process used in determining the actuarial value of the City's assets, the poor investment returns of 2001-2003 will continue to negatively impact the funding status of the plan until 2008.[103]

---

96 Technically, at June 30, 2000, the City's plan had a funded ratio of 105%. However, that number was adjusted downward to 97.3% when the SDCERS Board decided to recognize, during that fiscal year, the liability to the system represented by the non-contingent portion of the settlement of the *Corbett* litigation, discussed below.

97 *See* 2002 CAFR, *Actuarial Section*, at 120, *at* http://www.sdcers.org/images/pdf/2002_sdcers_cafr_actuarial.pdf.

98 *See* 2003 Actuarial Report, at 42. These figures represent the actuarial rate of investment return for SDCERS and NOT the market value rate of return. The real rate of investment return was -1.6% in 2001, -7.1% in 2002, and -7.5% in 2003.

99 *See* 2003 Actuarial Report, at 10; 2003 CAFR, *Actuarial Section*, *supra* note 56, at 120.

100 The aggregate difference in the amounts that the City contributed in accordance with its agreements with SDCERS and the amounts that it would have paid to the SDCERS in accordance with a more conventional actuarial funding method was approximately $80.2 million through June 30, 2003. The additional amount that SDCERS assets could have earned during this period from the difference in contributions is estimated to be approximately $18.1 million. *See* Offering Statement for the Public Facilities Financing Authority of the City of San Diego Refinancing Lease Revenue Bonds, Series 2004 (Ballpark Project), Appendix A, at A-37.

101 *See infra* Part II.K (discussing the analyses of the relative impact of these factors on the system's funding status).

102 *See infra* Part II.J (discussing the *Gleason* litigation and its settlement in greater detail).

103 *See* Offering Statement for the Public Facilities Financing Authority of the City of San Diego Refinancing Lease Revenue Bonds, Series 2004 (Ballpark Project), Appendix A, at A-41.

# Part II

# The Evolution of the SDCERS Funding Deficit

## I. The Snake in the Garden of SDCERS: the seductive concept of "Surplus Earnings"

The evolution of the SDCERS funding shortfall began in 1980 with the adoption by the San Diego City Council of a provision that allocated 50% of the annual returns from SDCERS assets – to the extent those returns exceeded the SDCERS actuary's assumed rate of return – as a supplemental lump-sum payment to retirees.[104] Under this provision, cash returns that exceeded the actuarial rate in a given fiscal year were defined as "surplus earnings," half of which was distributed to retirees as what became known as a "13th Check," paid on an annual basis.[105]

The remaining 50% of surplus earnings went to the "Employer Contribution Reserve" – essentially an accounting entry representing the residue of aggregate contributions to the system not allocated to other reserves[106] – "for the sole and exclusive purpose of reducing retirement system liability."[107] "Counted" for actuarial purposes within System assets, the Employer Contribution Reserve provides a source of funding for all System liabilities. It is not available to offset or reduce the City's required annual contributions.[108] Thus, under this provision of the

---

104 San Diego, Cal., Ordinance 0-15353 (N.S.) (Oct. 6, 1980).

105 SDCERS accounts for its operations on an accrual basis under GASB standards. The various benefits paid from "surplus earnings," however, are calculated on a cash basis. As provided by Municipal Code ch. 2, art. 4, div. 1, § 24.0103, "investment earnings received," from which "surplus earnings" are derived, are defined as:

> all interest received (net of interest purchased) on notes, bonds, mortgages, short-term money market instruments, and savings accounts; cash dividends received on stock investments; and all realized gains and losses from the sale, trade, or conversion of any investments of the Retirement System.

This accounting anomaly would seem to require an annual truing up between the cash-basis calculations done to determine, for example, the interest credited to various reserves, and the way in which System returns are allocated on an accrual basis. It appears this is not done. The primary difference between the two approaches, however, is the treatment of unrealized investment gains and losses, which can be predicted to wash out over time as assets are turned over.

106 SDCERS requires three basic reserves for operational accounting purposes. The first is "the Employee Contribution Reserve," which represents the total amount contributed by City employees, with interest thereon, minus outflows to fund individual pension benefits. The second is the "Retiree Contribution Reserve." Whenever an individual retires from City employment, an amount representing the (actuarially calculated) present value of the liability to fund that individual's retirement benefits is added to this reserve and offsetting deductions made to the employer and employee contribution reserves. The third reserve, as mentioned, is the "Employer Contribution Reserve." It receives any amounts generated by the System not committed to any other use. If earnings from fund assets are insufficient in any given year to pay required expenditures of the System, such as SDCERS' administrative costs or interest on the employee and retiree reserve accounts, the amount is debited against the Employer Contribution Reserve to balance the System's books. These three reserves are not separately funded, but rather are bookkeeping categories for internal accounting purposes. As described below, however, additional reserves have been created by SDCERS, often reflecting additional benefits granted by the City. These reserves have affected the allocation and distribution of SDCERS assets.

107 Former Municipal Code ch. 2, art. 4, div. 2, § 24.0907.1(b).

108 *Claypool v. Wilson*, 4 Cal. App. 4th 646 (1992).

Municipal Code, half the "surplus earnings" generated by the system in any given fiscal year were to be distributed to retirees and the other half retained to support the fiscal soundness of the system. Prior to the adoption of this measure, all cash returns generated by SDCERS assets went to deepen system funding.[109]

This provision responded to a serious problem of the City's retiree population, but in a manner characterized by the fiscal shortsightedness that, over the following twenty years, was to become a recurrent theme in the City's dealings with SDCERS. It responded to the bleak financial situation faced by many City retirees at the beginning of the 1980s. Retirees of that period received substantially lower pension benefits than do employees retiring today. The factor that, when multiplied against years in service and highest one-year salary, determines the basic annual benefit was then approximately 1.5%, compared to 2.5% (for general members) today. Moreover, the purchasing power of even this modest allowance had been eroded by the double-digit inflation of the late 1970s. By earmarking half the System's "surplus earnings" to supplement the income of its retired workers, the Council sought to address this situation without depleting the City's operating funds.

In the short-term, this approach worked as intended. Retirees received additional financial support, with no recognized cost to the City. And because the 13th Check was to be paid wholly from "excess" cash generated by SDCERS investments, rather than the draw-down of actuarially "counted" assets, the provision of this benefit did not *immediately* increase the City's required contributions to the System. Thus, it looked very much as if this measure did no more than distribute investment windfalls to needy retirees. This view, unfortunately, was based on a fundamental misunderstanding of the actuarial concepts that underlie the funding of pension systems, public and private.

A pension system derives its ability to pay benefits from three sources: employer contributions, employee contributions and earnings generated from such contributions when retained within the system and productively invested. In determining the level of employer and employee contributions necessary to achieve the goal of "generational equity" in a pension system, a critical component is the assumed rate of return on fund assets. The greater that rate, the less must be contributed by system participants to fund projected retirement benefits on a basis that remains stable over time as a percentage of payroll. Obviously, no one can predict

[109] Municipal Code ch. 2, art. 4, div. 9, § 24.0907.1. As initially enacted, however, this section provided that all residual amounts were to be credited to an "Advance Reserve Account," to be used solely to reduce future employer contributions to the System. Ordinance 0-9620 (July 1, 1967). It appears that before the enactment of that ordinance other distributions were made from surplus earnings. For example, excess earnings for FY 1965 were divided evenly between the City (reducing its contribution to the System) and the accounts of individual members of the System (a benefit only to those who left the System before retirement or the families of those members who died before retirement). *See* Letter from Edward T. Butler, City Attorney, to Ralph W. Kausch, Retirement Officer, SDCERS (Feb. 14, 1966). In that letter, the City Attorney recommended increasing the assumed rate of return on fund assets to reduce future contributions from both the City and members of the System.

with certainty the future returns that will be generated by any particular category of assets. Projected rates of return, like many other actuarial calculations, are educated guesses derived from historical experience. They recognize that market performance will vary significantly from year to year but assume that returns from specific asset categories will average out over time at close to historical levels. This, of course, means that above-average returns in some years will offset below-average returns in others.

The surplus earnings concept ignores this long-term dynamic of actuarial projections. It evaluates returns on a year-by-year basis and treats all cash generated by system assets (beyond assumed rates of return) as free money. This, of course, flies in the face of the basic premise of actuarially assumed returns: they are rarely met for any individual year, but are expected to average out over time to approximate the projections. Therefore, the concept of "surplus earnings" is a misnomer. Unless and until it can be demonstrated that the actuary's projections are unrealistically conservative, *all* earnings are necessary to support the long-term viability of the system – none are truly "surplus" or "excess."[110]

Eventually, the bill comes due in the form of additional required contributions. The diversion of amounts that would otherwise be added to system assets increases the gap between those assets and the system's projected liabilities: in actuarial terminology the "Unfunded Actuarially Accrued Liability" (or "UAAL"). An amount calculated to amortize the UAAL is a component of the "actuarially required contribution" ("ARC") that must be paid each year by the plan sponsor (here the City) to avoid a funding shortfall. Thus, any increase in system underfunding must be paid back (with interest) by the plan sponsor over the amortization period of the UAAL. *Any diversion of earnings from system assets should therefore be seen as a financing arrangement, requiring repayment over time.*[111]

The dangers inherent in treating surplus earnings as a windfall were eventually pointed out by a number of people. For example, SDCERS Retirement Administrator Lawrence Grissom advised the board in April 2002: "[I] believe there has come a perception over the years that

---

[110] As a legal matter, the use of surplus earnings to pay various contingent benefits is also dependent on the view that these funds, until designated as "inside" System assets by the pension board, are not necessary for the actuarial soundness of the System. *See Claypool v. Wilson*, *supra* note 98. This, too, contains an element of fiction in that it fails to recognize that projected returns on fund assets are fundamental to the sound funding of any pension system.

[111] The exception to this rule is when a system's investment returns exceed projections on a sufficiently consistent basis that it accumulates more assets than it will need to pay all of its obligations as they come due. SDCERS achieved a funded level above 100% only once in its history – 105% at June 30, 2000 – and that number was adjusted downward to 97.3% when the SDCERS Board decided to recognize, during that fiscal year, the liability to the System represented by the settlement of the *Corbett* litigation, discussed below. For many years, however, SDCERS' returns were, on average, higher than the actuarially assumed rate. For example, in the decade prior to 1992, its returns averaged over 14%. This gave rise to a widely-held view that SDCERS would continue to exceed the assumed rate of return on a regular basis.

earnings are cash in pocket, which is not the case."[112] During the same month, fiduciary counsel to the SDCERS Board opined:

> Defining Surplus on a cash basis leads to draining off liquid assets and reducing future earning power. It also undercuts actuarial assumptions about earnings. An assumption of earnings is based on expected averages over a long period of time. By draining off cash in good years, the structure makes it harder to meet the long-term earnings assumption.[113]

San Diego is far from unique in its embrace of the view of surplus earnings as a budgetary free lunch. According to Gary Caporicci of Caporicci & Larson and Lawrence Grissom, the SDCERS administrator, many other municipalities nationwide have used surplus earnings to fund benefits that otherwise would come out of their general budgets (or not be granted). For example, the City of Fresno, California and the County of San Diego, California both subscribe to this practice. The California Civil Code has also recognized this concept, although in statutes not applicable to the City of San Diego.[114] If the benefits funded from "surplus earnings" are carefully limited and the assumed market returns conservative, the damage to the actuarial soundness of a system from this skimming of earnings may be minimal. With San Diego, however, serious problems arose when benefit levels escalated – in part as the result of successful litigation brought by System members – while measures were adopted that allowed the City to make annual contributions at a rate less than that calculated by the System actuary to fund the annual cost of the City's plan (the ARC).

## II. The Andrews litigation

The initial use of surplus earnings to fund a System benefit – here the 13th Check – was flawed for another reason. The measure failed to place any limits on the amount of the annual payment to retirees, apparently from the assumption that surplus earnings generated in any single year would be modest. This expectation quickly proved erroneous. The amount of surplus earnings jumped from $0.6 million at June 30, 1982 to $6.9 million at June 30, 1983. The Board, after consultation with its actuary, enacted a rule capping the amount that could be distributed annually through the 13th Check at $30 for each creditable year of City service. This resulted in

---

[112] Minutes of SDCERS Board Meeting, at 28 (Apr. 19, 2002). SDCERS minutes are not the official record of its deliberations, which is, instead, the videotapes of its meetings.

[113] Letter from Constance M. Hiatt, Hanson Bridget Marcus Vlahos and Rudy ("Hanson Bridgett"), to Loraine E. Chapin, General Counsel, SDCERS (Apr. 16, 2002). This theme was also taken up by the SDCERS actuary, Rick Roeder and Board member Diann Shipione. *See* Letter from Diann Shipione to P. Lamont Ewell, Assistant City Manager, City of San Diego, at 1-2 (Dec. 31, 2002).

[114] *See* former Ca. Gov. Code § 20132, added by Stats 1982, c. 330, at 1621, § 13, and Cal. Gov. Code § 20816 (c).

a distribution for that year of approximately $1.4 million. The remaining $5.5 million of surplus earnings was placed in a reserve for unspecified future benefits and "contingencies."[115]

SDCERS members responded with a lawsuit, claiming that the Board had exceeded its authority in declining to distribute the full 50% of FY 1983 surplus earnings to retirees.[116] After the plaintiffs prevailed at the trial court level and the City appealed, a settlement was reached under which the City agreed to certain benefit enhancements and paid $9.7 million to members of the plaintiff classes, but succeeded in retaining a modified version of the cap. The 13th Check remains in the Municipal Code as a benefit to be paid annually out of surplus earnings, when they are sufficient for this purpose.[117] It has subsequently been joined by other contingent commitments of surplus earnings, arranged in a hierarchy referred to as the "Waterfall."[118] These other uses of surplus earnings, including the payment of healthcare premiums and cost of living increases, each discussed in detail below, are paid only to the extent realized cash earnings from the System exceed the amount necessary to pay interest (at a rate set by the Board) on the System's basic reserves: the Employer, Employee and Retiree Contribution Reserves.

As a contingent benefit, the 13th Check is not included in actuarial projections of the System's long-term liabilities and therefore not factored into the annual contribution rates required from the City and active employees. From FY 1980 through FY 2002, this benefit absorbed approximately $60 million from SDCERS earnings (without compounding). In FY 1997, the SDCERS Board set aside a reserve of $3,500,000 (taken from FY 1996 surplus earnings) to fund the 13th Check benefit in years when surplus earnings prove insufficient. This reserve is carried outside System assets. By reducing System assets without decreasing projected liabilities, its creation increased the gap between assets and liabilities and consequently the size of the UAAL. Unlike certain other reserves, it was not credited with interest at the actuarially assumed rate, but did receive a share of the System's realized gains from asset sales.

In FY 2003, the System was unable to fund the 13th Check from that year's surplus earnings. Responding to pleas from retirees, the City Council approved the application of the

---

[115] The Board enjoys the authority under the Municipal Code to create "such reserves as the Board deems appropriate" Municipal Code ch. 2, art. 4, div. 15, § 24.1502(a)(3). This does not provide it with discretion to use System earnings in any manner it deems appropriate, as discussed below.

[116] *Andrews v. City of San Diego, Board of Administration of the San Diego City Employees' Retirement System* (San Diego County Super. Ct.) (No. 515699).

[117] Municipal Code ch. 2, art. 4, div. 15, § 24.1502(a)(6). If the surplus available for this purpose in a particular year is less than $100,000, no payment is required by the Code for that year and the surplus, if any, is rolled into a reserve. In such later year as the reserve exceeds $100,000, the benefit again becomes payable.

[118] Municipal Code ch. 2, art. 4, div. 15, § 24.1502.

13th Check Reserve – its balance increased since its creation in 1997 by $539,000 as a result of realized gains on asset turnover – to pay the 13th Check for FY 2003.[119]

III. The Post-retirement healthcare benefit

In 1982, the City withdrew from the Social Security System. Under federal law, this required that it provide certain comparable benefits to retired employees, including medical benefits. Rather than pay insurance premiums from its own budget, however, the City enacted an ordinance directing that the premiums be paid from SDCERS' surplus earnings.[120] As noted above, in 1980 the City had determined that 50% of surplus earnings would be distributed to retirees – thus putting in motion the chain of events that led to the *Andrews* settlement. With this 1982 measure, the City applied a portion of the remaining surplus earnings to fund retiree healthcare benefits. In the event that surplus earnings should prove inadequate in a particular year, the City was ultimately responsible for the cost of the premiums, as remains true today.[121] To date, this eventuality has not occurred, and all costs attributable to the healthcare benefit have been borne by earnings from SDCERS assets, either directly or through the depletion of reserves established for this purpose.[122]

The retiree healthcare benefit was paid directly out of earnings from 1983 until 1992, when a determination was made that this violated federal tax regulations by improperly paying non-pension benefits from dedicated pension assets. In an attempt to avoid this compliance problem, the City and SDCERS developed a complicated mechanism of "bifurcated payments" to fund the healthcare benefit while continuing to avoid any outlay from the City budget. At the beginning of each fiscal year, an estimate was made of the cost of retiree insurance premiums for that year. The City's contribution to the System, including the cost of healthcare premiums, was "credited" with the projected amount of those premiums. Thus, each year, the City paid the

---

[119] The only other fiscal year in which the 13th Check was paid from a reserve was 1990. That year, the total return on SDCERS assets was approximately 9%, but cash earnings were insufficient to fund this benefit, which was paid from a reserve established for this purpose as a result of the *Andrews* litigation. This illustrates the difference between returns calculated under GAAP and under the cash basis provided by Municipal Code ch. 2, art. 4, div. 15, § 24.1502.

[120] Ordinance 0-15758 (N.S.) (June 1, 1982).

[121] *See* Ordinance 0-16510 (N.S.) (Sept. 30, 1985), and Ordinance 0-17295 (N.S.) (May 15, 1989). The *Andrews* settlement extended the class of eligible retirees by an additional two years. SDCERS Board member and Fire Fighter's Local 145 president Ronald Saathoff recounted this year to the San Diego City Pension Reform Commission:

> we knew that people were desperately in need of health care and having to take many times out of savings to pay for it. So we said, we'll make you a deal. We'll agree with $30 per year of service if you'll pay the healthcare for these retirees. And that was the deal that was done.

Minutes of the Pension Reform Commission Meeting, at 18 (Jan. 27, 2004). Mr. Saathoff declined to be interviewed by Vinson & Elkins for purposes of this Report.

[122] However, as described immediately below and in the discussion of Manager's Proposal 1, a mechanism was developed through which the City contributes amounts to the SDCERS healthcare reserve in return for a dollar-for-dollar offset from surplus earnings against its other obligations to the System. This roundabout funding mechanism was designed to sidestep problems with the Internal Revenue Code.

basic ARC, with no additional amount for the post-retirement healthcare benefit. At the end of the year, when the total cost for insurance premiums was known, surplus earnings would be credited to the Employer Contribution Reserve, offsetting the net deficit to the City's contribution to the pension system created by drawing the year's insurance premiums from that account.

As outside counsel to the SDCERS Board concluded, this approach was also legally flawed. By letter dated August 22, 1995, Morrison & Foerster advised that this practice: "transgresses the constitutional and statutory trust obligations that govern use of Surplus Earnings and that prohibit the diminution of retirement assets to pay non-retirement-trust liabilities."[123] Counsel noted, however, that his firm's view might be different if healthcare insurance were a SDCERS benefit, rather than a City benefit. As described below, this issue was addressed the following year in a significant restructuring of SDCERS' funding.[124]

In the early years in which the healthcare benefit was provided to City retirees, the cost was negligible. For the first three years, for example, the total cost of insurance premiums was $299,969. Nevertheless, the potential for the healthcare benefit to become a severe financial burden on SDCERS has been apparent for many years. In 1989, at the request of SDCERS administration, Buck Consulting provided the City Manager's Office with a draft report on post-retirement medical benefits.[125] That report stated the issue as follows:

> The City of San Diego currently pays retiree health insurance premiums for eligible retirees from surplus undistributed earnings of the City Employees' Retirement System. If no such funds are available, premiums are paid from the General Fund. The City is concerned that at some future time the surplus undistributed earnings may be insufficient to provide for such premiums and is interested in determining a more formal, predictable way of funding these benefits. The City is also concerned with the "uncontrollability" of these benefits and would like to explore the alternatives that might be acceptable to both the City's taxpayers and employees that would entail better financial control.

The Buck Consulting report also provided estimates of the size of the healthcare liability under two actuarial methods. Under the "projected unit credit" ("PUC") method, it determined that the "unfunded accrued liability" for the healthcare benefit stood at $103,493,846.[126] Alternatively, under the "entry age normal" ("EAN") method, it calculated the liability to be

---

123 Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator, SDCERS (Aug. 22, 1995).

124 Minutes of SDCERS Board Meeting (Aug. 25, 1995).

125 Draft report, *City of San Diego: Design and Funding of Postretirement Medical Benefits*, under cover letter to Jack McGrory, Assistant City Manager, City of San Diego (Apr. 24, 1989).

126 *Id.* at Appendix I.

$145,288,143.[127] This report was the only formal attempt to estimate the cost of the healthcare benefit until recent events brought renewed scrutiny to this issue. The report's recommendation that the City actuarially fund the retiree healthcare liability has, to date, not been adopted. However, the City will be required to account for and report the annual cost of this benefit beginning in FY 2008.[128]

## IV. SDCERS changes its actuarial methodology

The history of the relationship between the City of San Diego and SDCERS plays out as a series of initiatives by the City to reduce (at least in the short term) its contributions to the System, typically in response either to economic conditions that caused budgetary strain or to concessions made to the City's labor organizations. Many of these initiatives have been supported by the labor representatives on the Board. The result in each case was the postponement of difficult budgetary decisions into the future, often exacerbating the problems through the delay in confronting them.

In 1991, for example, the SDCERS Board approved a change in the method of calculating the System's annual cost. The annual cost consists of two components: (1) the actuarial present value of the pension benefits and expenses allocated to a particular year and (2) the amount necessary to amortize the portion of the actuarial accrued liability ("AAL") that exceeds System assets (i.e., "UAAL"). The annual cost, in turn, is used to determine the City's actuarially required contributions. Until this time, SDCERS had utilized the EAN method for determining the System's annual cost. The EAN method allocates the total value of a member's expected benefit liability as a level percent of payroll from entry age until retirement. If this level percent is contributed, all actuarial assumptions are met and there are no design changes, this level percent of pay contribution is designed to be sufficient to fund a member's retirement benefit and there is no UAAL. This level cost per person, when aggregated with the level cost for all members, will remain relatively constant for a fund if the average age at hire of the population remains relatively stable, design and actuarial assumptions are unchanged, and experience matches actuarial assumptions. Among the six actuarial funding methods approved by the Governmental Accounting Standards Board ("GASB"), it recommends itself as a relatively stable and conservative approach and, for this reason, is commonly used by governmental entities. Indeed, in a recent survey conducted by the SDCERS staff, 21 of 23 systems surveyed employ the EAN method.

SDCERS, however, chose to migrate from the EAN to the PUC method. The PUC method evaluates the future actuarial liability of the covered group as a whole, applying various

---

[127] *Id*. at Appendix II. Both funding methods are described in the next section.

[128] *See GASB Statement No. 45*.

actuarial assumptions concerning population demographics and returns on system assets. For an individual member, the PUC method allocates a cost as a percent of payroll that increases geometrically from entry age until ultimate retirement. When combined for an entire population, the annual cost remains stable only if the average attained age of the membership remains stable, something few employee populations have experienced as the baby boomers have been aging. A notable characteristic of the PUC method is that, at least in the early years after its adoption, it tends to generate a lower annual cost than the EAN method, and therefore results in lower actuarially required employer contributions. In the case of SDCERS, the change in methodology resulted in an immediate decline in AAL of approximately 2.8%.[129] Jack McGrory, San Diego's City Manager at that time, explained in an interview with Vinson & Elkins attorneys that the change in method was intended to reduce City contributions to SDCERS at a time of intense pressure on the City's General Fund. SDCERS administrators have confirmed that there was no purpose for the switch in methods other than to provide temporary contribution relief to the City.

It was anticipated by the SDCERS staff and actuary that the PUC rate would eventually increase to the point that it equaled the EAN rate, at which time the City would resume making contributions at the EAN rate. This apparently never happened.[130] Although the gap narrowed significantly in the mid-1990s, the PUC rate, as applied to the City's contributions to SDCERS, has remained more volatile than the EAN rate without ever exceeding it. As described below, however, conversion back to the EAN method remains a stated goal of the City.

In addition, as of June 30, 1991, the City reset the period for the amortization of its UAAL. The amortization period remained 30 years, but was restarted from that fiscal year-end. The result was to stretch out the period for the amortization of the UAAL, thus reducing that component of the ARC. Again, there appears to have been no purpose for this action other than to reduce the City's contributions to SDCERS.

The System's actuary acceded to actions of this type, so long as they remained within the sometimes-vague standards that govern actuarial science. This remained the case in later years as the City struggled to restrict the impact on its General Fund of escalating liabilities to the retirement system. In 1998, for example, at the suggestion of SDCERS actuary Gabriel Roeder Smith & Company, the City adopted a 40-year amortization period, for purposes of ***expensing*** (and consequently reporting) its UAAL, in contrast to the 30-year amortization period used for calculating its annual contributions to SDCERS. As described below, this treatment has allowed

---

[129] Letter from Lawrence B. Grissom, Retirement Administrator, SDCERS, to Ann M. Smith, Tosdal, Levine, Smith & Steiner (May 16, 1996).

[130] For many years no calculation was made of what the contribution rates would have been under the EAN method. But for the last three years, the SDCERS actuary has calculated the City's ARC under both the PUC and the EAN methods and, in each case, the PUC rate resulted in a significantly lower contribution.

the City to report a lower "net pension obligation" ("NPO") every year from FY 1997 forward, and was not clearly disclosed by the City until January 2004.

Although migrating to the PUC funding method and resetting the amortization period did not violate established actuarial standards, these actions eventually made a contribution to the under-funding of SDCERS. Then, as now, California law recognizes the minimization of employer contributions as a legitimate objective for pension system fiduciaries.[131] This objective, however, is clearly subordinate to their responsibility to protect the actuarial soundness of the systems they serve.[132]

V. The City seeks additional contribution relief from SDCERS

In the mid-1990s, the City was under significant financial pressure due to a downturn in the local economy.[133] According to former City Manager Jack McGrory, the City's budget woes were compounded by its limited revenue sources – the result of San Diego's strong anti-tax bias – and by repeated raids on the City Treasury by the California Legislature. In 1995, in response to warnings from City officials, including City Auditor Edward Ryan, that the alternative would be significant lay-offs of City staff, the SDCERS Board entertained proposals to grant one-time contribution relief to the City.

The contemplated mechanism for this concession was the "Earnings Stabilization Reserve," established by transferring $10 million of FY 1994 surplus earnings to an account held outside SDCERS' assets. Under the City's proposal, this reserve would be depleted to reduce the City's contribution to SDCERS for FY 1996. As with any diversion of funds from "countable" fund assets, the Earnings Stabilization Reserve increased the System's under-funding by the amount of the diversion, and would be recovered, over time, through increased City contributions to amortize the increased UAAL.[134] The System actuary advised that granting this one-time contribution holiday was within the fiduciary discretion of the Board.[135]

In a seven to six vote, the Board agreed to this proposal, contingent upon approval of the Board's fiduciary counsel, Morrison & Foerster.[136] Such approval, however, was not

---

131 Cal. Const. art. XVI, § 17.

132 *Sacramento v. Public Employees Retirement System*, 229 Cal. App. 3d 1470, 1493-94 (1991).

133 The City was reported at that time to be facing a budget shortfall of approximately $10 million. Philip J. LaVelle, *Pension trustees OK parts of plan to ease city's ills*, San Diego Union-Tribune, June 22, 1996, at A1.

134 Also considered was the possibility of establishing a "corridor funding" mechanism that would allow the City to pay a reduced contribution rate over a period of five years as it "ramped up" to the "actuarially required rate." This concept was further developed and implemented as an element of Manager's Proposal I, discussed immediately below.

135 Minutes of SDCERS Board Meeting, at 5 (Mar. 24 , 1995) (remarks of Mr. Roeder).

136 Minutes of SDCERS Special Board Meeting, at 10 (March 24, 1995).

forthcoming. Although fiduciary counsel had previously approved the establishment of the Earnings Stabilization Reserve as within the discretion of the Board,[137] it now declined to provide an opinion supporting the application of that reserve for the proposed purpose.[138] Morrison & Foerster noted that the reserve was established prior to determination of the actuarial gain or loss from System assets for the fiscal year ending June 30, 1994. Subsequently, the SDCERS actuary had determined that the System had experienced an actuarial loss for the year as the result of a negative investment experience of $2.95 million. Referring to a holding of the California Supreme Court that members of a retirement system have a legal right to an actuarially sound system,[139] counsel opined that all FY 1994 earnings were necessary to support the soundness of SDCERS.[140]

Had the System's assets returned more than the actuarially assumed 8% for that year, the logic of counsel's opinion would have supported the use of this reserve to provide rate relief for the City. The SDCERS Earnings Stabilization Reserve remained on the books for approximately one more year, after which it was folded back into system assets in connection with the implementation of the "Manager's Proposal" described in the next section.

## **VI.** Manager's Proposal 1 ("MP1")

### A. The City proposes additional benefits in exchange for contribution relief

In 1996, the proposed modifications to the SDCERS funding system described above evolved into a comprehensive package of benefit improvements for SDCERS members coupled with a complicated mechanism for the provision of contribution relief to the City. Although this was not apparent for several years, these measures were to bring about a substantial erosion of SDCERS' funded status.

As of calendar year 1996, the SDCERS actuary was proposing adjustments to his assumptions with negative implications for the City's budget. The local recession had resulted in lower turnover among city employees. This, together with a hiring freeze that meant younger workers were not being added to the workforce, had caused an "actuarial aging" of the System.

---

137 Letter from Morrison & Foerster to Lawrence Grissom, Retirement Administrator, SDCERS (Mar. 23, 1995). *See also* Minutes of SDCERS Board Meeting, at 9 (May 19, 1995).

138 Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator, SDCERS (Aug. 22, 1995).

139 *See Board of Administration v. Wilson,* 52 Cal. App. 4th 1109, 1134, 1136 (1977); *Valdes v. Cory*, 139 Cal. App. 3d 773 (1983).

140 Not specifically addressed by the Board was the question of whether rate relief in the form contemplated would have run afoul of the San Diego City Charter, Article IX, Section 143, which requires the City to make annual contributions to cover the "normal cost" of the retirement System approximately equal to that made by employees. This issue later came to the fore in the *Gleason* litigation, described below. *See* Minutes of SDCERS Special Board Meeting, at 9-10 (Mar. 24, 1995) (remarks of Joel Klevins).

The resulting change in actuarial assumptions threatened to increase the City's contribution rate significantly. Moreover, the adoption of the more volatile PUC method four years before had resulted in the City experiencing less predictable contribution rates.[141] Mr. McGrory told Vinson & Elkins that the City was not in a position to immediately absorb the proposed rate increases. He therefore sought from the SDCERS Board a ramp-up period to achieve the adjusted contribution levels.

In the spring of 1996, moreover, the City and its unions concluded negotiations for the extension of San Diego's municipal labor contracts. The agreement that came out of the "meet and confer" process included a number of new or enhanced benefits including:

- Significant increases in the formula for calculating the basic pension benefit. The multiplier for general members increased from 1.45% to 2.00% per creditable year of service.[142]

- The expansion of the "Purchase Service Credit" ("PSC") benefit, which permitted City employees to purchase up to 5 additional creditable years of service within the SDCERS system for payments intended to reflect the full projected cost to the System of the additional "air time" purchased.[143]

- An increase in the "cap" on the 13th Check for former employees who retired prior to October 6, 1980.

- The agreement of the City, subject to certain conditions, to implement a Deferred Retirement Option Plan ("DROP"). This program, as later implemented by the City, permits employees who have reached their maximum benefit level to "bank" with SDCERS the payments they would have received in retirement and receive a lump sum payment upon retirement.[144]

---

[141] Draft Memorandum from Lawrence Grissom to Keith Enerson, Re: Proposed Retirement Package (Mar. 1, 1996).

[142] The projected cost of this benefit enhancement, which applied retroactively to service years for which it had not been included in the "normal cost" of the System and so was not reflected in employer and employee contributions, resulted in an estimated $76.7 million increase in the UAAL. This, in turn, would have resulted in an increase in the City's payments to SDCERS to amortize the UAAL had Manager's Proposal 1 not allowed the City to avoid paying actuarially determined rates for a period of years.

[143] This benefit became controversial when it was determined that SDCERS had not adjusted the price of "air time" as necessary to reflect increases in actuarially required employee contributions. The Board increased the price of PSCs in 2003 to address this problem, but, by that time, the System had incurred significant costs through the provision of this benefit.

[144] This benefit has also become controversial as a result of the substantial lump sum payments that employees at the higher pay grades who utilize the DROP program may obtain upon the conclusion of their City service.

The agreement also included certain enhancements to the post-retirement healthcare benefit, coupled with an agreement that this would become a benefit provided by SDCERS rather than the City. The latter provision apparently responded to the determination by SDCERS' outside counsel, described above, that the healthcare benefit could not be funded from surplus earnings unless it was specifically designated a SDCERS benefit.

Faced with the prospect of dramatically increased contributions to SDCERS as a result of revised actuarial calculations, as well as the increased benefits that came out of the meet and confer process, the Manager's Office cast a covetous eye on the extraordinary returns the bull market had showered on SDCERS. As Mr. McGrory summed up the situation to the *Union-Tribune*:

> It's very hard… for the City to be looking at significant increases in our contribution rate while at the same time seeing record earnings being received by the (retirement system). It seems to me we've got a window of opportunity.[145]

Accordingly, the City Manager required, as a condition for providing this package of benefits, the agreement of the SDCERS Board that the City's contributions to the System follow a multi-year formula that provided both predictability and a temporary reduction in rate levels.[146] Under this proposal, later referred to as Manager's Proposal 1 (or "MP1"), the City's contribution for FY 1996 would be made at the FY 1995 rate of 7.08% and the contribution for FY 1997 would be made at the rate of 7.33%.[147] In subsequent years, it would rise in annual increments of .5% of total City payroll until it reached the EAN funding rate. The City would then switch to that rate going forward. The contribution shortfall accumulated during the period before the City resumed paying the full actuarial rate was estimated in the Manager's Proposal to total approximately $110 million.[148] The ramp-up period was intended to conform to the following schedule:

Employer Contribution Rate Stabilization Plan

| Period | Rate | City Paid Rate | Difference % | Difference $ |
|---|---|---|---|---|
| FY1996 | 8.60% | 7.08% | 1.52% | $5.33m |
| FY1997 | 10.87% | 7.33% | 3.79% | $13.88m |

[145] *Id.*

[146] Minutes of SDCERS Board Special Meeting, at 2 (May 2, 1996) (comments of Jack McGrory).

[147] Although the FY 1996 contribution rate was intended to be determined under MP1, the contribution rates under MP1 did not take effect until FY 1997.

[148] Memorandum from Cathy Lexin, Labor Relations Manager, City of San Diego, to Lawrence B. Grissom, Retirement Administrator, SDCERS (July 23, 1996). This memorandum is the final expression of this proposal. No written agreement was ever executed between the City and SDCERS memorializing Manager's Proposal 1.

| | | | | |
|---|---|---|---|---|
| FY1998 | 12.18% | 7.83% | 4.35% | $16.67m |
| FY1999 | 12.18% | 8.33% | 3.85% | $15.40m |
| FY2000 | 12.18% | 8.88% | 3.35% | $14.00m |
| FY2001 | 12.18% | 9.33% | 2.85% | $12.45m |
| FY2002 | 12.18% | 9.83% | 2.35% | $10.72m |
| FY2003 | 12.18% | 10.33% | 1.85% | $8.82m |
| FY2004 | 12.18% | 10.83% | 1.35% | $6.73m |
| FY2005 | 12.18% | 11.33% | .85% | $4.43m |
| FY2006 | 12.18% | 11.83% | .35% | $1.91m |
| FY2007 | 12.18% | 12.18% | -0- | -0- |
| FY2008 | 13.00% | 13.00% | -0- | -0- |
| **TOTAL** | | | | **$110.35** |

The actuarially required "rate" in the second column and the resulting shortfalls in the last column were projected by the SDCERS actuary, Rick Roeder. The total projected shortfall over the relevant period of $110.35 million – extrapolated from Mr. Roeder's projections of contribution rates by SDCERS administrator Lawrence Grissom – was comprised of approximately $71 million attributable to the costs of the new benefits and $39 million in foregone City contributions. As described below, subsequent events rendered these projections far wide of the mark.

Deputy City Manager Bruce Herring – who was also a member of the SDCERS Board (as the City Manager's designee) at the time of MP1 – acknowledged to Vinson & Elkins that the purpose of the "contribution rate stabilization plan" was to push into the future current City costs. In this way, the City could avoid the immediate employee lay-offs, with the consequent reduction in services to City residents, that would otherwise have been required to recoup the cost of the added benefits. Put differently, this provision of MP1, like the rate relief sought the previous year, had aspects of a loan from SDCERS to the City. As noted in a judicial decision of the following year not specifically referring to San Diego's situation: "This shift [into the future] of costs can accurately be characterized as a loan to cover the current employee costs—a loan that must be repaid by future generations."[149] Nor did this aspect of the plan go unnoticed by local commentators.[150] As the *Union-Tribune* reported:

> the reduced contributions to the retirement system will have to be made up somewhere down the line. And future taxpayers may get stuck with the bill, since

[149] *Board of Administration v. Wilson*, 53 Cal. App. 4th 1109, 1140 (1997). MP1 might also be analogized to a derivates contract in that it restructures financial obligations based on unpredictable future events.

[150] *See, e.g.*, Minutes of SDCERS Board Workshop, at 16 (June 11, 1996) (statement of Mr. Casey).

the City Council allocates the city's contribution to the pension system from general tax revenues.[151]

The City Manager posited that changes in demographics associated with the new benefits would counteract the contribution shortfalls. He believed that the increased multiplier for the basic pension benefit would enable employees to retire at an earlier average age, skewing the actuarial age of the System downward.[152] It is now apparent, however, that only a long bull market with a soft landing could have prevented Manager's Proposal 1 from resulting in a serious under-funding of the retirement system. Only the first of these events was to occur.

The City's municipal unions supported MP1 as a *quid pro quo* for the increased benefits described above. The City Manager's proposal, however, explicitly required Board approval of the contribution relief that was the City's primary incentive to do this deal. This effectively gave the Board a veto over the entire package of benefits and concessions represented by MP1. The division between the roles of City Council and SDCERS Board contemplated by the City Charter – with the Council granting benefits and the Board administering them – was thereby significantly compromised.

Although the SDCERS staff had participated over several months in fashioning the proposal, it was viewed skeptically by some members of the Board, and its complexities confused almost all, even after lengthy discussion. In promoting the proposal to the Board – as well as to its actuary and fiduciary counsel – City representatives emphasized two "safeguard" provisions intended to protect the System's funded ratio. First, the City was required to resume paying the full PUC rate by no later than July 1, 2009, as described below. Second, a drop of 10% or more from the FY 1996 funding level would trigger an immediate adjustment in the City's contributions. The level at June 30, 1996 was approximately 92.3%. Thus, the trigger level was 82.3%.[153]

The pending changes in actuarial assumptions and methodology were recognized at June 30, 1996, increasing the UAAL by approximately $25 million. This amount, with 8% interest compounded annually over the intervening years, has contributed significantly to SDCERS' present UAAL. Ironically, at the time of MP1, the City was eager to have the revision of actuarial assumptions be as immediate and extensive as possible to create "breathing room from the 10% deal breaker."[154]

---

[151] Philip J. LaVelle, *City has a deal, but will pension trustees buy it?* San Diego Union-Tribune, June 21, 1996, at A1.

[152] *Id*.

[153] Members of the City staff have contended that the actual ratio was 81.4%. Whatever the merits of this position, the 82.3% figure has been widely accepted and will be used for purposes of this Report.

[154] E-mail from Terri Webster to city_mgr.CTL, Re: Proposal (June 21, 1996).

Several years later, when it became probable that the 82.3% threshold would be crossed, the potential consequences for the City's contribution rate became a matter of controversy. The final version of Manager's Proposal 1 provides:

> The City will pay the agreed-to rates shown above for FY 96 through FY 2007.[155] In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation.

This would appear to require that the City make a lump sum payment in the amount necessary to restore the funding level to 82.3%. Nevertheless, individuals involved in negotiating this agreement insist that the intention was to "sunset" the proposal beginning the fiscal year after the year in which the trigger event occurred, resulting in a return to a contribution level set under the PUC method.[156] This was, in fact, the way in which the trigger provision was discussed before the Board.[157] It was also the understanding of fiduciary counsel to SDCERS.[158] But the following exchange between a Board member and the SDCERS actuary indicates that the potential decline in funding level resulting from the Manager's proposal was given at least passing consideration in dollar terms:

> Ms. Wilkinson stated that a 15% drop would lower the System's funding level to the high 70% range and asked what this amounts to in dollars.
>
> Mr. Roeder responded that the 10% drop would not occur for another 5-6 years and that this would be hard to predict. However, he stated that currently the amount at 15% would be approximately $225 million.[159]

---

155 The reference is to the table provided above.

156 One of the many potential flaws in MP1 derives from the "one year lag" built into the System. The SDCERS actuary calculates the System's funded ratio as of June 30 of each fiscal year. This complex calculation is then subject to evaluation and approval by the SDCERS Board before it can be adopted. Typically, this occurs many months into the next fiscal year. Because the City makes its contribution to SDCERS at the beginning of each fiscal year, the most current funding calculation available on the contribution date is always a year old. For the operation of MP1, this meant that the City would not begin to pay the amount required by the trigger provision until a year after the trigger was hit, during which time an additional decline in the System's funded status might have occurred. This, in fact, was the result that obtained after the trigger provision was engaged at June 30, 2002, as described below.

157 *See, e.g.*, Minutes of SDCERS Board Meeting, at 22 (June 21, 1996) (comments of Lawrence B. Grissom).

158 Letter from Dwight Hamilton to Lawrence B. Grissom, Retirement Administrator, SDCERS, at 3 (June 21, 1996).

159 Minutes of SDCERS Board Special Workshop, at 14 (June 11, 1996).

As it happened, Mr. Roeder's 5-6 year estimate of when the threshold would be crossed proved prescient. When that event occurred, which among the competing interpretations of the operation of the trigger provision would prevail became of critical importance.

B. The opinions of SDCERS' actuary and fiduciary counsel

As modified, the proposal won the endorsement of the SDCERS actuary and fiduciary counsel. According to Board minutes, the System's actuary, Mr. Roeder, opined that:

> … he would have been reluctant to recommend this plan without some sunset provisions. However, he stated that he believes that this is a sound proposal as long as the funded ratio does not drop significantly, and with the appropriate sunset provisions in place.[160]

Mr. Roeder subsequently proposed to the GASB that it consider "corridor funding" as an acceptable alternative to the six funding methods previously approved.[161] "Corridor funding" in this context meant the setting of contractually specified contribution rates to achieve, over time, actuarially calculated funding objectives, rather than pursuing those objectives by adjusting contribution levels on an annual basis. Boundaries of the "corridor" – here the trigger mechanism – would be imposed to safeguard the System's actuarial soundness.[162] Mr. Roeder's proposal resembled an approach under Generally Accepted Accounting Principles ("GAAP") for valuing assets held in pension funds of business corporations,[163] but was not recognized as an acceptable method to set employer contributions to a pension fund, either in the public or private sector. Because the funding approach taken in MP1 was not among the six approved methods, GASB rules required that the City disclose, in its annual financial statements, the shortfall between the actuarially required contribution and the contribution it actually made (the NPO).[164] Winning the approval of the GASB for the "corridor funding" method would have eliminated that disclosure requirement.

Mr. Roeder obtained the written support of SDCERS administration and the City Auditor's Office for this proposal, but the GASB was apparently not persuaded. In an interview

---

160 *Id*. at 15.

161 GASB Statement of Standards No. 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans," ¶ 44.

162 In a May 21, 1998 letter to the SDCERS Retirement Administrator, Mr. Roeder described corridor funding as superior to the PUC method and, in a letter dated July 14, 1998, urged the City Auditor and his deputy to join him in promoting it as an acceptable alternative to previously approved methods.

163 Financial Accounting Standards Board, ***Statement of Financial Accounting Standards No. 106*** ("Employers Accounting for Postretirement Benefits Other than Pensions") ¶ 59.

164 As described below, the City has made this disclosure from FY 1998 through FY 2002, the last year for which, as of the date of this Report, it has issued financial statements.

with Vinson & Elkins, Mr. Roeder stated that he followed up his initial letter with a second letter and, eventually, a telephone call, but received no response. Around calendar year 2001, he finally gave up hope that GASB would consider his proposal.

Fiduciary counsel for both SDCERS and the City also approved MP1. The SDCERS Board replaced its previous fiduciary counsel, Morrison & Foerster, with Dwight Hamilton of Hamilton and Faatz.[165] The explanation given to the Board for the change in counsel was that Morrison & Foerster had been slow in responding to requests for legal opinions.[166]

After examining the initial draft of MP1, Mr. Hamilton expressed serious reservations about certain of its provisions. He stated that "there were 'red flags' raised in his mind by this proposal, as it relates to the Board's duty of loyalty to the integrity of the fund and addressed those individually…."[167] In connection with the transfer of the post-retirement healthcare benefit to SDCERS, he noted that the City Charter did not appear to authorize this type of benefit, and stated: "the Board must remember that they can not breach their duty of loyalty to the beneficiaries and/or the integrity of the fund by using fund proceeds to pay for the premiums for health insurance."[168] In this he echoed previous fiduciary counsel. In response to questions from the Board, he voiced concern that the Board would be abdicating a key fiduciary responsibility in agreeing to a freeze of actuarial assumptions, as proposed by the City Manager:

> Another troublesome area to Mr. Hamilton was the specific agreement that there would be no changes in actuarial assumptions or methodology until fiscal year 2007. He reminded the Board that the pension beneficiaries and members have a vested right to an actuarially sound system and that the Board has a duty of loyalty to the integrity of the fund that cannot be contracted away. He stated that he believes the Board's rights to annually and continually review their methodology and assumptions [are] essential.[169]

Mr. Hamilton also objected to a mechanism initially contemplated to offset the shortfall with transfers from surplus earnings. The City Manager proposed that 50% of surplus earnings from each year during the operative period of MP1 would be applied to offset the difference between the ARC and the City's actual contributions under the MP1 schedule. Mr. Hamilton

---

165 Mr. Hamilton's firm had recently become associated with the larger firm of Frandzel & Share, and his opinions were rendered on behalf of both firms.

166 Minutes of SDCERS Board Special Meeting, at 3-4 (May 2, 1996).

167 Minutes of SDCERS Board Workshop, at 18 (June 11, 1996).

168 *Id.* at 19.

169 *Id*. at 20. Fiduciary counsel for the City, Jeffrey Leavitt, Jones Day Reavis & Pogue, also raised concerns about the provision that would freeze actuarial assumptions. He viewed the ability to make changes in actuarial assumptions and methodology as fundamental to the Board's role and suggested that the Board be left an avenue to make appropriate adjustments. Letter from Jeffrey S. Leavitt to Bruce Herring, Deputy City Manager (Apr. 29, 1996).

objected to this approach because it committed *future* excess earnings to a particular use before the SDCERS actuary determined they were not necessary for the soundness of the System.

Various changes were made to the Manager's Proposal subsequent to this date responsive to Mr. Hamilton's stated concerns. These included a provision that only *past* excess earnings would be used to offset the projected shortfall, as described in detail below. The Manager's proposal was also modified to respond to criticisms that it stripped the SDCERS Board of its authority to approve proposed changes in actuarial assumptions. The final version of MP1 contained the following language:

> If the System's actuary makes changes in actuarial assumptions or methodology which are approved by the Board prior to July 1, 2007, any changes in the employer contribution rate will adjust the PUC rate to be achieved through extended incremental increases shown in [the table] above. If the phase-in would require an extension past July 1, 2009 in order to achieve the full actuarial PUC rate, the City-paid rate will be adjusted by the amount necessary to achieve full phase-in by that date.

In practical terms, however, this provision did little to preserve the Board's discretion to implement changes in actuarial assumptions. Although it could indeed approve such changes during the operation of the proposal, the effects would be postponed until FY 2008, then restricted to increasing the City's contribution to an additional 50 basis points a year for two years. At the end of that two-year period, any changes in actuarial assumptions would be incorporated into the City's required contributions. Thus, the only practical effect of this provision was that changes in actuarial assumptions would be factored into the calculation of the Systems' funded ratio, potentially affecting the operation of the trigger mechanism.

Finally, the post-retirement healthcare issue was carved out from the matters upon which fiduciary counsel would opine, to be addressed through an amendment to the City Charter. Under this amendment, healthcare would be re-classified as a SDCERS benefit, but would be funded from surplus earnings in almost the same manner as before, with the City remaining the ultimate payer in any fiscal year that surplus earnings – generated that year or specifically reserved from previous years – proved inadequate. This was, therefore, a largely cosmetic change intended to satisfy certain requirements of the Internal Revenue Code with which the System had apparently not been in compliance previously.

On June 21, 1996, Mr. Hamilton provided a written opinion to SDCERS concluding that, setting aside the issue of the healthcare benefit,[170] the Board would be acting within the ambit of its fiduciary discretion in approving Manager's Proposal 1. The letter stated:

> Provided that the City-paid rate in the Employer Contribution Rate Stabilization Plan is not less than an amount substantially equal to that required of employees for normal retirement allowances as certified by the actuary, the Board will be acting within the discretion granted to the Board to administer the System and discharging fiduciary duties set forth in Article XVI, Sec. 17 of the California Constitution.[171]

With respect to basing the City's contributions to SDCERS on a contract rate rather than an actuarial rate, his letter further opines: "[n]othing in this proposal changes the Board's discretion to adjust the actuarial assumptions on which the System is based as needed in order to insure the long-term funding integrity of the System." Although this was literally correct, any such adjustments by the Board, as noted, would have no effect on the contributions actually paid by the City until FY 2008. In answering a question from the Board on this point, Mr. Hamilton stated that the limited duration of this departure from actuarially-determined contribution rates was a critical factor in his determination that the Board would not be abusing its discretion in agreeing to this provision of MP1.

The City's own fiduciary counsel also weighed in with an opinion supporting the proposal. Jeffrey Leavitt of Jones, Day, Reavis & Pogue wrote that he understood the contribution relief provided to the City under the Manager's proposal to be "the quid pro quo for the proposed benefit improvements."[172] He found this aspect of the proposal unobjectionable:

> … from the Board's point of view as a fiduciary, it should be reasonable for the Board to consider making these funding-related changes as part of an overall program of plan revisions which will be advantageous from the perspective of the members.

Thus, in his view, it was appropriate for the Board to evaluate the proposal in its entirety, including the range of potential benefits it offered to members of the System, and not merely its effect on the System's funded level. Indeed, this appears to have been the view taken by the Board in approving MP1. But also implicit in its decision were assurances it received that the proposal would not seriously undermine the System's funding status.

---

[170] Mr. Hamilton told the Union-Tribune, "I am still troubled by the use of surplus moneys to pay for health care… I'm not ready to bless this." LaVelle, ***supra*** note 133, at A1.

[171] Letter from Dwight Allan Hamilton to Laurence Grissom, at 3 (June 21, 1996).

[172] Letter from Jeffrey S. Leavitt to Bruce Herring, Deputy City Manager (Apr. 29, 1996).

Board member John Casey asked fiduciary counsel to address what he saw as the conflict of interest involved in voting upon a measure that would affect financially most members of the SDCERS Board. As he stated in a memorandum to the Board:

> All the *ex officio* and elected Board members would gain some financial benefit in approving this action. This apparent conflict, in my opinion, is a real conflict. For the record, I do not believe that any member voted for this proposal for personal gain, rather it was inadvertent and due to the way the proposal was presented. Nevertheless, the conflict is real.[173]

This was an issue that should have received serious attention from the Board. From interviews with individuals involved in this process, however, it appears that it was given little consideration by any member of the Board other than Mr. Casey. The Board, however, did agree to seek the opinion of fiduciary counsel on this issue. Unfortunately, counsel provided minimal analysis. In a September 19, 1996 letter, Mr. Hamilton pointed out that the drafters of the section of the City Charter that set the composition of the Board were aware that it would include individuals who were also System members and therefore financially interested in the outcome of certain Board decisions. He quoted the California Supreme Court's *Claypool* decision for the proposition, "where a trustee is named by a settlor who is aware of the potential conflicts of interest in the appointment, removal on the ground of conflict of interest is ordinarily unwarranted without an actual breach of trust."[174] In his view, such a breach would occur only if Board members actually allowed themselves to be influenced by considerations of personal gain in actions they took as Board members.[175]

This analysis does not fully address the conflict of interest issues raised by the Manager's proposal. MP1 provided an extensive package of benefits to System members – which included a majority of the Board – made expressly contingent upon Board approval of a measure with the potential to undermine the financial condition of SDCERS. Giving the Board veto power over a major escalation in benefit levels raised the conflict of interest inherent in having beneficiaries of a trust also act as trustees to a much higher level than could have been anticipated at the time the structure of the Board was determined. This matter was not comparable to decisions the Board is routinely called upon to make about investment strategies or actuarial assumptions. If such decisions may affect future benefits received by Board members who are also SDCERS members, the effects are typically indirect and speculative. The conflict of interest created by

---

[173] Memorandum from John Casey to Fiduciary Counsel via Retirement Administrator, Re: Improper Board Function (Negotiating) and Apparent Conflict of Interest (July 16, 1996).

[174] *Claypool*, 4 Cal. App. 4th at 676-77. A similar analysis was provided to the Board by other fiduciary counsel in a somewhat different context. Letter from Robert D. Klausner to Lawrence B. Grissom, Retirement Administrator, SDCERS (Jan. 7, 1998).

[175] Letter from Dwight A. Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator, SDCERS (Sept. 18, 1996).

MP1, to the contrary, was substantial and fully realized. Mr. Casey was almost certainly correct in concluding that no Board members supported the proposal as a means of increasing their own benefits in retirement – those who supported the measure did so to promote the interests of the constituencies they represented. But the ill-considered way the proposal was placed before the Board created at least the appearance of an erosion of fiduciary standards.

In addition, the agreement between management and labor that gave rise to MP1 was negotiated on both sides by individuals who also sat on the SDCERS Board. Thus, they were highly invested – personally and as representatives of either the City or its labor organizations – in seeing the measure implemented. This factor arguably impeded the ability of those Board members to view the measure purely from a standpoint of its benefits or detriments to SDCERS.[176] In short, the SDCERS Board was placed in a role not contemplated in the City Charter.

Left unaddressed in the record of the Board's deliberations was the potential conflict between the "corridor funding" aspect of MP1 and the provision of the Municipal Code requiring that the City contribute to SDCERS "a percentage of earnable compensation as determined by the System's actuary pursuant to the actuarial evaluation required by [SDMC] Section 24.0901.…"[177] It seems to have been the intention of the City to amend this provision to reflect the adoption of MP1, but this was never done. In 2003, this and related issues became the subject of a class action brought against the City and SDCERS that resulted in significant changes to the negotiated approach to SDCERS' funding begun with MP1.[178]

---

[176] The Board obtained an opinion letter from Florida attorney Robert Klausner as to whether a conflict of interest exists, in fact or in appearance, when a Board member votes "on the approval of a proposal that he, as labor union president" was involved in negotiating. On technical legal grounds involving the definition of "income," he answered the question in the negative. Letter from Robert D. Klausner to Lawrence Grissom (Jan. 7, 1998), *supra*. We do not express an opinion as to whether Mr. Klausner correctly interpreted the relevant sections of the California Political Reform Act or SDCERS Board Rules, and acknowledge that, under the structure created by the City Charter, SDCERS Board members who are also members of the System cannot avoid voting on issues that will have at least *some* potential effect on their own benefits in retirement. Nevertheless, we note that the authorities cited in Mr. Klausner's letter do not directly address the very unusual situation created by MP1 or, for that matter, the specific question posed to him by Mr. Grissom.

[177] Former Municipal Code ch. 2, art. 4, div. 15, § 24.0801. This code section was amended in 2002 to reflect the implementation of Manager's Proposal 2, discussed in detail below. *See also* Charter, art. IX, § 143, which requires SDCERS Board approval of actuarial valuations before they become conclusive and final. This Charter provision has been argued to grant the Board sufficient discretion to approve the departure from actuarially determined contribution rates represented by MP1. Defendant San Diego City Employees' Retirement System's Memorandum of Points and Authorities in Opposition to Plaintiffs' Motion for Summary Adjudication, *Gleason v. San Diego City Employees' Retirement System* (San Diego County Super. Ct.) (No. GIC 803779).

[178] *Gleason. v. San Diego City Employees' Retirement System*, No. GIC 803779, discussed below.

C. The intended application of surplus earnings to the contribution shortfall created by Manager's Proposal 1

A significant aspect of MP1, as it later affected the City's public disclosure, was the attempt by the City and SDCERS to route surplus earnings through reserve accounts to offset the funding shortfall created by that measure's combination of increased benefits and reduced employer contributions. Initially, the City Manager proposed that 50% of SDCERS' surplus earnings be allocated every year to the Earnings Stabilization Reserve, the account to which $10.7 million from FY 1994 surplus had previously been transferred. These funds would be applied to offset the funding shortfall over the applicable period.[179] In response to a question from a Board member, SDCERS' head administrator explained this mechanism:

> Mr. Grissom responded that once all has been paid as required by the Municipal Code, the remainder is considered to be surplus earnings. As it now stands, 100% of surplus earnings is put back into the employer contribution reserve for the sole purpose of reducing the System's unfunded liability. What this plan visualizes is that 50% of that surplus would be put in the stabilization reserve, while the other 50% would be put into the employer's contribution reserve. As a means to make this rebalancing possible, money would be taken from the stabilization reserve and put back into the employer contribution reserve.[180]

In application, however, this approach would have had no practical effect on SDCERS' funding. Whenever surplus earnings are diverted to a reserve held outside System assets, the result is a dollar-for-dollar reduction to the Employer Contribution Reserve (which receives all amounts not allocated to other uses). Under this proposal, surplus earnings placed in the Earnings Stabilization Reserve would be bled annually into the Employer Contribution Reserve in amounts equal to the contribution shortfall. Upon the exhaustion of the Earnings Stabilization Reserve, the balance of the Employer Contribution Reserve would be essentially the same as if there had there been no intervening transfers.[181] In no sense would this process compensate the System for the contribution shortfalls contemplated in MP1.

As mentioned, this approach drew criticism from fiduciary counsel Dwight Hamilton. He objected that it committed surplus earnings to a use other than the payment of basic pension benefits in advance of a determination by the System actuary that these funds were not necessary for the financial soundness of the System. In this, he followed former fiduciary counsel

---

179 "Concept Overview," included in Minutes of SDCERS Special Board Meeting (May 2, 1996).

180 Minutes of SDCERS Board Workshop, at 11 (June 11, 1996).

181 Some disparity would result from the fact that funds held in the Earnings Stabilization Reserve, unlike those in the Employer Contribution Reserve, would not be credited with interest. Thus, to the extent these funds represent amounts that would otherwise have gone into the Employer Contribution Reserve, their withdrawal from System assets may act to free up surplus earnings to go for contingent benefits that are funded only after the required interest payments to the basic reserves are made.

Morrison & Foerster. Like Morrison & Foerster, however, Mr. Hamilton did not question whether the concept of surplus earnings is fundamentally at odds with sound actuarial practice.

In part to address the concerns raised by Mr. Hamilton, a different approach was adopted to achieve the intended result. Rather than fund the shortfall from previous and future years' surplus earnings, the shortfall would be funded entirely from earnings accumulated to that date. The $10.7 million in FY 1994 excess earnings held in the Earnings Stabilization Reserve[182] would be supplemented with FY 1995 and FY 1996 surplus earnings as follows:

| | |
|---|---|
| Earnings Stabilization Reserve | $ 10,769,620 |
| FY 1995 surplus earnings | $ 38,813,314 |
| FY 1996 surplus earnings | $ 85,472,254 |
| **TOTAL** | **$ 135,056,188** |

The total balance of $135 million would then be transferred to the Employer Contribution Reserve – $106 million (over the operative period of MP1) to offset the projected cost of the contribution relief included in the proposal, and the remaining $28.4 million to "reduce the System's normal unfunded liability." Mr. Hamilton approved this approach because it looked only to funds determined to be "actuarially available." SDCERS' Board minutes reflect that: "[h]e stated… that he believes that this method of transferring the surplus on a one-time basis for crediting it to the contribution reserve is a proper action."[183]

There is indeed nothing improper about applying surplus earnings to reduce System under-funding. This is precisely the application contemplated by the Municipal Code and the necessary basis for an actuarially sound system. The error in this approach lies in the mistaken idea that assigning previously unallocated surplus earnings to the Employer Contribution Reserve could effectively offset the contributions lost as a result of Manager's Proposal 1. Much like the idea, previously considered and discarded, that the shortfall could be erased by allocating surplus earnings into an account held outside System assets, then, over time, transferring them back again, this approach accomplished nothing of practical value. Running previously "unallocated" excess earnings through a special reserve account before booking them into the same "inside" account to which they otherwise would have gone directly does not affect System

[182] These are the same funds that fiduciary counsel had previously opined could not be used to provide contribution relief to the City because they derived from a year in which the System suffered an actuarial loss. As it happened, these funds were simply transferred back into System assets in FY 1997, an unobjectionable result.

[183] Minutes of SDCERS Board Meeting (June 21, 1996) , at 17. *See also* Letter from Dwight Alan Hamilton and John A. Graham, *supra* note 175.

funding levels or employer contribution rates. It resolves itself into accounting entries that ultimately cancel out.[184]

The approach outlined in MP1 was, in fact, never followed. The Earnings Stabilization Reserve – containing $10.7 million in FY 1994 surplus earnings – was closed into the Employer Contribution Reserve at June 30, 1996, rather than being applied as described in the Manager's proposal. According to SDCERS administrator Lawrence Grissom this was done because the Board found that its lacked authority under the Municipal Code to use the funds as proposed.[185]

The attempt to use FY 1995 and 1996 surplus earnings to provide contribution relief to the City also proved futile. In FY 1996, $144.3 million was taken from FY 1995 and 1996 surplus earnings and placed in a "Proposed Retirement Changes Reserve," in anticipation of the implementation of MP1. In FY 1997, $82.5 million of this amount was credited to a Reserve for Retirement Changes (City)" and $4.3 million to a "Reserve for Retirement Changes (Port District)." Another $3.5 million from the Proposed Retirement Changes Reserve was transferred to a newly created 13th Check Reserve, to provide a back-up source of payment for the benefit arising from the *Andrews* litigation. The remaining balance of approximately $53.6 million was folded into the Employer Contribution Reserve, where it would have gone initially had it not been diverted into the Proposed Retirement Changes Reserve.[186] This amount appears to correspond to the portion of the Proposed Retirement Changes Reserve derived from FY 1995 excess earnings.

This $87 million in the City and Port Reserves for Retirement Changes, the only funds purportedly dedicated to offset the funding shortfall created by MP1, was then left dormant, with no crediting of interest or additional allocations from earnings, and no withdrawals to "fund" the contribution shortfall in the years following the adoption of the Manager's proposal. As mentioned, because these funds were held inside SDCERS assets, their allocation into designated accounts had minimal effect on the System's funding ratio. According to Mr. Grissom, nothing was done with these reserves because, again, SDCERS found it had no authority under the Municipal Code to dispense them for their designated purpose and, in addition, because he and others concluded that shifting funds from one inside account to another accomplished no more than moving "money from the left pocket to the right."

---

184 This approach does have one small practical effect. It reduces temporarily the balance in the Employer Contribution Reserve and, hence, the amount of interest allocated annually to that account for purposes of calculating the amount of earnings available to pay contingent benefits. A more indirect effect, perhaps contemplated by City representatives, was that shelving excess earnings in this way effectively puts them off the table to fund additional benefits.

185 *See also* Minutes of SDCERS Special Board Meeting, at 7-8 (May 29, 2002) (remarks of Mr. Blum).

186 Municipal Code ch. 2, art. 4, div. 15, § 24.1502.

Eventually, the City Auditor's Office also questioned the utility of these two reserves. In notes from a meeting with Mr. Grissom that appears to have occurred in early 2001, Deputy City Auditor Terri Webster wrote: "[t]he reserves of $86.8 set up to prevent a [sic] NPO. Sounds good in CAFR. That's all." According to her statements to Vinson & Elkins, she had been asked by City Auditor Ed Ryan to figure out SDCERS' complicated system of reserves; they concluded, as did SDCERS administration, that several served no practical purpose. In FY 2003, as part of a general effort to simplify the SDCERS balance sheet, these reserves were dropped into the Employer Contribution Reserve.

Another reserve created as a result of Manager's Proposal 1 and later closed as useless was the "Net Pension Obligation Reserve." Unlike the reserves described above, the "NPO Reserve" was held outside system assets. Each year from FY 1997 through FY 2002, as the name implies, the NPO Reserve was credited with an amount corresponding to the difference between the ARC and the amount actually paid by the City pursuant to the Manager's proposal. City and SDCERS employees indicate that this reserve was established as a result of a misunderstanding of GASB requirements. It was incorrectly thought that SDCERS was required to reserve for the amount of the NPO. When in FY 2003 it was determined that SDCERS was merely required to calculate and disclose this amount, the NPO Reserve was, like the other reserves discussed above, folded into the Employer Contribution Reserve.[187] The balance at that time was $ 39.2 million. Its transfer from outside to inside System assets reduced the System's under-funding by the same amount.

This trail of accounting entries was eventually concluded through the allocation of SDCERS surplus earnings from three fiscal years into basic system assets, as would have occurred in earlier years had none of this activity taken place. This wasted effort, which, as described below, had a distorting effect on the City's public disclosure, appears to have been the result of simple confusion about the nature of surplus earnings and actuarial liabilities. When faced with the projected funding shortfall from MP1, City and SDCERS officials looked to the substantial build-up of System earnings that had occurred over the previous three years and asked if that surplus, which could have been used to fund new benefits or for other purposes, could *somehow* be applied instead to offset the projected shortfalls. Although intuitively appealing, this concept does not square with applicable accounting principles because it confuses two separate accounting methodologies, designed for wholly different purposes. "Surplus earnings" is a cash-basis calculation required by the San Diego Municipal Code for the sole purpose of determining if certain contingent benefits can be paid in a particular year. The City's Net Pension Obligation, on the other hand, is a balance sheet item required to be recognized and reported under GASB standards. A temporary "asset" for purposes of the Waterfall provision of the Municipal Code simply cannot be applied to offset a GASB liability.

---

[187] Minutes of SDCERS Special Board Meeting, at 22 (May 29, 2002) (remarks of Mr. Grissom).

D. Modifications to the post-retirement healthcare benefit under Manager's Proposal 1

The City Charter was amended in November 1996 so that post-retirement health insurance became a SDCERS benefit, funded, in the first instance, from the System's excess earnings. This was the final requirement before MP1 could be implemented. Although this endorsement by City voters may have satisfied concerns raised by SDCERS' fiduciary counsel, it did nothing to reduce the potential for this increasingly costly benefit to undermine the System's funded status through the depletion of its earnings, and to create a major liability for the City when SDCERS' earnings could no longer support the cost of premiums.

The reclassification of post-retirement healthcare insurance as a SDCERS benefit required the approval of the electorate. Proposition D, placed on the November 1996 ballot, provided that:

> Rather than paying for health insurance benefits to retired City employees directly from the City's operating funds, as is the current practice … San Diego City Charter Section 171 [shall] be amended to authorize the City Council to provide these benefits through the San Diego City Retirement System.

It passed easily, perhaps from the mistaken belief that this initiative would result in cost savings to the City. City Manager Jack McGrory promoted it as "a good thing because it relieves from our operating budgets the obligation to pay approximately $6 million a year for health benefits for retirees."[188] In fact, the City had *never* paid retiree healthcare premiums out of its operating funds, although, should Proposition D not have passed, it could no longer have ignored the failure of its existing funding method to comply with IRS regulations and might have been forced to begin doing so.

Yet the pitfalls inherent in using SDCERS earnings to fund a potentially expensive benefit did not escape notice. The *San Diego Union-Tribune* reported:

> Proposition D promises a warm and fuzzy result – better health-benefit security for city workers – but critics say it's as dangerous as an iceberg, with most of its menace lurking beneath the surface… Under a proposal put forth by McGrory, the city would reduce its contributions to the system, forcing the system to make up the difference by relying on reserves. The City would use the freed-up money to cover operating budget shortfalls.[189]

---

[188] Philip J. LaVelle, ***Shift in Health Benefit Sought***, San Diego Union-Tribune, Oct. 18, 1996, at B4.

[189] *Id*.

The article noted that critics of the Manager's proposal (which was contingent upon the passage of Proposition D) doubted the City would, in fact, ramp up to the required contribution level, and suggested that the measure – by failing to directly address the long-term cost of benefit improvements – was creating a dangerous precedent.[190] In reporting the subsequent passage of Proposition D, the same journalist wrote:

> McGrory has touted the proposed changes to the retirement System as important to the city's fiscal health. He noted that City Hall has had to pay more because of spiraling health-care costs and changing public-employee demographics, including the fact that city workers stay on the job longer than in previous years, boosting benefit costs to new levels. Proponents of Proposition D said the move will add stability to the public-employee insurance system. Critics said it threatens the fiscal strength of the retirement system and could lead it into trouble if the economy slides into a prolonged bear market.[191]

To implement the approach to the healthcare benefit included in MP1, SDCERS and the City set up the system that remains in place today. First, a separate trust account was established within SDCERS. Into this account, the City pays the estimated cost of the retiree insurance premiums for each fiscal year (plus any additions to reserves). All premiums are then paid from this account. An identical amount is transferred from the System's surplus earnings to the City's obligation to the basic pension benefit, allowing the City to recover the cost of the health insurance premiums while avoiding the direct contamination of a non-pension benefit (healthcare) with earnings from pension fund assets. The mechanics are as follows:

1. By May 31 of each year, SDCERS administration notifies the City Auditor and Comptroller of the estimated cost of health insurance premiums for the coming year and whatever additional amounts are to be allocated to fund the health insurance reserve, subject to Internal Revenue Code limitations.[192] SDCERS administration also certifies that surplus earnings for the year will be adequate to cover the amount to be reserved.

2. On July 1, the Auditor and Comptroller transfers to SDCERS the annual employer contribution, less the amount specified above, which is transferred into the health insurance reserve.

3. After the completion of the outside auditor's annual Report of Changes in Undistributed Earnings, SDCERS transfers an amount from surplus earnings into the Employer

---

[190] *Id*. (quoting statements from Jack Katz and Ray Blair).

[191] Philip J. LaVelle, *Proposition D: Easy victory a green light to savings*, San Diego Union-Tribune, Nov. 6, 1996, at B3.

[192] The amount that can be contributed for this benefit cannot exceed a certain percentage of the employer's overall contribution to the retirement system, unless a different type of trust arrangement is established.

Contribution Reserve equal to that previously contributed by the City to the health insurance reserve.

These "wash transactions," constructed to satisfy requirements of the Internal Revenue Code,[193] result in a net City contribution to SDCERS that equals the basic pension benefit, with no additional amounts contributed to fund the healthcare benefit. Thus, the full cost of this benefit continues to be borne by earnings from the System's assets.

During FY 1997, when this approach was implemented, the cost of the insurance premiums was approximately $5 million, where it remained for several years. More recently, however, the cost of healthcare increased at a substantially greater rate than inflation and it has now become a more significant expense to the retirement system. From FY 2000 through FY 2004, the annual costs of retiree health insurance premiums were:

| FY2000 | FY2001 | FY2002 | FY2003 | FY2004 (estimated) |
|---|---|---|---|---|
| $5,332,000 | $7,208,000 | $8,882,000 | $11,450,200 | $13,000,000 |

It is likely that the cost of healthcare premiums for City retirees will continue to increase at a comparable rate for some years. This suggests that this benefit, if it remains funded (albeit indirectly) from System assets, will eventually absorb all of the System's surplus earnings, additionally impeding the ability of SDCERS to overcome its present under-funded status.

A projected liability for retiree healthcare was not then – and is not now – disclosed by the City in any of its public documents. Unlike the situation in the private sector, governmental entities are not required to actuarially fund, or even disclose, their estimated liabilities for healthcare or other non-pension benefits provided to retirees. This situation is changing – the GASB is in the process of bringing governmental entities more in line with private sector employers on this issue.[194] The City's position during the relevant period, however, was described in a December 10, 2003 e-mail exchange between Deputy City Auditor Terri Webster and City disclosure counsel. She stated that "[n]either the SDCERS trust fund nor the City has

---

[193] This approach was approved by SDCERS' tax advisors. Letter from Robert Blum, William M. Mercer, Inc., to Lawrence Grissom, Retirement Administrator, SDCERS, Re: Contributions to 401(h) Account (Mar. 13, 2000). We do not suggest that the present method of funding the retiree healthcare benefit offends applicable IRS regulations. We note, however, that the language of the August 22, 1995, letter from Morrison & Foerster appears to raise concerns about the use of surplus earnings to pay non-pension benefits that go beyond the technical segregation of funding sources implemented by the City and SDCERS.

[194] *See* GASB *Statement No. 45* ("Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions"), which addresses how state and local governments should account for and report costs and obligations related to post-employment healthcare and other non-pension benefits. The statement, which becomes effective for San Diego in FY 2008, "generally requires that state and local governmental employers account for and report the annual cost of such non-pension benefits and related obligations in essentially the same manner as they currently do for pensions." Thus, they must accrue for the actuarially determined costs of the benefits.

hired an actuary to do an actuarial valuation of retiree health,"[195] but will follow any GASB requirements to calculate and disclose what everyone knows "will be a big number" when those requirements are finally implemented.[196]

It appears, however, that the SDCERS actuary and the City Auditor's Office considered, at least briefly, whether recognition should be given to this liability. In a 1998 letter to Michael Phillips, the accountant in charge of the SDCERS funds for the City Auditor's Office, the SDCERS actuary noted:

> All these numbers presuppose that 1996-97 is the first year in which the calculated actuarial contribution is greater than the actual contribution. You made an excellent point a year ago that this may not be the case. This issue may go back close to a decade after the use of "bifurcated" rates was implemented. The case could be made that the City has a Net Pension obligation.[197]

In interviews with Vinson & Elkins, neither Mr. Phillips nor Mr. Roeder had a specific recollection of this correspondence or the discussions to which it referred. The thought, however, appears to be that the offset the City received to its contributions to the pension system for its healthcare payments should have been treated as a failure to pay the full actuarially required rate. It is our understanding that the City is presently considering recognizing an increase to its NPO reflecting its reliance on SDCERS earnings to pay retiree health insurance benefits. This change to its reporting practices had been suggested by KPMG in connection with its audit of the City's 2003 financial statements, but would go only to the cost of healthcare premiums from FY 1998 forward, reflecting the effective date of GASB 27.

Also affecting funding for the healthcare benefits has been SDCERS' creation of reserves to provide a cushion for the payment of premiums in years of insufficient surplus earnings. In 1997, the SDCERS Board contributed $7 million from FY 1996 surplus earnings to a "Retiree Healthcare Reserve," established under Section 401(h) of the Internal Revenue Code. This reserve account is the vehicle presently used for the payment of all health insurance premiums, as described above. Every year until recently, allocations to this reserve have exceeded the costs of premiums, resulting in a reserve balance at June 30, 2003, of $20,740,269. Primarily because of recent investment losses, however, that reserve is presently being depleted and may soon be

---

[195] In an interview with Vinson & Elkins, Ms. Webster stated that she was not aware of the Buck Consulting report before we brought it to her attention. It appears that the report received little dissemination or attention, although its estimate of the healthcare liability is mentioned in a 1993 letter from the City Attorney's Office to SDCERS. Letter from Loraine L. Etherington to Lawrence Grissom, Retirement Administrator, SDCERS (July 7, 1993).

[196] E-mail from Terri Webster to Paul Webber, Orrick Harrington (Dec. 10, 2003).

[197] Letter from Rick Roeder to Mike Phillips, City of San Diego (Feb. 12, 1998).

exhausted.[198] At such time, the City will be responsible for funding retiree healthcare benefits to the extent they are not covered by new surplus earnings.

This reserve is maintained outside SDCERS assets and is not "counted" for actuarial purposes. Therefore, transfers into this reserve from sources that otherwise would go into System assets increase SDCERS' under-funding by the same amount. This reduction to System assets, which would otherwise be credited with interest at the actuarial rate in future years, increases the funds available to pay contingent benefits by the amount of that foregone interest. The result may be the further shifting of earnings from accounts that support the actuarial soundness of the System to the payment of contingent benefits.

Of more importance, the Municipal Code specifies that the City is the payer of last resort for the retiree health insurance benefit. The Retiree Healthcare Reserve provides an intervening source of payment when surplus earnings prove inadequate to protect the City from being required to discharge this responsibility. Thus, the creation and funding of this reserve acts to reduce the overall contribution of the City to SDCERS. From discussions with SDCERS staff, however, we conclude that SDCERS has committed System assets to this use primarily out of concern that, in the event of a surplus earnings shortfall, the City may fail to promptly fund the healthcare benefit when called upon to do so, resulting in a lapse in insurance coverage for retirees.

E. The impact of Manager's Proposal 1 on the retirement system

In retrospect, the faults of MP1 are readily apparent. First, the manner of its adoption compromised the independence of the SDCERS Board, involving it, however reluctantly, in the benefit-granting process reserved by City Charter to the Council. This issue re-emerged in 2002, when the Board was requested to amend the agreement, again in the context of a contingent grant of benefits.

Second, the "corridor funding" provision of MP1 – which freed the City for a period of years from contributing at actuarially determined rates – altered and reduced the role of the SDCERS actuary and, indeed, the Board itself from that provided by the City Charter. The Board's ability to adjust the City's contributions as necessary to reflect changes in actuarial assumptions and investment experience was at least temporarily obviated, subject to certain limitations that now appear inadequate. In short, the Board contracted away an important aspect of its authority with detrimental results. That it obtained the approval of its actuary and fiduciary

[198] The Board has voted to establish a new reserve under Section 115 of the Internal Revenue Code, funded with $25 million to be transferred (indirectly) from surplus earnings, to support the healthcare benefit *See* Minutes of SDCERS Special Board Meeting, at 2 (May 29, 2002) (remarks of Mr. Grissom); Minutes of SDCERS Board Meeting, at 4 and 8 (July 11, 2002) (remarks of Mr. Roeder, Mr. Grissom and Mr. Crow). It appears, however, that this action has been placed on hold pending resolution of inquiries into the System's funding status.

counsel for this decision reflects the Board's intention to discharge its fiduciary duties, and the willingness of those professionals to support the measure may be attributable to the difficulty in foreseeing the potential risks inherent in its highly complicated provisions. Nevertheless, this measure represented a risky departure from convention and should have been approached with greater caution.

The City, too, failed to appreciate the risks created by MP1. Most significantly, the measure's payment schedule, which raised the possibility of a significant funding shortfall, coupled with its trigger mechanism created a risk that the City would face a substantial balloon payment should the System experience significant investment or actuarial losses. Under normal practice, such reversals are factored into the System's unfunded liability (UAAL) and the impact on employer contribution rates is mediated by the amortization mechanism used to address such changes in liability. Under MP1, however, any deterioration in SDCERS' funded status would not result in additional City contributions until the 82.3% floor was breached. Given the one-year lag between such an event and the resulting adjustment to the City's contribution rate, negative momentum in investment experience could cause the SDCERS funded level to fall well below 82.3% before any responsive action occurred. If the trigger mechanism is read ***as written,*** rather than as various participants in its creation state it was meant to be written, this created the possibility of immediate and massive liability to the City. As became apparent in 2002, this was more than a theoretical possibility.

In addition, MP1 compromised a significant restraint on the City's fiscal policies: the check on the City's ability to make concessions to politically powerful municipal unions that comes from having to find immediate room in the budget to fund those concessions. Under the first Manager's proposal, pension and post-retirement healthcare benefits could be provided at no immediate cost to the City's General Fund. As SDCERS administrator Lawrence Grissom opined in an interview with Vinson & Elkins, this may have contributed to a lack of discipline in the labor negotiation process, which resulted in the elevation of benefit levels beyond the fiscally manageable level.

F. The City's public disclosure concerning Manager's Proposal 1

The City made no disclosure, in its annual reports or its offering documents, of the changes to its retirement system resulting from MP1 until its 1998 CAFR. The City's 1997 CAFR described the funding of the City's pension obligations as follows:

> 'SDCERS' funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are designed to accumulate sufficient assets to pay benefits when due. The normal cost and actuarial accrued liability are determined using the projected unit credit actuarial funding method. Unfunded actuarial accrued liabilities are

> being amortized as a level percent of payroll over a period of 30 years (25 years remaining).... The City and the District contribute a portion of the employees' share and the remaining amount necessary to fund the system based on an actuarial valuation at the end of the preceding year under the projected unit credit method of actuarial valuation... (emphasis supplied).

Thus, not only did the relevant section of the 1997 CAFR fail to mention the significant changes to the funding policy resulting from MP1, it described that policy in terms that were inaccurate for that fiscal year. Specifically, that year the City had ceased contributing to SDCERS on an actuarially determined basis, having substituted the agreed-to rates of MP1.[199] This had resulted in a net pension obligation for that fiscal year of $5.975 million. But Note 9 to the financial statements in the City's 1997 CAFR states, "[t]here is no Net Pension Obligation at year end as Actuarially Required Contributions and Contributions Made have always been identical during [fiscal years 1995 through 1997]."[200]

The footnotes to the City's financial statements throughout the relevant period were drafted primarily by the City's outside auditing firm, Calderon, Jaham and Osborn ("CJO"). Under Generally Accepted Governmental Auditing Standards ("GAGAS"), it is permissible, within certain bounds, for outside auditors to perform this function.[201] It is important to note, however, that the financial statements, including all footnotes, constitute representations of the City. Although GAGAS permits the involvement in the outside auditors in the drafting process, the City cannot delegate responsibility for the accuracy of its financial statements to anyone, including its outside auditors.[202]

In an interview with Vinson & Elkins, Thomas Saiz, the CJO partner in charge of that audit, explained that it was not until fiscal year 1998 that the existence of a net pension obligation, as well as various other information about the City's retirement system, were required to be disclosed under accounting standards applicable to governmental employers. It is correct that GASB Statement of Standards No. 27, "Accounting for Pensions by State and Local

---

199 Moreover, up until August 2003, Appendix A to the City's Official Statements failed to disclose the effects of MP1, stating instead: "State legislation requires the City to contribute to SDCERS at rates determined by actuarial valuation."

200 The 1998 CAFR, however, accurately disclosed an NPO of $5.975 million for the period ending June 30, 1997.

201 *See* U.S. General Accounting Office, *Government Auditing Standards*, ¶ 3.16(f) (July 1999); U.S. General Accounting Office, *Government Auditing Standards: Amendment No.3, Independence*, GAO-02-388G (Jan. 2002); U.S. General Accounting Office, *Government Auditing Standards: Answers to Independence Standard Questions*, GAO-02-870G (July 2002); U.S. General Accounting Office, *Government Auditing Standards (2003 Revision)*, ¶ 3.18(a), GAO-03-673G (June 2003). Under Regulation S-X (applicable only to public companies), however, this would constitute a clear violation of auditor independence standards. *See* Regulation S-X, Item 2-01(4)(i) and (vi). This is one of many areas where the standards applicable to governmental entities and related professionals are considerably more lenient that those that apply under SEC regulations.

202 The City Auditor's Office does not dispute this principle and, indeed, in responding to the discovery of numerous errors in the footnotes to the City's FY2002 financial statements, determined that the City would no longer rely on its outside auditors to prepare the initial draft of the City's financial statement footnotes.

Governmental Employers" ("GASB No. 27"), is mandatory for financial statement periods beginning after June 15, 1997, but the Independent Auditors' Report of CJO in the City's 1997 CAFR stated that the City had adopted GASB No. 27 as of July 1, 1996.[203] Therefore, the City was required to adhere to the requirements of GASB No. 27 for its fiscal year ended June 30, 1997.[204]

In fact, the City tried but failed to properly comply with the requirement of GASB 27 that it disclose its NPO for the previous three years. Its disclosure on this point included the inaccurate statement that it had no NPO for FY 1997. Closely related to this misstatement was the misleading nature of the description of the amortization of the City's long-term liability to the retirement system (the UAAL). Although the City did, in fact, use a closed 30-year period to calculate the component of its annual contribution to SDCERS reflecting the UAAL amortization, it used a different and longer period for calculating UAAL for *reporting purposes*.

As mentioned above, in a February 1998 letter to the accountant in the City Auditor's Office in charge of the SDCERS accounts, actuary Rick Roeder stated that he had calculated the ARC for fiscal year 1997, the first year in which the Manager's proposal was in effect, and found that the City's contribution fell short of the ARC by $7,283,516. Rather than merely convey this information, however, Mr. Roeder also suggested how that number could be reduced within the ambit of accepted actuarial practice:

> One reasonable hope is that assumptions could be changed to reduce or eliminate the shortfall. However, question 25 (enclosed) of the Implementation Guide [for GASB 25, 26 and 27] indicates that all assumptions and methods used for funding should also be used for expensing.
>
> The problem may be able to be slightly eased, based on a conversation that we had with the GASB's pension representative last week. We had wondered if the City's current funding method[,] which we had dubbed the "Corridor method[,] could be added to the six approved methods. While they were unwilling to say yes at this point, they did give insight. They indicated that if a method did not fit into one of the six approved methods, that one of the acceptable methods could be used. So… we could compare the actual contributions made against the acceptable method which produces the least contribution. We believe that this

---

[203] *City of San Diego Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1997*, Independent Auditors' Report, and Notes 2 and 21 to the financial statements therein.

[204] In addition, even if the City had not adopted GASB 27, GASB Statement of Standards No 5, "Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers" ("GASB No. 5"), which was in effect for San Diego's fiscal year 1997, required disclosure of information necessary to determine whether employers were making actuarially required contributions. As noted, the City was not. GASB No. 5 also required footnote disclosure of "[e]mployer and employee obligations to contribute and the authority under which those obligations are established." At that point, an agreement between the City and SDCERS had altered the City's contribution obligations, but this was not disclosed in the 1997 CAFR.

> method would be Projected Unit Credit with 40-year amortization on a level-percent-of-payroll basis.
>
> Under this basis, the normal cost would be unchanged… but the unfunded liability amortization would be lowered to $4,857,243 from $6,164,770. This would reduce the ARC to $34,036,492 and the resulting shortfall to $5,975,989.[205]

Mr. Roeder was correct that GASB rules permitted, at that time, the 40-year amortization of UAAL for expensing purposes.[206] Nevertheless, the City's statements concerning its UAAL amortization, contained in the footnotes to its annual financial statements from FY 1997 through 2002, misleadingly provided a different period (30 years) than the period actually used *for reporting purposes* (40 years).

The following year, the City affirmatively addressed the changes wrought by MP1.[207] The pension footnote in the 1998 CAFR, in language carried forward into many later disclosure documents, stated:

> In 1996 the City Council approved proposed changes to the [SDCERS], which included changes to retiree health insurance, plan benefits, employer contribution rates and system reserves. The proposal included a provision to assure the funding level of the system would not drop below a level the Board's actuary deems reasonable in order to protect the financial integrity of the SDCERS. A citizen required vote on the changes related to retiree health insurance passed overwhelmingly in 1996. In 1997 the active members of the SDCERS voted and approved the changes. Portions of the proposal requiring SDCERS Board approval (employer rates and reserves) were approved after review and approval by its independent fiduciary counsel and consultation with the actuary. The San Diego Municipal Code was then amended to reflect the changes. The changes provide the employer contribution rates be 'ramped up' to the actuarially recommended rate in .50 percent increments over a ten year period. At such time it was projected that the Projected Unit Credit (PUC) and Entry Age Normal (EAN) rates would be equal and the SDCERS would convert to EAN. The actuary calculated the present value of the difference between the employer contribution rate and actuarial rates over the ten-year period and this amount was

---

[205] Letter from Rick Roeder to Mike Phillips, Office of the City Auditor (Feb. 12, 1998). This was, in fact, the figure reported by the City (a year late) for its FY 1997 NPO.

[206] GASB 27, ¶ 10.f. This provision specified a maximum of 30 years, subject to an additional 10-year grace period applicable to San Diego's situation.

[207] SDCERS did not disclose information concerning MP1 until the following year, when its FY 1999 CAFR included information about the City's scheduled payments. That disclosure inaccurately stated that the MP1 rates would "remain in place unless the City of San Diego's [sic] funded ratio falls below 82.3% *or there are insufficient monies in Surplus Undistributed Earnings to cover the shortfall between the City-Paid Rate and the actuarially computed rate." San Diego City Employees' Retirement System, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1999*, at 31 (emphasis supplied). From its FY 2000 CAFR forward, however, SDCERS' disclosure about MP1 was generally superior to that provided by the City.

> funded in a reserve. This 'Corridor' funding method is unique to the SDCERS and therefore is not one of the six funding methods formally sanctioned by the [GASB] for expending purposes. As a result for June 30, 1998, the actuary rates are reported to be $5,975,0000 more than paid by the City which, technically per GASB 27, effective for periods beginning after June 15, 1997, is to be reported as a [NPO] even though the shortfall is funded in a reserve. The actuary believes the Corridor funding method is an excellent method for the City and that it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method, which would then eliminate any reported NPO.

This disclosure was drafted by CJO, in consultation with the SDCERS actuary and the City Auditor's Office. On the most general level, it fails to describe Manager's Proposal 1 for what it was – a form of contribution relief obtained by the City in exchange for various benefit enhancements, the cost of which would not be reflected in the City's contribution rates for many years. There is also no disclosure that the System's earnings were being committed to a variety of uses not associated with supporting its long-term financial strength. The reader can glean that a funding shortfall is an expected result of this agreement, but there is no disclosure that it is in excess of $100 million over a ten-year period. Further, there is no discussion of the factors that could cause the actuary's projections to be inaccurate and the implications for the soundness of the system should that prove the case.

The projected shortfall is dismissed as a technical accounting matter with no practical significance because it is purportedly "funded in a reserve." As described above, however, this reserve merely reflected that the System had surplus earnings from previous years, not, as this language suggests, that there were assets outside the system dedicated to supplementing the City's contributions.[208] The NPO reflecting the funding shortfall for fiscal year 1998 is similarly described as an accounting technicality, likely to disappear once GASB recognized the utility of the "corridor funding method." It was indeed the case that the SDCERS actuary had made such an application to GASB, but there was no reason at that time to assume it would be successful – as we now know it was not. Also, the NPO balance at June 30, 1998 is incorrectly stated in this footnote as $5.975 million. That was the NPO balance for the previous fiscal year. By June 30, 1998, as disclosed elsewhere in the 1998 CAFR, the balance was approximately $16 million.[209]

---

[208] The existence of this surplus, however, was not meaningless. The shortfall caused by underfunding a pension system is compounded over time because, "[w]hen monies are contributed later than expected, reduced earnings result—thus creating a shortfall." *Board of Administration v. Wilson*, 52 Cal. App. 4th at 1140. Had events worked out as optimistically projected at the time of MP1, earnings derived from the substantial surplus that existed at June 30, 1996 could have effectively offset the loss of earnings caused by MP1's contribution relief. Put differently, the System was ahead of the game in 1996 and, had it continued to operate at no less than break-even in relation to its actuarial liabilities, the excess could have been extracted without a decline in long-term funding objectives. Faltering investment returns and increasing benefit levels dashed this hope, as described below.

[209] That the correct figure is readily ascertainable by reading further in the same footnote suggests that this was simply an error, resulting from a failure by the City's accounting staff and its outside auditor to thoroughly review the footnote disclosure.

The trigger provision is described in a way that would lead the reader to conclude it represented a valuable new safeguard implemented at the actuary's request. In fact, it was an attempt to limit the additional risks to the System's fiscal soundness resulting from MP1. Nor is there any disclosure that, in the event of substantial market losses, the trigger provision could result in an enormous lump-sum payment from the City to SDCERS or, under the competing interpretation, an abrupt increase in contribution rate. In short, the text of the footnote minimizes rather than fully discloses the risks inherent in Manager's Proposal 1.

Finally, the statement that the San Diego Municipal Code had been amended to reflect the changes in the City's relationship to SDCERS brought by MP1 is at least partially mistaken. The Municipal Code was indeed amended to reflect the new benefits granted at the time of MP1, as well as the new mechanism for funding the retiree healthcare benefit.[210] However, the failure of the City to amend Municipal Code Section 24.0901 to clearly permit a departure from actuarial funding was later to cause it considerable grief in the form of the *Gleason* litigation.

While describing why the City's disclosure about MP1 was inaccurate from the outset – and became increasingly misleading as actual events diverged from hopes, guesses and actuarial projections – we also note that there is no evidence to suggest that the language was drafted to mislead. It is apparent that both SDCERS and City staff, as well as various attorneys and auditors, were genuinely confused about the operation of the reserves that would supposedly offset the contribution shortfalls from MP1 – and remained confused for years to come. In addition, had the offending footnote simply stated that SDCERS had generated surplus earnings during the previous three fiscal years in an amount greater that the projected shortfall (omitting the ill-chosen language about reserves), much the same reassuring effect could have been created without misleading.

Most important, there is no reason to believe that City officials viewed this as significant disclosure from the standpoint of defending the City's credit status, their only apparent motive to distort the facts, assuming their willingness to do so. The Rating Agencies – Moody's, Fitch and Standard and Poor's – did not routinely focus on pension issues until the 2000 market downturn created widespread funding problems for public and private systems. According to City officials, in prior years the Rating Agencies looked only at the basic funded ratio and City contribution levels. As long as these numbers were strong, their interest lay elsewhere. The City's disclosure made clear it had adopted an eccentric approach of funding its retirement system. Had the Rating Agencies or other interested parties wished to inquire further, information about the risks incurred through the adoption of MP1 could have been obtained by them. Indeed, most of the key facts had been discussed in the local newspapers. Thus, any attempt at concealment could have been readily frustrated by basic financial research.

---

[210] Ordinance O-18392 (Mar. 31, 1997).

## VII. Additional burdens placed on SDCERS' surplus earnings, 1998-2000

### A. The Employee Contribution Rate Increase Reserve and the Supplemental COLA Reserve

Due to the continued vitality of the bull market, the arrangement created under the first Manager's proposal enjoyed a charmed life for several years. Almost immediately, the SDCERS funded ratio began to regain a portion of the approximately 5% actuarial loss that had resulted from the benefit increases (***i.e.***, additional "past service liability") and changes in actuarial assumptions associate with MP1. Deputy City Manager Bruce Herring breathed a sigh of relief in a January 1997 memorandum to City Manager Jack McGrory and others:

> Rick [Roeder] just called me to let me know that we had a significant actuarial gain based on his most recent analysis. In spite of the average age jumping another ½ year, the net actuarial gain was $60 million. This translates into the funded ratio going from 93.5% to 97.1% without the Manager's Proposal and only drops to 92.3% with the Manager's Proposal. This compares very favorably to what Rick was forecasting last year[,] which was in the mid-80's. This should really help with the Board members that [sic] were nervous about the Proposal.[211]

Several years later (at June 30, 2000) the System achieved a funding level of 105%.[212] Additional developments had taken place by this time, however, that would contribute to the abrupt deterioration of that funded level that began the following year.

During the 1998 "meet and confer" process, agreements were reached between the City and the municipal unions that involved additional diversions of SDCERS' surplus earnings. First, the enhanced benefits agreed to in 1996, because they increased the "normal cost" of the System as well as the UAAL, required additional contributions from City employees. To alleviate this added burden, the City Manager,[213] by memorandum dated May 14, 1998, proposed that SDCERS establish a reserve, taken from FY 1997 surplus earnings, that could be used to offset the employee rate increases. Specifically, the City Manager proposed:

1. SDCERS would create an Employee Contribution Rate Increase Reserve and fund it with $35 million in FY 1997 surplus earnings.

2. This reserve would be credited annually with interest at the actuarially assumed rate (8% at all relevant times).

---

[211] Memorandum from Bruce Herring to Jack McGrory, Cathy Lexin and others, Re: Good Retirement News (Jan. 1, 1997).

[212] This figure does not reflect liabilities associated with the *Corbett* settlement, discussed below.

[213] By this time, Mr. McGrory had resigned and been succeeded as City Manager by Michael Uberuaga.

3. At the beginning of each fiscal year, an amount equal to .49% of total payroll would be credited to employee contributions and transferred from this reserve into the Employer Contribution Reserve.

The System actuary approved this use of surplus earnings but, because the reserve was intended for a purpose other than the payment of SDCERS benefits, determined that it should be held outside system assets. The SDCERS Retirement Administrator noted that this would cause an increase in the UAAL of the same amount, and would also negatively affect the NPO.[214]

In addition – again reflecting the 1998 meet and confer process – the City Manager asked the Board to approve the transfer of an additional $35 million of surplus earnings into a "Reserve for Supplemental COLA." This reserve would also be held outside SDCERS assets and draw interest at the actuarially determined rate, contingent upon the availability of sufficient funds after senior claims on surplus earnings were satisfied. Its purpose was to place a floor, defined in terms of current buying power, under the retirement benefits received by City employees who retired prior to June 30, 1982.

The concern expressed by Mr. Casey during deliberations over Manager's Proposal 1 – that the Board was being improperly dragged into the benefit-granting business – had by now become more general. At the request of several trustees, an opinion letter was obtained from Florida attorney Robert Klausner. In a June 10, 1998 letter to SDCERS administration, Mr. Klausner stated that he had been asked to opine on the fiduciary implications of a proposal by the City Manager to use SDCERS surplus earnings "to fund employer contributions, COLA payments to retirees, and to fund a portion of the employee contributions."[215] Based on assurances that this allocation of surplus earnings "will not result in an unsound actuarial status for the System," and the lack of any prohibition in the Municipal Code of this use of surplus earnings, he viewed the proposal as within the fiduciary discretion of the Board. Mr. Klausner concluded: "[i]n the final analysis, the Board is being asked to approve the use of System assets to benefit participants and beneficiaries. Assuming the Board is otherwise satisfied that it has provided for the actuarial soundness of the system, it acts within its lawful authority in approving the Manager's proposal."[216]

The Board approved this proposal, and the "Waterfall" section of the Municipal Code was subsequently amended to provide for the use of surplus earning to pay interest on the

---

214 Memorandum from Lawrence Grissom to Business Procedures Committee, Re: Implementation of Employee Rate Proposal (June 10, 1998).

215 By "employer contributions," counsel refers to the creation and funding of the NPO Reserve.

216 Letter from Robert D. Klausner to Lawrence B. Grissom (June 10, 1998).

balance held in these reserves.[217] The Employee Contribution Rate Increase Reserve was created in FY 1998 and initially funded with $35 million of FY 1997 surplus earnings. The first transfer out from this reserve into System assets (*i.e.*, the Employer Contribution Reserve), in the approximate amount of $2 million, was made in June 1999. The share of employee contributions funded through this mechanism was increased as a result of labor negotiations in 2000 and 2002, and tapped to cover a portion of the City's "pick-up" of employee contributions in FY 2002 and 2003.[218] Through FY 2003, the total amount of System assets placed in this reserve (*i.e.*, the initial amount reserved plus subsequent interest allocations) was approximately $50.1 million. Because poor investment returns in recent years have diminished the amount of interest credited from surplus earnings to this reserve, SDCERS administration has warned that in coming years it may no longer contain sufficient funds to cover the specified percentage of employee contributions.[219]

The Reserve for Supplemental COLA was established in FY 1999 with $35 million in surplus earnings from the previous fiscal year. The year delay after the creation of the Reserve for Employee Contribution Rate Increase was necessitated by the exhaustion of FY 1997 surplus.[220] Through June 30, 2003, an additional $11.0 million in interest was credited to this account.

That the System's already burdened earnings were being further depleted by these measures was, of course, obvious. At that time, however, the System's returns on its invested assets were so rich that there appeared a basis for optimism they could continue, at least for the time being, to support a variety of benefits. Referring to the Reserve for Employee Contribution Rate Increase, SDCERS administrator Lawrence Grissom told the Board: "… there is a reasonable expectation that our experience, especially in the investment area, has been good enough to create sizeable actuarial gains. These gains may well be sufficient to offset the increase in unfunded liability created by this reserve, at least in the near term."[221] System actuary Rick Roeder, moreover, continued to support the concept of "corridor funding' instituted with MP1. In an April 8, 1999 letter to the SDCERS Board, he stated: "… continuation of the current rate structure is an actuarially reasonable method to use." From FY 1996 through FY

---

217 Municipal Code ch. 2, art. 4, div. 15, §§ 24.1504 and 24.1507.

218 Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Mayor and City Council, Re: Meet and Confer: Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration (June 14, 2002).

219 San Diego City Employees Retirement System, *Report to the City Council Committee on Rules, Finance and Intergovernmental Relations, Re: Response to the Blue Ribbon Committee Report on City Finances*, at 5 (Feb. 5, 2003).

220 Memorandum from Lawrence Grissom to SDCERS Business Procedures Committee, Re: Implementation of Supplemental COLA Benefit (June 9, 1998).

221 Memorandum from Lawrence Grissom to Business Procedures Committee, Re: Implementation of Employee Rate Proposal (June 10, 1998).

2001, his annual actuarial evaluations contained the conclusion: "Overall, we believe the City's Retirement System to be in sound condition in accordance with actuarial principles of level-cost financing."

B. The Corbett Settlement

City Auditor Ed Ryan expressed a less sanguine view. In a 1998 memorandum that appears to have been directed to the City Manager,[222] Mr. Ryan cautioned that the City "should under no circumstances feel rich in the retirement area…. No matter how good the year is, you're not ahead of the curve." He specified as cause for concern the ramp-up in City contributions provided by Manager's Proposal 1, "a $200-400 million off the books liability you don't have to show for giving everyone retiree health insurance,"[223] and:

> a couple of potential retirement lawsuits coming your way that if employees win, as they have in Ventura and Los Angeles, will cost you millions to include items in the base of retirement such as overtime, sick leave, etc. that are presently not counted.

In *Ventura Deputy Sheriffs' Association v. Ventura Co. Board of Retirement*,[224] the California Supreme Court had ruled that employee "final compensation" for purposes of determining the basic pension benefit should include not only base salary but also such "add-on" items as overtime pay and accrued leave. As Mr. Ryan suggested, this holding was potentially applicable to San Diego and, indeed, on October 28, 1998, a class action was filed against SDCERS based on allegations that it had miscalculated retirement benefits for System members by omitting these factors.[225] The City was named as a "real party in interest," rather than a defendant. But a verdict for the plaintiffs would increase System liabilities by hundreds of millions of dollars, resulting in substantially increased City contribution rates. The City's legal advisors estimated that a loss could result in a $743 million expense to the City, a $75 million per year increase in annual employer contributions and a decline in SDCERS' funded ratio from 94.4% to 70%. Despite the huge potential cost to the City represented by this litigation, San Diego made no disclosure of this matter in its FY 1999 CAFR or relevant offering documents from that year.

---

[222] Mr. Ryan declined to speak with Vinson & Elkins in connection with this inquiry. He did, however, provide copies of a substantial quantity of documents that he had taken with him upon his retirement from City service in early 2004. Although this memorandum does not specifically indicate its author, it was among the documents produced by Mr. Ryan and is edited in what appears to be his handwriting.

[223] The origin of the estimate for the healthcare liability is not indicated in this memorandum or other documents obtained from Mr. Ryan. It appears to be reasonably in line with the projections done by Buck Consulting, with allowance for inflation in the cost of healthcare insurance in the ten years since the creation of that report.

[224] 16 Cal.4th 483 (1997).

[225] *Corbett v. City Employee Retirement System* (San Diego County Super. Ct.) (No. 722449).

After a year and a half of litigational sparring, a mediated settlement proposal was presented to the City Council in March 2000. This proposed resolution of this matter, which the City ultimately accepted, dovetailed with ongoing labor negotiations. It provided that:

- retired employees would receive a 7% benefit increase;
- DROP participants would receive a 7% increase in previously accrued benefits and a 10% increase in prospective benefits; and
- active employees would be able to elect, on an individual basis, between receiving an enhanced benefit formula (2.25% at age 55 for General Members, 3.0% at age 50 for Safety Members) and a 10% increase on the existing formula.

The financial impact on the City of this settlement was much less than the potential exposure from an adverse judgment. The cost to the City was projected at approximately $162 million – not including the "contingent" aspect of the settlement discussed below – and the decline in the SDCERS funded ratio at 10%. Moreover, much of the immediate cost of the settlement would not be paid from the City's operating funds but (once again) from SDCERS surplus earnings. The 7% increase in the benefit formula for retirees is treated under the settlement as a "contingent" benefit to be paid from System surplus when available.[226] Unlike other items in the "Waterfall," however, in years this claim is not paid it rolls forward to the next fiscal year in which surplus earnings are adequate to make a distribution against the accrued balance. The System actuary estimated the initial magnitude of this liability at approximately $70 million. The present annual cost is approximately $5.5 million. Because these payments go to a diminishing group of recipients (the retiree population as of the time of the settlement), it will decline over time.

Although this settlement allowed the City to sidestep a short-term budgetary crisis, it raised significant fiscal issues for the future. City Auditor Edward Ryan expressed his views in a memorandum that, after several drafts, was ultimately delivered orally to the City Council and others, rather than in writing.[227] Addressing what he described as "spending issues that have an important bearing on the budget for the next couple of years," he wrote:

> Part of the settlement was a creative <u>contingent</u> liability to retirees, part was a <u>non-contingent</u> liability option to present employees. You may or may not have heard the plan to pay that liability is to mortgage the future by agreeing to pay

[226] The liability for previous years was addressed by the City in a one-time payment in the amount of $23 million.

[227] According to Mr. Ryan's notes, he discussed the contents of this memorandum with the City Manager, his deputy, Mr. Herring, SDCERS administration, the Mayor and the Council. He indicates that he also raised these issues in the March 21, 2000 closed session of the City Council.

> more later. This was done in the last retirement deal when the City was in a difficult recession. I have serious doubts as to the wisdom of this method of finance 4 to 5 years into the recovery from that recession. The City is already paying approximately $8.0 million annually less than it should be to the retirement system. For every 1% of payroll these new benefits cost, this shortfall will increase by $4-4.5 million annually (emphasis in original).[228]

The *Corbett* settlement was made contingent upon a determination that it would not cause the System's funded ratio (measured as of June 30, 1999) to decline below 90%. William M. Mercer, Inc. conducted a valuation as of that date and concluded that the "non-contingent" element of the *Corbett* settlement would result in a 4.1% decline in funding, bringing it to 90.3%. Had the "contingent" aspect of the Corbett settlement been included in the valuation, the ratio would have fallen to 87.2%, below the minimum required for approval of the settlement. In the view of the Auditor's Office, this was legally acceptable but potentially misleading, and it recommended that the Council be informed how this requirement was met.[229] The City Manager's Office did so by forwarding to the Council a letter from the System actuary explaining the exclusion of the contingent element of the *Corbett* settlement from his calculation of the funded ratio.[230]

This settlement was authorized by the City Council, approved by the SDCERS Board and subsequently by SDCERS membership, and the "contingent" element of the settlement was added to the "Waterfall" provision of the Municipal Code.[231] The full formula amount was paid in fiscal year 2001: approximately $5.5 million. In fiscal years 2002 and 2003, however, the System's realized earnings proved insufficient and the liability for those years ($11 million) was rolled forward. We understand that all accrued amounts will be paid out of FY 2004 surplus earnings.

The City did not disclose the *Corbett* litigation or settlement in its CAFRs for the relevant time period. The only public disclosure we have been able to locate in connection with the City's bond offerings is two paragraphs in an Annual Report filed with the Disclosure Repositories on April 5, 2000 for the Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, and Taxable Lease Revenue Bonds, Series 1996A. Under the heading, "Potential Settlement Litigation [sic] Related to Pension Plan," and after a brief but accurate description of the basis for the suit, that document stated:

---

228 Draft memorandum from Edward Ryan to Mayor and City Council, re: Relationship of On-Going Revenues In the Proposed Budget for '01 And Beyond and Bonding Priorities (Apr. 11, 2000) (emphasis in original).

229 E-mail from Terri Webster to Bruce Herring, Deputy City Manager, Re: Corbett (Apr. 4, 2000).

230 Letter from Rick Roeder to Laurence Grissom (Mar. 30, 2000); Memorandum from Bruce A. Herring to Mayor and Council Members (Apr. 13, 2000).

231 Municipal Code ch. 2, art. 4, div. 15, § 24.1502(7).

> A tentative settlement has now been reached in this case, subject to court approval on May 12, 2000, and a vote of the SDCERS membership as required by the San Diego City Charter. Under the proposed settlement, additional benefits to be paid to retired employees will be paid from sources other than City's [sic] General Fund (or its enterprise funds). Active City employees will receive increased benefit payments from SDCERS commencing in the Fiscal Year ending June 30, 2001, which will represent an increase of 0.5% in the cost of benefits payable by the City from the General Fund and other funds of the City, in accordance with the current funding mechanism.

The *Corbett* settlement was, of course, a public document and could have been obtained by any interested person. That said, it should also be noted that the quoted description of the settlement would not give the otherwise uninformed reader an accurate understanding of the significance of this matter for the City's finances. Although it is correct that the purportedly contingent element of the *Corbett* settlement was to be paid out of SDCERS surplus earnings and not the City's operating funds, the City nevertheless had a financial stake in this settlement provision that was not disclosed. Any diversion of SDCERS' surplus earnings reduces overall System assets and thereby increases the UAAL and the City's required contributions to amortize the UAAL. As noted above, therefore, diverting surplus earnings to purposes other than supporting the basic soundness of the System presents aspects of a loan from the System to the City.

More critically, the statement that the cost of enhanced benefits for presently active employees represents "an increase of 0.5% in the cost of benefits payable by the City" is misleading. In fact, the basic multiplier for determining pension benefits was increased for general members retiring at age 55 by 12 1/2% (from 2.0% to 2.25% of salary for each creditable year of service) under one option provided by the *Corbett* settlement and by 10% under the other. Finally, there is no mention of the $23 million lump sum payment that was also a provision of the settlement.

The "contingent" component of the *Corbett* settlement is not included in the actuary's annual calculation of System liabilities. This treatment comports with the general rule that contingent liabilities are not actuarially "priced" and factored into the AAL.[232] In this case, however, given the near certainty that these benefits will eventually be paid in full, there is reason to question whether this should be viewed as a contingent liability at all. For this reason, the Retirement Administrator, Mr. Grissom, and the SDCERS actuary, Mr. Roeder, opposed this treatment.[233] All the same, a majority of the Board followed the language of the settlement

---

[232] GASB, *Guide to the Implementation of GASB Statements 25, 26 and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers*, at 10 (1997).

[233] *See also* Letter from Constance M. Hiatt, Hanson Bridgett LLP, to Loraine E. Chapin, General Counsel, SDCERS, Re: City of San Diego Employee's Retirement System – Surplus Undistributed Earnings (Apr. 16, 2002). In that letter, Ms. Hiatt states: "If one believes SDCERS will earn its assumed actuarial assumption of 8% earnings at any point, one must conclude

documents and decided that the ostensibly contingent aspect of the *Corbett* settlement would not be included in actuarial calculations of System liability. As Mr. Roeder has commented:

> The only liability that we have been asked [by SDCERS] to exclude is the potential liability relating to "Corbett" retirees. There has been discussion as to whether this is a contingent liability or one of certainty. We have commented on this each year in the actuarial comment section, including the impact on the System's funded ratio if it were included.[234]

Every year from 2000 forward, Mr. Roeder's annual valuations have disclosed the reduction to the SDCERS funded ratio that would result if the contingent element of the *Corbett* settlement were included. It has been between 2 and 2 1/2% each year.[235] We understand that, at the suggestion of KPMG, the City may request that SDCERS revise its approach to the *Corbett* settlement and include the projected cost of its purportedly contingent element in calculations of System liabilities. We believe that this approach will improve the quality of the City's public disclosure.

Despite the drain on System funding created by these additional benefits, SDCERS did not ask the City to increase its contribution rate from the schedule contained in the Manager's proposal. SDCERS administrator Lawrence Grissom told Vinson & Elkins that any such increase was inconsistent with the terms of that agreement, which he regarded as one of its flaws. Fiduciary counsel Constance Hiatt took a different view. In an April 2002 letter explaining the intricacies of the "Waterfall," she suggested that the Board broadly reconsider the manner in which System earnings were being applied:

> Long-term, the Board may want to consider eliminating the reserve concept and including all promised benefits in liabilities and including all assets in the total assets for funding determinations. This would require requesting that the City include all benefits in the Code without the contingency of Surplus. To counter any negative effect on funding, the Board may also want to consider evaluating the application of the Manager's Proposal to benefits enacted after the inception of the Manager's Proposal. The Manager's Proposal froze the City's contribution rate for existing benefits for as long as the funding level of SDCERS remained at a certain level (or for a certain number of years). The Board has not requested any increase in the contribution rate even for the benefit improvements enacted

---

that while the Corbett liability is deferred, but [sic] really isn't contingent except as to time of payment." *See also* Minutes of the SDCERS Retirement Board, at 10 (June 1, 2002) (remarks of Mr. Vortmann).

234 Letter from Rick Roeder to Lawrence Grissom, SDCERS (Mar. 7, 2003).

235 *See, e.g.*, Gabriel, Roeder, Smith & Co., SDCERS, Annual Actuarial Valuation, June 30, 2001 ("2001 Actuarial Valuation"), at cmt. E: "We have NOT included any Corbett contingent liabilities in the valuation. If we had included the value of such liabilities, estimated to be in the $70-76 million range, the funded ratio would drop in the 2-2.5% range."

after the inception of the Manager's Proposal and therefore not covered by the Manager's Proposal.[236]

These were sensible suggestions with no immediate likelihood of being adopted. The severe downturn in the stock market that began in 2000, together with MP1's contribution relief and the various benefit increases described above, resulted in a decline in SDCERS' funded ratio to a level that implicated MP1's trigger provision. Addressing the potential budgetary problems such an event would cause would occupy City administrators before any consideration would be given to remedying flaws in SDCERS' funding. As described below, that effort led in late 2002 to a significant revision to the first Manager's proposal, with mixed results for the System.

## VIII. The Mayor's Blue Ribbon Committee

In April 2001, Mayor Dick Murphy appointed a nine-member committee to examine the City's fiscal health. One of the areas targeted was the City's liability to its retirement system. The member of the committee charged with primary responsibility for preparing this section of the report was Richard H. Vortmann, later a member of the SDCERS Board. Various City offices provided support to members of the Blue Ribbon Committee. Mr. Vortmann was assisted in particular by Deputy City Auditor Terri A. Webster.

Mr. Vortmann focused on the City's failure to contribute to SDCERS at actuarially determined rates after the implementation of MP1 and the long-term effects of this policy on the fiscal soundness of SDCERS. He was also troubled that the System's liability for post-retirement healthcare benefits was not calculated and actuarially funded. The City Auditor's Office[237] was generally supportive of Mr. Vortmann's suggestions for changes to the System.[238] For example, in September 4, 2001, Ms. Webster responded to his draft presentation to the Blue Ribbon Committee as follows:

> Overall: I support highlighting that there is a negative fiscal impact to the City when retiree benefits are increased and they need to be reminded that they are paying artificial low rates now and pushing the liability out to the future. This is timely since the labor side of the Board was successful in June in pulling $100 million out of FY 00 earnings so they have a pot to bargain with in the upcoming

---

[236] Letter from Constance Hiatt to Loraine Chapin (Apr. 16, 2002), *supra*.

[237] Mr. Ryan declined to speak with Vinson & Elkins in connection with this inquiry.

[238] The City Auditor's Office also supported Mr. Vortmann for a seat on the SDCERS Board. In an interview with Vinson & Elkins, Mr. Vortmann stated that he believed this was because they saw him as a voice for fiscal reform.

labor negotiations.[239] It also doesn't hurt to highlight the health care rising expense.[240]

The City Auditor's Office did not agree, however, that the healthcare expense should be actuarially funded by the City – which would have represented a major expense item – pointing out that "Generally Accepted Principals for Government and Pensions does not require booking health future costs, nor is it required that health be actuarially funded."[241] Mr. Vortmann accepted this as a correct statement of accounting standards, but continued to advocate this approach as the better practice.

Mr. Vortmann attempted to quantify the magnitude of the City's liability for the retiree healthcare benefit. In response to his inquiries, SDCERS Retirement Administrator Lawrence Grissom provided an informal estimate of $100-200 million. According to Ms. Webster's notes of the conversation, his basis for that number was simply "judgment." In an interview with Vinson & Elkins, Mr. Grissom stated that he likely relied on the evaluation done by Buck Consulting in 1989, the only projection of the healthcare liability done to that date.

The Blue Ribbon Committee's report, issued in February 2002, posed the following questions:

> 1. Whether the City is paying out of its current year's budget the full cost being incurred by its current workforce for their future pension and retiree health benefits; [and]
>
> 2. Whether the budgetary process adequately comprehends the steadily growing annual expense obligation, particularly given the uncontrollable and non-discretionary nature of this obligation.[242]

It then answered both questions in the negative. Given that the Committee had no information on the SDCERS funded ratio more current than June 30, 2000, which, at 97% (including the "non-contingent" elements of the *Corbett* settlement), was the highest ever achieved by the System, and that FY 2001 payments for retiree health insurance premiums were a relatively modest $7 million, the Blue Ribbon Committee deserves credit for its prescience in targeting issues that the City's policymakers indeed did not, as the report suggests, "adequately comprehend."

---

239 This $100 million reserve, held inside fund assets and therefore actuarially neutral in effect, was folded back into the Employer Contribution Reserve the following fiscal year.

240 E-mail from Terri Webster to Lhugheg@nassco.com re: final report (Sept. 4, 2001 10:48 AM).

241 *Id.*

242 *Blue Ribbon Committee Report*, at 21.

The report pointed out that easy choices in the present could lead to hard choices in the future:

> The potential risk is that policy makers grant benefit enhancements today (to satisfy employee concerns, to negotiate trade-offs with unions, etc.), but avoid recognizing the actual annual cost of such by actuarially spreading the cost over years far out in the future, long after the individuals who made the policy decisions are gone.[243]

In what may be the first instance of this concern being voiced in a public policy forum, the report also raised the specter of the potential snowballing of healthcare costs. The cost of premiums had increased between FY 2000 and FY 2001 from approximately $5 million to $7.2 million. Although this was still a relatively small item, the report noted that this "might be a false comfort and therefore misleading."[244] It pointed out that the City faced unfavorable demographic changes – in particular lengthening life spans – a growing workforce and significant and unpredictable inflation in the cost of healthcare services. It stated that the present value of this liability "could exceed $100 million," a number we now know to have been unrealistically low, and questioned whether City policy makers appreciated the potential of this item to dramatically increase in cost over time.

This section of the report concluded by recommending that the City:

- fully fund the actuarially determined cost of the retirement system, including that of the healthcare benefit;[245] and

- obtain a comprehensive analysis of projected pension and healthcare expenses to determine their impact on future City finances.

Mr. Vortmann stated in an interview with Vinson & Elkins that the report did not address what he now knows to be significant additional issues concerning SDCERS' funding because no one on the Committee, himself included, sufficiently understood the complexities of the System. These issues included the use of surplus earnings to fund various contingent benefits (other than retiree health insurance) and the related issue of SDCERS' arcane system of accounting reserves.

The reaction to this report was muted. It received little public attention and brought about no immediate changes in policy. It does not appear that the Blue Ribbon Committee's

---

243 *Id.*

244 *Id.*

245 This would have meant departing from the MP1 schedule of payments and also accruing for the estimated healthcare liability, although this was not required by applicable accounting standards.

report was considered at that time by the Rating Agencies in their evaluations of the City's financial status. Indeed, as a general matter, the rating agencies seem to have been insensitive to retirement system issues until late in the relevant period, when a precipitate decline in SDCERS' funded ratio finally captured their attention.

With respect to this section of the report, the Manager's Office, responding to a directive from the Council, asked SDCERS to prepare a report addressing the Blue Ribbon Committee's concerns. Eventually, SDCERS did so, but not until a new arrangement among the City, its labor unions and SDCERS had significantly modified SDCERS' funding situation.

## IX. Manager's Proposal 2

### A. The first approach

The stock market downturn that began in 2000 had a severely detrimental effect on the funding status of retirement funds, public and private. A report from Moody's Investors Service noted that many local governments in California had "seen their pension position deteriorate dramatically":

> In the late 1990's most local governments in California had over-funded pensions. Today, as a result of stock market losses and employee benefit increases, most have unfunded pension liabilities. Even in the absence of an unfunded liability, most agencies are experiencing sharply increased annual pension costs after years of having been relieved of those costs by excess portfolio earnings.[246]

A report from Wilshire Associates found that the average funded ratio for 78 city and county retirement systems surveyed declined from 103% in 2001 to 88% in 2002.[247] SDCERS' conservative asset allocation, which had restricted investment returns during the bull market, cushioned its loss experience in the three-year bear market that followed. Ranked against comparable funds, its investment performance was admirable. Nevertheless, its returns for fiscal years 2001-2003 were far less than in previous years, and fell far short of the actuarially assumed rate that was its most critical benchmark.

---

[246] Moody's Investors Service, *Special Comment: Moody's Perspective on Increased Pension Cost fort California Local Governments* (June 2003).

[247] Wilshire Associates, *2003 Wilshire Report on City & County Retirement Systems: Funding Levels and Asset Allocation* (Sept. 19, 2003). Nor was this situation limited to public sector employers. A caption in Businessweek's July 19, 2004 cover story "The Benefits Trap" states: "Three years of stock market declines plus record low interest rates have left pension funds woefully underfunded." The article cites a CreditSights Ltd. study finding that 85% of the defined benefit plans of S&P 500 companies do not have enough assets to cover their pension obligations. A chart in the article lists six corporations whose pension deficits exceed their market capitalization by more than 50%. In one case, the deficit exceeds the company's market capitalization by 379%.

History of SDCERS Investment Returns[248]

| | Year Ending 6/30/98 | 6/30/99 | 6/30/00 | 6/30/01 | 6/30/02 |
|---|---|---|---|---|---|
| Fund's Total Return | +14.62% | +9.53% | +14.93% | -0.45% | -2.48% |
| Average Public Fund's Total Return | +17.60% | +10.82% | +9.45% | -4.06% | -5.15% |
| Fund's Percentile Ranking | 94% | 56% | 6% | 17% | 14% |
| Fund's Realized Earnings | $246.1 million | $189.3 million | $415.9 million | $168.0 million | $51.2 million |

By late 2001, City officials began to fear that these plummeting returns were likely to pull SDCERS' funded ratio below the 82.3% floor provision of MP1. In an e-mail from Terri Webster to Deputy City Manager Cathy Lexin, dated October 11, 2001 and cogently titled "EEEK," Ms. Webster stated to her fellow SDCERS Board member:

> YTD SDCERS earnings as of August 31, 2001 in the SDCERS Trust fund is about $15m compared to $53M same time 2000… a 71% drop! BEFORE 9-11-01! It will be tight to even meet the base undistributed earnings distributions for FY 02 (i.e., 13th Check, Corbett, etc.). I hope meet and confer negotiations result in returning as much of the $100 million as possible to employer reserves because the Trust Fund really need[s] to build its equity and halt cost increases to ride through the next few years and keep a fiscally sound funding ratio.[249]

Under the interpretation urged by the Manager's Office and Mr. Grissom, the trigger provision would require that the City begin paying the full PUC rate as of the first fiscal year after the floor was breached. The Manager's Office estimated that this would mean a payment of approximately $25 million in the first year.[250] As it was later calculated, avoiding paying the full PUC rate in FY 2004, the first fiscal year after the SDCERS actuary determined that the trigger had been hit, reduced contributions to SDCERS from the City's General Fund by approximately $44 million.[251]

---

248 SDCERS, *Report to Rules Committee of City Council, supra*.

249 Memorandum from Terri Webster, Deputy Auditor and Comptroller, to Cathy Lexin, Deputy City Manager, Re EEEK, (October 11, 2001). The $100 million referred to here and mentioned above was a Reserve for Contingencies set aside from excess earnings in FY 2001. It was transferred into the Employer Contribution Reserves the following year and, therefore, did not result in any diminution of System assets.

250 Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Mayor and City Council, Re: Meet and Confer: Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration (June 14, 2002). In interviews with Vinson & Elkins, both Mr. McGrory and Mr. Herring conceded that the language of the trigger provision requires the City to restore System funding to the 82.3% level, whatever the intention of its drafters might have been.

251 Closed Session Council Briefing by Luce Forward Hamilton and Scripps LLP (Jan. 27, 2004) (PowerPoint presentation).

Alternatively, if the trigger provision were read to require that the City restore System funding to the 82.3% level, the implications were even more ominous.[252] If the funded level fell only slightly below the floor, such a lump sum payment could have been less costly to the City than going to the full PUC rates. On the other hand, a more substantial drop could have mandated a massive infusion of cash from the City into SDCERS. As we now know, SDCERS' funding fell 15% below the floor level by June 30, 2003. By rough estimate, the City would have needed to pay more than $500 million in FY 2004 and 2005 to restore the funded level to 82.3%.

The concern that the trigger would be hit that year or the next increased substantially when a draft of the actuarial report for FY 2001 became available on February 12, 2002. The actuarial valuation for June 30, 2001 showed a funded ratio of 89.9%, a decline of approximately 8% over the previous year, not including the effects of the contingent element of the *Corbett* settlement. Given the continued decline in the market that had occurred after June 30, 2001, it was apparent that a significant additional deterioration in SDCERS' funded ratio should be anticipated at the next valuation.[253] In addition, SDCERS' realized earnings for fiscal year 2001 were too meager to fund any of the contingent benefits in the Waterfall. In a May 29, 2002 Board meeting, Mr. Grissom:

> … provided the Board with a history of the System and discussed realized gains. He reported that the System has historically utilized earnings as a means to pay certain benefits within the System. However, the Board is now faced with a situation where the projected earnings for this fiscal year are far short of what they have been over the past ten years. He reported that the System's high mark was in June of 1999, when the System achieved $468 million in realized earnings. This year, Staff projects the earnings will be somewhere between $40 million and $50 million.[254]

During the spring of 2002, the City concluded labor negotiations with three of its municipal unions. In the meet and confer process, the City agreed to increase the basic multiplier for retirement benefits for general employees to 2.5% at age 55. Combined with the increase from 2.0 to 2.25% from the FY 2000 negotiations, this meant that the cost of the basic retirement

---

252 This interpretation was adopted by System actuary Rick Roeder, fiduciary counsel Robert Blum, and Board member Ron Saathoff. Minutes of SDCERS Board Meeting, at 16-17 (June 21, 2002) (remarks of Mr. Roeder, Mr. Blum and Mr. Saathoff). At other times, however, Mr. Roeder appears to have subscribed to the competing interpretation.

253 Another factor pointing toward additional declines in SDCERS' funded ratio was the use by Gabriel, Roeder, Smith & Co. of actuarial "smoothing" to calculate rates of return on fund assets. In essence, returns were blended over a five-year period to avoid abrupt changes in asset levels and, consequently, volatile contribution rates. Because the years that were about to fall out of this calculation had provided strong returns, the burden on the next years would be that much greater. At the time the Board was considering the second Manager's proposal, the market value of System assets trailed their actuarial value by approximately $230 million. *Id*. at 18 (remarks of Mr. Roeder).

254 Minutes of SDCERS Special Board Meeting, at 1 (May 29, 2002).

benefit would increase 25% over a two-year period. Labor and management also agreed that the City Manager would propose to the SDCERS Board that it transfer $25 million from surplus earnings into a reserve to fund the healthcare benefit in future years in which earnings were insufficient for this purpose.

These new benefits were explicitly contingent upon the willingness of the SDCERS Board to grant the City additional breathing room with respect to the MP1 funding floor. Specifically, for the benefits to be implemented, the Board was required to lower the trigger level from 82.3% to 75% of actuarial assets. In the event that the new floor was breached, furthermore, the City would have five years to ramp up to the full actuarial rate. Although in other contexts it attributed the need for these concessions primarily to investment losses,[255] in its communications with the municipal unions, the Manager's Office emphasized the cost of pension benefits previously granted as necessitating the proposed modification of the trigger provision. In a "Summary of the City's Final Position" sent to its municipal unions on May 9, 2002, the City stated:

> Substantial benefit improvements granted by the City since the adoption of the "City Manager's Retirement Proposal" dated July 23, 1996 (Manager's Proposal) have created additional unfunded liability to SDCERS that was not anticipated when the City agreed to the "trigger" provisions. Significant improvements in benefits are contained in this three-year proposal. Consequently, the "trigger" provisions must be adjusted as a condition of the City's three-year proposal[;] therefore, this three year proposal is contingent upon, and subject to, approval by the SDCERS Board of Trustees of an adjustment to the "trigger" provisions contained in the Manager's Proposal.[256]

Thus, the Board was again placed in a position of being forced to veto benefit enhancements to System members should it decide the contribution relief that came attached to these benefits unacceptably threatened SDCERS' financial soundness. This came at a time when the Board was increasingly concerned about the City's failure to pay for benefits granted to SDCERS members. The role played by SDCERS reserves in the growing gap between assets and liabilities was explicitly recognized. At a May 29, 2002, meeting of the Board, its president stated:

> one of the other things that was called into question was whether it was a breach of the Board's fiduciary duty if the Board were to take money from the reserve accounts and move them outside plan assets for contingent benefits or other

---

[255] Memorandum from Cathy Lexin and Elmer Heap to Mayor and City Council (June 14, 2002), *supra*; and Memorandum from P. Lamont Ewell, Assistant City Manager, City of San Diego, to Mayor and City Council, Re: San Diego City Employees' Retirement System Benefit Enhancements (Dec. 6, 2002).

[256] Memorandum entitled "City of San Diego Police Offices Association" (May 9, 2002) at 1.

> purposes that didn't provide the funding of the benefits that the System is inherently responsible for paying.[257]

Mr. Vortmann, by this time a member of the SDCERS Board, expanded on this theme. After noting with approval the Board's efforts to formalize the status of certain contingent benefits, he commented:

> However, the Board must constantly reconcile [this effort] to the Board's primary mission to insure [sic] there are adequate assets to pay off all the future benefits to both current retirees and current employees when they become retired. The Board needs to assure that the Board is getting the plan sponsor to contribute adequate cash to the Plan the Board administers. For several years now, the Board has been approving an actuarial report that has in its wording: the funding objective of the retirement system is to establish and receive contributions expressed as a percent of active member payroll which will remain approximately level from year to year and will not have to be increased for future generations of citizens. The Board adopts this each year but doesn't follow it. Every effort the fund has to pay a contingent benefit creates a bigger departure from achieving that funding objective. He stated he doesn't begrudge anybody any benefits. However, he is very concerned that for various reasons the Board has continued to create a situation where the City is not paying to the trustees of this Board the cost that the City is incurring each year. The City is purposely pushing out onto future taxpayer's payments for services they are incurring today.[258]

On the same day, Michael Uberuaga, who had succeeded Mr. McGrory as City Manager, appeared before the SDCERS Board and stated that the City intended to seek a modification to MP1 lowering the trigger provision from 82.3% to 75%. On June 10, 2002, he submitted a written proposal requesting that modification to MP1, as well as the Board's agreement that, should the funded ratio decline below the new floor, the City would have a five-year period to ramp up to the full PUC rate.[259] His expressed reasons for this request included the terrorist attack of September 11, 2001, the collapse of the dot.com economy, raids by the State of California on San Diego revenues, and the benefit enhancements mandated by the *Corbett* settlement. He stated that the cost of the benefit enhancements coming out of the meet and

---

257 Minutes of SDCERS Special Board Meeting, at 6 (May 29, 2002) (remarks of Mr. Pierce).

258 *Id*. at 20-21 (remarks of Mr. Vortmann).

259 Memorandum from Michael T. Uberuaga, City Manager, to San Diego City Employees' Retirement System Board of Administration, Subject: Proposal of the City of San Diego Regarding Employer Contribution Rates, Health Insurance and Reserves, at 2 (June 10, 2002). The exact language of this proposed provision was:

> If the actuarial rate falls below the floor in any year, the City will increase its contribution rate on July 1 of the following year by an amount equal to one-fifth of the amount necessary to reach the full actuarial rate. The City will pay this increased amount for each of the subsequent four years in order to achieve the full actuarial rate over a five year period.

confer process, estimated at 1.52% of payroll, would be incorporated in the City's contribution levels, which would otherwise continue to follow the schedule provided by MP1.

### B. SDCERS' fiduciary counsel and actuary recommend against the first iteration of MP2

The SDCERS Board sought advice from its fiduciary counsel and actuary, and it quickly became apparent that neither would approve the proposal without significant modification. Fiduciary counsel Constance Hiatt and Robert Blum of Hanson Bridgett, in a June 12, 2002 draft letter to SDCERS, described the new Manager's proposal as, in essence, a request that the retirement system give up something of value – the protection of the 82.3% floor – in exchange for nothing. Unlike previous fiduciary counsel, they did not consider the contingent benefit enhancements as an adequate *quid pro quo* in determining whether the SDCERS Board had been offered an acceptable bargain on behalf of System membership. Rather, they focused exclusively on the effect the proposal would have on the financial soundness of the System.

They began their draft opinion letter by noting that the City had been contributing to SDCERS at a level below the actuarial rate since July 1, 1997, and that the disparity between the actuarial rate and the paid rate was increasing. For FY 2003, the City's contributions, pursuant to the first Manager's proposal would be 10.44%, a full 5.26% below the actuarial rate of 15.59%. To date, MP1 had cost SDCERS $90 million in foregone City contributions, including interest. Further, they noted that the anticipated funded ratio at June 30, 2002 was approximately 82.3% – the trigger level for MP1.[260] This would represent a decline of approximately 7.6% over the current valuation.

Ms. Hiatt and Mr. Blum interpreted the trigger mechanism, in accordance with its actual wording, to require that the City make a one-time payment to restore the funded level to the specified floor. Offering the example of a decline in the funded ratio to 80.0%, they estimated that this would require a contribution of approximately $75 million above the scheduled amount. Their letter notes that the new Manager's proposal would allow the City to escape its obligation to make such a balloon payment. Counsel viewed this as a sign that MP1 had proven unworkable. At the time MP1 was under consideration, the City had represented that it would address any potential balloon payment situation by increasing its payments to the System. But, in the event, the City had failed to do so, instead citing financial hardship and requesting additional leniency from SDCERS. In counsel's view, this signaled deterioration in San Diego's financial situation that should be of concern to the Board.

---

[260] The actuarial valuation would not be completed for many months and would then conclude that the funded ratio at June 30, 2002 was 77.3%. Neither this nor the 82.3% projection in counsel's letter included the additional cost of approximately 2.5% of payroll that would result from factoring in the contingent element of the *Corbett* settlement.

More generally, counsel addressed the proposal as a request by a borrower (the City) for a credit accommodation from its creditor (SDCERS), and found little to recommend it from the creditor's standpoint. "Viewing the City as a 'borrower,' as the Board did in 1996, the City is requesting more favorable terms even though its 'debt' is greater than in 1996 and the original deal objective was not reached."[261] Counsel found that the proposal would weaken the protection to the System provided by the trigger mechanism – which the letter notes was of particular significance to the System's actuary in approving MP1 – without providing any mitigating benefits.[262]

The Hanson Bridgett letter rejects the argument that additional benefits could, in and of themselves, constitute an acceptable *quid pro quo* for the additional "flexibility" in scheduled contributions requested by the City. Although "the courts have indicated that the impairment of the vested right to a soundly funded retirement system can be mitigated by providing comparable new benefits," Counsel concluded that this doctrine goes only to the employer's contractual obligations and not the Board's fiduciary duty to act in a "prudent" fashion. Raising obliquely the perverse incentive created by the benefits-for-contribution-relief aspect of MP1, Ms. Hiatt and Mr. Blum pointed out that, if this were a permissible approach:

> each time [an employer] persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. This would not pass elementary actuarial requirements. Instead, as set out in the Municipal Code, whenever benefits are increased they should be paid for in accordance with the standard actuarial practice, so normal cost is paid currently and past service costs amortized over an appropriate number of years…[263]

In considering what *would* justify the requested rate relief, counsel suggested: "the Board may wish to consider a lower 'trigger' point if there were material increases in the City's scheduled contributions, so the funding level of SDCERS is substantially strengthened on a current basis." Fiduciary counsel also urged that the Board ensure that all benefit increases (past, present and future) be reflected in the City's contribution rate. This was stated to be necessary to bring the City into compliance with Section 24.0801 of the Municipal Code, which required that

---

[261] Draft letter from Constance M. Hiatt and Robert Blum, Hanson Bridgett, to Lawrence Grissom, SDCERS, at 7 (June 12, 2002).

[262] Hanson Bridgett appears to have derived little comfort in the trigger mechanism as a safeguard against under-funding. The letter notes that the floor level is most likely to be hit during periods of economic downturn, when the City will be least able to make additional contributions. Its letter also points out that the 75% level proposed by the Manager's Office is substantially below that used by ERISA "to determine when the employer must make additional contributions to certain private sector plans." *Id.*

[263] *Id*. at 15.

it contribute an amount to SDCERS that covered the normal cost of the System, plus the amortization of past service liabilities over no more than 30 years.[264]

The letter concluded that, should the Board approve the proposal in its current form, a court might conclude that: "the decision was not a proper exercise of the Board's fiduciary responsibilities based on the facts before the Board and the actuaries [sic] opinion to the contrary." The daunting list of remedies a court could then impose included:

> ordering the Board to reconsider its decision; ordering members of the Board who were directly involved in the bargaining process to recuse themselves from any reconsidered decision; ordering the permanent removal from the Board of some or all of its members… [and] imposing personal liability on each member of the Board who voted to approve the proposed amendment…[265]

The SDCERS actuary, Mr. Roeder, was, if possible, less favorably disposed toward the initial iteration of the new Manager's proposal than was SDCERS' fiduciary counsel. His primary objection was that the weakening of the trigger provision transgressed the intended limits of "corridor funding." In materials provided to the SDCERS Board, Mr. Roeder pointed out:

- On an EAN basis, SDCERS had one of the lowest funded ratios in California;
- The gap between the actuarial rate and the City contribution rate was increasing;
- The SDCERS funded ratio was at its lowest point since the 1980s; and
- At the next evaluation, it was expected to fall further.

In a slide, colloquially entitled "Which Way Ya Goin'?," Mr. Roeder illustrated the widening gap between SDCERS' assets and liabilities under two diverging arrows labeled "enhanced benefits" and "contribution relief." Among the listed benefits were enhancements to the pension formula stemming from the 2000 and 2002 labor negotiations. Specified items of contribution relief were: the adoption of the PUC funding method; the resetting of the 30-year amortization period in 1991; the lowered contribution rates under MP1; and the phase-in of certain changes in actuarial assumptions.[266] He provided graphs to illustrate the growing

---

[264] *Id*.

[265] *Id*. at 16-17.

[266] In an interview with Vinson & Elkins, Mr. Roeder stated that the assumptions to which he referred involved the reduction in City contribution rates reflecting the fact that certain employees on whose behalf contributions were made would not become vested members of the System. The number of such employees had been overestimated in previous years, causing

disparity between the City's contributions and the PUC rate and the yet greater disparity between those contributions and the EAN rate.

Mr. Roeder had also voiced criticism of certain aspects of SDCERS' funding situation in his actuarial valuation for the fiscal year ended June 30, 2001, completed in early February 2002 and available to the public as an attachment to the SDCERS CAFR for that year. He referred in particular to the damage to the soundness of the System that could result from the misuse of the concept of surplus earnings:

> We offer comment related to disposition of Surplus Undistributed Earnings. Suppose that the System earns 0% in the current fiscal year and 16% next year. Our understanding is that a contribution to Surplus Undistributed Earnings will be made for the 16% year even though there will be no net gain from investments over the two-year period. If extra benefits are conferred in the "good" years, then the median, "after the fact" investment return to finance all other benefits should theoretically be correspondingly lower. We will revisit this issue in the experience investigation.

In all previous years after the adoption of MP1, the Gabriel Roeder Smith & Co. annual valuations had concluded that the System was, as a general matter, actuarially sound. In the 2001 valuation, however, this language included an added element of caution:

> Overall, the financial condition of the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. However, we want all parties to be acutely aware that the current practice of paying less than the computed rate of contribution or pickup will help foster an environment of additional declines in the funding ratios in absence of healthy investment returns.[267]

Also opposed to the amendment to MP1, as initially proposed, was San Diego attorney Michael Aguirre, who, in a letter dated June 20, 2002, threatened the Board and its members with litigation should they approve the proposal as presented. Mr. Aguirre objected to the reduction of the trigger level and expressed skepticism that the City would honor even the reduced level should it be breached. He opined that the SDCERS Board should follow the advice of its fiduciary counsel, Hanson Bridgett, and reject the proposal. "This advice is based

---

an excessive discount to the City's contribution rate. Rather than incorporate this in a single upward adjustment to the City's rates, the SDCERS Board had agreed that it would be phased in over a five-year period.

[267] 2001 Actuarial Valuation, supra note 221, at cmt. M, at 17.

on the most fundamental law of trusts," he wrote, "a trustee shall not dissipate the *res* of the trust."[268]

C. Further iterations of the second Manager's proposal

Given the opposition of its fiduciary counsel and actuary, the Board communicated to the Manager's Office that it would not consider the proposal as it then stood. Mr. Uberuaga and his staff responded with two significant modifications. Rather than retain the MP1 schedule of .50% annual increases in City contributions, the Manager proposed to double the increase to 1% of applicable payroll. The amended proposal further provided that the agreement would sunset in FY 2009, at which time the City would pay the full PUC rate – however much progress it had or had not made toward that goal through seven years of stepped-up contributions. The City's contributions would thereafter continue to increase by .50% a year until the EAN rate was achieved, as under MP1.[269] The second iteration of the new proposal, however, retained the proposed reduction of the funding floor to 75% of the AAL.[270]

At the June 21, 2002 meeting of the SDCERS Board, its actuary acknowledged the improvements made in the revision to the new Manager's proposal, but again pointed out in detail the deterioration in the System's funded status, which was even more pronounced when measured under the EAN method. He indicated as causes of the funding shortfall changes in System demographics, substantial additional benefits and the five years of contribution relief provided by MP1. Under these circumstances, he remained unconvinced that lowering the funding trigger was an appropriate action.

> With the original Manager's Proposal, Mr. Roeder said he had similar misgiving as he has today. However, he was more comfortable with the [original] proposal because of the 82.4% [sic] floor. With that floor, it seemed to provide the necessary prudent protection to the System. However, he is concerned with the new proposal because of the coupling of benefit increases to funding, along with the significant change from the 82.3% safeguard to 75%.[271]

Mr. Roeder also objected to the involvement of the Board in the benefit-granting process, a criticism that was voiced in the Hanson Bridgett letter of June 12, 2002, and would be repeated

---

[268] Similarly, *see* Minutes of SDCERS Board Meeting, at 21 (July 11, 2002) (remarks of Mr. Aguirre).

[269] Initial ambiguity on this point was addressed by the Manager's Office in: Memorandum from Bruce Herring, Deputy City Manager, to Lawrence Grissom, Retirement Manager, SDCERS, Re: City's Proposal Regarding Contribution Rates and Reserves and Responses to Questions from SDCERS Trustees (July 1, 2002).

[270] Memorandum from Michael T. Uberuaga, City Manager, to SDCERS Board of Administration, Re: June 18, 2002 Modification to the Proposal from the City of San Diego Regarding Employee Contribution Rates, Health Insurance and Reserves (June 18, 2002). *See also* Minutes of SDCERS Board Meeting, at 16-17 (June 21, 2002) (remarks of Mr. Herring).

[271] Minutes of SDCERS Board Meeting, at 17- 19 (June 21, 2002).

by several Board members. He estimated that the funded ratio at the end of the current fiscal year would be between 80% and 84%.[272] Thus, he was unable to determine at that time whether the trigger provision of MP1 would be hit at June 30, 2002.

If Mr. Roeder was not supportive of the City Manager's proposed modification to MP1, the Manager's Office was not enthusiastic about Mr. Roeder's presentation to the Board. Deputy City Manager Bruce Herring, in an individual discussion with Mr. Roeder after his presentation, criticized him for opining on policy concerns that Mr. Herring believed to be outside the actuarial sphere.[273] In an interview with Vinson & Elkins, Mr. Roeder said he felt a degree of pressure to support the proposed modifications to MP1, but also stated that this did not influence his eventual willingness to describe as "reasonable" the final iteration of MP2.

In a lengthy discourse before the Board, fiduciary counsel Robert Blum contrasted the present situation to that in 1996, when MP1 was approved. He pointed out that the substantial surpluses that supported the adoption of MP1 no longer existed. He cautioned the Board that it should consider carefully the effect on the System's financial status of the PUC funding method and the contingent component of the *Corbett* settlement.[274] In addition, like Mr. Roeder, he advised the Board to: "decouple negotiations and fiduciary decisions. One of the reasons this is such an awkward situation is that these two things have been brought together, which is unfortunate."[275] In response to a question from trustee Diann Shipione, Mr. Blum stated that it was also incumbent upon the Board to examine the creditworthiness of the City in connection with any agreement that increased the City's future payment obligations.[276]

The SDCERS Board "trailed" the new Manager's proposal pending receipt of additional information. On July 1, 2002, Deputy City Manager Bruce Herring submitted a memorandum clarifying certain aspects of the proposal, responding to questions from Mr. Vortmann and providing information on the City's financial situation.[277] The exchange with Mr. Vortmann can be described as unhelpful answers to contentious questions. For example, in reply to Mr. Vortmann's assertion that the "the City is addicted to a 'give now, pay later' approach that burdens future taxpayers," Mr. Herring wrote: "The City disagrees with this perception. The City has endeavored to maintain an adequately funded retirement system. Employee retirement

---

[272] *Id*. at 18. Mr. Roeder clarified that this "guess" assumed PUC method funding and did not reflect *Corbett* "contingent" liability. *Id*. at 19.

[273] Mr. Herring was no longer a member of the SDCERS Board at this time, having been succeeded by Ms. Lexin as the City Manager's designee. He took the lead role in presenting the second Manager's proposal to the SDCERS Board.

[274] Minutes of SDCERS Board Meeting, at 24-26 (June 21, 2002).

[275] *Id.* at 26.

[276] *Id.* at 30-31.

[277] Memorandum from Bruce Herring, *supra* note 253.

benefits are by their very nature paid in the future, when employees retire, for services performed today." The financial information consisted of reports from rating agencies and the most recent auditor's report on the City's annual financial statements.

It became apparent that the System's actuary and fiduciary counsel, and consequently a majority of the Board, would not support any change to MP1 that did not retain the 82.3% funding floor. Recognizing this reality but still eager to obtain relief from the "hard" aspect of the floor provision, Cathy Lexin and Deputy City Attorney Elmer Heap requested authority from the Mayor and Council to modify the proposal to leave undisturbed the present floor but permit the City a five-year ramp-up to full actuarial funding should that level be breached. "Given the importance of avoiding a [sic] immediate full rate implementation (versus five year phase in)," they wrote, "it is recommended that the Council authorize the staff to agree to this modification should the proposal currently before SDCERS not prevail." Ms. Lexin and Mr. Heap stated this was necessary because the Board's fiduciary counsel had written an opinion "clearly erring on the side of caution due to the fact that counsel, from his perspective, did not have time to evaluate the proposal sufficiently to render final advice."[278]

At its July 11, 2002 meeting, the Board addressed what had devolved into an offer from the City to double its yearly contribution increases to SDCERS over the MP1 levels in exchange for relief from having to make a balloon payment to SDCERS should the trigger provision of MP1 be engaged. Most Board members presumably also believed that the package of benefits agreed to in the meet-and-confer process remained contingent on the Board's approval of the new Manager's proposal (now "MP2"). In fact, the City Council, in closed session, had determined to grant the specified benefits whether or not SDCERS agreed to MP2. According to statements made by Cathy Lexin to Vinson & Elkins, the purportedly contingent nature of these benefits was now no more than a bluff. Shortly before the meeting, the City once again entered the TANS Market without disclosing concerns about the MP1 trigger, the proposed changes to MP2, or the scope of the new benefits package.

In that meeting, Mr. Roeder projected, through FY 2009, the potential effects of the new Manager's proposal on SDCERS' funded level and the City's contribution rates.[279] In general, his conclusion was, as might be expected, that the second iteration of the proposal provided greater contributions from the City than did the MP1 rates unless and until the trigger provision engaged, at which point its five-year ramp up to full PUC funding would result in lower contributions than the immediate restoration of actuarial funding. He estimated that this iteration of the proposal reduced by 75% the additional contribution shortfall that would have resulted

---

[278] Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Mayor and City Council, Re: Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS (July 8, 2002).

[279] We express our appreciation to Gabriel, Roeder, Smith & Co. for providing these and other actuarial materials to Vinson & Elkins in connection with this inquiry.

from the initial version. He also noted: "the modified proposal will provide added contributions after 2009 in an effort to attain Entry Age Normal Funding levels."

Mr. Roeder also provided projections of the System's funded ratios and the City's contribution rates under earnings scenarios other than the 8% assumed rate of return. He calculated that with a 4% rate of return, the SDCERS funded ratio would decline to approximately 60% by June 30, 2009, whether or not SDCERS adopted MP2. With a 12% rate of return, the funded ratio would increase to approximately 100%. This exercise, whatever the intention at the time, illustrates that the difference in City contributions between MP1 and MP2 rates, as it affected the SDCERS funded level, would likely be far less significant than the role of market forces over the same years.

Thus, the SDCERS Board was faced with a difficult question of judgment. Depending on whether the 82.3% floor was breached and, if so, when and by how much – as well as which interpretation of MP1's trigger provision would then be applied – MP2 could result in greater or lesser payments by the City than the existing agreement. Although the SDCERS actuary declined to predict whether the funded level would fall below the 82.3% floor during the next two years,[280] the substantial decline in the System's funded ratio between FY 2000 and 2001, and the continued bear market through FY 2002, made that appear likely. Indeed, that was the very reason the City sought relief from the "hard floor" provided by MP1.[281] It was, therefore, probable that the proposed modification to the 1996 agreement would result in at least a modest reduction in City contributions over a several year period. Weighed against this, however, were the problems that would result should the City become liable to its retirement system for an enormous balloon payment as early as July 1, 2003. The layoffs and other expense reduction measures that would follow a City budgetary crisis would negatively affect many elements of SDCERS' membership.[282]

After fiduciary counsel Robert Blum indicated that he could not support reducing the trigger level to 75%, but might find acceptable a proposal that would leave the 82.3% floor in place while allowing the City a ramp-up period to achieve that level, Board member Ronald Saathoff, as anticipated by the Manager's Office, made a motion to approve MP2 contingent

---

280 Minutes of SDCERS Board Meeting, at 19 (July 11, 2002).

281 As Ms. Lexin stated: "her understanding is that the City is before the Board with this request because… there was a good chance we would hit the floor, and that the City would be faced with a $25 million hit to next year's budget." *Id.* at 25. ***See also id.*** at 26 (remarks of Mr. Blum) ("He believes there is a high probability that the 82.3% trigger will be hit in a couple of years….").

282 It is notable that the City's municipal unions supported MP2. *Id.* at 22.

upon it being so modified.[283] The Board passed his motion, additionally contingent upon review and approval by the SDCERS actuary and fiduciary counsel.[284]

D. The final positions of SDCERS' fiduciary counsel and actuary on MP2

As foreshadowed in Mr. Blum's remarks at the Board's July 11, 2002 session, Hanson Bridgett eventually opined that approving the final version of MP2, which retained the 82.3% trigger, would not cause the Board to violate its fiduciary responsibilities. Counsel's legal analysis concluded:

> In these circumstances, it is reasonable for the Board to have decided that this Agreement is the best way to achieve long term financial integrity and soundness of SDCERS. The Board has diligently examined the alternatives presented by the City and requested input from its outside experts. The Board provided a full and reasoned consideration of the facts and issues before approving the Agreement. Therefore, it is our opinion that it is reasonable for the Board to enter into the Agreement in the exercise of its fiduciary responsibilities.[285]

Moreover, actuary Rick Roeder gave his somewhat grudging approval (or at least statement of non-opposition) to the proposal in a November 5, 2002 letter to the SDCERS Board. He made several points. First, he stated that it would be preferable for the City to begin contributing at the full PUC level as soon as possible. He noted that under MP2 this goal would be accomplished more rapidly than under MP1 only so long as the 82.3% trigger was not hit. He considered it "likely that the 82.3% trigger will be hit by June 30, 2003." Therefore, he concluded:

- From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger… [and]

---

283 *Id*. at 27, 31 and 33.

284 Eight Board members voted to approve Mr. Saathoff's motion: Trustees Casey, Vattimo, Pierce, Saathoff, Wilkinson, Torres, Webster, and Lexin. Mr. Rhodes and Mr. Crow voted in opposition. Mr. Garnica abstained and Mr. Vortmann and Ms. Shipione left the meeting prior to the vote. Ms. Shipione had previously expressed her opposition to this measure. Memorandum for Diann Shipione, Trustee, SDCERS, to SDCERS Board, Re: Proposed Amendment to the 1997 [sic] Manager's Proposal, Issue #3, To Lower the Funding Ratio From 82.3% to 75% (June 20, 2002).

285 Letter from Robert Blum and Constance Hiatt, Hanson Bridgett, to Frederick W. Pierce, IV, President, SDCERS (Nov. 18, 2002). In June 2004, SDCERS filed an action in state court against Hanson Bridgett claiming, among other things, that it committed malpractice in advising the Board that it could properly approve MP2. ***SDCERS v. Hanson, Bridsen, Marcus, Vlahus & Rudy,*** Civ. No. GIC-831938 (Cal. Sup. Ct., filed June 25, 2004). Lewis, "Officials: Pension fund agreement was a mistake. Board sues former lawyers for malpractice, fraud," ***San Diego Transcript***, Aug. 23, 2004. ***SDCERS v. Hanson, Bridgett, Marcus, Vlahos & Rudy,*** Civ. No. GIC-831983 (Cal. Sup. Ct.) (filed June 25, 2004). *As* of this writing, the summons and complaint in that matter have not been served on the defendants.

- From a pure actuarial viewpoint, we would prefer it if the Board did not provide a transition period to the City to reach the full PUC rate and then move to the full EAN rate.[286]

Nevertheless, he opined that the matter ultimately lay within the sound discretion of the Board. He concluded:

> If the Board decides that a transition period is needed, then the transition period chosen is reasonable as the City will commit to contribute an additional amount each year starting in July 2004; if the 82.3% accelerated funding trigger is hit the ramp up to full PUC rates will be accelerated; the City will contribute the full PUC rate starting in July 2006; the entire agreement will sunset on June 30, 2010; and the City and Board agree to move to the EAN rate rapidly after that date.[287]

In an interview with Vinson & Elkins, Mr. Roeder stated that his decision to provide this letter was partly a result of the willingness of Mr. Blum, whom Mr. Roeder regards as highly experienced counsel, to approve MP2. He also indicated that he viewed the retention of the 82.3% trigger – if no longer a "hard" floor – as a critical factor. In response to the question whether he felt pressure from any source to approve MP2, he stated in a June 21, 2004 e-mail to Vinson & Elkins:

> Not really pressure, but I did want to stick in a sentence in our November 2002 letter to the Board of Ret[irement] saying that MP2 [together with MP1] could result in 12 consecutive years of paying less than the actuarial rate. Bob Blum asked me not to do so and we decided not to include [it]. We had earlier said in a public meeting that they were entering a "Brave New World" in terms of meeting provisions, so we felt that this was somewhat apparent anyhow.

The City and SDCERS entered into a formal agreement on November 18, 2002, which, in essence, embodied the City Manager's proposal as modified by Mr. Saathoff's July 11, 2002 motion. This followed majority votes by the SDCERS Board and the City Council approving the agreement. Citing the "undue hardship that would be imposed on the City if the Board were to require that the City immediately increase its contributions to the full [PUC] rate," it provides a table of City contribution rates through FY 2009, after which the agreement would sunset.[288] These rates incorporated an annual increase of 1.0% of payroll, plus the actuarial cost of the enhanced benefits from the 2002 meet-and-confer process. The City and SDCERS specifically

---

[286] Letter from Rick Roeder, Gabriel, Roeder, Smith & Co., to SDCERS Board, Re: Agreement Regarding Employer Contributions Between the City and SDCERS (Nov. 5, 2002).

[287] *Id*. at 2.

[288] Agreement Regarding Employer Contributions Between the City of San Diego and the San Diego City Employees Retirement System, (Nov. 18, 2002).

agreed that future benefits granted by the City would be reflected in increases to those rates. However, changes in actuarial assumptions during the MP2 period would not affect the City's contributions until FY 2010. In the event that SDCERS' funded level fell below the 82.3% floor, the agreement provided a mechanism to amortize the difference between the contract rate and the PUC rate over the remaining life of the agreement.

The provision requiring the City to continue ramping up its contributions in annual .50% increments until it achieved EAN funding was not included in the final agreement. Instead, MP2 provided:

> … the Board will take all necessary and appropriate actions, starting with determining the City's contribution rates beginning on July 1, 2009, to rapidly bring the City's contributions to SDCERS to the contribution rates determined under the entry age normal funding method.

In a provision intended to provide additional comfort to the Board, it was empowered to "nullify this Agreement to the extent required by its duties established under the California Constitution…" This would allow the Board to terminate the agreement in the event that it was later determined by counsel not to comport with any provision of the state constitution.[289]

The agreement of the Board to enter into the second Manager's proposal has been the subject of significant criticism. Most notably, SDCERS trustee Diann Shipione, who was one of two Board members to vote against MP2, has asserted that it represents a breach of the fiduciary duty of Board members.[290] In a December 31, 2002, letter to (then) Assistant City Manager Lamont Ewell, Ms. Shipione traced the various measures taken by SDCERS to accommodate agreements between the City and its labor unions and, more generally, to postpone City contributions to SDCERS.[291] In addition to MP2, she was particularly critical of the decisions by the SDCERS Board to move from EAN to PUC method funding, to allow years of contribution relief through MP1, and to exclude the "contingent" aspect of the *Corbett* settlement from the actuary's annual calculation of the AAL. As mentioned above, all of these actions – particularly when taken in sum – did indeed contribute to the erosion of SDCERS' funded status over a period of many years. If efforts were already underway to address the declining financial soundness of SDCERS, Ms. Shipione brought public attention to this issue and, with it, additional political impetus toward more expeditiously confronting problems within the System.

---

289 Further comfort was provided by the City Council in a special measure providing indemnification to the members of the SDCERS Board in connection with all claims arising from its agreement to enter into MP2.

290 *See, e.g*., D. Shipione, ***The city retirement system underfunding makes it a disaster waiting to happen*** San Diego Union Tribune, Apr. 9, 2003.

291 Letter from Diann Shipione Shea to P. Lamont Ewell, Assistant City Manager, City of San Diego, Re: Your Memorandum of December 6th, 2002, Regarding City's Under-funded Pension Plan (Dec. 31, 2002).

It is beyond the scope of this Report to opine whether the Board abused its discretion by acceding to the second Manager's proposal. As we have already noted, however, the Board was placed in a difficult and fundamentally inappropriate role with respect to both Manager's proposals – by being made an inadvertent party to labor negotiations. Any action taken under those circumstances would have proved controversial. Moreover, the Board knew that SDCERS' membership consists of individuals who are, to one degree or another, economic dependents of the City of San Diego. The City's financial problems were, therefore, of potential consequence for many of the individuals to whom the Board owes a fiduciary duty. The possibility that its actions could cause a fiscal crisis for the City thus complicated the choices it was called upon to make.[292] We also note that the Board's decision to accept MP2 was fully considered and approved by counsel with a sophisticated understanding of the System's funded status and applicable fiduciary standards. Moreover, its actuary advised that it would act reasonably in approving the final version of the proposal.

At the same time, the Board gave up a position of extraordinary leverage by agreeing to MP2. With the trigger mechanism strongly implicated by the dramatic decline in the System's funded status, it is likely the Board could have insisted on additional concessions from the City to make up for lost ground in employer contributions. For example, it could have set a five-year (or less) deadline to achieve full EAN-method funding, whether or not the MP1 trigger was hit, and been confident that the City would have acquiesced to that proposal. That it chose not to do so may reflect the basic structure of the Board, comprised of individuals representative of various political constituencies, as established by the City Charter.

E. Disclosure failures relating to MP2

In its 2002 CAFR, the City provided no disclosure concerning the adoption of MP2. Although MP2 was not approved and did not take effect until the following fiscal year, under these circumstances, disclosure of this highly significant change to the City's obligations to its retirement system was indicated to prevent the disclosure actually made from being misleading. The adoption of MP2 had essentially rendered obsolete the City's footnote disclosure concerning its negotiated schedule of contributions to SDCERS. Thus, it should have amended that disclosure to reflect changed circumstances.

In addition, the events of that year placed the historical inadequacies in the City's disclosure about MP1 in stark relief. If the disclosure in previous CAFRs – going back to FY 1997 – had failed to alert the reader to *potential* risks created by the City's failure to pay

[292] During the Board's deliberations over MP2, Board member Terri Webster stated: "If the Board stays with the 97 MP, it could result in the City paying a balloon payment of up to $26 million in less than twelve months. Having to come up with this type of payment could place public services at risk, force layoffs or force the City to issue pension obligation bonds." Minutes of SDCERS Board Meeting, at 36 (July 11, 2002).

actuarial rates while granting increased benefits, those two factors had now contributed to a significant ***realized*** decline in the System's funded status. The City Auditor's Office was aware of this situation, and was concerned that the MP1 trigger level might be hit as early as the June 30, 2002 valuation. Also, by the time the 2002 CAFR was released, the City Auditor's Office had examined the reserves mentioned in Footnote 12 to the City's FY 2002 financial statements, and had concluded that they did not effectively cover the contribution shortfall resulting from MP1. This was all the more evident because the cumulative shortfall now greatly exceeded levels projected at the time MP1 was approved. Nevertheless, the City failed to amend its disclosure to reflect its increased knowledge of problems with the funding of its retirement system.

In the 2002 CAFR, a change was made to the description of the actuary's views of "corridor funding" that imperfectly addressed problems with that disclosure. According to the staff accountant within the City Auditor's Office responsible for compiling SDCERS' financial statements,[293] she faxed and e-mailed Mr. Roeder that section of the pension footnote for his comment.[294] When she received no response, she telephoned him and asked if he was still awaiting a decision whether GASB would accept "corridor funding" as one of its "formally sanctioned" methods. He told her that this was no longer the case and, as a result, that statement was deleted from the footnote.[295] Left untouched, however, was the statement: "The actuary believes the Corridor funding method is an excellent method and that it will be superior to the PUC funding method." In a mark-up of the relevant footnote he provided in connection with a subsequent inquiry into inaccuracies in the City's financial statements, Mr. Roeder indicated that this statement was no longer correct because of the weakening to the "corridor funding" mechanism resulting from MP2.

Finally, various clerical errors were made by the City Auditor's Office and others with respect to the disclosures required under GASB 27 concerning the City's contributions to SDCERS. These errors are addressed in detail below.

The events of 2002 touched other portions of City disclosure. Under the heading "Labor Relations," the City's Appendix A historically discussed pay increases coming out of the meet and confer process, including providing those to go into effect in future years. Beginning in the 2002 offerings of the City's securities, the amount of employee pick-up was also disclosed. The tradition of not disclosing the parameters of the overall retirement benefits package continued.

---

[293] Financial statements for the City's numerous funds, including SDCERS, are prepared separately by the Auditor's Office and rolled up into the City's comprehensive financial statements.

[294] Mr. Roeder stated to Vinson & Elkins that he has no recollection of these communications.

[295] This deletion, however, was not picked up in the 2002 financial statements for the San Diego Metropolitan Wastewater Utility. This failure to reconcile the City's disclosure with that of its enterprise funds revealed a failure of internal controls discussed below.

No disclosure was made in the discussion of current and future City budgets either. Only in the cover letter to the City's CAFR, which is not included in the Official Statement, could a reader find information about the increased Retirement Benefit Calculation factor. To readers of City Official Statement, the admonitions and concerns of the Blue Ribbon Committee as to the need to appreciate the impact of additional benefits grants to future City budgets went fresh and unheeded. The City Manager's office was intimately familiar with the negotiations and aware of the Blue Ribbon report.

## X. The Gleason Litigation

In January 2003, a class action suit was filed against the City and SDCERS relating primarily to alleged breaches of law and fiduciary duty in connection with the negotiated departures from actuarial funding represented by the two Manager's proposals. Two other suits followed, asserting additional violations relating to the City's relationship to its retirement system.[296] Among the allegations were:

- The City violated Section 143 of the City Charter by paying less than the actuarially required rate to SDCERS, and less than an amount substantially equal to that paid by employees;

- The City violated former SDMC Section 24.0801 by failing to pay the actuarially required rate;[297] and

- Certain SDCERS Board members violated the California Political Reform Act and Section 1090 of the California Government Code by agreeing to MP2 in order to obtain additional retirement benefits for themselves as members of the System.

No CAFR has been issued by the City after the instigation of these actions.[298] The City, however, described as follows the initial *Gleason* complaint (it was not a named party in the other two actions) in the various offering documents it issued subsequent to that filing:

---

[296] *Gleason v. San Diego City Employees' Retirement System* (San Diego County Super. Ct.) (No. GIC 803779); *Gleason v. San Diego City Employees' Retirement System* (San Diego County Super. Ct.) (No. GIC 810837); and *Wiseman v. Board of Administration of the San Diego City Employees' Retirement System* (San Diego County Super. Ct.) (No. GIC 811756).

[297] That provision of the Municipal Code was amended in November 2002 to require that the City contribute to SDCERS in accordance with the schedule provided in MP2. Previously, it stated:

> Commencing July 1, 1954, the City shall contribute to the Retirement Fund in respect to members a percentage of earnable compensation as determined by the System's Actuary pursuant to the annual actuarial evaluation required by Section 24.0901.

[298] It is anticipated that the 2003 CAFR will be issued following the completion of a re-audit, presently in progress, of the City's financial statements for that fiscal year.

> On January 16, 2003, a class action complaint (*Gleason v. City of San Diego, et al.*) for declaratory relief was filed in the Superior Court against the City, the City's Employee's Retirement System (SDCERS), and certain named members of the SDCERS board of administration. The plaintiffs, former City employees who receive City retirement benefits, allege that as a result of recent actions taken by the defendants, the SDCERS trust fund has an unfunded accrued liability of $720 million, and that by 2009, the City will owe approximately $2.8 billion to SDCERS, with an annual City budget expense of more than $250 million. In addition to the declaration of their rights, plaintiffs ask for restitution to the SDCERS trust fund, an injunction prohibiting the City from unlawfully underfunding the trust fund in the future, money damages, attorney' fees, and other relief. [299]

SDCERS and the City litigated the matter for over a year, then, in August 2004, entered into a settlement with the plaintiff class on terms that bolstered the financial stability of the System. The settlement essentially obviated any future operation of the Manager's proposals, providing among other things:

- The City shall pay the full ARC (calculated under the PUC method) beginning FY 2006;[300]

- The City shall pay $130 million for its FY 2005 contribution to the system; and

- The City shall provide a total of $500 million in security interests in real property to secure its required contributions to SDCERS through FY 2008. The security interests will be released in the amount of $125 million annually through FY 2008 as the required contributions are made.

The agreement further provides that the amortization of the System's UAAL will be reset at June 30, 2004, based on a new 30 year period. However, after FY 2008, the City, absent an amendment to the City Charter, must contribute to SDCERS at the rates calculated by the SDCERS actuary and approved by the SDCERS Board. This may involve changed actuarial assumptions or yet another, and potentially shorter, amortization period.[301] A shorter amortization period would, at least initially, act to increase the City's contribution rate.

---

[299] *See, e.g., Official Statement, City of San Diego/MTDB Authority, 2003 Lease Revenue Refunding Bonds*, April 30, 2003, at A-38.

[300] Accordingly, the City agreed to repeal the provisions of Municipal Code ch. 2, art. 4, div. 2, § 24.0801 that conformed the City's contribution obligations to the payment schedule contained in MP2.

[301] We understand that a rolling 15-year amortization period is contemplated. A rolling amortization period, which is acceptable under GASB standards, results in the employer paying a set fraction (here 1/15) of the UAAL every year. Thus the UAAL is never extinguished, unless as a result of factors other than the amortization mechanism.

## XI. The SDCERS Report to the Rules Committee of the City Council in February 2003

The response from SDCERS to the Blue Ribbon Committee's February 2002 report, requested by the City Council, was a full year in gestation. In interviews with Vinson & Elkins, SDCERS administrators Lawrence Grissom and Paul Barnett attributed the delay, in part, to the need to have the 2002 actuarial evaluation in hand before opining on the status of the System and, in part, to the bureaucratic process involved in creating the pronouncement.[302] The June 30, 2002 actuarial evaluation was indeed a significant factor in evaluating the funded status of the System, showing an additional 12.6% decline from the previous year. This made it clear that the MP1 trigger had indeed been hit at June 30, 2002, and, absent the implementation of MP2, would have required a dramatic increase in City contributions beginning July 1, 2004.

History of SDCERS Funded Ratio

| Actuarial Valuation Used | 6/30/95 | 6/30/96 | 6/30/97 | 6/30/98 | 6/30/99 | 6/30/00 | 6/30/01 | 6/30/02 |
|---|---|---|---|---|---|---|---|---|
| Funding Ratio | 86.8% | 92.3% | 94.2% | 93.6% | 93.2% | 97.3% | 89.9% | 77.3% |
| Assets Allocated to Funding (AVA) | $1.380 billion | $1.553 billion | $1.717 billion | $1.85 billion | $2.03 billion | $2.459 billion | $2.526 billion | $2.448 billion |
| AAL | $1.477 billion | $1.682 billion | $1.822 billion | $1.98 billion | $2.18 billion | $2.528 billion | $2.810 billion | $3.169 billion |
| UAAL | $96.3 million | $129.3 million | $105.6 million | $127.5 million | $148.4 million | $68.959 million | $284 million | $720.7 million |

If not expeditiously generated, the report presented to the Rules Committee in February 2003 displayed a reasonable degree of candor. The Report begins with a statement that "[t]he declining investment market over the past three years, along with changes in benefits such as the addition of the Corbett settlement liability, have dramatically impacted the funding level of the Retirement Fund." These factors together with the City's negotiated departure from contributing to the System at actuarial rates had resulted in the System experiencing its lowest funded ratio "in well over a decade, and the compounding effect of a less than full-actuarial contribution policy has impacted the future and current strength of the City's Retirement Fund."[303] That ratio, calculated as of June 30, 2002, was 77%: a decline of approximately 20% over two fiscal years. In an oral presentation made to the Rules Committee on February 12, 2003, SDCERS administrator Lawrence Grissom further cautioned that realized gains through November 30 of the current fiscal year were a negative $55.5 million. He advised: "Our portfolio is, in the common parlance, under water."

Board president Frederick Pierce, in his presentation to the Committee, stated that only 15% of this decline ($102 million with compounding) resulted from the contribution relief

[302] The project also involved comment from the staff of the Offices of the City Manager, Auditor and Treasurer.

[303] SDCERS, *Report to City Council Committee, supra*.

provided by MP1.[304] The remaining 85% he attributed to the bursting of the Internet bubble and the general decline in the securities markets. This position was later asserted by the City in the *Gleason* litigation and in a presentation to the municipal bond rating agencies.[305] This was in conflict with the position taken by the *Gleason* plaintiffs and statements in the press that the System's growing UAAL was primarily the result of the City's failure to contribute to the System at the actuarial rate.

As later, more comprehensive analyses have demonstrated, the fraction of the SDCERS funding shortfall that can be attributed to particular causes largely depends on the way in which the various contributing factors are classified and the time period chosen for the calculation.[306] If the shortfall is defined as the difference between the SDCERS funded level at its 97% peak at June 30, 2000 and its 77% level at June 30, 2002, the decline is indeed primarily the result of extraordinarily poor investment returns over that period.[307] The same could be said for the additional 10% decline in SDCERS' funded ratio the following year.[308]

That simple picture becomes more complex when the time frame is expanded to encompass the entire period from the implementation of MP1 to the end of FY 2003. Towers Perrin and Gabriel, Roeder and Smith & Co. have separately conducted analyses of the factors contributing to the present under-funding over this expanded time frame.[309] Both concluded that the under-funding begun with MP1 was a direct cause of approximately 14-15% of the total funding shortfall – closely in line with the estimate presented to the Rules Committee. Mr. Roeder, at the request of Vinson & Elkins, further estimated that this reflected a 7.4% rate of

---

304 SDCERS administrator Paul Barnett has advised that the $102 million figure is based on actuarially assumed rates of interest. By his calculation, if the effect of the contribution shortfall is analyzed based on the rate of return actually achieved by SDCERS during the relevant period, the dollar amount of the shortfall attributable to City under-funding, with compounding, is approximately $84.8 million. Memorandum from Paul Barnett, SDCERS, to Cathy Lexin, Re: Impact of Manager's Proposal 1 (Aug. 29, 2003). An earlier draft of the SDCERS report to the Rules Committee, however, calculated the total contribution shortfall to be $421.4 million. E-mail from Lawrence Grissom, Retirement Administrator, SDCERS, to Diann Shipione, Trustee, SDCERS, Re: Presentation to the Port (Aug. 25, 2003).

305 Defendant City of San Diego's Memorandum of Points and Authorities in Opposition to Motion for Summary Adjudication of Plaintiffs' First Cause of Action, at 4, *Gleason v. San Diego City Employees' Retirement System* (San Diego County Super. Ct.) (No. GIC803779).

306 *See* Letter from Diann Shipione, Trustee, SDCERS, to Fred Pierce, President, SDCERS, Re: your August 29, 2003 to Port Chairman Van Deventer (Sept. 7, 2003).

307 Gabriel, Roeder, Smith & Co., SDCERS Annual Actuarial Valuation, June 30, 2002 ("2002 Actuarial Valuation"), at 14 (attributing 85.7% of aggregate actuarial loss for year to investment losses).

308 According to an analysis done by the SDCERS actuary for the Pension Reform Commission, however, this factor accounted for from 62-65% of the increase in unfunded liability from July 1, 2000 to June 30, 2003. Letter from Rick Roeder to Members of the Pension Reform Commission (May 18, 2004).

309 These analyses were conducted at the request of the Pension Reform Commission, established in the summer of 2003.

return on the actuarial value of SDCERS' assets for the seven-year period concluding June 30, 2003.[310]

In contrast to the analysis of a shorter time period presented by SDCERS to the Rules Committee, however, the remaining 84-85% of the UAAL increase from FY 1997 to FY 2003 was not attributed by either actuarial firm in the main to investment losses. According to the Towers Perrin analysis, investment losses accounted for approximately 22% of the increase to the UAAL. Gabriel, Roeder, Smith & Co. calculated this factor to represent a mere 6% of the total. The most significant causes of the decline in System funding, as it emerges from both reports, were: 1) benefit increases that stretched across the period of the two Manager's proposals and included the increases associated with the *Corbett* settlement and 2) changes in actuarial assumptions and System demographics.

The two reports categorize these factors in different ways but agree that they were, in the aggregate, the dominant cause of the System's ballooning unfunded liability. The most significant elements of the non-investment actuarial losses were listed in the Gabriel, Roeder Smith study as:

1. extremely low employee turnover;

2. significant purchase service subsidies;

3. pay increases above those assumed; and

4. retirement/DROP incidence.[311]

In a pie chart diagram, he presented "benefit increases" as responsible for 41% of the increase in unfunded liability, with "contingent benefits" contributing another 12%. What he categorized as "other actuarial losses" were responsible for an additional 31% of the total.[312]

The Towers Perrin analysis concluded that the *Corbett* settlement had increased unfunded liabilities by 18% and other "plan changes/benefit increases" by an additional 4%. Under that analysis, demographic losses and changes in actuarial assumptions together contributed 30% to the increase in the System's UAAL. "Reserve diversions," defined as "increases in reserves not

---

310 E-mail from Rick Roeder to Richard Sauer, Vinson & Elkins, Re: San Diego (June 21, 2004).

311 Letter from Rick Roeder to Pension Reform Commission (May 18, 2004), ***supra***. Mr. Roeder mentioned in his analysis that certain of these factors were reflected in actuarial assumption changes calculated in 1998 and in the most recent "experience study" he had conducted. He noted, however, that under MP2 these factors were not reflected in employer-paid rates.

312 All of these figures back out the one-year lag factor built into the manner in which the City's contributions to SDCERS are set.

included in valuation asset base," added another 12%. This last category includes many of the uses of surplus earnings – such as the payment of healthcare benefits and the supplemental COLA – described above.

The role of increased benefits was not neglected in the SDCERS report to the Rules Committee, even if not quantified in terms of effect on funded ratio. The Report explains the evolution of the SDCERS funding decline. The contingent benefit obligations – the purportedly contingent element of the *Corbett* settlement, the 13th Check, the supplemental COLA, and the Employee Contribution Rate Increase Reserve – are described in detail.

The SDCERS report estimated the present value of the 13th Check liability at $58 million, and of the *Corbett* retiree liability at $75 million. In addition, the postretirement healthcare benefit received particular attention from the SDCERS staff, as requested by the Manager's Office. For the first time since the Buck Consulting analysis in 1989, an attempt was made to quantify the present value of this liability. The estimate provided by SDCERS was $1.1 billion. Of this amount $400 million was attributable to existing healthcare eligible retirees and $750 million to active employees. This number received significant press attention but should be approached with caution. First, projecting the costs of healthcare is difficult given the tendency of this item to exceed at unpredictable levels the general rate of inflation. In addition, this particular estimate was not based on rigorous actuarial projections. Mr. Grissom and Mr. Roeder, in separate interviews with Vinson & Elkins, each referred to this number as "SWAG," an acronym for a "sophisticated wild-assed guess." It was based on several very simplistic assumptions:

- All active employees will receive the healthcare benefit;
- Each retiree would choose the most expensive plan options; and
- The inflation rate for healthcare insurance would average 5% per annum.

The first two assumptions were unrealistically conservative. A significant number of retirees will, for a variety of reasons, not avail themselves of the healthcare benefit. Those who do, of course, will not all opt for the most expensive of the available plans. On the other hand, the third assumption – that "medflation" will average 5% – is highly optimistic in light of its history of significantly exceeding this rate.

From subsequent analyses of the cost of this liability, it appears that this estimation of the healthcare liability may have erred on the side of conservatism. Earlier this year, Mr. Roeder provided the Pension Reform Commission with a somewhat more formal analysis. He estimated the present "accrued liability" for healthcare benefits to be between $447 million and $672 million, applying inflation assumptions ranging from 4 to 6%. Adding in "the estimated value of

benefits attributable to projected future service for active members," and applying the same inflation assumptions, he calculated the present value of the projected benefits as between $604 and $938 million.[313] In a more formal analysis conducted for the City of San Diego, Towers Perrin estimated the total actuarial accrued liability for the healthcare benefit, as June 30, 2003, to be $753,773,223.[314]

Receiving less attention in the SDCERS report to the Rules Committee was the role of non-contingent benefits, particularly the purchase service credit benefit and the DROP program. Commenting on a draft of the report, Deputy City Auditor Terri Webster stated:

> The Contingent benefits are half the report … that is too much… Why is the Board administering the PSC program at a loss for the Fund? What is the fiduciary basis for that? How is the funding ratio being hit for that under funding and when is it getting fixed? Why is the Board paying 8% to retirees… who are no longer in DROP… what is the fiduciary basis for that?[315]

In a separate e-mail to Mr. Barnett, Ms. Webster stated that, during the first years after the fall 1997 implementation of the DROP program, investment returns had exceeded the 8% return allocated to DROP participants.[316] This was, of course, advantageous to the System's funded ratio. But because the program was then in its infancy, it represented a relatively small portion of SDCERS assets. Unfortunately, substantial year-to-year increases in contributions to the DROP program roughly corresponded to substantial declines in the investment markets. From June 30, 2000 to November 30, 2002, she noted, funds on account with DROP increased from $38 million to $109 million. Thus, the DROP program increasingly placed a drag on System funded levels.[317] As of this writing, changes to the DROP program remain under review.

The criticism Ms. Webster and others made of the Purchase Service Credit program – that the SDCERS Board had failed to adjust as appropriate the price of so-called "air time"– was addressed in late 2003 by the Board through an increase in the price of that benefit. By June 30,

---

313 Memorandum from Rick Roeder to the Pension Reform Commission, Re: Retiree Medical Analysis Requested by the Pension Reform Commission (June 14, 2004).

314 Towers, Perrin, *Draft City of San Diego, Postretirement Welfare Benefit Plan, Actuarial Valuation Report with Estimated Results* (June 2004).

315 E-mail from Terri Webster to Paul Barnett, Assistant Retirement Administrator, SDCERS (Jan. 27, 2003).

316 E-mail from Terri Webster to Paul Barnett, Assistant Retirement Administrator, SDCERS, Re: BRR blue ribbon report (Jan. 25, 2003).

317 The DROP program, which allows employees no longer in their DROP period to leave their contributions in the program and draw interest at the actuarially assumed rated, may be argued to present a perverse incentive to participants. During a poor investment climate, individuals will be more likely to leave their savings in the System to obtain the guaranteed 8%, while in a bull market (when SDCERS would also be more likely to obtain substantial earnings on invested assets), they will be more likely to withdraw their funds from the System.

2003, however, SDCERS had incurred a $56 million loss as a result of administering this benefit at below its cost to the System.[318]

The SDCERS presentation to the Rules Committee was followed by a period of public comment. Two statements deserve mention. The San Diego attorney who had threatened to sue the system had the original iteration of MP2, with its 75% funding floor, been approved commented that the funding problems faced by SDCERS required immediate attention because it would not be possible to effectively deal with them in "the out years." He also stated that an 8% assumed rate of return: "is a huge assumption that we cannot make in light of where the stock market is now." This is an important point. Considerable thought has been given to whether the assumed actuarial rate should be adjusted to reflect the various contingent benefits parasitic on System earnings. For example, Mercer recently concluded a review of the actuarial assumptions and methods applied to SDCERS by Gabriel Roeder Smith & Co. It suggested, as has Mr. Roeder himself, that a reduction of 25 basis points to the assumed rate might be warranted.[319] Although this is a valid inquiry, it should be remembered that the investment climate over the coming years is likely to dictate SDCERS' investment earnings to a degree that will dwarf such relatively minor considerations. A substantial deviation from the assumed rate of return will render all of the projections discussed here meaningless.[320]

James Gleason, one of the named plaintiffs in the *Gleason* class actions, also spoke during this session of the Rules Committee. He stated that, since 1991, the retirement system has been the object of "manipulation that looked like creative financing at the time." In his view, the object of this manipulation has been to reduce City contributions to SDCERS.

As described in detail above, many of the measures that affected the funding status of SDCERS were indeed initiated with an eye to restrict – or, more accurately, postpone – City contributions to the System. In some cases, this was done openly. In others, a lack of transparency accompanied the policy changes. In each instance, however, the concessions made to the City were accompanied by concessions to its labor organizations. The measures that led to SDCERS' complex and administratively awkward funding system are the result of management and labor together treating SDCERS as an object for their negotiations.

---

318 E-mail from Terri Webster to Lawrence Grissom, Re: PSC (July 15, 2003).

319 Mercer: Human Resources Consulting, *Audit of Actuarial Work, San Diego City Employees' Retirement System* (May 11, 2004). To assist City administration in responding to issues raised before the Rules Committee, Towers Perrin also examined Mr. Roeder's assumptions and methodology and, with some suggestions for technical adjustments, also found them to be reasonable. Letter from Leslie P. Finertie, Principal, Towers Perrin, to Timothy R. Pestotnik, Luce, Forward, Hamilton & Scripps LLP, Re: Actuarial Review of San Diego City Employees' Retirement System (May 5, 2003).

320 In his letter to SDCERS analyzing the first iteration of MP2, cited above, fiduciary counsel Robert Blum noted that a SDCERS investment consultant has told it that "there has been a structural change in the capital markets and in the future it is less likely that SDCERS will have earnings in the ranges that were achieved during the prior 10 years."

XII. The analysis of SDCERS' funding by Public Financial Management

By early 2003, the deteriorating financial condition of SDCERS could no longer be easily ignored. The System's funded ratio had declined approximately 20% over the two years from June 30, 2000 to June 30, 2002, and was expected to show an additional decline as of June 30, 2003. Although this reflected harsh investment conditions that had pushed down asset values in public and private pension funds throughout the nation, SDCERS' valuation was additionally burdened by the measures described above that variously: 1) increased benefits, 2) decreased employer contributions, 3) diverted System earnings to pay contingent benefits; and 4) postponed adjustments to actuarial assumptions.

In its actuarial valuation for FY 2002 (issued in January 2003), Gabriel Roeder Smith & Co., for the first time declined to describe SDCERS as actuarially sound. Instead, it described the condition of the System as "adequate":

> Overall, the financial condition of the retirement system *is in adequate condition* in accordance with actuarial principles of level-cost financing. However, all parties should be acutely aware that the current practice of paying less than the computed rate of contribution will help foster an environment of additional declines in the funding ratios in the absence of healthy investment returns (emphasis supplied). [321]

In an interview with Vinson & Elkins, actuary Rick Roeder stated that this term has no specific meaning in actuarial science. However, he indicated that the purpose of the change in terminology was to emphasize the negative trend in SDCERS' financial condition.

In light of SDCERS' plummeting funded ratio and the alarming report made by SDCERS to the Rules Committee in February 2003, the City Council was faced with the possible necessity of reengineering the financing of SDCERS before the situation deteriorated further.[322] In the initial step towards this end, the Rules Committee requested that the City Manager provide a report to the Mayor and Council responding to the issues raised in the SDCERS presentation to the Rules Committee. Thus, in February 2002, the City Manager's Office, joined by the Offices of the City Auditor and Treasurer, began to fashion proposals to return SDCERS to a more solid financial condition. The City engaged Public Finance Management ("PFM"), as financial advisor to the City, to analyze the situation and describe potential remedies.

---

321 2002 Actuarial Valuation, ***supra*** note 307, at 17.

322 *See* Philip J. LaVelle, *City pension system seen under siege, under-funded. New report shows threat to San Diego for decades*, San Diego Union-Tribune, Feb. 12, 2003, at A1; Donohue, *Memo: City's retirement fund could be $2 billion short by '09*, San Diego Daily Transcript, May 9, 2003.

PFM quickly sought information from the SDCERS actuary and, on February 28, 2003, Mr. Roeder provided a schedule projecting the growing disparity between the actuarial rate and the MP2 rates through FY 2009, and its implications for the System's unfunded liability. His spreadsheet showed the build-up in UAAL exceeding $2 billion by June 30, 2009, the point at which MP2 would sunset.[323]

[323] Letter from Rick Roeder, Gabriel Roeder Smith & Co., to Lawrence Grissom and Paul Barnett, SDCERS (Feb. 28, 2003), *copied to* Mary Vattimo, Terri Webster, Alex Burnett and Missy Labuda, City of San Diego.

| Fiscal Year End | Actuarially Calculated Rate | MP2 Rate | Unfunded Liability (millions) BOY | Funded Ratio BOY |
|---|---|---|---|---|
| 2003 | 15.59% | 10.33% | $720.7 | 77.3% |
| 2004 | 21.12 | 13.44 | 949.0 | 73.0 |
| 2005 | 25.30 | 15.37 | 1,119.7 | 70.9 |
| 2006 | 27.64 | 17.33 | 1,305.4 | 69.0 |
| 2007 | 30.25 | 20.01 | 1,509.5 | 67.3 |
| 2008 | 33.20 | 24.54 | 1,729.3 | 65.8 |
| 2009 | 35.27 | 35.27 | 2,029.4 | 65.6 |
| 2010 | | | | 66.5 |

This analysis assumed that the declining 30-year amortization period adopted in 1992 would remain in place until June 30, 2006, at which point it would be replaced with a rolling 15-year period. Mr. Roeder commented: "[i]n general, we like the 15-year rolling amortization since it avoids the bigger contribution volatility associated with shorter amortization periods." The benefits of this method, as described in his letter, are that the 15-year period roughly corresponds to the average period of future service expected of active employees and is short enough to provide some amortization of principal.

Mr. Roeder provided an additional analysis projecting the City's contribution shortfalls through FY 2009 on a basis that eliminated the effect of the one-year "lag" between the annual valuation date and the fiscal year in which the rate adjustments are applied. He explained: "for most Systems, a one-year lag is theoretically neutral." San Diego, however was not "most Systems" because of its need to "catch up" in its contributions following seven years of paying less than the actuarial rate. By his calculation, the disparities as between the two methods of calculating City contributions were as follows:

| Fiscal Year End | Shortfall with lag (millions) | Shortfall without lag (millions) |
|---|---|---|
| 2003 | $28.7 | $59.0 |
| 2004 | 43.8 | 67.6 |
| 2005 | 59.0 | 72.9 |
| 2006 | 63.8 | 80.0 |
| 2007 | 66.1 | 85.1 |
| 2008 | 58.3 | 72.2 |
| 2009 | 0.0 | 9.0 |

He stated that the cumulative difference between the two columns of figures explains "why the rates go up and the funded ratio declines, even when we assume no actuarial gains or losses in future years." He ended the letter with a reminder that this analysis excluded all

*Corbett* liabilities (contingent and non-contingent), the effect of certain actuarial assumption changes adopted the previous week and the effect of poor investment returns for the first eight months of FY 2003. Were these additional factors included, he stated, the numbers would "paint a more somber picture."

From March through July 2002, PFM provided the City's Finance Services department with a series of draft memoranda projecting increases in the SDCERS UAAL as far in the future as FY 2021. SDCERS actuary Rick Roeder and Leslie Finertie, a principal in the actuarial firm Towers Perrin, also contributed to these projections, which slowly evolved as various actuarial and other assumptions were examined and adjusted. These projections, as PFM acknowledged, applied speculative assumptions about interest rates, financial performance and benefit changes. The purpose of this analysis was to provide a basis for evaluating various options available to the City to restructure or refinance its obligations to SDCERS.

From at least mid-March 2003, City officials were aware that PFM's projections showed substantially increasing UAAL levels in future years. A handwritten memorandum from City Treasurer Mary Vattimo, dated March 13, 2003, states: "PFM getting us something today… '09-'21 growth… numbers are staggering… 36% of payroll $5b[illion] problem." Ms. Vattimo's notes also indicate that the estimate of UAAL provided a month earlier to the Rules Committee "understated the problem since only going out to '09." In fact, the $5 billion figure overshot the projections PFM would eventually deliver. In the initial draft of its report, dated March 12, 2003, PFM estimated that the System's UAAL (absent remedial measures) would reach $2 billion by FY 2009 and $5 billion by FY 2021, with a funded ratio of approximately 67%. While the next iteration of the PFM report, dated April 16, 2003, continued to project a UAAL of $2 billion at June 30, 2009, the figure for 2021 declined to $2.9 billion. These projections assumed that MP2, with its five-year ramp-up to payment of full actuarial rates, would remain in force. Various drafts of the Report noted: "[u]nder this plan, the City's UAAL continues to grow, regardless of actuarial losses or gains, due to the contribution shortfalls. In essence, the City is creating incrementally new AAL on top of the current AAL of $720 million for fiscal year [2002]."[324]

The April 16, 2003 draft provides analyses of several different scenarios for reducing the System's under-funding. One of these assumes that the City would forego the five-year ramp-up to actuarial rates allowed under MP2 and begin paying the full PUC rate at FY 2005. This would result in a modest improvement to SDCERS' funded status at June 30, 2021 – with a UAAL of $2.793 billion instead of the $2.903 billion projected under the MP2 rates. PFM also sketched out a scenario under which the City would issue $720 million in pension obligation bonds

[324] Draft memorandum from Alex Burnett and Melissa La Buda, PFM, to Mary Vattimo, Lakshmi Kommi and Michael Carrier, City of San Diego, Re: Preliminary Pension Analysis, at 5 (Apr. 16, 2003).

("POBs") in FY 2004. By PFM's estimate, this would result in a UAAL of $1.6 billion at June 30, 2021, as compared to $2.9 billion with no such action taken. Obviously, however, this scenario would also require that the City service the new debt obligation represented by the POBs. Under the PFM analysis, this approach – after netting the cost to service the POBs against reductions in payments to amortize the UAAL – would result in a savings to the City of over $329 million through 2021.[325]

In a May 1, 2003 memorandum to other City officials, Mary Vattimo suggested that PFM provide projections only to 2011, which became the time frame used in subsequent iterations of the PFM memorandum.[326] In a July 14, 2003 draft of its memorandum, PFM calculated that the UAAL at June 30, 2011 would grow to $2.1 billion, representing 22.09% of payroll or a $173,683,616 annual amortization payment. Under alternative scenarios – variously contemplating increased City contributions, the issuance of POBs and the extension of the UAAL amortization period – the UAAL at 2011 ranged from $1.232 billion to $2.741 billion.

The PFM draft memorandum also opined on the importance of addressing SDCERS' funding shortfall from the standpoint of the Rating Agencies:

> We have found that Rating Agencies expect municipal entities with large un-funded obligations to have, or develop, a plan to reduce their UAAL over time, either by debt issuance or by increasing the percent of payroll payments…. The City's current proactive approach to exploring options on the UAAL is a positive step towards maintaining its current credit rating. We do not believe that the current UAAL, or corresponding funding levels, unto itself will trigger an adverse credit event: however, we would recommend that the City needs to develop a cohesive and comprehensive strategy to fund the Pension system as part of the City's long term credit strategy.[327]

This advice appears to comport with the views of the Rating Agencies. Moody's, for example, has opined that: "the emergence of an increased pension liability should not in and of itself created pressure on the rating of a California government agency," so long as the agency is taking steps to address the problem.[328] The advice was also timely. On June 3 and 4, 2003, while the PFM analysis was ongoing, City officials met separately with representatives of Fitch, Moody's and Standard and Poor's. The City has traditionally briefed the Rating Agencies on the

---

[325] It should be noted that these projections assume that SDCERS' assets will perform at the actuarially determined rate of 8%. Should earnings be less than that amount, the projected benefits from funding the System through POBs could disappear.

[326] Memorandum from Mary Vattimo to Pat Frazier, Cathy Lexin, Ed Ryan, and Terri Webster, Re: Draft Closed Session Retirement Report (May 12, 2003).

[327] Draft memorandum from Alex Burnett and Melissa La Buda, PFM, to Mary Vattimo, Lakshmi Kommi and Michael Carrier, City of San Diego, Re: Preliminary Pension Analysis, July 14, 2003, at 3.

[328] Moody's Investors Service, *supra* note 246.

City's financial situation, including trends in employment and tourism, in June of each year, approximately the time it issues its annual tax anticipation notes.

In previous years, the Rating Agencies had expressed little interest in the City's retirement system and, in the view of several City officials interviewed by Vinson & Elkins, had only a very basic understanding of pension issues. Of the three agencies only Moody's included pension liability as part of its calculation of the City's long-term debt. Typically, the City provided little information on this subject. In 2003, however, the retirement system had become a focus of interest for the Rating Agencies due primarily to the swoon in SDCERS' funded ratio between June 30, 2000 and June 30, 2002. As City Economist Michael Carrier stated in an interview with Vinson & Elkins, that problems existed with the pension system was public knowledge that could not be ignored.

Prior to the June 2003 meetings, Ms. Kommi, who was the City's primary contact with the Rating Agencies, had received inquiries from a Moody's analyst about various factors affecting funding of the retirement system. These included the operation of the two Manager's proposals, the *Corbett* settlement and the Mayor's Blue Ribbon Committee report.[329] Ms. Kommi appears to have been open in responding to the analyst's inquiries, providing, among other things, a copy of the SDCERS report to the Rules Committee. She also informed Moody's that the City had retained an actuary (Towers Perrin) to "verify/examine the current actuarial findings and assumptions…" and had "also engaged [PFM] to assist the City in presenting the findings and assessing our funding options." Although Ms. Kommi promised to have PFM address the analyst's issues when it concluded its report, this never occurred. According to Ms. Kommi's statements to Vinson & Elkins, the PFM materials were placed under the auspices of the City's defense counsel in the *Gleason* matter to prevent their discovery in litigation and were then treated as confidential material.

In the June meetings, City officials including Ms. Frazier, Mr. Ryan, Ms. Webster, Mr. Carrier, and Ms. Kommi made a presentation to the Rating Agencies that, for the first time, included significant information about the retirement system. Addressing the severe decline in funded level, a slide prepared for that meeting attributed 85% of the deterioration to investment losses, 10% to benefit increases and 5% to the rate relief provided by MP1. The City stated that its failure to pay full actuarial rates had contributed only 2% to the decline in funded level (taking it from 79% to 77%). As later, more comprehensive analyses show, these figures are defensible within certain time frames but do not tell the entire story. They do not convey the role played by failing, over many years, to match increasing benefit levels and changes in actuarial assumptions with corresponding increases in employer contribution rates.

[329] E-mail from Lakshmi Kommi to Dai Barzel, Re: pension fund reports (Feb. 20, 2003).

The PFM draft memoranda were not provided to or discussed with the Rating Agencies. Both Ms. Frazier and Ms. Kommi cited confidentiality concerns as the reason to withhold this information. The week before the meetings, Ms. Vattimo, in an e-mail to Ms. Frazier, suggested providing the agencies with information about contemplated options to address the UAAL, "in order to show how we are pro-actively attempting to address the issue." [330] The e-mail also stated that Moody's would want "some quantification of these options." It does not appear, however, that the City officials went beyond a very general discussion of these matters in their June 2003 meetings with the Rating Agencies.

According to Ms. Kommi, the City attempted in the June 2003 meetings to elicit from the Rating Agencies any benchmarks they apply for determining acceptable funded ratios for municipal pension systems. In a February 19, 2003 e-mail to Moody's analyst Dari Barzel, Ms. Kommi had sought the same information. According to Ms. Kommi, the agencies indicated that a 65% level might present credit concerns, but stated that there are no absolute criteria and each case must be examined individually with respect to the strength of the City's General Fund and its ability to respond to increases in UAAL.

In subsequent months, the Rating Agencies continued to question City staff about the SDCERS situation to better understand San Diego's exceptionally complex relationship to its retirement system. As described elsewhere in this memorandum, these inquiries, and additional public disclosure by the City concerning errors in its financial statements, eventually led to the downgrading of San Diego's credit rating by each of the three Agencies.

The report from the Manager's Office to the Mayor and City Council was never finalized. According to the statements to Vinson & Elkins of various City officials involved in this effort, defense counsel hired by the City in the *Gleason* litigation advised that such material might be discoverable and therefore should not be generated. In any event, on September 24, 2003, Mayor Dick Murphy appointed nine individuals to form the Pension Reform Commission to look into many of the same issues previously referred to the City Manager for analysis.[331] The decision was therefore made to shelve, in draft form, the memorandum from the City Manager's Office.

---

330 E-mail from Mary Vattimo to Pat Frazier, Re: Ratings Materials (May 27, 2003).

331 Memorandum from Dick Murphy, Mayor, to the City Council, Re: Pension Reform Commission (Sept. 24, 2003). In his memorandum proposing the creation of this Commission, Mayor Murphy attributed 85% of the System's unfunded liability to "poor stock market conditions," and asserted his belief that the SDCERS Board "is doing its best to discharge its fiduciary duties under the existing system." In light of "public consternation over the long term viability of the city's pension system," however, he proposed the creation of a Commission composed of financial, accounting, legal and pension experts to broadly examine the performance and structure of the System. Memorandum from Dick Murphy, Mayor, to the City Council, Re: Pension Reform Commission (July 11, 2003).

## XIII. The January 27, 2004 Voluntary Disclosure

### A. The City's disclosure comes under scrutiny

Despite mounting indications of long-term problems with SDCERS' funded level, no serious review and assessment of the City's disclosure of its pension-related liabilities was undertaken until the fall of 2003.[332] Earlier that year, the City went to market with several securities offerings.[333] As a result of the lag in the availability of actuarial valuations, the most recent data provided by the City about SDCERS' funding in its offering documents was as of June 31, 2001. During the intervening two years, the funded ratio fell approximately 20%. The provision of stale and otherwise inaccurate information in early 2003 bond offerings is probably the most significant of the City's failures to properly police its public disclosure, particularly in light of the generally optimistic statements it continued to make about its pension system. Without necessarily committing material breaches of specific GASB requirements, its pension disclosure had diverged from reality in ways that, if known, would likely have been meaningful to the market for its securities.

When a thorough examination of the City's pension disclosure finally occurred, it was initiated not by the City but by an outside attorney. The Orrick Herrington firm has served as San Diego's disclosure counsel on a number of general fund and enterprise fund financings. On September 5, 2003, Orrick partner Paul Webber received an e-mail written to SDCERS administrator Lawrence Grissom and others by SDCERS Trustee Diann Shipione, and forwarded to Mr. Webber by Dennis Kahlie of Financing Services.[334] The e-mail asserted that certain information in a Metropolitan Wastewater District ("MWWD") Preliminary Official Statement attributed to the SDCERS Actuary was inaccurate because: "the independent SDCERS Actuary indicates that these comments are, in fact, dated and out of context" and that the actuary views these issues "in a very different light than that being represented to the purchasers of these securities."[335] The statements at issue concerned Mr. Roeder's views about the excellence of the "corridor funding" mechanism initiated with the first Manager's proposal and the prospects for its acceptance by the GASB as one of its approved funding methods. As described above, Mr.

---

[332] Attorneys for Stradling Yocca Carlson & Rauth, which served as disclosure counsel on several City offerings in 2003, discussed with City employees the *Gleason* litigation and the issues it raised. This resulted in increased disclosure about the *Gleason* suit, and in particular the amount in controversy, but not a comprehensive examination of the City's relationship to its retirement system.

[333] Those offerings included the following: (1) $15,255,000 City of San Diego/MTDB Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding); (2) $17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding) Evidencing Undivided Proportionate Interest in Lease Payments to be Made by the City of San Diego Pursuant to Lease with the San Diego Facilities and Equipment Leasing Corporation; and (3) $110,900,000 City of San Diego, California 2003-04 Tax Anticipation Notes Series A.

[334] E-mail from Dennis Kahlie to Paul Webber, Re: Fwd: Incorrect Pension Materials in Bond Circular (Sept. 5, 2003) (forwarding e-mail from Diann Shipione to Lawrence Grissom, Dick Murphy, Rick Roeder, and Fred Pierce).

[335] At about the same time, the CERS Actuary, Rick Roeder, transmitted to the City his written comments on the pension footnote to the MWWD POS, objecting to the statements mentioned in Ms. Shipione's e-mails.

Roeder had, by this time, given up on his effort to persuade the GASB of the virtues of "corridor funding." The statement to the contrary had been taken out of the City's 2002 CAFR – after a City accountant had queried Mr. Roeder about its continuing validity – but that deletion had, through clerical error, not been picked up in the MWWD disclosure.[336] Moreover, Mr. Roeder's enthusiasm for "corridor funding" as practiced in San Diego had not survived MP2's softening of the 82.3% floor. Therefore, Ms. Shipione was correct that these statements no longer reflected the views of the SDCERS actuary. More broadly, Ms. Shipione stated in her e-mail that the offering materials "do not provide any of the material deficit concerns even at the levels described by our staff." This appears to refer to the projections of pension and healthcare liability presented by SDCERS to the Rules Committee in February 2003, as well as the estimates in Mr. Roeder's February 28, 2003 letter to PFM.[337]

City officials and other members of the SDCERS Board vehemently disputed many of the statements made during this period by Ms. Shipione.[338] In their view, Ms. Shipione was taking issues that were of concern to many of them and using them as a weapon to discredit other members of the Board for personal reasons. For example, in a September 7 letter to the chairman of the San Diego Port Authority, Ms. Shipione contended that SDCERS "openly acknowledges that their financial materials do not conform to GASB."[339] Deputy City Auditor (and SDCERS Trustee) Terri Webster reacted in an e-mail to certain SDCERS trustees and administrators:

> Her latest comments have MORE damaging, false allegations… Her comment about "financial material not conforming to GASB" is FALSE. (we discuss [that] the corridor funding for actuary purposes is not recognized by gasb…as required…full disclosure)[.] ALL our financials, footnotes[,] etc[.] DO comply with GASB[,] which is why GFOA and CSMFO for decades has [sic] awarded the city with the Excellence in Financial Reporting award !! Not to mention her comments that include such words as illegal[,] hiding[,] regularly cooks the book[,] to try to fool people[.] [ellipses in original][340]

---

336 There is no reason to believe the failure to import into the MWWD document this change in the City's disclosure was the result of anything other than clerical error, as several City accountants stated in interviews with Vinson & Elkins.

337 Ms. Shipione did not respond to requests to speak with Vinson & Elkins for purposes of this investigation.

338 Letter from Frederick W. Pierce IV, President, CERS, to Jess E. Van Deventer, Chairman, San Diego Port Authority (Aug. 29, 2003); Letter from Loraine E. Chapin, General Counsel, CERS, to Diann Shipione, Trustee, CERS (Sept. 12, 2003) (objecting to Ms. Shipione's characterization of other Board members as "incompetent or deceitful"); Electronic Memorandum from Cathy Lexin to Diann Shipione (Aug. 18, 2003); Memorandum from P. Lamont Ewell, ***supra***, note 255.

339 Letter from Diann Shipione, Trustee, CERS, to Jess E. Van Deventer, Chairman, San Diego Port Authority, Re: Letter of Fred Pierce to you of August 29, 2003 (Sept. 7, 2003).

340 E-mail from Terri Webster to Cathy Lexin, Frederick W. Pierce IV, Lawrence Grissom, Mary Vattimo, and Paul Barnett, Re: Diann (Sept. 7, 2003).

Ms. Webster and others were also distressed that the misstatements in City disclosure that were initially at issue were, they believed, the result of the SDCERS actuary failing to respond to inquiries in connection with the preparation of the City's FY 2002 financial statements. As Ms. Webster later commented: "[a]sking Rick what specific year he changed his mind is not a credible process in light of his track record."[341]

B. The discovery of multiple errors in the footnotes to the FY 2002 financial statements

The evening of September 5, 2003, Mr. Webber spoke by telephone with Ms. Webster. They agreed that the City and its auditors would immediately examine the issues raised in the e-mail. From that initial review, Orrick's concerns expanded to include other issues, such as the representation in the notes to the City's financial statements that the contribution shortfall from MP1 was "funded in a reserve."[342] This sparked an extensive examination of the City's footnote disclosure, which led to the discovery of numerous errors going beyond pension issues, and eventually to the issuance by the City of its Voluntary Disclosure of January 27, 2004, detailing the results of the inquiry. The MWWD offering, which was scheduled to be priced on September 9, 2003, was postponed pending resolution of the disclosure and financial statement issues. In fact, sufficient uncertainty about this issued has remained, despite the City's Voluntary Disclosure, that San Diego has not conducted any public offerings of its debt securities since the summer of 2003.

The review was ordered by City Auditor Edward Ryan at the urging of Paul Webber who concluded in late September that additional due diligence on the City's financial statements was necessary. It was conducted primarily by the staff of the City's Accounting Division, which prepares the City's financial statements, and internal Audit Division, which typically performs investigative functions. City accounting staff, among other things, gathered and verified documents supporting footnote numbers, and reviewed GASB standards, SDCERS actuarial valuation reports, and disclosures made by other cities. The Accounting Division and the Audit Division each discovered errors in the footnotes.[343]

The City's (and SDCERS') outside auditors at that time, Caporicci & Larson, also participated in the review of the City's footnote disclosure.[344] The Caporicci & Larson effort

---

341 E-mail from Terri Webster to Darlene Morrow-Truver, Audit Division Manager, and Ed Ryan, Auditor and Comptroller, Re: 12-23-03 draft o[f] error disclosure (Dec. 24, 2003).

342 E-mail from Daniel Deaton, Orrick, to Paul Webber, Re: City of San Diego: Pension explanation in Auditor's consent letter (Sept. 6, 2003).

343 City of San Diego CAFR Review Comments for Year Ended June 30, 2002.

344 Caporicci & Larson had recently acquired CJO, which served as the City's outside auditors through FY 2002. As noted above, under its contract with the City, CJO was responsible for drafting the footnotes to the City's financial statements based on information provided by the City Auditor's Office.

was led by senior partner Gary Caporicci, and involved engagement partner Tom Saiz, as well as quality control reviewer Chris Woidzik. According to Mr. Caporicci and Mr. Saiz, their firm's role included checking trial balances and comparing the City's disclosure against GFOA checklists.[345] Caporicci & Larson, after extensive discussions with the City's inside auditors, generated a six-page list of errors and an additional analysis as to whether these errors were material.[346] While referring the reader to the January 2004 Voluntary Disclosure for additional detail, we will mention the most significant among these errors.

- Note 5 to the City's FY 2002 financial statements contained a multitude of errors in the stated interest rates and maturities for various San Diego bond offerings. According to the City accountants interviewed for this Report, the errors existed because many initial entries were made inaccurately, and were then carried forward from year to year without being checked against source documents.

- The total amount payable on operating leases for 2003 to 2027 was stated to be $13.7 million, when the actual amount was $127.2 million. According to City accountants, the error occurred because the City's Real Estate Accounting Division did not include this information in its report to the accountants preparing the financial statements. The magnitude of this error, although it did not affect the City's balance sheet, draws attention to the lack of review that was accorded the City's footnote disclosure.

- The pension footnote contained a number of relatively minor errors connected to the City's required GASB 27 disclosure. First the NPO was understated because calculations received from the SDCERS actuary improperly included the City's contributions to the DROP program as contributions to the pension system. This error was originally caught by the City accounting staff in June 2003. Otherwise, the NPO was correctly reported for the three-year period covered by the pension footnote. In addition, the City's disclosure stated that its contribution to the System was determined as part of the June 30, 1996 actuarial valuation, rather than, as was the case, the June 30, 2001 valuation. This error was apparently the result of a failure to review and update information as appropriate and appears in San Diego CAFRs for previous fiscal years. Also, certain numbers were carried forward from previous years without proper adjustment.

---

345 No examination was conducted of issues going to entries in the financial statements proper, other than those tied to errors discovered in the footnotes. We understand, however, that KPMG has discovered additional historical financial statement errors in connection with its engagement to audit the City's FY 2003 financial statements.

346 "Caporicci & Larson's Recommendations; Reissued Notes to the Financial Statements; Review of Technical Material; and, Calderon, Jaham & Osborn's Reissued Audit Report Relating to Metropolitan Wastewater Utility 2002 Financial Statements," (Oct. 8, 2003); and, Letter from Gary M. Caporicci, Caporicci & Larson, to Les Girard, Office of the City Attorney (Dec. 10, 2003).

There are no indications, and no one involved in the review has suggested, that any of these or similar errors were the result of intentional misstatement. To the contrary, in each case the error can be confidently attributed to: data entry problems that were not corrected through subsequent review; failure to properly update information from year-to-year; and omissions by other City offices or third parties to provide accurate information to the City Auditor's Office. The very number (and, in some cases, obviousness) of the errors, however, raises issues about the adequacy of the City's internal controls for financial reporting.

In interviews conducted for this Report, the City accounting staff freely admitted to problems associated with the financial statement preparation process, such as excessive reliance on the outside auditor to prepare the footnotes and to gather and maintain supporting documents. A look-back memo from Principal Accountants Phil Phillips and Rudy Graciano notes:

> The preparation of the CAFR, and standalone financial statements, footnotes have historically been the responsibility of the independent auditor. The responsibility has been included in the [Request for Proposal] scope of services packages and as a term of the executed service agreement… The purpose of having the independent auditor perform this function was due to the technical complexity of interpreting the GAAP requirements of the footnotes and the city not having the staffing capacity to have staff assigned to specialize in footnote preparation.[347]

The authors of the memorandum further note that the outside auditor took the lead in determining what notes were required and what the content of the notes should be. After the discovery of the various footnote errors, City officials were critical of the quality of CJO's audit of the financial statement footnotes. They recognized, however, that the City also bore a measure of responsibility in that it provided little oversight to confirm that its outside auditor was accurately and effectively integrating information from the City and other sources into what was ultimately a public statement of the City, not its auditor.

Another defect identified by the internal accountants was the absence of any procedure to verify information from third parties, such as the SDCERS Actuary. They also noted a lack of controls to assure that City disclosure documents are cross-checked against each other and the content of each checked against source materials. The Voluntary Disclosure discusses certain of these problems and City's plans to implement procedures to remedy them.

In truth, however, the problems went beyond these issues. It is apparent that there was a general lack of understanding of the importance of accurate footnote disclosure within the City

[347] Memorandum from Phil Phillips, Accounting Division Manager, and Rudy Graciano, Accounting Operations Section Manager, to Terri Webster, Acting Auditor and Controller, Re: Footnote Preparation (Mar. 4, 2004).

Auditor's Office.[348] Primary responsibility for the accuracy of the footnotes was delegated to line-level staff accountants with limited understanding of the larger structure of the City's financial obligations. The accountant responsible for the SDCERS fund, for example, was not aware of the existence of MP2 at the time the FY 2002 financial statements were in preparation. More generally, there was no reasonable possibility that she would have understood the complex actuarial issues that affected the accuracy of the City's disclosure concerning the funding of its retirement system. Further, quality control by supervisors was superficial. In response to a March 2004 inquiry from the City Attorney's Office asking "Did anybody at the City review the FY02 CAFR footnotes?" accountant Rudy Graciano, who supervised the accounting for the SDCERS fund, wrote: "the footnotes were distributed to all Principal Accountants…. I know I looked at them[;] I can't speak for others. And I can't remember them providing comments." Former Accounting Division Manager Phil Phillips added that the pension footnote went directly to Ms. Webster and Mr. Ryan for review, bypassing lower level supervisions whom, he said, did not understand the pension system. According to Ms. Webster, City Auditor Ed Ryan took responsibility for reviewing the overall content of the footnote disclosure. Although Mr. Ryan could not have been expected to detect the minor numerical errors peppered through the footnotes, it is not apparent why his review did not flag issues of faulty disclosure concerning the operation of MP1, such as the misleading statements about the function of certain reserves, and the complete omission of any disclosure of MP2. Mr. Phillips also indicated to Vinson & Elkins that he found that, over the years he worked for Mr. Ryan, the City Auditor was disinclined to include information in City disclosure that reflected badly on the City and would sometimes excise negative statements from disclosure documents, although the deletions Mr. Phillips described seem more cosmetic than substantive. Mr. Ryan did not agree to speak with Vinson & Elkins for purposes of our inquiry, and the question remains whether he or other City officials recognized a disclosure issue with respect to SDCERS' funding but delayed addressing it until the City could say it had a solution in place.

### C. Bond counsel insists upon additional disclosure

While the review by the inside and outside accountants was underway, Mr. Webber proposed language to cure the deficiencies he saw in the City's existing disclosure about its pension system. This effort took several months, delved into the intricacies of SDCERS' accounting, generated hundreds of e-mails and other documents, and brought Mr. Webber into conflict with City officials, who felt he was demanding more disclosure than the situation or GASB standards warranted. To illustrate: on September 12, 2003, Mr. Webber circulated proposed pension disclosure, which included an estimate of $1 billion for the UAAL and a

[348] In a September 3, 2004 interview with Vinson & Elkins, Ms. Webster responded to a query as to why the 2002 CAFR still contained the description of the shortfall in contributions being funded on a reserve: "Now do you think a bondholder ever reads a CAFR to this extent? This is going over it with a microscope."

description of the Manager's proposals.[349] City Treasurer Mary Vattimo commented in an e-mail to Deputy City Manager Pat Frazier:

> I think we need a conference call with Cathy, Terri, etc., because I don't think that he [Mr. Webber] fully understands the agreements (or maybe I don't understand what he is communicating.) In addition, this disclosure is OVERKILL and I would like to confidentially submit this to FA on Ballpark (Gary) and Paul Maco (through Elizabeth and Lakshmi) to get their view on the necessity of this.[350]

The relationship between Mr. Webber and City officials became progressively more strained over time. Mr. Webber felt that City officials did not appreciate the seriousness of the disclosure issues. In an interview with Vinson & Elkins, he alleged that City Auditor Ed Ryan attempted to pass off the financial statement errors as typographical errors "to pull the wool over the eyes" of the City Council. Late in the process, Mr. Webber complained in an e-mail to member of the City's legal staff:

> I could see no upside to us to having to recommend that the City make the disclosures, and have sensed from the outset a growing anger as the disclosures grew as we found out more information. The angst and anger, I believe, has grown as disclosure day has approached. Terri [Webster]'s last email to me exemplifies that anger. ("Onto the public flogging . . . I can't wait.") Mary [Vattimo]'s response was "much ado about nothing all you had to do was ask." Well I did ask, and I also asked why no one had bothered sharing that with me. So far that has not been answered, and I don't imagine will be.[351]

The issue referred to in this e-mail, and a source of distrust between the City and bond counsel, was Mr. Webber's belief that projections of the City's pension-related liabilities had been withheld from him. As noted earlier, the City staff had commissioned PFM to provide projections of its future liability to its retirement system as a basis for recommended actions to contain that liability. In September 2003, Mr. Webber asked the City to have the SDCERS actuary perform a series of "stress tests" that would explore various funding scenarios.[352] Rather than commission additional, potentially expensive, work from Mr. Roeder, the City's Financing

---

[349] E-mail from Cathy Smith, Orrick, to Pat Frazier Re: Paul Webber's Transmission of Pension Plan Disclosure (Sept. 12, 2003).

[350] E-mail from Mary Vattimo to Pat Frazier, re: Fwd: Paul Webber's Transmission of Pension Plan Disclosure (Sept. 15, 2003). Mr. Maco, a Vinson & Elkins partner who is also an author of this Report, had, prior to this time, provided Securities law advice to the City on a matter unrelated to the matters at issue here. He was asked by the City to also serve as a "sounding board" as the City prepared its pension disclosure and asked as to whether the expansive disclosure advocated by Mr. Webber was appropriate. He concurred with Mr. Webber's judgment.

[351] E-mail from Paul Webber to Kelly Salt , Office of the City Attorney, (Jan. 26, 2004).

[352] E-mail from Paul Webber to Mary Vattimo re: Stress Tests (Sept. 25, 2003).

Services Department provided Mr. Webber with the latest version of the PFM scenarios.[353] These projections showed SDCERS' UAAL reaching $2.3 billion in 2011. In Mr. Webber's view, these materials should have been provided to him in response to earlier information requests.[354]

For its part, the City staff felt that Mr. Webber's suspicions were unjustified. As Ms. Vattimo stated in an e-mail at the conclusion of the process:

> I could've answered this question in a phone call, but this is what happens when trust is lost between client and consultant. When have we hidden anything from Orrick? . . . I think we all need a rest from each other. Also, I hope that the City's reputation, and our individual reputations, are not diminished in the public finance community because of what Orrick thinks of the City of San Diego and its employees.[355]

D. Differing views on the materiality of the footnote errors

The difference of opinion between Mr. Webber and City of San Diego administration had, at bottom, less to do with factual matters – as to which there was general agreement – than the slippery issue of materiality. Disclosure is generally required only of material information. There the division of views was dramatic, in general pitting accountants against lawyers.

The City's outside auditor Caporicci & Larson concluded that the footnote errors in the FY 2002 financial statements – individually or in the aggregate – were not material, and therefore no restatement of the City's financial statements was required. Rather, in its view, the errors could simply be corrected in the FY 2003 statements. This conclusion was based largely on the fact that the identified errors had no significant effect on the City's financial statements proper. In a letter to the Office of the City Attorney, the firm opined:

> Concerns have been raised as to errors in the City's 2002 CAFR. We have carefully reviewed the 2002 CAFR and have met with staff of the Office of the City of San Diego Auditor and Comptroller regarding these errors…. We do not consider these errors found as being individually or collectively material to the City's 2002 CAFR….. Although not required or recommended, if the City chooses to consider reissuing the statements, there would not be changes in the

---

353 E-mail from Lakshmi Kommi to Paul Webber, re: Alternative Scenarios (Oct. 1, 2003).

354 E-mail from Paul Webber to Mary Vattimo, Re: Paul Webber's Transmittal of Draft of Ballpark Pension Plan Disclosure (Sept. 9, 2003). Mr. Webber later learned that PFM had generated additional materials that were not provided to him and concluded that they were intentionally withheld. City officials with whom we spoke stated that these materials were not provided to Mr. Webber because they were no longer current at the time of his request. Although there is no clear indication of an attempt to mislead Mr. Webber, we conclude that the City staff was less inclined to freely provide information to him than if it had been more supportive of his efforts.

355 E-mail from Mary Vattimo to Paul Webber, Re: Revised Pension Disclosures (Jan. 26, 2004).

> individual financial statements, however certain immaterial changes corrections and clarifications to the Notes to the Financial Statements may be considered (see attached spreadsheet). In our opinion, it is certainly rare for financial statements to be reissued for footnotes changes alone… and certainly not for footnote changes of such an immaterial nature.[356]

Mr. Caporicci explained in an interview with Vinson & Elkins that his firm's conclusion was based on an exercise of professional judgment, informed by the AICPA standards for materiality. He stated that the City's financial statements contained all of the information required by GASB, although the presentation of that information could have been better. In his opinion, the financial statements of municipalities are never free of mistakes. The issue is whether the mistakes render the financial statements materially misleading, and he believes that was not the case with San Diego's FY 2002 financial statements.

The City's accounting staff took the same view. In a November 12, 2003 letter to the City Attorney's Office, the City's Audit Division Manager stated: … "we have conducted a review of the footnotes contained in the City's 2002 financial statements…. [N]othing came to our attention which would be considered material according to Generally Accepted Accounting Principles."[357]

Paul Webber disagreed. While the City focused on the fact that the errors were not quantitatively material, largely because few of them tied to the City's balance sheet, Mr. Webber viewed the existence of so many errors, and the outside auditors' failure to catch them, as a breakdown in the reporting process that was in itself material.

> I believe that the errors and the corrections thereof is information that needs to be disclosed in the Official Statement. While you and the auditors may conclude that the errors and corrections as such were not material either individually collectively, what I believe is material from a disclosure standpoint is the fact that somehow the process broke down permitting that to happen . . . and what has the City done[.][358]

E. The Voluntary Disclosure

The tensions between Mr. Webber and various members of City staff grew as he wrestled to frame the City's pension circumstances within the City's disclosure. He was charting new territory. As discussed elsewhere, there are no SEC guidelines for municipal disclosure

---

356 Letter from Gary Caporicci to Les Girard, Office of the City Attorney (Dec. 10, 2003).

357 Letter from Darlene Morrow-Trouver, Audit Division Manager to Leslie J. Girard, Assistant City Attorney, Re: Review of the City's FY02 Financial Statement Footnotes (Nov. 12, 2003).

358 E-mail from Paul Webber to Ed Ryan, Re: Financial Statements (Nov. 14, 2003).

regarding pension issues or, indeed, any other matters. The closest analog that Mr. Webber found to the City's arrangement with SDCERS was "pension obligation bonds" because, as he told Vinson & Elkins, they convert an obligation to pay actuarially required amounts into an obligation on which one has to pay scheduled debt service. The question that Mr. Webber sought to answer in formulating a disclosure template was how to meaningfully explain to the market all of the factors determining the dimensions and components of the City's annual pension obligations.

Mr. Webber believed that the basic information that should be disclosed was: (1) the City's currently required payment amounts, (2) the amount that the City is paying, per collective bargaining agreements, of its employees' share of their currently required contributions, and (3) the amount of supplemental benefits paid from Plan Assets, thus increasing the UAAL. Other information he thought should be conveyed included methodologies used in calculating UAAL, such as amortization periods, and key assumptions, such as investment returns. Finally, information about responsibility for payment for health care benefits and how they are being funded should, in his view, be disclosed. Mr. Webber viewed the obligation to fund these different benefits as similar to the obligation to pay a debt and, while future debt payments are typically sums certain, and projections regarding the categories described above are not, he believed that "order of magnitude" disclosures could be made to give the prospective investor a general sense of the City's obligations. Mr. Webber believed that the City had a duty to estimate and disclose its anticipated obligations over a reasonable period into the future.

The City staff continued to believe the proposed disclosure was unnecessary and potentially harmful. As the City Treasurer stated to Mr. Webber: "[w]e are in an environment where mountains are made out of molehills, and true credit issues could easily be overshadowed by this one issue."[359] Eventually, however, the City acceded to his views, apparently on the advice of the City Attorney's Office, and filed Voluntary Disclosure Statements with the Disclosure Repositories concerning the FY 2002 CAFR and MMWD financial statements.

The Voluntary Disclosure describes various numerical and clerical errors in the notes to the FY 2002 financial statements. In addition, it remedies deficiencies in the City's previous disclosure concerning the funded status of its pension system. Indeed, the first item in the statements explains the different AAL amortization periods used for calculating the City's annual contributions to SDCERS and for financial reporting purposes. The disclosure also addresses the representations that the contribution shortfall resulting from MP1 was "funded in a reserve." As Mr. Webber explained the necessity for retracting this statement:

[359] E-mail from Mary Vattimo to Paul Webber, Re: Paul Webber's Response re: Scenarios (Sept. 26, 2003).

> I believe that a reasonable reader of that note would understand the reference to "reserves" to mean City reserves, and would draw the inference that the City already had a reserve for this amount, so what is the big deal? Obviously that was not the case.[360]

The Voluntary Disclosure provides the information that the SDCERS actuary no longer supported the statements attributed to him in the pension footnote concerning the "corridor funding method." Finally, it discloses the existence and operation of MP2. As a result of further review, the City discovered an additional error in its FY 2002 CAFR. In that document, the City had overstated its outstanding debt on the Horton Plaza project by $6.64 million. Although the correction of this error benefited the City, it also raised additional questions about the reliability of its internal controls and audit mechanisms. Therefore, the City filed additional disclosure with the Disclosure Repositories describing this mistake.

[360] E-mail from Paul Webber to Les Girard, Re: CAFR (Oct. 22, 2003).

# Part III

# Disclosure Process and Deficiencies

The Voluntary Disclosure of January 27, 2004 fixed many disclosure deficiencies accumulated over the years, as discussed in Part II and illustrated in Appendix I. Many of the disclosure deficiencies described in this Report, including those corrected in the Voluntary Disclosure, result from the way City Management and employees went about the tasks involved in disclosure preparation and dissemination and the overall tone with which disclosure and financial reporting were approached. This section examines the roles and actions of key City departments and officials together with other players in the disclosure process.

## I. Financing Services

Financing Services, already briefly described in Part I, is "the trenches" where the fundamental work of preparing City disclosure occurs and is the keeper of Appendix A. Financing Services is a primary point of contact with Rating Agencies and was involved in the Manager's response to the Rules Committee Report, an effort ultimately superceded by the Pension Reform Committee.

City staff, both inside and outside Financing Services, explained to us that Appendix A has been prepared by the Financing Services group of the City for over a decade and A has been in substantially its current form since 1992.[361] Despite this responsibility and a staff tenure ranging from more than sixteen to less than two years, no one in Financing Services has received any formal training in disclosure practices.

Lakshmi Kommi, one of three Financing Services Managers, oversees the production of Appendix A, which is maintained and updated from time to time by an associate economist under the supervision of a more senior economist. The economist periodically obtains updated information from counterparts in relevant departments throughout the City to maintain a current version of Appendix A. Appendix A is updated by the City under bond/disclosure counsel's supervision prior to an offering. The final version of Appendix A may either be sent directly to the printer or through bond counsel. Although one of the objectives of the internal production of Appendix A is to preserve uniformity from offering to offering, the content may be shaped to conform to a particular offering in response to the comments of bond counsel. We were told that from time to time, a "play-off" occurs in which a City member of the working group resists disclosure counsel's comment based on the advice of a different disclosure counsel in a

[361] The following description of the Appendix A preparation process is based on the interviews, documents and e-mails assembled during our investigation as well as detailed lists captioned "Steps Involved in Preparation and Review of Appendix A" together with an Interested Parties List for each of the City's offerings relating to its General Fund in calendar years 2002 and 2003. These lists were provided to us by Financing Services.

contemporaneous or prior transaction, for instance, that another disclosure counsel did not raise the issue or affirmatively stated that it was unnecessary. Members of the City staff within the usual working group have the perception that Financing Services makes its own determinations as to what is material and maintains control over what is disclosed in Appendix A.

In assessing the performance of the Financing Services office, there are several key considerations: (1) the awareness of Financing Services staff regarding important features of the City's pension situation; (2) the process used by Financing Services to update the City's disclosures; and (3) the extent to which pension-related issues were raised in the discussions to which Financing Services was a party.

In our interviews, the team in Financing Services responsible for preparing Appendix A said they were unaware of MP1 or 2 or of the Blue Ribbon Committee report. According to Ms. Kommi and others, few people knew of the pension funding agreements, and not many (if any) had the big picture. Before the 2003 Rules Committee report, Ms. Kommi explained, Financing Services had not been exposed to actuarial concepts, and when the actuary's valuation report was read by staff in updating Appendix A, it was read at a very basic level. Only through the work on the Manager's Response to the Rules Committee did the staff in Financing Services become familiar with the Waterfall.

Staff told us the usual practice in updating the pension section was to highlight the numbers and fax the pages to the SDCERS staff for review and update. This "fax and plug in" procedure was the practice followed in Financing Services prior to 2002. While this "fax and plug" process provided SDCERS with an opportunity to comment on the disclosure, there is no recollection of proposed changes ever being suggested by SDCERS. In 2002, when Financing Services was folded into the Treasurer's Office,[362] it gained access to the Valuation Reports produced by the SDCERS actuary and began to simply lift and plug the numbers into the disclosure. The staff economist long responsible for this task noted that the approach was to update the numbers and leave it at that, without an understanding, for example, of what the funded ratio meant. The language, it appeared to this staff economist, had been "fixed and blessed."

In spite of individuals with a broad cross-section of City knowledge participating in financing working group sessions, City staff consistently told us that pension-related topics did not come up in these sessions, nor were they raised by bond/disclosure counsel or the City's independent financial advisers until after the *Gleason* case was filed. Following the filing of *Gleason*, additional language was developed among the City Attorney's office, disclosure counsel, the City Treasurer, and Financing Services and added to the April 8, 2003 Annual

[362] The Treasurer serves on the CERS Board pursuant to the City Charter.

Report, as well as to Appendix A in the April 30, 2003 Official Statement for the MTDB offering and subsequent offerings in 2003.[363] It was at this time that pension issues became part of the annual presentations to the Rating Agencies.

As noted earlier, the Financing Services staff served as the primary point of contact for the Rating Agencies and was heavily involved in the response to the Rules Committee hearing in February of 2003. The disclosure chronology in Appendix 1 demonstrates that the issues raised in these two contexts were not integrated into the City's disclosures until the Voluntary Disclosure. The failure to integrate this information demonstrates a deficiency in the City's approach to preparing disclosure documents essentially – the updating numbers in preexisting disclosure documents without significant analysis – which apparently kept the people preparing disclosure documents from incorporating the results of their analytical work in other contexts, such as preparing the response to the Rules Committee or addressing rating agency issues.

One reason Financing Services may have been slow to incorporate information and analysis from the Rules Committee and Rating Agency responses was its perceived mission to ensure consistency in the content of Appendix A, resisting change for the sake of accommodating the style of different working groups and skeptical of adding information without sufficient support. This was manifested in a cautious approach to introducing new information from sources outside Financing Services or the City, with a pattern of first seeking to determine whether any quantification was well founded, a skepticism toward future projections, and an insistence that the question "why must this be added?" be thoughtfully answered. This conservatism was compounded by cautions received from the City Attorney's office after *Gleason* was filed to exercise care in making statements that might be considered admissions.

A chain of e-mails in mid-summer 2003 after the 2003 TANS offering illustrates both the protective nature of Financing Services and the tension on pension disclosure that would grow to a boiling point between disclosure counsel and several members of the working group. In the chain, Ms. Kommi e-mails Deputy City Attorney Kelly Salt and the City Treasurer Mary Vattimo regarding changes proposed by Paul Webber, who was not involved in preparing the *Gleason* disclosure used in the Annual Report and Appendix A for the Balboa Park/Mission Bay Refunding, San Diego Old Town Light Rail, and 2004 TANS offerings.

> **Ms Kommi:** Kelly, I understand you put Paul in contact with (litigation counsel) on pension litigation. Who has he contacted? It is in City's interest to have the City Attorney (names) who helped draft the section on pension in the Appendix A to be present on all calls/meetings that Paul has with (litigation counsel). Paul is proposing that the City provide extensive disclosure on

[363] The crafting of the language as reflected in e-mails provides insight into the caution exercised in revising Appendix A by Financing Services.

> litigation, along the lines the County did in the Fall POB issue, If that is the case (name of a City Attorney) or others need to be in close loop on this issue to help draft/amend the current section on this matter. Since we just went to market with 3 General Fund issuances making certain disclosure on the pension litigation status, we cannot deviate too much other than the normal updates. Do you agree?
>
> **Ms. Salt:** I understand and I have told Paul that we need to be cautious because of the prior issuances. He, however, has made it very clear that he thinks our disclosure is nto [sic] enough…. (City attorneys) have referred me to our outside counsel, hence the referral to Paul. …I do not want to fail to do our proper due diligence on these matters.
>
> **Ms. Vattimo:** Kelly, I agree with you, but I also agree that this will be a battle with Paul. At a minimum, you, (names of other City Attorneys) need to scrutinize the language….

A few weeks later, the Terri Webster commented on the draft's inclusion of additional details from the *Gleason* complaint:

> **Ms. Webster:** Laksmi:…Why would be [sic] ever print a totally false accusation that could be misinterpreted as fact to harm us? We should delete the reference to 68% funded…that is false. IF HAVE TO HAVE IN to get Paul's opinion…then in the "City contents" section put the ration IS 77.3% per independent actuary…BUT I would rather delete the 68% totally.

These exchanges occurred in drafting the never-released Ballpark Official Statement, anticipated for early fall of 2003, but placed on hold as disclosure counsel and City staff unraveled the errors in the 2002 CAFR and crafted additional disclosure relating to the City's pension plan. Mr. Webber was also preparing the Wastewater Official Statement, so the Ballpark drafting was reflected in the August 26, 2003 Wastewater Preliminary Official Statement that was later pulled from the market. The exchanges indicate both institutional stubbornness and the degree to which Financing Services and others had yet to fully grasp the dimensions of the problems in the pension system. As one senior economist told us, after the Rules Committee hearing in February 2003, it took a while for the issue (of out-year liability) for the UAAL to settle in for him; Financing Services had not focused in on it as a separate issue initially. As they looked into it more, the awareness that they would have to do something grew. He never thought that they would not be able to somehow deal with the issue, and he believed there was no sense of panic or alarm. It was more a matter of determining what to do. He knew that other governments had issued pension obligation bonds and that other funding options were available.

In our interviews, Financing Services staff readily admitted that they need a greater understanding of what disclosure means. Some viewed it merely as one more task and did not

fully appreciate its importance. As one staffer said to us, "it needs to be clear that responsibility does not end with updating numbers." Materiality, the Supreme Court has said, "may be characterized as a mixed question of law and of acts."[364] To make materiality judgments without the benefit of counsel is to take on a degree of risk, and may, if all facts are not shared with disclosure counsel, undercut whatever future "comfort" may be received from counsel. Members of the Financing Services staff were also concerned about the lack of information provided by City management to the staff during the disclosure process. Lamont Ewell, who only recently became City Manager, told Vinson & Elkins that his understanding is that, in preparing past Official Statements, information was lifted from department documents and dropped into the Official Statement. Given the polarized environment (described below) disclosure drafts never went around to the Senior Managers for confirmation of facts. Rather, the team of the Deputy Manager for Finance relied on the departments who contributed to the Official Statement and dealt directly with them. This part of the City's culture seemed odd to him, "but questioning the process was sometimes like questioning the Bible."[365]

## II. The City Manager's Office

The City Manager oversees the various offices responsible for developing City disclosures as well as those offices holding substantive responsibilities regarding pension and labor relation issues. Thus, the failure of the City to comprehensively integrate the knowledge and information that was apparently compartmentalized across various City departments must, to a certain extent, rest at the door of the Office of the City Manager.

### A. Structure and Responsibilities of the City Manager's Office

San Diego has what is known as a "strong manager" form of municipal government. The City Manager is elected by the City Council and, according to the City Charter, is the chief administrative officer of the City.

> Among the duties of the Manager enumerated in the City Charter are: to keep the Council advised of the financial condition and future needs of the City; to prepare and submit to the Council the annual budget estimate and such reports as may be required by that body…. The Manager, as Chief Budget Officer of the City, shall be responsible for planning the activities of the City government and for adjusting such activities to the finances available.

---

364 *TSC Industries Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

365 Interview of Lamont Ewell, conducted by Paul Maco and Rick Sauer on June 30, 2004.

Under the Charter, the City Manager hires the Treasurer, subject to the approval of the City Council.[366] The City organization chart shows that the City Treasurer reports to the Deputy City Manager for Finance, as does the Financial Management Director, to whom the Budget Director reports. The Director of Human Resources, who serves as the City's point person in labor negotiations, reports to the Deputy City Manager for Operations. The current Director of Human Resources, Cathy Lexin, has also served as the City Manager's designee on the SDCERS Board for three years. The City Manager is also looked to by independent auditors to sign the manager's letter, a lengthy series of representations that is part of the foundation for the audit opinion. In a variety of ways, the City Manager serves as a gatekeeper for city disclosure. It is an important task and must be perceived as such.

The City Manager may, and in the past has, delegated authority for providing certifications of various disclosure documents to the Deputy City Manager for Finance. The City Manager was also a member of the Public Facilities Finance Authority until he stepped down in October 1999, although Official Statements continued to list his name for several years thereafter.

B. Working Style and Roles of Recent City Managers

The City Charter's description of the responsibilities of the City Manager allows a great deal of room for individual style and personality to determine the tenor of City administration. The current City Manager, Lamont Ewell, has held office since April 11, 2004. The previous City Manager, Michael Uberuaga, served from November 1997 to March 2004, the bulk of the period covered by this report. This report also covers the final 21 months of the prior City Manager, Jack McGrory, who served from March 1991 until September 1997.

As explained by Mr. McGrory, the City Manager oversees the day-to-day activities of the City administration and is responsible for carrying out City activities while staying within the City's budget. When the City is facing tough times, the City Manager can step in and push the City in a given direction. According to Mr. McGrory, this was not his successor's style, although the current City Manager may act more in this manner.

Under Mr. McGrory, department directors reported directly to him. During his tenure, he reorganized the reporting departments into six "business centers," one of which was Finance. Staff meetings were held to discuss major policy initiatives or major projects to make sure things did not fall through the cracks. Before approving disclosure documents, Mr. McGrory did not read all of them, leaving that to disclosure counsel and the financing team. Certificates for PFFA

[366] The City Manager, City Auditor and Comptroller, and City Treasurer are each designated as members of the Board of Administration of the pension system by the City Charter.

issuances would come to him through the City Attorney's office, and, before executing them, he would ask the attorney if it was all right for him to sign.

Mr. McGrory's successor, Michael Uberuaga, adopted a different style of management. Midway through his tenure, he reorganized the departments in the City Manager's Office so that they reported to the Assistant City Manager, who functioned as Chief Administrative Officer and handled day-to-day operations.[367] Mr. Uberuaga considered his role equivalent to being the CEO of the City. He delegated responsibility for details to his subordinates. In Mr. Uberuaga's view, the City Manager has only a high level view of most issues. He believed disclosure and the City's Official Statements were important matters, but disclosure was not sufficiently important to require the City Manager to read the disclosure documents. He could not specifically recall delegating authority to sign the City's general certificate in connection with bond financings to the Deputy Manager for Finance and did not know what it was. Mr. Uberuaga's view was that those people responsible for disclosure would handle it professionally and completely. The steps he took to assure himself that they did so were evaluating employees and making sure they were doing their jobs.

Mr. Uberuaga did sign the Manager's letter to the auditors in connection with the independent audit of the City's financial statements each year since 1999. However, after the discovery of numerous errors in the City's financial statements, he became concerned about the certifications because of his limited personal knowledge of the information provided to the outside auditors and relevant accounting standards. He told Vinson & Elkins that he was not informed of the errors disclosed in the City's January 27, 2004 Voluntary Disclosure at the time he signed, only of general non-material errors.

Lamont Ewell came to the City in January 2001 as Assistant City Manager, a position that Mr. Uberuaga intended to serve as intermediary between the City Manager and the rest of the staff. According to Mr. Ewell, Mr. Uberuaga did not always honor this structure, at least downward, as he would go around Mr. Ewell from time to time and deal directly with the people he wanted to handle an issue. Shortly after Mr. Ewell's arrival, weekly senior managers meetings were discontinued as redundant by the City Manager. Thereafter, there was no sharing of information. People worked on their own areas of concern, and issues were not discussed within the broader group. No opportunities were created to draw out an issue from one particular group that might be of interest to others. The Assistant and Deputy Managers were individually focused on the topics on the City Council's agenda. This has since changed and, as the new City

[367] See City of San Diego Memorandum, dated December 6, 2001 to Honorable Mayor and City Council, from Michael T. Uberuaga, City Manager, Subject: Organizational Structure Revisions. According to the Memorandum, the Assistant manager "will serve as the point person for internal operational matters. He will be responsible for assisting the organization in resolving day-to-day issues and coordinating activities."

Manager, Mr. Ewell has reinstated weekly meetings with all the Deputy City Managers, as well as monthly meetings with directors, to talk about policy issues.

In describing the degree to which the collective flow of information within the City Manager's Office ran past Patricia Frazier, the Deputy Manager for Finance prior to the signing of disclosure certifications such as the City's general certificate, Mr. Ewell responded with the observation that the City is a unique organization, with a culture in which some members of the City government tend to be very provincial, safeguarding their areas of responsibility, although the culture is improving. Mr. Uberuaga and Ms. Frazier did not communicate very well with each other, and Mr. Ewell was asked to serve as an intermediary.[368] This task occurred on behalf of Mr. Uberuaga with a number of other staff members, including Ed Ryan, the City Auditor and Comptroller.

C. The Director of Human Resources

As noted above, the Director of Human Resources, Cathy Lexin, is one of the Directors reporting to the City Manager through the Assistant City Manager and the Deputy Manager for Operations, Bruce Herring. The Director of Human Resources is the contact point for labor negotiations, also known as "meet and confer." The results of the meet and confer process extend beyond Human Resources and policy implications, both short and long term, can greatly affect the City's disclosure and the City's budget. First, there is a direct, identifiable effect through salary increases. Second, the effects of pension benefit increases ripple through future years and kick into the budget after a full year of actual benefit impact is realized. For example, when benefits are increased in May at the end of meet and confer, such as the jump in 2002 from 2.25% to 2.5% for the multiplier used to calculate the annual member benefit received, the increase may go into effect at the beginning of the new fiscal year on July 1 but may not show up in City contributions for another 26 months, when the actuarial valuation report is released in January or February for the June 30 end of the Fiscal Year in which the increase first became effective.[369] The City contribution for the coming fiscal year's budget – 26 months after the meet and confer process providing the increase – will then reflect the increase in benefits. This is according to a "normal" cycle.

Ms. Lexin, the Director of Human Resources, maintains she was not a direct participant in the disclosure process. She was, however, quite involved in developing MP1 and MP2 and regularly participated in the meet and confer sessions generating salary and benefit increases. The short and long-term financial implications of meet and confer, particularly expanded

[368] In Mr. Ewell's view, the Deputy felt isolated and that some of her responsibilities had been stripped away.

[369] The 26 months is the sum of (1) May-July 1 = 2 months, plus (2) 12 months of the Fiscal Year July 1- June 30, plus (3) the one year lag once the actuary results are complete when the next payment is made in another 12 months on July 1: 2+12+12=26.

retirement benefits, require careful consideration by City managers, as the Blue Ribbon Committee admonished the City in 2002. The consequences may also rise to a level of materiality so as to require disclosure. If one of the key participants in the process is not a participant in the City's disclosure process, the disclosure process may be "built to fail."

D. The City Financial Management Director

The City Financial Management Director, Lisa Irvine, is also part of the City Manager's Office and reports to the Deputy Manager for Finance. The City Budget Director, the Purchasing Agent and the Assistant Optimization Manager report to the Financial Management Director. Ms. Irvine is responsible for preparation of the City's $2.4 billion budget. The budget is done on a fiscal year basis and, as Ms. Irvine told us, is revenue driven because the State continues to erode the City's revenue base and there is not enough money to meet all needs.

In preparing the budget, Ms. Irvine told us she receives information on the pension system from Terri Webster in the Auditor's Office. Based on estimated budgeted salaries and wages by labor union, Ms. Webster provides the SDCERS contribution rates, which are budgeted by bargaining unit. Ms. Irvine, also told us that, in preparing the budget, her staff does its best to consider the decisions of the SDCERS Board, as Ms. Webster can tell them how some of the Board's decisions will affect the budget.

We were told in our interviews that policy issues associated with the meet and confer process were addressed one-on-one between the City Manager and Deputy Manager for Operations. There was little opportunity for input from other Deputy Managers on the consequences of the meet and confer process; no executive team meeting was called to discuss these things. Updates on meet and confer were provided to the Budget Director, providing the information needed to get the budget done. Without the opportunity and cross-management discussions necessary to explore critical decisions in other departments of the Manager's office, careful consideration of budgetary consequences is difficult to accomplish. Equally difficult to accomplish, without such consideration, is a meaningful budget discussion in the City's disclosure documents.

III. Auditor and Comptroller

Under the City Charter, the City Auditor and Comptroller is elected by the City Council for an indefinite term and serves until a successor is elected and qualified. The City Auditor and Comptroller is the chief fiscal officer of the City and exercises supervision over all accounts. Ed Ryan served as the City Auditor and Comptroller for a period of years, and resigned February 13, 2004. As noted elsewhere, we did not have the benefit of an interview with him, although we did receive and review copies of e-mails and documents from his files. From all accounts, he

was highly respected. Upon his resignation, the Assistant Auditor and Comptroller, Ms. Webster, was appointed as Acting Auditor and Comptroller.

Given the overarching responsibility of the City Auditor and Comptroller for the generation of the City's financial statements and Mr. Ryan's extensive experience at the City, Mr. Ryan certainly had opportunity to observe development of issues critical to the City's disclosure. For instance, Mr. Ryan's department was responsible for preparing both the City and SDCERS financial statements. Mr. Ryan was a board member of PFFA, and approved the use of disclosure documents in connection with City securities offerings. During his time on the PFFA, records show he took an active role.[370] On December 4, 1996 he voted, along with City Manager Jack McGrory, to approve the preliminary official statement for the 1996 stadium bond issuance.

Mr. Ryan providing support to the Blue Ribbon Commission, which raised several issues already discussed in our report. The Ballpark Official Statement, however, dated February 14, 2002, overlapped with Mr. Ryan's work on behalf of the Blue Ribbon Commission, yet makes no mention of these issues. Mr. Ryan was also well aware of the potential threats to the City's financial condition associated with the *Corbett* litigation, as discussed above. *Corbett* was mentioned only once in City disclosures. Mr. Ryan also signed the glowing letters transmitting the City's, which stated:

> Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the City and its related agencies. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the City and its related agencies. All disclosures necessary to enable the reader to gain an understanding of the City's, and its related agencies, financial activities have been included.

The CAFRS, of course, had the shortcomings discussed in this report. The Auditor and Comptroller serves as a gatekeeper for the City's disclosure, particularly its financial statements. Regrettably, we never had the opportunity to assess and incorporate his perspective on these issues.

[370] For instance, at the January 28, 1997 meeting, the minutes reflect that Mr. Ryan was looking into one issue in the preliminary official statement relating to the planned issuance of sewer revenue bonds (the minutes do not reflect what that issue was) but that it was being worked out, and he approved the form of the document before the Board.

## IV. City Attorney

The City Attorney is an elected official and, as stipulated in the City Charter, is "the chief legal adviser of, and attorney for the City and all Departments and offices thereof in matters relating to their official powers and duties. It is the City Attorney's duty,…to prepare in writing, all ordinances, resolutions, contracts, bonds, or other instruments in which the City is concerned, and to endorse on each approval of the form or correctness thereof; to preserve in the City attorney's office a docket of all cases in which the City is interested in any of the courts…"

The City Attorney's Office employs over 120 attorneys divided into civil and criminal units. Attorneys from the City Attorney's Office participate in a variety of aspects of the City, including the meet and confer process, litigation, contract negotiation, financings and enforcement of the Municipal Code. The City Attorney's office is the last stop for the Form 1472 before docketing with the City Clerk's office. The City Attorney or a designee is present at all City Council meetings.

There is no one within the City Attorney's Office officially designated as responsible for disclosure matters, although several attorneys routinely participate in bond offerings, one assigned to short term offerings or TANs, one to Redevelopment, and one to general and special fund offerings. Beyond this division of labor, there is no official set of procedures for attorneys involved in bond offerings. The Office has had at least one attorney participate in each bond issuance since 1996. Bond and Disclosure Counsel are hired and supervised by the City Attorney's office. The drafting, review, comment on, and circulation of bond documents are coordinated with Bond Counsel by the assigned City attorney. The assigned City attorney also assists Bond Counsel in ensuring that the bond documents comply with the Municipal Code and City Charter. Final sign-off on the Form 1472 covering the ordinance or resolution relating to a bond financing, together with related documentation, is provided by the assigned City attorney. Typically the assigned City attorney attends the City Council meeting at which a bond deal is up for approval, together with the Bond Counsel and Project Manager from Financing Services, to answer any questions the Council may have regarding the financing. None of the City attorneys routinely assigned to bond transactions, or that have become involved under special circumstances, have any special training in the securities laws generally or in the disclosure requirements applicable to issuers of municipal securities, nor do they hold themselves out as having such knowledge.

The assigned City attorney also assists in preparation of the Litigation section of Appendix A and will check with the head of the City Attorney's litigation section to identify pending litigation with exposure in excess of $10 million. If any such claims exist, the assigned City attorney asks the City attorney responsible for that matter to prepare a draft disclosure and will then give it to the Disclosure Counsel for review. The Disclosure Counsel may then ask

questions of the attorney who prepared the draft disclosure. The City Attorney's Office's expectation is that even though the City Attorney's Office prepares a draft of the disclosure, Disclosure Counsel will edit the proposed disclosure and ask for additional information if the Disclosure Counsel believes that more information should be disclosed. The assigned City attorney also asks the Disclosure Counsel if the information they provided about the litigation is sufficient.

We interviewed several attorneys in the City Attorney's Office, including one who has been involved with most long-term City offerings relating to the general fund since 1996. As related to us, the attorney did not recall any working group discussions of MP1 or MP2 until a few months before the interview. The attorney had no recollection of any working group discussions of additional benefit plans or any matter relating to SDCERS, other than *Gleason*, during the course of any financing. The attorney did not recall any of the City's financial advisors raising questions about the performance of the City's pension plan or about providing more current information on the plan's financial condition. Nor did the attorney recall the section of Appendix A captioned "Pension Plan" as receiving any particular attention, or anyone, including Disclosure Counsel, of having asked of the source of the information or for its verification. The attorney did not recall anyone on the working group list provided by Financing Services for the Fire and Safety financing, Balboa Park refunding, or Old Town refunding, asking questions about, discussing, or mentioning the Blue Ribbon Commission report, the February 2003 City Council Rules Committee hearing on SDCERS, or any of the op-ed or press articles containing questions raised about the City's funding of SDCERS by Ms. Shipione. A second attorney involved in the City's short term offerings confirmed that none of the City's outside advisors or the internal working group, raised any questions about the pension system or pension disclosure.

The City Attorney's office typically delivers one or more legal opinions in connection with the closing of publicly offered City securities, including what is known as an "affirmative 10b-5 opinion" covering the entirety of the Official Statement.[371] The text of this opinion, as rendered in connection with the issuance of both short-term and long-term City securities reads:

> To my actual knowledge, the information contained in the Official Statement concerning the City, including in the Appendices thereto, is true and correct in all material respects and does not contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading.

[371] The 10b-5 refers to SEC Rule 10b-5 promulgated under Section 10b of the 34 Act. The "affirmative" is evident from the content of the opinion, as cited in the text above.

The opinions are signed under the name of the City Attorney as by one of the Deputy City Attorneys assigned to the financing. The scope of the opinion appears broad in some respects, narrow in others. The opinion is broad in that it covers the entire document. It is narrow in that it is limited to the signer's "actual knowledge." Further narrowing depends upon who the signer is understood to be, the City Attorney or the Deputy City Attorney. There is no process in place to marshal the collective knowledge of the City Attorney's Office before signing these opinions.

Among the City's Disclosure Counsel, two said the City Attorney's opinion is important to them in providing disclosure comfort and a third, regarded by City staff as by far the most demanding of the three, said the opinion wasn't given much consideration, although he had high regard for the non-disclosure duties performed by the assigned City attorney.

In our interviews, attorneys from the City Attorney's office could not identify any process by which an attorney from the City Attorney's Office advises the City Council as to the adequacy of disclosure. It is not a routine part of the presentation to go through offering documents in any detail and nothing in particular in the approval process is intended to give the Council comfort that the City Attorney's Office has reviewed disclosure and found it to be adequate.

## V. Independent Auditor

The City's Audit firm, Caporicci and Larson, became the independent auditor for the City of San Diego as of January 1, 2003 through the acquisition of Calderon, Jaham & Osborn ("CJO"). CJO had been the City's Independent Auditor since 1993 and had their contract renewed in 1998 and again in 2002 pursuant to an RFP solicitation conducted by the Financial Management Department of the City Manager's Office. As part of our interviews we were told that in 2002, four firms responded to the RFP, one of which was a "final four" firm, and three were interviewed. CJO was selected because their price, experience, action plan, the number of consultants assigned, the audit work planned and technical experience were all very good. Technical expertise was measured by years of experience and similar factors. Certain people on the selection committee were very pleased with CJO's demonstrated knowledge in answering questions. The panelists consisted of employees of the City or its component units. CJO's costs were significantly less than the "final four" firm. Back-up files for earlier RFPs had not been kept. City records show that in 1993, CJO had not been the firm selected by the City Manager's Office. According to the Minutes of the City Council for April 26, 1993, Deloitte & Touche/Armando Martinez & Company was recommended by the panel as most qualified. On motion of a Councilmember, CJO was proposed, seconded and approved by a vote of 8-1. We

were told in the course of our interviews that CJO had heavily lobbied the City Council following the choice of another firm.[372]

The Independent Auditor's contract with the City is administered by the Financial Management Director. There is no formal periodic oversight or review of the Independent Auditor's work conducted by the City. The Director relies on the Auditor's office and the agencies as to how well the firm is doing. In the past, the City's Independent Auditor also served as the Independent Auditor for SDCERS. In 2002, as an oversight, SDCERS was not included in the RFP process. SDCERS had the opportunity to be covered under the agreement, but was considering hiring someone else. SDCERS complained that CJO "has not been responsive to their requests and has not been current on key pension issues." SDCERS "also explained that CJO has made some mistakes that they [SDCERS] have had to point out."[373] SDCERS ultimately continued use of CJO's acquiring firm Caporicci and Larson for FY 2003, but **[**has**]** retained a separate audit firm for FY 2004.

Independent Auditors serve a well known and critical function in assuring their integrity of a city's financial statements. When considerations such as cost weigh on selection, care must be taken to avoid the compromise of quality. As a former senior city official remarked, it is ridiculous to have cost rather than performance drive a decision, particularly given the tremendous impact mistakes can have on a City's credibility.

## VI. City Council

As explained elsewhere in this Report, the City Council approves all long term bond offerings, including the Preliminary Official Statement, by ordinance, and short term offerings, including the Preliminary Official Statement, by resolution. The documents are docketed with the City Clerk under a completed form 1472. The City's CAFR is not reviewed or approved by the City Council prior to its release by the City Auditor and Comptroller. We were told during our interviews that the City Counsel has no formal procedures in place for the review and approval of disclosure documents. Prior to February, 2004, the City Council received the advice of outside counsel as to its obligations with respect to the City's disclosure obligations under federal securities law on one occasion. That same occasion was the only time the City Attorney's office could recall providing advice to the Council on disclosure obligations and did so by reference to the outside counsel.

---

[372] We reviewed records of political contributions for the relevant period on file in the City Clerk's office. The records showed several small contributions to different Council members by members of CJO as well as contributions by the firm selected through the RFP process. The amounts, on their face, do not appear to be significant or out of the ordinary.

[373] E-mail (Oct. 17, 2002) from Lisa Irvine to Cathy Lexin, Mary Vattimo, and Terri Webster (cc to Patricia Frazier and Ed Ryan). In the e-mail, Ms. Irvine recounts expressing surprise to SDCERS "since the other agencies which are also independent from the City have received very good services from CJO."

The City's February 14, 2002 sale of $169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 (Ballpark), also referred to as the "Ballpark bonds," is one of the most contentious offerings in recent City history. Litigation had stalled the offering for several years. The investigation of a City Council member under allegations of conflicts of interest and receiving favors in return for supporting the financing and the threat by one opponent to send the City's disclosure document to the SEC heightened the sensitivities of the participants in the offering, particularly at the City, to avoiding any further problems. A highly regarded securities lawyer who was the former long-time head of the SEC's Los Angeles Regional Office was retained as special counsel to the City to advise the City Council and the Public Facilities Financing Authority on requirements of the federal securities laws. In a letter to an Assistant City Attorney, captioned "Review of Disclosure Documents as to Lease Revenue Bonds 2001, the lawyers advised:

> The importance of the review of municipal securities disclosure documents was highlighted in connection with an SEC report that was critical of the supervisors of Orange County, California for shortcomings relating to their review of such documents. *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors,* Exchange Act Release No. 36761 (January 24, 1996). As stated by the SEC in the Orange County matter:
>
> > In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. **In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.**[374]
>
> The message communicated by the statements of the SEC in the foregoing report is that members of the body approving disclosure documents cannot simply "rubber-stamp" the document. Rather, each member has the responsibility to demonstrate that he or she was actively involved in the process – that is, each person must review the disclosure document, inquire as to the source of the information, ask questions of the City officials and other professionals who

[374] *Id*. (emphasis added).

> provided information (as well as ask if there are other sources of information that should be reviewed), and follow-up to ascertain whether the information makes sense in the circumstances. In short, the members of the City Council and the Board of Commissioners must demonstrate that they have satisfied themselves, after diligent inquiry that all material facts have been accurately disclosed, that the POS is not misleading.[375]

This letter was circulated to the City Council and members of the PFFA by the City Attorney's office and the City Council was advised in closed session by the letter's authors of their "responsibilities regarding the consideration of the Preliminary Official Statement for the City's ballpark bonds."

The passages quoted above are not confined to special situations, but are phrased in terms of general applicability, as was the presentation in closed session.[376] Although the articulation of responsibilities was not expressly confined to the special circumstances of the Ballpark bonds, it was regarded as such, as we were told in our interviews. Yet at no other time, before or after the Ballpark bonds until the last vote taken by the City Council to access the public securities markets in August of 2003, was the City Council advised of its responsibilities under federal securities laws. In spite of the letter's clear direction to the standard articulated in the Orange County report, neither the City Attorney's Office nor the City Manager took steps to put in place procedures to be followed by the City Council to meet the standard.

Members of the City Council who were present at that presentation stated in interviews that while they did not recall the specific details of that presentation, they conducted a much more careful review of the disclosure documents connection with the Ballpark Financing than had been their previous practice. All who we interviewed recalled that the Council was careful to read the disclosure and that members asked a number of questions. One Councilmember recalled Les Girard of the City Attorney's office reviewing the draft official statement for that financing with the City Council. This extra attention was also attributed to concerns regarding ongoing legal threats against the City in connection with the ballpark project.

The Councilmembers interviewed did not, however, recall anyone emphasizing to them the need to continue this level of scrutiny for subsequent financings, and those that joined the

---

[375] This may be an overly harsh, although under the circumstances, fully appropriate repackaging of the Commission's message in the Orange County 21(a) report. A milder perspective was offered several days after the release of the Commission's Orange County 21(a) report by the then Director of the Division of Enforcement: "May public officials reasonably rely on lawyers, financial advisors, underwriters and governmental employees? Absolutely -- just as officials of public companies do. That reliance however -- must be reasonable." William R. McLucas Director, Div. Of Enforcement, Sec, "Municipal Securities Law Enforcement: A Current Assessment," Remarks Before The Government Finance Officers Association (Jan. 30, 1996).

[376] Memorandum from Paul S. Maco to File, Re phone interview with Gerald Boltz and Matt Anhut of Bryan Cave LLP. (Aug. 18, 2004).

Council after Mr. Boltz's presentation did not recall receiving the information about their obligations under the securities laws that he provided. Perhaps as a result, the City Council continued to rely on City staff to ensure the accuracy of City disclosures.

Disclosure documents typically are included in the collection of financing documents that is circulated to the Councilmembers to review before a financing comes up for their approval. The City Manager's office and the City Attorney's office occasionally schedule individual briefing sessions with the Councilmembers, but this only occurred for those matters that were expected to generate a lot of questions, either from the City Council or the public. Councilmembers interviewed said that they generally asked their staff to review and research planned financings, with individual staffers focusing on particular matters (such as transportation, park issues, etc.), and that they might review those documents personally as well. Historically, that review was not conducted primarily with the intent of ensuring the accuracy of the factual statements disclosed. The Councilmembers were most interested in issues of concern to their constituents and other matters viewed as having significant policy or political implications.

Even on those matters of particular concern, the Councilmembers relied on the City officers and staff. For example, one Councilmember said that his staff first reviewed the Manager's Report to see what issues might affect his district, and Councilmember Madaffer stated that his primary concern was making sure that the City would be able to pay the debt service on its bonds. Another Councilmember said that he relied on the certification of the City Auditor that the City could afford to pay its debt service.

A number of the Councilmembers interviewed stated that they looked to the City officers and staff to review and evaluate any significant matters, including disclosure concerns, and to raise them for the City Council, as the Charter requires.[377] They emphasized that due to their own lack of knowledge of the relevant standards and the details of the various matters affecting the City, they relied heavily on City staff to ensure that the documents presented for their approval were prepared properly. They gave particular weight to the recommendations of the City Manager, the City Auditor and Comptroller, the City Attorney, and the City's outside bond counsel relating to City financings. One Councilmember stated that he relied on the City Manager to review and evaluate any relevant issues and on the City Attorney to look out for the interests of the City Council on legal matters. Another Councilmember also stated that he expected that any significant issues relating to financings would be brought to his attention by the City Manager, the City Auditor, or the City Attorney. It was his practice to review the bond

[377] Section 32.1 of the Charter specifically requires the City Manager and all non-managerial officers of the City to inform the Council of all material facts or significant developments relating to all matters under the jurisdiction of the Council as provided under this Charter except as may be otherwise controlled by the laws and regulations of the United States or the State of California and to comply promptly with all lawful requests for information by the Council.

financing documents to make sure that all of the necessary City officials had signed off on the financing, and he said that those signatures indicated to him that the appropriate City officials had reviewed the financing documents and believed them to be correct. Despite their own admitted lack of knowledge regarding disclosure standards, several of the Councilmembers have indicated that they are now conducting a more careful review of the accuracy of the disclosure documents as a result of the problems addressed in this Report.

One consequence of the City Council's reliance on the staff to ensure that financing documents were properly prepared is that a number of the issuances approved by the City Council (the TANs, for example) were often included on the City Council's docket as consent items, which as a matter of procedure results in only a cursory review by the City Council. A review of the audiotape transcripts of the Council meetings at which bond documents were approved reveals that approval of issuances as consent items was relatively common; for the other financings, those discussions that did take place did not address the disclosure documents (except for the offering documents for the Ballpark Financing), although they might involve other matters relating to the financing at issue. Similarly, the transcripts reviewed did not contain any representations by the staff as to the accuracy or completeness of disclosure provided.

It also appears from the interviews and transcripts that the Councilmembers did not appreciate the need to ensure that those matters which they were considering that might be material to investors in the City's securities were properly disclosed in the City's disclosure materials. In connection with the disclosure relating to the Balboa Park and Trolley issuances in early 2003, during the time that pension issues were becoming a matter of increasing concern, one Councilmember said that City officials did not suggest to the City Council that the City's pension problems were a matter for disclosure and that at that time the City Council had not yet received what he considered definite information regarding the pension issues. Another Councilmember also indicated that he did not recall discussing disclosure of the pension issues in connection with those issuances at the time; nor did he recall the City Manager or the City Attorney raising the question of disclosing the pension situation in connection with those bonds. Both Councilmembers noted that there were ongoing questions at that time as to the true severity of the pension situation and stated that the City Council had asked the Manager to research the matter further.

As a general matter, it appears from the transcripts that review and approval of financing documents was considered by both the Councilmembers and the City staff to be one of the many legislative chores with which the City Council was burdened, and one to be completed as quickly as possible, at least in the case of those financings that were not considered controversial. It was pointed out to us that the City Council has a busy agenda, generally considering approximately 50 items each week and 2000 each year. While it is regrettable that the individual

Councilmembers devoted so little time to reviewing financing documents, given the constant press of issues demanding the City Council's attention every week it can hardly be considered surprising.

The press of City business notwithstanding, when hundreds of millions of dollars are borrowed in the public markets, public officials, whether elected or appointed, acquire a new, second constituency. This constituency is deserving of time and attention too, particularly with respect to the reliability of the representations upon which they lend their money.

A. Representations, Warranties and Certifications by the City to its investors

Municipal securities, including those of the City, are not initially sold to an underwriter or reach the public markets unless a number of conditions at closing have been met. Those conditions are generally set forth in the bond purchase agreement or, if competitively bid, a notice and terms of sale document. As a matter of course, one typical item required at closing is a certificate of the issuer attesting to the accuracy of information provided in the disclosure documents, such as the City's Official Statements, on which the underwriters of the securities rely for initial pricing and for the resale of the City's securities to investors in the secondary market.

Those certificates, together with an official statement conforming to the requirements of Rule 15c2-12, ordinarily would be authorized by the resolution of the City Council that approved the debt offering. As described above, the City Council approves debt offerings and the forms of certain documents and agreements necessary to such offerings, including official statements, by resolution. A standard resolution might authorize the City Manager, the Deputy City Manager, and their authorized designees to execute the official statement in substantially the form approved by the City Council at such time as he deems it final, together with such additions or changes as such officers may require, such approval to be conclusively evidenced by the execution and delivery of that official statement on behalf of the City. The resolution also would authorize the City Manager, the Deputy City Manager, the City Clerk, the City Attorney, and their respective designees to make, among other things, such certifications and representations as they deem necessary or appropriate in order to consummate the execution and delivery of the documents approved in the resolution.

A closing certificate provided by the City (sometimes referred to as the City's "general certificate") typically would include the assurance, among others, that the information contained in the official statement with respect to the City is true and correct in all material respects and such information does not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements therein, in light of the circumstances under which

they were made, not misleading.[378] Representations and warranties as to the condition of an item being sold are common assurances demanded of sellers by purchasers of many sorts of goods, including municipal securities, and issuers are typically expected to give similar representations and warranties prior to closing in connection with the execution of a bond purchase agreement, together with an explicit representation and warranty as to the accuracy of the issuer's financial statements contained in the official statement and their compliance with generally accepted accounting principles.[379] The antifraud provisions of federal securities laws give such representations particular emphasis by making it a violation of securities law to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[380] City Council and City Manager Michael Uberuaga delegated the responsibility for signing such certificates in connection with City financings to Deputy City Manager Patricia Frazier.[381] In financings by the City's related authorities, a certificate of this sort might be provided by one or more officers of the authority.[382]

As discussed above, the City Attorney ordinarily would be expected to provide a similar certification or opinion at closing as part of his opinion letter, although such letters might actually be signed by one of the City Attorney's subordinates. That certification or opinion would state that to his actual knowledge, the information contained in the official statement concerning the City is true and correct in all material respects and does not contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or

---

[378] Recently, in proposing enhanced requirements for certifications by corporate officers, the SEC explained its view of the scope of a corporate officer's certification that "to his or her knowledge … the report contains all information about the company of which he or she is aware that he or she believes is important to a reasonable investor as of the end of the period covered by the report." The Commission stated: "by its terms, the proposed certification is subjective in nature, in that it is limited to the knowledge of the principal executive officer and the principal financial officer and to their belief as to whether the information would be important to a reasonable investor. The principal executive officer or principal financial officer would not, as a result of the proposed certification requirement, have to separately inquire as to information not known to him or her by virtue of his or her certification of the contents of the company's periodic reports." Exchange Act Proposed Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports Release No. 34-46079, (June 17, 2002).

[379] *See, e.g.,* Contract of Purchase between Merrill Lynch, Pierce, Fenner & Smith Incorporated with the Public Facilities Financing Authority and the City of San Diego, in connection with the $169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002 (Ballpark Project) (Feb. 14, 2002).

[380] SEC Rule 10b-5.

[381] *See, e.g.,* Closing Certificate of the City in connection with the $15,255,000 City of San Diego/MTDB Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding), (May 20, 2003) (signed by Deputy City Manager Pat Frazier).

[382] *See, e.g.,* Closing Certificate of the Authority in connection with the $15,255,000 City of San Diego/MTDB Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding), dated May 20, 2003, and signed by the Chair of the City of San Diego/MTDB Authority; Certificate of the Authority in connection with the $169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002 (Ballpark Project), signed by the Vice Chairman, (Feb. 15, 2002).

necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading.[383]

In addition to the certifications provided in connection with debt offerings, City officials provided various other assurances in other contexts as well. The City Manager, the City Auditor and Comptroller, and the City's Accounting Division Manager all signed the City's letter to its independent auditors. That letter confirmed a long list of representations made to the independent auditors during the course of the audit that establish the factual basis for the auditors' work. In addition, in the cover to the City's Annual Reports, which typically included or incorporated by reference the City's CAFRs as well as a textual discussion of the pension system, the Deputy City Manager provided a certificate stating, among other things, that the information contained in the Annual Report was obtained from sources which are believed to be reliable.

The failure of an issuer to ensure the accuracy of its disclosure limits the value of such certifications, however, and introduces an unnecessary element of risk into financings. The consistent delegations of authority to sign such certifications by the City Manager and the City Attorney may have been an efficient way of dealing with the constant press of business facing the City, but they could be expected to result in a corresponding lack of attention on the part of the delegating official to the need to make sure that the information being certified was in fact accurate. Generally, however, such delegations were part of the routine functioning of the City's financing activities, one of the various elements in which City staff carried out the necessary processes and completed the usual forms without necessarily knowing or appreciating the nature of the certifications they were providing. Investors expect, and deserve, a higher degree of consideration.

[383] *See, e.g., O*pinion Letter of the City Attorney provided in connection with the $110,900,000 City of San Diego, California, 2003-04 Tax Anticipation Notes, Series A, (July 1, 2003).

# Part IV

# Federal Securities Laws and the City's Disclosures

When the City of San Diego and other municipal governments in the United States raise money in the securities markets, they may issue any of a variety of different debt obligations. In the case of the City, these have included short term Tax Anticipation Notes ("TANS"), Certificates of Participation ("Cops"), and Lease Revenue Bonds. Lease Revenue Bonds are issued through a separate entity, such as the Public Facilities Financing Authority of the City of San Diego, for reasons explained earlier in this Report. In all cases, these instruments are considered "securities" under federal securities law. The credit behind the City's obligation to repay obligations such as TANS, Cops, and Lease Revenue Bonds ultimately runs to funds legally available to the City, with the exception of TANS, for which the source of repayment ultimately runs to lawfully available funds attributable to the fiscal year in which the TANS are issued. The ability to meet the obligation to repay debt is of obvious interest to the holders of the debt, as are limitations and burdens upon the sources and security for repayment.

When offering, purchasing, or selling securities, issuers of the securities must comply with the federal securities laws. However, the scope of applicable federal law is substantially less for municipalities like the City of San Diego than it is for public companies. Congress expressly exempted state and local governments from the registration and reporting provisions found in the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). This means generally that when issuing securities, municipalities like the City do not need to register the offering with the SEC, comply with the many complex rules relating to the offering process, or subsequently file or furnish periodic reports with the SEC at the times and in accordance with the many detailed rules and regulations governing such reports (often known as "line-item disclosure"). Congress likewise chose to exempt issuers of municipal securities like the City from the application of what many consider the most significant expansion of the federal securities laws since the 1930s, the Sarbanes-Oxley Act of 2002. The SEC'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 issuers of municipal securities. Congress also did not extend to municipal issuers the protections provided to certain forward-looking statements by issuers of securities and others when it amended the Securities Act and the Exchange Act in 1995 to provide such protections to registered issuers and certain others.

While exempt from the application of the great bulk of federal securities law, the City and other issuers of municipal securities are subject to the antifraud provisions of Securities Act Section 17(a) and Exchange Act Section 10 and Rule 10b-5. In addition, the SEC has fashioned

a broker-dealer Rule, Exchange Act Rule 15c2-12, that in general limits market access for municipal securities issues to those offerings in which the issuer agrees to file annual financial disclosure as well as reports of certain events, if material, with central repositories designated by the SEC, the Disclosure Repositories. The SEC considers the antifraud rules to apply to such disclosures, as well as any other statements made to the market.

Eight years ago, following the Orange County, California bankruptcy, the SEC initiated and settled its first comprehensive series of enforcement actions against an issuer of municipal securities, the issuer's governing body, certain officials of the issuer, and certain professionals involved in the offering of Orange County's securities.[384]

The SEC summarized the basics of the antifraud provisions in the settled Administrative Proceeding for Orange County:

> Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make it unlawful for any person, in the offer or sale (Section 17(a)) or in connection with the purchase or sale of any security (Section 10(b) and Rule 10b-5), to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact, to omit to state a material fact, or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person through the means or instruments of interstate commerce or the mails. Information is material if there is a substantial likelihood that a reasonable investor would consider it important to an investment decision. See Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Furthermore, when the information pertains to a possible future event, materiality will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. "Basic Inc., 485 U.S. at 238 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).
>
> Scienter is required to establish violations of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. See Aaron

[384] *In re County of Orange, California; Orange County Flood Control District; and County of Orange, California Board of Supervisors*, Securities Act Rel. No. 7260, Exchange Act Release No. 36730 (Jan. 24, 1996), A.P. File No. 3-8937 ("Administrative Proceeding"); *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (January 24, 1996) ("Report"); *SEC v. Robert L. Citron and Matthew R. Raabe*,. SACV 96-74 GLT (C.D. Cal.), Litigation Release No. 14792 (Jan. 24, 1996) (complaint); *SEC v. Robert L. Citron and Matthew R. Raabe*, Litigation Release No. 14913 (May 17, 1996) (settled final orders); *In re Newport-Mesa Unified School District*, Securities Act Release No. 7589, A.P. File No. 3-9738 (Sept. 29, 1998). *In re CS First Boston Corp., Jerry L. Nowlin and Douglas J. Montague*, Securities Act Release No. 7498, Exchange Act Release No. 39595, A.P. File No. 3-9535 (Jan. 29, 1998); *In re Merrill Lynch, Pierce, Fenner & Smith Inc.*, Securities Act Release No. 7566, Exchange Act Release No. 40352, A.P. File No. 3-9683 (Aug. 24, 1998); *In re RBC Dain Rausche, Inc.*, Securities Act Release No. 8121, Exchange Act Release No. 46346, A.P. File No. 3-10863 (Aug. 13, 2002); *In the Matter of Kenneth D. Ough*, Securities Act Release No. 8141, Exchange Act Release No 46736, A.P. File No. 10922 (Oct. 29, 2002); *In re Jean Costanza*, Securities Act Release No. 7621, A.P. File No. 3-9799 (Jan. 6, 1999).

> 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 (9th Cir. 1990) (en banc), cert. denied, 499 U.S. 976 (1991). 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.

In settling with one of the underwriters of Orange County securities,[385] the SEC explained that negligence is sufficient for a violation of Securities Act Sections 17(a)(2) and (3):

> Sections 17(a)(2) and (3) of the Securities Act make it unlawful for any person, through the means or instruments of interstate commerce or the mails, in the offer or sale of any security: "(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." Scienter is not required to prove violations of Sections 17(a)(2) or (3) of the Securities Act. 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).

Since the Orange County proceedings, the SEC has brought enforcement actions against numerous issuers of municipal securities in a variety of circumstances in which the municipal issuer's disclosure was deemed misleading.[386]

In contrast to a public company, when a municipal government such as the City issues its securities, it does not file any documents with the SEC or wait for review, comment and approval of its registration materials before it may sell those securities to investors. While municipalities are spared the time and expense associated with completing and filing the detailed forms prescribed by federal securities laws required prior to the sale of most corporate securities, they also do not benefit from the implicit guidance available in SEC forms, rules and regulations surrounding the registration process. Municipal issuers preparing disclosure also do not benefit from the interaction between their counsel and staff in the Division of Corporation Finance over staff comments to their filings. SEC staff are available and often diligent in helping issuers comply with SEC reporting requirements, particularly in unusual situations and times of

---

[385] Securities Act Release No. 7566, *supra* note 407.

[386] The SEC posts these cases on its website at www.sec.gov/info/municipal.

transition, such as the flood of new rules and regulations following passage of the Sarbanes-Oxley Act.

Municipal issuers have no such guidance available to them and must look elsewhere for guidance in preparing their disclosures, in particular, to the marketplace and best practices. In an Interpretive Release providing guidance on its views of the application of the antifraud provisions to municipal securities, the SEC observed:

> In the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers has been governed by the demands of market participants and antifraud strictures. Spurred by the New York City fiscal crisis in 1975 and the Washington Public Power Supply System defaults, participants in the municipal securities market have developed extensive guidance to improve the level and quality of disclosure in primary offerings of municipal securities, and to a more limited extent, continuing disclosure in the secondary market.[387]

As noted above, the SEC'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 issuers of municipal securities. In the same Interpretive Release, the SEC favorably refers to the best practices promulgated by the Government Finance Officers Association:

> In the primary offering of municipal securities, the extensive voluntary guidelines issued by the Government Finance Officers Association ("GFOA") have received widespread acceptance and, among a number of larger issuers, have been viewed as "in essence obligatory rules."[388]

and continues, observing:

> The GFOA Guidelines call for financial statements that are either prepared in accordance with GAAP or accompanied by a quantified (if practicable) explanation of the differences. To avoid misunderstanding, investors need to be informed of the basis for financial statement presentation. Accordingly, when a municipal issuer neither uses GAAP nor provides a quantified explanation of material deviations from GAAP, investors need a full explanation of the accounting principles followed.[389]

---

[387] Release No. 33-7049; 34-33741; Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others (Mar. 9, 1994).

[388] Release No. 33-7049; 34-33741, referencing *Disclosure Guidelines for State and Local Government Securities,* (Jan. 1991). Unfortunately, these guidelines are out of print.

[389] *Id.*

When referring to GAAP, the Interpretive Release points out, it means GAAP "as determined by the Government Accounting Standards Board ("GASB")."[390]

When an issuer of municipal securities looks for guidance beyond the general rubric of the antifraud provisions as to disclosure matters relating to its obligations as a sponsor of a defined benefit, or pension, plan, they look to best practices and other available but non-binding guidance. The federal securities laws applicable to registrants may be a signpost as well. As a joint project of the American Bar Association Committee on Federal Regulation of Securities and the National Association of Bond Lawyers points out: "a comparative review of conduct in registered transactions, however, may be instructive in the formulation of practices for municipal securities transactions." [391] Each of these sources of potential guidance is briefly discussed below.

I. Pension Disclosure Guidance

The framework for the City's pension disclosures is provided by standards established by the Governmental Accounting Standards Board ("GASB"), which promulgates guidelines for plan accounting and financial reporting for public employee retirement systems. Financial reporting for defined benefit plans like SDCERS is governed by GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans* ("GASB 25"). Accounting and disclosure standards for governmental employers that contribute to such plans are set forth in GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* ("GASB 27"). GASB 25 is effective for periods beginning after June 15, 1996, and GASB 27 is effective for periods beginning after June 15, 1997.[392]

Under GASB 27, employers participating in defined benefit pension plans are required to provide disclosures describing the plan and its funding policy in the notes to their financial statements. The plan description must include the name of the plan, the name of the entity administering the plan, an identification of the plan as serving a single employer or multiple employers, a description of the types of benefits and the authority for establishing and amending them, and information regarding any separately issued pension plan report and how to obtain it. For employers participating in agent multiple-employer plans like SDCERS, the description of the plan's funding policy must include the authority for establishing and amending the funding

---

390 *Id.*

391 ABA Sec. of Urban, State and Local Gov't. Law, *Disclosure Roles of Counsel In State and Local Government Securities Offerings,* 2nd ed. 1994.

392 *Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers, Questions and Answers*, GASB (1997) (hereinafter "GASB Q&A"); *see also* William R. Schwartz, *Pension Accounting and Reporting*, Governmental Finance Officers Association (1995); *Accounting for Pensions by State and Local Government Employers*, California Commission on Municipal Accounting White Paper (Jan. 1997).

policy, required contribution rates for active members, required contribution rates for the employer in dollars or as a percentage of current-year covered payroll, and how the contribution is determined if it differs from the annual required contribution.[393]

Employers participating in agent multiple-employer plans are also required to disclose the annual pension cost and contributions made and the pension cost, percentage of pension cost contributed, and net pension obligation for that year and the two previous years. If there is a net pension obligation, the employer must disclose the components of the pension cost (such as annual required contribution, interest on net pension obligation, and adjustment) and any increase or decrease in the net pension obligation.[394] GASB emphasizes that an employer participating in an agent multiple-employer plan is responsible for measuring its annual pension cost based on the annual required contributions (the "ARC"), regardless of whether the ARC coincides with the contributions that the employer is required to make by law or by the plan's funding policy, and regardless of the amount of such contribution that the employer actually makes.[395]

The employer should also include in the notes to its financial statements information relating to the actuarial valuation, including: the date of the actuarial valuation; the actuarial cost method; the actuarial method used for valuing assets; the assumptions regarding inflation, interest rates, projected salary increases, and projected postretirement benefit increases; the amortization method; the amortization period and whether it is open or closed; and, if the aggregate method is used, a statement that the actuarial cost method does not identify or separately amortize unfunded actuarial accrued liabilities.[396]

GASB 27 also requires employers to provide trend information, either as required supplementary information or as part of the notes to the financial statements. Such trend information must include, for each of the three most recent actuarial valuations: the actuarial valuation date, the actuarial value of the plan assets, the actuarial accrued liability, the total unfunded actuarial accrued liability or funding excess, the actuarial value of the plan assets as a percentage of the actuarial accrued liability (the funded ratio), the annual covered payroll, and the ratio of the unfunded actuarial accrued liability (or funding excess) to the annual covered payroll. It should also include factors that significantly affect the identification of trends in the

---

393 Schwartz, *supra* note 415, at 17-18; *GASB Q&A*, *supra* note 392, at 111.

394 *GASB Q&A*, *supra* note 392, at 111.

395 *Id.*, at 5.

396 Schwartz, *supra* note 392, at 18; *GASB Q&A*, at *supra* note 392,111.

amounts reported, such as changes in benefits, the size or composition of the group participating in the plan, or the actuarial methods and assumptions used.[397]

## II. Rating Agency Criteria

The municipal credit rating agencies – Standard & Poor's ("S&P"), Moody's Investors Service ("Moody's"), and Fitch Ratings ("Fitch") – periodically publish their rating methodology and criteria to inform the market and rating applicants of the information they evaluate and the analysis they perform in assigning credit ratings. All three rating agencies currently state in their published guidance that they take into account the status of a municipal issuer's pension obligations in evaluating the credit quality of that issuer's general obligation bonds. As the issue of pension obligations has grown in importance in recent years, the rating agencies have expanded their discussions of the nature of their review of such obligations, while recognizing the pressures on governments sponsoring pension plans.

The guidelines and methodologies published by the rating agencies indicate that, in analyzing a government's credit quality, they do not rely on bright-line rules relating to pension obligations, in part due to the high degree of variation between different plans, but instead view matters relating to pension plans as factors to be considered in evaluating that government's financial performance and management. Thus, for instance, a history of unfunded pension obligations could be viewed as evidence of fiscal stress and/or as an indicator of questionable management practices. Pension obligations are typically treated as a long-term liability like bonded debt for purposes of evaluating fiscal pressures, although the rating agencies differ in whether to include pension obligations in determining issuer debt ratios. They all have recognized the role that actuarial assumptions, investment returns, and actuarial techniques of smoothing investment gains and losses play in contributing to the volatility of pension funding liabilities.[398]

Based on available rating agency publications, it appears that the rating agencies have employed this analysis, or a version thereof, without fundamental changes since at least 1996, although the specific factors considered and the level of detail provided by the rating agencies in their published guidance has increased over time as pension issues have become an increasing concern for governmental issuers. S&P noted in the 1996 edition of its *Public Finance Criteria*

---

[397] Schwartz, *supra* note 392, at 18-19; *GASB Q&A supra* note 392, at 112.

[398] Moody's notes that because of actuarial techniques of smoothing investment gains and losses, the decline in earnings beginning in 2001 have produced larger unfunded liabilities, and similar significant increases are expected through 2005 or 2006, depending on investment returns. Fitch stated that the actuarial practice of smoothing gains and losses on invested assets "takes some of the sting out of the recent market slide because actuaries are still factoring in the great returns earned prior to 2000." *See* Joseph D. Mason "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Fitch Ratings, Special Report (Sep. 18, 2003); see *also* Credit FAQ: Public Pension Funds, Standard & Poor's (Nov. 17, 2003).

that due to the lack of comparability of actuarial studies among plans, it did not perform a system-by-system comparative analyses, but rather focused on trends relating to unfunded liabilities, contributions, investment rates of return and benefits provided.[399] In connection with its analysis, it stated that it would review employee participation, actuarial methodology, funding contributions, investment guidelines, periodic actuarial reports, and independent reviews of the pension plan's financial position. Like S&P, Fitch published guidelines that year stating that it would review the magnitude of unfunded pension obligations and the trend in funded ratios, together with actuarial reports and related pension information, in assessing a government's financial performance and management capabilities.[400]

Later publications from the rating agencies reveal the addition of new criteria for review and a growing attention to pension issues. Moody's stated in its 1999 rating methodology that increasing employee benefits and pension deferrals or assumption changes were potential signs of credit distress, while S&P discussed in the 2000 edition of its *Public Finance Criteria* the importance of asset allocation strategies in ascertaining investment risk for pension portfolios and of actuarial assumptions regarding investment rates of return and rates of salary increases.[401]

In 2002, S&P published its rating criteria with an expanded discussion of its analysis of pension obligations.[402] Those criteria discussed the volatility of pension liabilities and the importance of consistently monitoring funding trends, stating that "[t]he long-term trend in funding progress is as important, if not more so, than the specific level at a single point in time." S&P also recognized that a pension system that was fully funded would face demands for improved retiree benefits, leading to new unfunded liabilities and a reversal in the positive funding trend.[403] That year, Fitch published a Criteria Report identifying best management practices for governmental entities.[404] Among its list of management practices that would cause concern were a pension funded ratio of less than 60% and the deferral of pension contributions.[405]

---

399 Standard & Poor's *Public Finance Criteria* 24, 26 (1996). *See also* 1997 to 2000 editions of *Public Finance Criteria*.

400 "Local Government General Obligation Rating Guidelines", Fitch Ratings Public Finance Tax Supported Special Report (Sep. 9, 1996).

401 "The Determinants of Credit Quality – A Focus on Moody's Methodology for Rating General Obligation, Lease-Backed and Revenue Bonds", Moody's Investors Service, Rating Methodology at 3 (Nov. 1999). *See also* the May 2002 edition of the same publication; "Moody's Approach To Local Government Financial Analysis", Moody's Investors Service (Special Comment) (Jan. 2002); *Public Finance Criteria*, Standard & Poor's, at 26, 28 (2000).

402 *Public Finance Criteria: GO Debt*, Standard & Poor's at 1 (Nov. 12, 2002).

403 *Id*. at 5-6; *Public Finance Criteria*, Standard & Poor's, at 43 (2003).

404 "The 12 Habits of Highly Successful Finance Officers – Management's and Disclosure's Impact on Municipal Credit Ratings," Fitch Ratings, Criteria Report (Nov. 21, 2002).

405 *Id*. at 9.

All three rating agencies provided additional guidance in 2003, reflecting growing concern over government pension liabilities. In June of that year, Moody's issued a Special Comment regarding its perspective on the increased pension cost environment for local governments in California.[406] It noted that because of recent stock market losses and increases in employee benefits, most local governments in California were facing marked increases in annual pension costs. Moody's stated that it did not believe that this trend posed an immediate credit threat to the majority of local governments in California due to the long-term nature of pension obligations, but it said that it would continue to monitor the management of pension obligations, including a government's analysis in determining to increase benefits, its plan for addressing any unfunded liability, and its ability to budget for increased costs.[407] It identified fully funding actuarially recommended costs as a key component of strong financial management.

Fitch issued its own Special Report in September 2003 containing its outlook and rating criteria with respect to an issuer's pension liabilities.[408] Fitch stated that it did not expect rating downgrades solely due to increased pension costs, but it said that downgrades could occur in the event an issuer fails to take corrective action to address rising pension costs.[409] It suggested that a current funded ratio of 70%-80% or better could be considered as generally sufficient for credit quality purposes, and it cautioned that pension funding has a direct effect on current budgets and a long-term impact on overall financial flexibility. Fitch currently analyzes pension liabilities as long-term liabilities in connection with an issuer's debt profile and borrowing plans for the future, but such liabilities are not included in debt ratios as contribution payments can be deferred or reduced. It evaluates plan status based on the overall funded ratio, the size of the annually required contribution relative to the sponsor's overall budget, and the sponsor's net pension obligation.[410] Deferrals of minimum required pension contributions can, in some cases, affect a plan sponsor's credit rating, depending on the current and historical funding level of the plan, the reason for the deferrals, and the overall credit profile of the plan sponsor. It also reviews actuarial, economic and demographic assumptions and changes to the plan's benefit structure.[411]

---

406 "Moody's Perspective On Increased Pension Costs For California Local Governments," Moody's Investors Service (Global Credit Research) (June 2003).

407 *Id*. at 1.

408 "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Fitch Ratings, Special Report (Sept. 18, 2003).

409 *Id*. at 1.

410 *Id*. at 5.

411 *Id*. at 2-3.

S&P also published new guidance in late 2003.[412] It noted the continuing downward trend in plan funding levels, which it attributed primarily to lower investment returns, and it predicted that UAALs, although higher than in years past for most issuers, will be self-balancing in years to come.[413] S&P identified the most significant issue relating to pension obligations as the fiscal pressure on employers to make increased contributions at a time when most are facing budgetary pressures resulting from lower revenues. S&P also stated that it considers managing unfunded liabilities to be a "litmus test" for plan sponsors, and it expects them to demonstrate an understanding of the dynamics and prudent use of pension fund variables.[414]

The latest guidance provided by the rating agencies also reveals their awareness that the sorts of challenges faced by the City with regard to its pension obligations are not unique, and that they are in fact an issue for governments generally. For instance, in its September 2003 Special Report, Fitch noted that:

> Pension funding issues received less attention during the latter half of the 1990s as a buoyant stock market boosted pension plan returns and restored the average funding ratio to 104% in 2000 from 81% in 1990…. These tremendous gains allowed many governments to take "funding holidays" – dramatically reducing or, in some cases, even eliminating annual pension payments…. [M]any governments were tempted by the strong plan valuations of the late 1990s to enhance member benefits. Many of those overfunded plans are now underfunded, even before the costs of the enhanced benefits are considered.[415]

Although the rating agencies currently do not appear to treat unfunded pension liabilities, in and of themselves, as a strict signal of weakening in a government's credit quality, they do share the view that the City's pension obligations are having a negative impact on the quality of its credit. For example, in lowering the City's general obligation bond rating from AAA to AA, Fitch pointed to the decline in the City's funded ratio and the impact that rising pension costs would have on the City's financial flexibility; similarly, on lowering its rating, S&P cited "increasing fiscal pressures relating to [the City's] burgeoning unfunded pension liability."[416]

---

412 *Credit* FAQ: Public Pension Funds, Standard & Poor's (Nov. 17, 2003).

413 *Id*. at 1.

414 *Id*.

415 "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Fitch Ratings, Special Report (Sep. 18, 2003).

416 That threshold is subject to adjustment depending upon how conservative or aggressive the actuarial assumptions are believed to be. "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Fitch Ratings, Special Report at 2 (Sept. 18, 2003). *See also* "Moody's Perspective On Increased Pension Costs For California Local Governments" Moody's Investors Service (Global Credit Research) (June 2003); "San Diego, CA's GO Debt Lowered to 'AA'; All Outstanding Bonds on CreditWatch Negative," S&P Ratings Direct (Feb. 23, 2004); "Pension-

## III. Government Finance Officers Association Guidance

The GFOA develops and periodically publishes guidance with respect to an array of issues facing finance officers of state and local governmental entities. Generally, the GFOA has not provided any guidance in its publicly available materials since 1996 on pension obligation disclosure practices, except with respect to the accounting and financial reporting requirements of the GASB.

In an article originally published in 1990, and most recently reprinted in October 2001, the GFOA included a discussion of funding requirement issues that face public pension plan administrators and governing boards.[417] With respect to the disclosure of funding practices, the GFOA stated that "[b]oth plan participants and the sponsoring governmental entities are best served by a full disclosure of pension liabilities and funding requirements, by consistency in results from year to year, and by stability of results over time."[418] The article also notes that because financial reporting and the actuarial valuations reported are the primary communications with the financial community, public pension plans should select their accounting and actuarial professionals with care.[419] The GFOA elsewhere has described reductions in or postponement of contributions as a threat to responsible funding.[420]

Over the years, the GFOA has promulgated several "Recommended Practices" that address issues relating to public pension plans. With respect to public pension plan investments, the GFOA has recommended that pension plan administrators provide and facilitate regular communications on investment results to participants, plan sponsors, and other interested parties.[421] In the area of measurement, reporting and collection of employer contributions, the GFOA recommends the following steps: having an actuarial valuation prepared at least biennially by a qualified actuary in accordance with the principles and procedures established by the Actuarial Standards Board, using funding methods and assumptions that are adopted following discussion with the actuary and that conform to the requirements of the Actuarial Standards Board and GASB; establishing a period for amortization for unfunded actuarial accrued liabilities in accordance with the parameters established by GASB; assuring that actuarially required contributions are collected by the pension plan on a timely basis; having an

---

fund woes prompt new downgrade in San Diego's bond rating," *Associated Press State & Local Wire* (Feb. 27, 2004); Philip J. LaVelle, "*San Diego's credit rating takes another hit*, San Diego Union-Tribune (Feb. 28, 2004).

417 Lawrence A. Martin, "The Legal Obligations of Public Pension Plan Governing Boards and Administrators," GFOA Public Employees Retirement Series at 30 (Dec. 1990).

418 *Id*. at 30.

419 *Id*. at 45.

420 "Funding of Public Employee Retirement Systems," GFOA Recommended Practice (1994).

421 "Public Employee Retirement System Investments," GFOA Recommended Practice (1993, 1995 and 1997).

actuarial experience study performed at least every five years and a review of the plan's actuarial valuations performed by an independent actuary at least once every 10 years; and preparing and distributing a CAFR in accordance with GFOA guidelines and summary information to all plan participants. The GFOA also recommends that every government should document its accounting policies and procedures and make them available to all employees who need access to them.[422]

In addition to promulgating recommendations, the GFOA also awards the Certificate of Achievement for Excellence in Financial Reporting to governmental entities for excellence in their financial reporting practices. Members of the GFOA review a governmental entity's CAFR against a checklist it publishes that sets forth the various required disclosures. The City received this award for its CAFRs for fiscal years 1995 through 2001.

IV. Pension Disclosure for SEC Registrants

Because of the many assumptions that are made by issuers in the reporting of the results of their pension and post-retirement plans, the Securities and Exchange Commission ("SEC") has for many years been focused on plan disclosures in publicly filed reports. During the past three years, however, the SEC has increased its scrutiny of these disclosures principally as a result of the impact of diminished returns on investments made by pension plans as well as fluctuations in interest rates.

A reporting company is obligated to disclose material changes, trends and uncertainties associated with their pension and post-retirement plans pursuant to Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). The purpose of MD&A is to provide a narrative explanation of the issuer's financial statements as seen through the eyes of management by providing both a short and long-term analysis of the business and financial condition of the issuer. The SEC has taken the position that this analysis should include a discussion of the trends, uncertainties, assumptions and methodologies used in reporting the results of an issuer's pension and post-retirement plans. In an SEC release dated April 17, 1987 entitled "Concept Release on Management's Discussion and Analysis of Financial Condition and Operations" (1987 WL 847497), the SEC stated: "the following are examples which registrants should consider in making disclosure: . . . 6. Material changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds; . . . ."

In the notice published by the SEC in February 2003 entitled "Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of

[422] "Documentation of Accounting Policies and Procedures", GFOA Recommended Practice (2002).

the Fortune 500 Companies," the SEC identified the reporting of pension income and expense as one of the significant areas of comment in connection with its review of the public disclosures of the Fortune 500 companies. In that statement, the SEC stated:

> The majority of our comments dealt with the long-term expected return assumption for plan assets. SFAS Nos. 87 and 106 provide guidance on accounting and disclosure for post-retirement plans. The majority of companies use an estimated return, and therefore must amortize the difference from the actual return, the unrecognized gain/loss, into income in future periods. The negative stock market returns of the last three years caused many companies to have significant unrecognized losses related to their pension plans, which are often not transparent to investors. We asked companies about the basis for and the reasonableness of their expected return assumption. We also asked many companies to expand their MD&A to clearly describe:
>
> - The significant assumptions and estimates used to account for pension plans and how those assumptions and estimates are determined, for example the method (arithmetic/simple averaging, or geometric/compound averaging) and source of return data used to determine the expected return assumption and the assumptions, estimates and data source used to determine the discount rate;
>
> - The effect that pension plans had on results of operations, cash flow and liquidity, including the amount of expected pension returns included in earnings and the amount of cash outflows used to fund the pension plan;
>
> - Any expected change in pension trends, including known changes in the expected return assumption and discount rate to be used during the next year and the reasonably likely impact of the known change in assumption on future results of operation and cash flows;
>
> - The amount of current unrecognized losses on pension assets and the estimated effect of those losses on future pension expense; and
>
> - A sensitivity analysis that expresses the potential change in expected pension returns that would result from hypothetical changes to pension assumptions and estimates.

A review of publicly available comment letters issued by the staff of the SEC revealed that the SEC is particularly focused on requiring issuers to disclose more details underlying the assumptions, estimates and methodologies used to calculate their pension assets and liabilities. The staff of the SEC hopes these details will allow an investor to better understand the different variables used by issuers to determine pension costs and funding obligations, and the likelihood of materially different reported results if different assumptions or conditions were to prevail or different methodologies were to be used. In addition, the SEC has on several occasions

requested issuers to provide sensitivity analyses assuming changes in (i) the expected long term return on plan assets assumption and (ii) the assumed discount rate. Attached hereto as Exhibit A is a sample comment that was given to multiple issuers during 2002 and 2003. This comment encompasses most of the questions that were raised by the SEC in comment letters to issuers with respect to the SEC's review of plan disclosures. The SEC also repeatedly requested issuers to more clearly identify known trends and uncertainties in pension funds, as changes in the results of pension funds may have a material impact on the results of operations, financial condition and liquidity of the issuer. In addition, the SEC has requested issuers to disclose when they intend to make changes in the assumptions underlying the disclosure of plan assets and liabilities.

While the comment letters issued by the SEC largely request additional disclosure and do not address the validity of the specific assumptions, estimates and methodologies used by issuers, the staff of the SEC has made certain public statements about the assumed discount rate in particular that is used by issuers in connection with their plan disclosures. In a speech delivered by Mr. Scott A. Taub, Deputy Chief Accountant, Office of the Chief Accountant of the SEC, at the University of Southern California Leventhal School of Accounting on May 27, 2004, Mr. Taub stated: "[t]he discount rate is meant to be the rate an issuer would have to pay to purchase high-quality investments that would provide cash sufficient to settle its current pension obligations. The SEC staff has previously made its views known that bonds rated Aa and higher would appear to meet the criterion of being quality." However, Mr. Taub went on to point out that many issuers use rates that are higher than the Aa index bond rate in their discount rate assumptions. He stated that the SEC believes that issuers should provide disclosure as to what the issuer has used to determine the proper interest rate upon which it is to base its discount rate, provided that the issuer can provide "empirical support" for the issuer's assumption. He went on to state that in determining the proper discount rate, issuers may not merely rely on their actuaries to select a rate and their auditors to confirm they agree with the rate chosen by the actuaries. Issuers must be able to provide support for the assumptions used beyond just comparisons to similarly-situated issuers. Such support may include referring to applicable index rates or constructing a hypothetical portfolio of high quality instruments with maturities that mirror the pension obligation. In many of the comment letters that are publicly available, the SEC requested issuers to provide detailed information regarding the discount rate that was used in their plan disclosure and the justification for that rate. Those letters also asked issuers to provide some of the information that would be required by GASB 25 and 27 in connection with public employee pension plans, such as actuarial methods and assumptions and the effect of changes in funding policy. However, much of the information requested related to such matters as assumed asset allocations and expected returns for each category, anticipated volatility in plan asset returns, and sensitivity analyses, and so went beyond that which is required under current GASB standards governing public employee pension plans.

# Part V

# E v a l u a t i o n

## Conclusions

### Conclusions Regarding the Disclosure Deficiencies

Standing alone, City disclosure since 1996 has failed to provide investors and other interested readers with adequate information to enable them to clearly understand the relationship between SDCERS and the City's General Fund and to fully evaluate the creditworthiness of the City. This relationship grew in significance after 1996, following the decision to implement MP1 as a means of providing the City a degree of budgetary relief. Unfortunately, neither the relief provided, nor the means of providing it – reduced contributions to SDCERS in exchange for increased retirement benefits – were ever clearly described to investors or others who read only the City's disclosures, until the City's Voluntary Disclosure on January 27, 2004. Beginning in 2000, anyone who obtained a copy of the SDCERS CAFR would have received a lengthy description of MP1.[423] MP1 was also openly discussed in the press at the time, along with a prescient prediction of future consequences by at least one reporter.

A succession of failures to disclose and discuss increases in retirement benefits and the corresponding effect upon SDCERS' funded status and, in turn, the City's future obligation to pay increased amounts out of the General Fund followed from January 1996 until the City's voluntary disclosure on January 27, 2004. The following analyzes these failures:

*Surplus Earnings and the Waterfall*

An inventory of the deficiencies catalogued in the disclosure chronology should begin with the "Waterfall" and the concept of "surplus earnings." The difficulty for readers of the City's disclosure is that it provides no description of the Waterfall or its potential effect upon the City's General Fund, most importantly with respect to funding the post-retirement health care benefit, in the event that surplus earnings are insufficient.

Throughout the period of our review until the City's Preliminary Official Statement of August 26, 2003, readers of Appendix A to the City's official statements were not directed to the City Charter or the Municipal Code where they could gain an understanding of both the structure of the System and the law by which it administered System assets. Instead, readers were simply

[423] Its disclosure in previous fiscal years on this topic was notably poor.

told "State legislation requires the City to contribute to SDCERS at rates determined by actuarial valuations," which would likely mislead them about the mechanics of the City's contributions to SDCERS and possibly lead them on a fruitless examination of state law in search of an understanding of the System.

More diligent readers of Appendix B would be directed to the Municipal Code by footnote 9 to the City's financial statements: "Benefits are established by the City's Municipal Code." However, a discussion of the Waterfall was not in the footnotes or elsewhere in the City disclosures. Readers of SDCERS CAFRs, on the other hand, received a clear description of both surplus earnings and the Waterfall.

*Corbett*

The institution of the *Corbett* suit in 1998 was never mentioned in the City's disclosure. The *Corbett* settlement was mentioned once in the 2000 Annual Report filed with the Disclosure Repositories as part of the continuing disclosure for three outstanding issues of City securities. It was never mentioned in an Official Statement or CAFR of the City, although SDCERS CAFRs provided a lengthy description. The brief statement about the *Corbett* settlement in the 2000 Annual Report was insufficient to allow investors and other interested parties to assess its effect upon the City. The *Corbett* settlement triggered an immediate drop in the City's SDCERS funded ratio from 105% to 97.3%, and its "contingent but accruing" mechanics erode surplus earnings as discussed earlier, but the meager disclosure on *Corbett* did not reflect either the magnitude of the claim made or the mechanics of the settlement.

*MPI and MP2*

Disclosure of the details of MP1 and MP2 could have opened the door to a discussion of the immediate budget relief achieved by each agreement, as well as a discussion of the increased benefits granted as part of each plan. However, the disclosure of MP1 was both late in coming and inaccurate. A vague outline of MP1 was first provided to investors and other readers in a confusing footnote of the 1998 CAFR, which was filed as part of the City's Annual Reports in the Spring of 1999. This came more than two years after the City first paid a reduced pension contribution on July 1, 1996, in anticipation of the adoption of MP1. Discussions of City budgets for FYs 1997-2003 never disclosed the effect of MP1, nor did the self-congratulatory cover letters introducing each year's CAFR or the MD&A sections added in the last few years. From FY 2000 forward, readers of the SDCERS CAFR were provided more comprehensible disclosure on MP1, although it too contained inaccuracies.

City disclosure was silent about the changes to the City budgeting process brought on by MP2, although, again, a reader of the SDCERS CAFR for 2002 found a description of the benefit

increases that were contingent upon adoption of the plan. Readers of the 2003 SDCERS CAFR found a description of the modifications to City funding of SDCERS adopted by the City on November 18, 2002, which was not provided until January 27, 2004 to those who read only the City's disclosure.

*Increases in Retirement Benefits in General*

Readers of the City's disclosure would find salary-based results from meet and confer provided under the heading "Labor Relations" and pay increases mentioned in discussions of the City's successive fiscal years. However, a breakout of the "City pickup" of employee retirement contributions did not occur until June of 2002. The disclosure did not discuss increases in the Retirement Benefit Calculation factor used in computing annual pension benefits, the effect on the UAAL, or the burden imposed on the General Fund in future years' budgets. The increase in the Retirement Benefit Calculation factor was included in the transmittal letter for the 2002 CAFR, but not in parts included in City Official Statement. In contrast, readers of the SDCERS CAFR would find a description of benefit increases, including the multiplier.

*Post-Retirement Healthcare Liability*

Readers of the City CAFR were informed of the amount expended for post-retirement healthcare benefits during the prior fiscal year, but not told who paid it and how it was paid. They were not told of the accrued liability for post-retirement healthcare benefits. GASB does not presently require such information, and the City had not attempted to quantify the present value of this liability since 1989. Beginning with FY 2008, GASB rules change for the City and municipalities of similar size, and the accrued liability for post-retirement healthcare benefits will become a required element of GASB financial statements.

*Blue Ribbon Committee*

The City's official statements, annual reports and CAFRs did not reveal the existence of the Blue Ribbon Committee Report in February 2002, although the report was covered by the press and the report was posted on the City's website.

*Required Supplemental Information and Notes to Financial Statements*

Readers of City official statements found CAFR extracts that often omitted Required Supplemental Information and, on one occasion, notes to financial statements, although corresponding schedules indicated they were included.

**Conclusions Regarding Intent**

Readers of the San Diego press have had the benefit of strong coverage of City pension-related issues, touching on many of the points made above, since 1996. In addition, at least from FY 2000 forward, many of the gaps in City disclosure are closed when City CAFRs are coupled with SDCERS CAFRs, although errors do remain, particularly the incorrect description of the funding mechanics established to offset the reduction in City contributions to SDCERS after MP1. This disparity is all the more remarkable given that Calderon, Jaham, & Osborn reviewed and compared the notes to the financial statements for both the City and SDCERS (although SDCERS staff prepared the notes to its financial statements) and that the City Auditor and Comptroller maintained the financial records for both the City and SDCERS. Given the availability of additional public disclosure from the SDCERS CAFRs, a history of local news coverage highlighting many of the risks surrounding MP1 and MP2, and the presence in the Municipal Code of a menu for the distribution of surplus earnings, it appears that any efforts on the part of City staff to conceal SDCERS funding situation would have been an exercise in futility, had the issue attracted interest prior to the abrupt decline in SDCERS funding that followed the reversal of its investment fortunes. Thus it is difficult to attribute the City's failure to fully and accurately describe this matter to intentional misconduct on the part of individual employees.

The failure to provide any meaningful discussion in Appendix A of the relationship between the City and SDCERS, including an explanation of the exchange of short-term relief in budgetary pressure for a *potential* longer-term obligation to pay an increased pension contribution of uncertain magnitude, likewise, is hard to categorize as intentional. The reliance on the surplus earnings concept long ago set the stage for a series of benefits increases combined with the agreed-upon underfunding of SDCERS that was reflected in the Municipal Code and in the SDCERS CAFRs. An unprecedented bull market shrouded the significance of these actions until the sudden jump in benefits and resulting drain on SDCERS brought on by the *Corbett* settlement and collapse of the bull market in the same year tore the curtain away. The Blue Ribbon Committee appreciated what was revealed and alerted the City. The SDCERS and City bureaucracies responded slowly, and the City's disclosure did not provide a full picture of the relationship between the City and SDCERS until January 27, 2004.

**Conclusions Regarding the Disclosure Process**

As a result of failures in the City's disclosure process, issues like the effect of benefit increases and actuarial changes and the consumption of surplus earnings on the City's pension obligations, which should have been disclosed, were not. If the City had been more attentive to the meaning and content of its disclosures, readers of its disclosure would have received a more accurate picture of the City's fiscal health, and – equally as important – City officials would have

been better informed about the state of the pension system, with a greater capacity to advise the City Council as to pension funding and benefits matters. Had an assessment of the pension system, the cost of new or increased benefits substituted for cash in meet and confer, and consideration of the effect of the benefits both on SDCERS and on the City's budget in future years historically been a part of the City's disclosure, the growing funding gap might have been more readily seen. When disclosure review does not extend far beyond the rote updating of numbers on a page and inclusion of current events without consideration of what it all means, the picture is likely to remain obscure, even to those who are involved in creating it.

Our interviews with City officials, employees and outside professionals and review of materials available to us, combined with the disclosure chronology we provide in Appendix 1, indicate that the City's disclosure was prepared in a routine and occasionally careless manner that focused on current issues while regarding long-term concerns as speculative and inappropriate for disclosure. Specifically, our investigation revealed the following weaknesses in the City's disclosure practices:

- Many of the City's officials and staff, as well as its outside disclosure counsel, were unaware of the dynamics generating the pension funding gap, although a few individuals may have had the opportunity to identify these issues but either could not or would not recognize them for what they were.

- One vantage point did offer the prospect to see it all: the Office of the City Auditor and Comptroller, who kept the books for both the City and the pension system and had a seat on the SDCERS Board. However, the preparation of accurate financial information, particularly footnote preparation, was a task assigned to the Independent Auditor and not given the necessary level of attention within the Office of the Auditor and Comptroller, which appeared to focus on matters of formal compliance with GASB standards and GFOA Certificate requirements, with little, if any, attention to the role of the antifraud provisions of federal securities law in shaping the City's disclosures.

- Evaluation and oversight of the Independent Auditor was lacking.

- Rather than actively promoting a full and complete disclosure of the City's finances, staff involved in the City's disclosure process operated primarily in a "check the box" mentality, emphasizing updating data without pausing to consider its implications.

- The City's disclosure, particularly Appendix A, did not receive critical review by senior City management.

- The preparation of the City's disclosures in Appendix A occurred without any consideration of the financial information provided in the City's financial statements, such that assessment of the accuracy and completeness of information provided in one part was not compared with the information provided in the other, allowing a gap to form.

- The City Manager – the CEO of San Diego's bureaucracy – did not place a premium on the quality of the City's disclosure but displayed a lack of attention that is mirrored in the City's disclosures. The accuracy and completeness of the City's disclosure and financial information were not considered to be of sufficient importance for the City Manager's direct participation. Rather, he delegated that responsibility to subordinate deputies and directors without preserving the accountability necessary to make the City's representations as to the accuracy of disclosure reliable. When making representations, as in the Manager's letter to the Independent Auditors, the City Manager did not consider the significance of such representations until after questions arose regarding the accuracy of the City's financial information.

- The full flow of information relevant to the representations made by the City as to its disclosure was impeded by decentralized responsibility, balkanization, and poor lines of communication among a variety of deputies and directors within the City Manager's Office relevant to the City's disclosure. As a result, the certifications as to the City's disclosures made from time to time may not have captured the full scope of relevant information existing within the City Manager's Office.

- No formal mechanism existed within the City Attorney's Office to assure the opinions provided at closing by the City Attorney reflected the knowledge of the City Attorney's office.

- City staff responsible for the preparation of disclosure, including those in the City Attorney's Office, received no formal training in disclosure practices or the securities law of municipal finance.

- SDCERS was often slow to produce the annual information necessary for the City to complete its CAFR and was not part of the disclosure team for City offerings or incorporated into the process in any meaningful way, although the City CAFR refers readers to the SDCERS CAFR.

- Disclosure Counsel was expected to assure compliance with applicable securities law but was not fully incorporated into the process of preparing disclosure. The City was reluctant to openly share information with counsel for fear its disclosure would be required, creating risk for both the City and its investors. Use of multiple disclosure counsels without systematic sharing of information among counsel created opportunities to "play off" advice of one counsel against that of another without either being fully informed. The City's decision to retain responsibility for Appendix A limited the comfort it could obtain from disclosure counsel as to the accuracy of the statements therein.

- The rotation of disclosure counsel prohibited them from taking full responsibility for the content of the City's disclosures. Disclosure counsel apparently did not monitor issues of concern to the City on a consistent and comprehensive basis.

- Members of City Council received no formal training in the securities law responsibilities associated with their approval of City disclosure in connection with City securities offerings.

- No procedures existed at City Council to assist Council members in fulfilling their responsibilities under the securities laws.

- No procedures currently exist within the City to evaluate the City's financial reporting and disclosure practices and procedures.

Our recommendations for reform seek to address these weaknesses and provide the City with the necessary tools for change. The tools will work, however, only if the people using them understand and are dedicated to the goal of full and fair disclosure.

Some of the disclosure deficiencies described in this Report reflect apparent carelessness in the preparation of disclosure documents, such as the frequent omission of Required Supplemental Information, and, in one instance, the notes to financial statements, from Appendix B. Others reflect the rote manner in which statistical information was periodically updated in sections relating to SDCERS by preparers of disclosure documents. The many errors in the notes to financial footnotes have also been discussed. Other topics are of much greater significance than omission of tables or even footnotes.

Had greater thought been given to these exercises, not only would errors have likely been avoided, but also the process itself may have stimulated greater consideration of the information conveyed with each update. This, of course, does not seem to have occurred given the process through which updates were accomplished.

## Recommendations

The City has instructed us to identify any problems with the City's disclosures and the means by which they have been prepared and, where appropriate, to produce recommendations for actions to minimize the likelihood such deficiencies would occur again. Some of our recommendations may be implemented in the City's Municipal Code, and a draft ordinance incorporating those proposals is appended to this Report. Other recommendations are set forth below.

***Proposed ordinance***. Appendix ___ contains a draft ordinance incorporating proposals to improve the quality of the City's disclosures. In crafting these proposals, we looked closely at the recent record of reform in America's corporate securities markets. The Sarbanes-Oxley Act of 2002 directed the Securities and Exchange Commission to develop and implement broad changes in regulation designed to improve the quality of corporate financial reporting and disclosure, improve standards of governance, and increase the accountability of corporate officers and directors. Although issuers of municipal securities such as the City of San Diego are largely exempt from the provisions of Sarbanes-Oxley, many of that Act's key concepts may be adopted to improve the quality and reliability of disclosure and financial reporting of municipal issuers. We have identified two such key concepts that hold promise for improvement of the City's disclosure and financial reporting: independent oversight and review, and disclosure controls and procedures.

### Independent Oversight and Review: Financial Reporting Oversight Board

In the corporate context, the invigoration of board audit committees through greater independence, financial expertise, responsibility for the hiring and periodic review of outside auditors, and oversight of the company's financial reporting is designed to restore integrity to financial reporting. The model of an independent audit committee does not transfer readily to governing bodies of municipal governments; however, an independent advisory board with the authority to review and evaluate the quality of the City's disclosures and audited financial statements will assist the City in restoring the integrity of the City's financial statements.

We recommend that the City establish a Financial Reporting Oversight Board to accomplish this purpose. As proposed, the Board would consist of three members possessing both high moral character and integrity and having extensive academic or professional experience in the fields of finance, accounting, or law, with at least one expert in accounting and one expert in federal securities law. The duties of the Board would include reviewing and evaluating: the annual report on the City's disclosure controls and procedures made by the Disclosure Practices Working Group (described below); the outside auditor's management letter, together with the City's response to that letter; the annual report on the City's internal controls

made by the City Auditor and Comptroller and City Manager; the procedures, diligence, ability, and work product of the outside auditor; and the City's exercise of its obligations under federal and state securities laws. The Board would be authorized to conduct such other studies, reviews, and public hearings on matters relating to or connected with the City's financings, disclosures, audits, and internal financial controls and procedures as the Mayor and City Council might direct. The Board would also establish procedures to receive and respond to any complaints or concerns regarding accounting, internal controls or auditing matters, including procedures for the confidential and anonymous submission by employees of any such complaints or concerns.

In order to ensure that the process for selecting the City's Independent Auditor is not subject to improper influence, the Board would review and evaluate all responses to a Request for Proposals for the City's Independent Auditor, and make a recommendation to the City Council as to which candidate it believes is most qualified. The City Council may approve or reject the Board's selection but may not substitute a candidate of its own choosing. In the event that the City Council rejects the recommendation of the Board, the Board would provide another recommendation or, in its sole discretion, provide for the issuance of a new Request for Proposals to encourage additional candidates to submit their proposals.

To encourage participation by qualified candidates, the members of the Board would be reimbursed for reasonable expenses incurred in the performance of their official duties, pursuant to City Administrative Regulations, and the members of the Board would be defended and indemnified with respect to the course and scope of their official duties as set forth in state law.

To permit the Board to effectively execute its responsibilities, the City Manager, the City Attorney, the City Auditor and Comptroller, and the City Treasurer would be instructed to fully cooperate with the Board and to provide such assistance and resources as are reasonably necessary to allow it to carry out its responsibilities. In the City's Annual Budget, in addition to budgeting sufficient internal staff resources as described above, the City Manager would be instructed to propose expenditures of funds sufficient to engage such independent counsel or other independent advisers to assist the Board in carrying out its responsibilities as the Board shall reasonably request. The City Council would agree to appropriate monies as proposed by the Manager sufficient to meet these needs. In addition, we recommend amending the Municipal Code to direct the City Attorney to assign one or more Deputy City Attorneys to serve as legal advisors to the Board.

**Disclosure Controls and Procedures: Disclosure Practices Working Group**

Prior to the enactment of the Sarbanes-Oxley Act, the Securities and Exchange Commission proposed rules that would require companies subject to the reporting requirements of the securities laws to "maintain sufficient procedures to provide reasonable assurance that the

company is able to collect, process and disclose, within the time periods specified in our rules and forms, the information, including non-financial information, required to be disclosed in its periodic and current reports filed pursuant to the Exchange Act."[424] While issuers of municipal securities are exempt from the registration and reporting provisions of federal securities laws, they are subject to the antifraud provisions. As the SEC reminded issuers of municipal securities a decade ago:

> Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a municipal offering. In light of the public nature of these issuers and their accountability and governmental functions, a variety of information about issuers of municipal securities is collected by state and local governmental bodies, and routinely made publicly available. Municipal officials also make frequent public statements and issue press releases concerning the entity's fiscal affairs.
>
> A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions. The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions.[425]

Since that time, the SEC has expanded the disclosures of municipal issuers to include annual reporting and notice of certain material events through the adoption of Rule 15c2-12.[426]

The City of San Diego has historically accessed the municipal securities market at least once a year through a short-term note, or TANS, offering. In addition, the City provides annual reports with respect to its outstanding securities pursuant to Rule 15c2-12. The City's CAFR has historically been posted on the City's website. The City Manager makes annual mid-fiscal year reports pursuant to the City Charter.[427] From time to time, the City makes presentations to rating agencies.[428] The City will likely seek to access the public securities markets in the future to finance its various capital needs and produce Official Statements in connection with the offer and sale of its securities. In light of the across-the-board failures of the City's internal disclosure

---

[424] Proposed Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 34-46079 (June 17, 2002).

[425] Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Release No. 33-7049; 4-33741 (Mar. 9, 1994)

[426] Exchange Act Rule 15c2-12 (17CFR 240).

[427] San Diego City Charter § 28.

[428] The SEC has taken the position that misleading rating agencies may violate the antifraud provisions. See Orange County Cease and Desist Order, *supra*.

processes identified in this Report and in view of the frequency with which the City makes disclosures subject to the antifraud provisions, we recommend that the City Council direct the City Manager, the City Attorney, the City Auditor and Comptroller, and the City Treasurer to establish a Disclosure Practices Working Group consisting of City officers, managers, and staff, together with the City's disclosure counsel to ensure the compliance of the City (and the City Council and City officers and staff in the exercise of their official duties) with federal and state securities laws and to promote the highest standards of accuracy in disclosures relating to securities issued by the City.

The responsibilities of the Disclosure Practices Working Group would include: designing and implementing the City's disclosure controls and procedures; reviewing the City's disclosures in connection with its securities; ensuring the City's compliance with federal and state securities laws; ensuring that City staff receive appropriate training regarding such controls and procedures; and evaluating the disclosure controls and procedures and its compliance with those controls and procedures on an annual basis, and making recommendations to the Manager, the City Council, and the Financial Reporting Oversight Board. The Disclosure Practices Working Group would also help to ensure that the City Council and City officers and staff comply with the federal securities laws in the exercise of their official duties in connection with securities issued by the City's related authorities.[429]

As proposed, the Disclosure Practices Working Group would consist of the City Attorney, the Deputy City Attorney for Finance and Disclosure, the Deputy City Attorneys designated to assist the City Council and the Board, the City Auditor and Comptroller, the City Treasurer, the Deputy City Manager responsible for the financial management functions of the City, and the City's outside disclosure counsel. The City Attorney would serve as chair of the Disclosure Practices Working Group.

The Disclosure Practices Working Group would be required to conduct a thorough review of the City's current disclosure practices and to recommend to the City Manager by December 1, 2004 new disclosure controls and procedures to ensure the accuracy of the City's disclosures and the City's compliance with all applicable federal and state securities laws. Such disclosure controls and procedures would be designed to ensure:

---

[429] "*Related entities*" means those independent agencies, joint power authorities, special districts, component units, or other entities created by ordinance of the City Council or by State law that issue securities, for which the City Council serves as the governing or legislative body, or for which at least one City officer serves as a member of the governing or legislative body in his or her official capacity, or for which the City has agreed to provide disclosure. *Related entities* includes but is not limited to the Public Facilities Financing Authority of the City of San Diego, the San Diego Facilities and Equipment Leasing Corporation, the City of San Diego Metropolitan Transit Development Board Authority, the Convention Center Expansion Financing Authority, the Redevelopment Agency of the City of San Diego, the San Diego Open Space Park Facilities District No.1, and the reassessment districts and community facilities districts created by the City.

(a) that information material to the City's proposed and outstanding securities is accumulated and communicated to senior City officials, including the City Manager, City Auditor and Comptroller, City Treasurer, City Attorney, and the City Council, as appropriate, to allow timely decisions regarding disclosure;

(b) that such information is recorded, processed, and summarized in a timely manner to enable the requisite senior City officials to certify the accuracy of disclosures made in connection with City financings;

(c) the compliance with all applicable federal and state securities laws, including the disclosure of all material information with respect to the City's proposed and outstanding securities; and

(d) the preservation of an audit trail regarding information reviewed or prepared in connection with such disclosures.

Those disclosure controls and procedures also should address the accuracy of information disclosed by the City in connection with securities issued by the City's related authorities.

The City Manager would be required to implement the recommendations of the Disclosure Practices Working Group relating to disclosure controls and procedures together with any recommendations of the Financial Reporting Oversight Board as soon as practicable, or within 45 days of receiving such recommendations to provide the City Council with a report as to why such recommendations should not be implemented.

Each year, beginning in 2005, the Disclosure Practices Working Group, in collaboration with the City Manager and the City Auditor and Comptroller, would conduct an annual evaluation of the City's disclosure procedures and controls. In the course of that review, the Committee would:

(a) meet with key managers and staff in the City Manager's Office (particularly those managers and key staff responsible for the financial management of the City), the City Treasurer's Office, and other relevant offices and departments to discuss the elements of the City's disclosure materials for which they are responsible and to evaluate the effectiveness of the disclosure procedures;

(b) meet with the City's independent auditors and disclosure counsel to review the design and operation of the disclosure controls and procedures; and

(c) submit a written report on the Committee's work and findings to the City Council and to the Financial Reporting Oversight Board on or before November 1 of each year, beginning November 1, 2005.

The City Manager and the City Auditor and Comptroller would be required to review such Annual Evaluation and Report and to provide any recommendations or dissenting opinions that they may have.

The Disclosure Practices Working Group would be responsible for reviewing the form and content of all of the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to its securities, including preliminary and final official statements, CAFRs, Annual Reports and other filings made with the Disclosure Repositories, as well as press releases, rating agency presentations, website postings and other communications reasonably likely to reach investors or the securities markets. The Disclosure Practices Working Group also would be responsible for reviewing disclosure provided by the City in connection with securities issued by the City's related authorities, together with all of such documents and materials prepared, issued, or distributed in connection with such securities, to the extent that the City, the City Council, or City officers or staff are responsible for the form or content of such documents or materials.

As discussed more fully elsewhere in this Report, the problems with the City's disclosures can be attributed in part to a lack of necessary resources to meet disclosure obligations. To address these constraints and to help ensure that City staff and officials are better equipped to carry out their responsibilities, the Disclosure Practices Working Group would be responsible for arranging for mandatory training, on a regular basis, for City staff, officials, City Council members, and the Mayor regarding their obligations relating to disclosure matters under federal and state securities laws.

We recommend that the Disclosure Practices Working Group give high priority assisting the City Auditor with the development of forms and documentation necessary to effectively implement the additional procedures relating to the review processes described in the City's January 27, 2004 voluntary disclosure, together with such additions and modifications as KPMG may recommend.

**City Attorney's Office**

In order to assist the City Council in fulfilling its responsibilities under federal and state securities laws, we recommend that the City Council amend the Municipal Code to direct the City to designate one or more Deputy City Attorneys to advise and assist the City Council in connection with matters related to financings, disclosures, and other matters relating to its

obligations under the securities laws. Part of that assistance will involve ensuring that matters of concern to the City Council are brought before the Disclosure Practices Working Group and are disclosed or otherwise resolved, so that the City Council can be assured that the disclosure process appropriately addresses significant issues of which it has knowledge.

We also recommend that the City Council amend the Municipal Code to direct the City Attorney to designate a Deputy City Attorney for Finance and Disclosure, who is knowledgeable about federal and state securities laws relating to municipal finance, to supervise the attorneys in the Office of the City Attorney who are responsible for matters relating to City financings and disclosure ,and to assist the City Attorney in carrying out the City Attorney's duties on the Disclosure Practices Working Group and in preparation for the issuance of the City Attorney's opinion in connection with City financings.

**Certifications**

In light of the procedural deficiencies identified in our report, and to improve the accountability of senior City officials, we recommend that the City Council amend the Municipal Code to require various City officers to make certain certifications to the City Council. In connection with the approval of offering documents for securities by the City Council, the City Manager and the City Attorney each should certify personally to the City Council that, to the best of his or her knowledge, such documents do not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. In the event that the City Manager or the City Attorney is absent, a deputy or other authorized designee of such officer could make the certification required by this Section.

Upon the issuance of the City's Comprehensive Annual Financial Report (the "CAFR") and in connection with the incorporation of all or portions of the CAFR in the disclosure documents of the City or the City's related authorities, the City Auditor and Comptroller should make the certifications to the City Council required by Chapter 2, Article 2, Division 7 of the Municipal Code.

**Other recommendations**

As noted in this report, offerings of debt by the City from time to time have been approved by the City Council as part of consent agendas, which limits the opportunity for discussion of matters included on such agendas. The City may wish to reconsider this practice and to evaluate whether including financings as regular agenda items would better ensure that Councilmembers have adequate opportunities to discuss any significant issues relating to those financings.

In the past, the City's reliance on multiple disclosure counsel created a situation in which the various firms that served as disclosure counsel were not, on an individual basis, fully responsible for the content of the City's disclosure materials and in which they appear to have accepted the presence of certain statements in the disclosure materials without verifying the accuracy of such statements. It is recommended that the City rely on a single, well-qualified firm to provide disclosure counsel services in order to provide for continuity in the City's disclosure materials and a greater accountability on the part of disclosure counsel. It is also recommended that such disclosure counsel undertake a complete review of all language in the City's disclosure documents with the goal of ensuring that each statement is not misleading and that its source can be identified. We strongly encourage the City to treat disclosure counsel as a key participant in any considerations relating to the materiality of information potentially subject to disclosure.

The Charter designates the City Manager as the chief administrative officer of the City, responsible for keeping the City Council advised of the City's financial condition and ensuring that City ordinances and State laws are enforced. Evidence reviewed during the investigation suggests, however, that managerial approach on the part of the prior City Manager contributed to the failure of the City staff and the City Council to effectively exercise their obligations with respect to the City's disclosures. Many of the organizational changes and delegations of authority instituted by the City Manager appear to have had the effect of insulating him from any direct involvement in or knowledge of matters relating to the City's disclosures. It is recommended that the City Manager play a central role in the disclosure process, in order to ensure the appropriate focus of managerial attention on disclosure matters needed to restore market confidence in the City's disclosures, to restore the City Council's confidence in the functioning of the City staff, and to instill a suitable appreciation among City staff of the importance of their disclosure obligations. The necessary tone to restore the City's credibility in the capital markets must be set and maintained at the top.

Finally, we recommend that the City simplify its funding relationship to SDCERS, avoiding the use of surplus earnings to pay for contingent benefits. In our view, this results in the obfuscation of the City's overall liability to its retirement system. We agree with the views of KPMG, as we understand them, that the City should recognize additions to its Net Pension Obligation to reflect the purportedly contingent component of the Corbett settlement and the cost of retiree health insurance premiums. Whether or not required under applicable accounting standards, this change will bring the City's financial disclosure more in line with economic reality. Beyond this, however, calculations of the City's total obligations to SDCERS would gain in transparency if future contributions were not subject to unpredictable allocations of cash earnings that do not comport with the System's basic accounting method and undermine the accuracy of actuarial projections.

# Appendices

# 1.
# Disclosure of Pension Funding Matters: 1996-2004

This Report examines the disclosures of the City of San Diego, California from January 1, 1996 through January 27, 2004 with respect to the City's obligation to fund the pension system for its employees, SCDERS, and the disclosure practices of the City staff and its officials in the preparation and dissemination of such disclosures.

Our review of the City's disclosure begins in 1996 and runs through the voluntary disclosure produced by the City on January 27, 2004. Over this period of time, the City released numerous disclosure documents relating to its securities, as discussed below.

**1996 Disclosures**

***June 5, 1996.*** In calendar year 1996, as the City negotiated and began to put in place the various measures referred to as MP1, the City accessed the municipal bond market for offerings secured by its General Fund on four occasions, beginning with the June 5, 1996 issuance of $73,500,000 City of San Diego, California 1996-97 Tax Anticipation Notes Series A.

According to the custom followed by the City, general information regarding the City was presented in Appendix A and portions of the City's financial statements were presented in Appendix B. Appendix A begins with the caution:

> The information and expressions of opinion set forth herein have been obtained from sources believed to be reliable, but such information is not guaranteed as to accuracy or completeness. Statements contained herein which involve estimates, forecasts or matters of opinion, whether or not expressly so described herein, are intended solely as such and are not to be construed as representations of facts. The information and expressions of opinion herein are subject to change without notice, and neither delivery of this Official Statement nor any sale of the Notes made thereafter shall under any circumstances create any implication that there has been no change in the affairs of the City or in any other information contained herein since the date of the Official Statement.

This disclaimer is standard in Appendix A to each Official Statement of the City through 2003. It does not distinguish between City (for which the language seems inappropriate, appearing to indicate the City does not consider as reliable its own employees responsible for preparing the information and raising the question of whether the information complies with

antifraud prohibitions of material misstatements or omissions) and non-City sources (for which the language would seem appropriate). As a result, it creates confusion as to which information is the City's responsibility and which is not. A better practice would be to identify the source for any non-City information, limit the disclaimer to such information, and expressly acknowledge the City's responsibility for the remainder, particularly since the City's representatives provide assurances as to its accuracy and completeness in the City's standard closing documents.

Under the heading "Fiscal Year 1997 Proposed Budget," Appendix A contains a discussion of the Fiscal Year 1997 Proposed Budget, which anticipates implementation of MP1 through a reduced payment to SDCERS. No discussion of MP1, including the "offset" to the City contribution to be derived from undistributed surplus earnings is contained in this discussion or anywhere else in the Official Statement.

Under the heading "Labor Relations," Appendix A provides information on negotiated salary increases with the four labor organizations that, taken together, cover most City employees. The section is silent as to negotiated increases in benefits for employees that increase the "pension benefit obligation" or overall value of future benefits to be paid out of SDCERS, which will require funding from some source, likely increased contributions by the City out of the General Fund. Among the components of MP1 were increases in benefits for General Members, Lifeguard Safety Members, and Police and Fire Safety Members in mid FY-1997, as well as implementation of the DROP effective April 1, 1997, in the fourth quarter of FY 1997.

The Pension Plan is discussed in three paragraphs in Appendix A under the heading "PENSION PLAN:"

> All City full-time employees participate with the full-time employees of the San Diego Unified Port District in the City Employees' Retirement System ("CERS"). CERS is a multiple-employer public employee retirement system that acts as a common investment and administrative agent for the City and the District. Through various benefit plans, CERS provides retirement benefits to all general and safety (police and fire) members.
>
> The CERS plans are structured as defined benefit plans in which benefits are based on salary, length of service and age. City employees are required to contribute a percentage of their annual salary to CERS. State legislation requires the City to contribute to CERS at rates determined by actuarial valuations.
>
> The City's last annual valuation dated June 30, 1995 stated the funding ratio (Net Assets at cost available for Benefits to Pension Benefit Obligation) of the CERS fund to be 86.8%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $96.3 million as of June 30, 1995. The UAAL is the difference between total actuarial accrued liabilities of $1.477 billion and actuarially valued

> assets allocated to funding of $1.380 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 1995, there were 26 years remaining in the amortization period. As there are some on-going meet and confer items being discussed, the June 30, 1995 actuarial report has not been ratified by the Retirement Board but is expected to be ratified in the near future.

These three paragraphs present a framework that continued largely unchanged up through the last time the City attempted to access the public securities markets in September 2003, except for periodic updating of the quantitative information contained. Additions to discuss particular developments are described below. The third sentence of the second paragraph that states that "State legislation requires the City to contribute to SDCERS at rates determined by actuarial valuations" apparently is without foundation. None of the City's disclosure counsel interviewed were able to identify the state legislation to which this sentence refers. This misstatement apparently entered the City's disclosure at an earlier point in time and became part of the "boilerplate," remaining unaltered under this heading in Appendix A up to and including the City's last public offering. Investors would have benefited from an express reference to the relevant sections of the City Charter and Municipal Code, which govern City contributions to SDCERS, as well as application of SDCERS assets to contingent benefits in addition to system benefits. Particularly missing from this discussion, is the significant use of "undistributed surplus earnings," within SDCERS assets, to fund the "13th Check" and other contingent benefits and the eroding effect this practice had on the ability of the system to withstand a sharp decline in the stock market. This practice would later be described as "shaving off the mountaintops." While this use was based upon authority in various sections of the City's Municipal Code, investors and potential investors were neither provided with any direct reference to such sections nor a description of the effect this use had upon the assets of the pension system.

The last sentence of the section points out that the June 30, 1995 actuarial report has not been ratified by the Retirement Board because of ongoing meet and confer items under discussion. However, no explanation of the meet and confer issues involved is offered, even though the succeeding fiscal year is about to close. Of greater significance, by June the City and SDCERS were well along in developing a plan to deviate from payment of an annual actuarial determination of the City contribution to a reduced, scaled rate, along with other changes in benefits provided to retired employees. No description of this proposal, its mechanics or the effect it would have on the City's payment obligation in future years is provided. Yet, in anticipation of implementation of MP1, the City's Fiscal Year 1997 Budget contained an appropriation that was approximately $7.2 million less than the actuarial contribution identified

by the SDCERS Actuary (the "ARC").[430] Although the text under "Fiscal Year 1997 Adopted Budget" contains discussion of additions in the amount of "$1.5 million to fund street and sidewalk improvements, and a $3 million Infrastructure Superfund to fund improvements in older areas of San Diego," no mention is made of this underfunding that is one of the earliest steps in changing the mechanics of funding SDCERS and the resulting effects upon the General Fund.

Appendix B to the Official Statement, captioned "CITY OF SAN DIEGO GENERAL PURPOSE FINANCIAL STATEMENTS," opens with the Independent Auditors' Report dated November 10, 1995, and the City's General Purpose Financial Statements. Readers of the Independent Auditors' Report were not informed that the independent auditors audited their own work, as was required under Section 1-5 "Additional Auditor Responsibilities" of the contract with the City. Section 1-5.1. provided: "The Auditor (unless otherwise specified) will be responsible for footnote preparation." While not a violation of independence requirements under GASB (and, we understand, quite common in municipal audits), in hindsight, investors might have benefited from greater awareness of the lack of an independent review of the footnotes. The non-performance of this function would have real consequences for the City and served to set the groundwork for the numerous errors accumulated over time and within Fiscal Year 2002, ultimately reflected in the January 27, 2004 Voluntary Disclosure.

Under the heading "GENERAL PURPOSE FINANCIAL STATEMENTS," Appendix B then stated: "IN ACCORDANCE WITH THE RECOMMENDATIONS OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD, THE FOLLOWING COMBINED STATEMENTS ARE PRESENTED:

> Combined Balance Sheet – All Funds Types, Account Groups and Discretely Presented Component Unit.
>
> Combined Statement of Revenues, Expenditures and Changes in Fund Balances – All Governmental Fund Types, Expendable Trust Funds and Discretely Presented Component Unit.
>
> Combined Statement of Revenues, Expenditures and Changes in Fund Balances – Budget and Actual (Budgetary Basis) – Budgeted Governmental Fund Types.
>
> Combined Statement of Revenues, Expenses and Changes in Retained Earnings/Fund Balances – All Proprietary Fund Types and Similar Trust Funds.

[430] According to a February 1998 letter from actuary Rick Roeder to the accountant in the City Auditor and Comptroller's office in charge of the SDCERS accounts.

Combined Statement of Cash Flows – Increase (Decrease) in Cash and Cash Equivalents – All Proprietary Fund Types and Nonexpendable Trust Fund. Notes to Financial Statements.

Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Ten Years.

Contrary to the table, the last item on this list , Required Supplementary Information, was *not* included in Appendix B or elsewhere in the Official Statement. This omission would be repeated in the disclosure for several future offerings.

*Footnote Discussion of Pension Plan*

Footnote 9 to the City's General Purpose Financial Statements, captioned "PENSION PLANS," states that "the City has a defined benefit plan and various defined contribution pension plans covering substantially all of its employees." This defined benefit plan is described under footnote 9-A: "all of the City and the San Diego Unified Port District (the "District") full-time employees participate in the City Employees' Retirement System ("CERS"), an agent multiple-employer public employee retirement system that acts as a common investment and administrative agent for the City and the District." Payroll data for the fiscal year ended June 30, 1995 is provided. The plan description continues: "all full-time City employees are eligible to participate in SDCERS. Retirement benefits are determined primarily by the member's age at retirement, the length of membership service and the member's financial compensation. Final compensation is the members' compensation earnable based on the highest one-year period. Benefits fully vest on reaching 10 years of service. SDCERS also provides death and disability benefits. Benefits are established by the City's Municipal Code. City employees are required to contribute a percentage of their annual salary to SDCERS. The City is required to contribute the remaining amounts necessary to fund SDCERS, using the actuarial basis specified by statute."

Footnote 9.B. "Funding Status and Progress," discloses the SDCERS total pension benefit obligation and unfunded pension benefit obligation as of June 30, 1994 (one year earlier than the employment data and two years earlier than the date of the Official Statement) as $1,338,279,000 and $154,095,000, respectively, and displays the calculation employed to derive these sums. In addition, the footnote provides, "the pension benefit obligation was computed as part of an actuarial valuation performed as of June 30, 1994. Significant actuarial assumptions used in the valuation include: (a) the rate of return on the investment of present and future assets of 8% a year compounded annually; (b) projected salary increases of 5% a year compounded annually (0.5% due to merit and 4.5% due to inflation); (c) up to a 4.5% per annum cost of living assumption; and (d) the Group Annuity Mortality Table with a 2 year setback for males and an 8 year setback for females."

Footnote 9.C, "Actuarially Determined Contribution Requirements and Contribution Made, states "the entry age normal cost method defines the normal cost as the level percent of payroll needed to fund benefits over the period from the date of participation to the date of retirement" and then notes that "beginning with the June 30, 1992 valuation, contributions are based on the projected unit credit method of actuarial valuation. Initial prior service costs are being amortized over a period of 30 years. Additional prior service costs due to plan changes in 1965 are being amortized over 30 years." The footnote then states that the "significant actuarial assumptions used to compute the actuarially determined contribution requirement are the same as those used to compute the pension benefit obligation." The footnote continues:

> [T]he contribution to CERS for 1995 of $59,057,000 (16.8% of current covered payroll) was made in accordance with actuarially determined requirements computed through an actuarial valuation performed as of June 30, 1993 (the June 30, 1994 valuation was not received by the City until March 1995). The contribution consisted of (a) $47,399,882 normal cost (13.5% of current covered payroll), and (b) $11,657,118 amortization of the unfunded actuarial accrued liability (3.3% of current covered payroll). The City contributed $40,644,000 (11.6% of covered payroll); employees contributed $18,413,000 (5.2% of covered payroll).
>
> Trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due. Ten-year trend information may be found on page 19 of the City's Comprehensive Annual Financial Report. For the three fiscal years ended 1992, 1993, and 1994, respectively, available assets were sufficient to fund 95.2, 90.3 and 88.5% of the City's pension benefit obligation. Unfunded pension benefit obligation represented 15.4, 34.9 and 42.8% of the City's annual payroll for employees covered by CERS for 1992, 1993 and 1994, respectively. Showing unfunded pension benefit obligation as a percentage of annual covered City payroll approximately adjusted for the effects of inflation for analysis purposes. In addition, for the three fiscal years ended 1992, 1993 and 1994 the City's contributions to CERS, all made in accordance with actuarially determined requirements, were 8.9, 10.0 and 10.3% respectively of annual covered payroll.

In footnote 10, readers were informed that: "Currently, expenses for post-employment healthcare benefits are recognized as they are paid. For the fiscal year ended June 30, 1995, expenditures of approximately $5,149,580 were recognized for such healthcare benefits."

"Substantially all of the City's general and safety members of SDCERS may become eligible for those benefits if they reach normal retirement age and meet service requirements as defined while working for the City."

***July 16, 1996.*** Six weeks later, the City returned to the municipal securities market with an offering of $33,430,000 City of San Diego, California Certificates of Participation (Balboa Park and Mission Bay Park Capital Improvement Program) Series 1996A. The disclosure relating to the pension system was substantively unchanged from the Official Statement of June 5, 1996. The last sentence of the third paragraph under "PENSION PLAN" was moved to a point earlier in the paragraph. Excerpts from the City's CAFR for FY 1995 were provided in Appendix F. This time "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Ten Years" was included as indicated on the table:

TRUST AND AGENCY FUNDS
PENSION TRUST FUNDS
CITY EMPLOYEES' RETIREMENT SYSTEM
REQUIRED SUPPLEMENTARY INFORMATION - ANALYSIS OF FUNDING PROGRESS
LAST TEN FISCAL YEARS
(IN MILLIONS)

| Fiscal Year Ended June 30 | Net Assets Available For Benefits | Pension Benefit Obligation | Percentage Funded | Unfunded Pension Benefit Obligation | Annual Covered Payroll | Benefit Obligation As a Percentage Of Covered Payroll |
|---|---|---|---|---|---|---|
| 1986 | $ 493.3 | $ 547.6 | 90.1% | $ 4.3 | $ 171.7 | 31.6% |
| 1987 | 590.7 | 616.9 | 95.8 | 26.2 | 195.4 | 13.4 |
| 1988 | 659.0 | 688.1 | 95.8 | 29.1 | 218.1 | 13.3 |
| 1989 | 746.0 | 786.5 | 94.8 | 40.5 | 241.4 | 16.8 |
| 1990 | 806.5 | 847.8 | 95.1 | 41.3 | 271.4 | 15.2 |
| 1991 | 896.4 | 947.6 | 94.6 | 51.2 | 303.5 | 16.9 |
| 1992 | 1,006.1 | 1,057.2 | 95.2 | 51.1 | 331.7 | 15.4 |
| 1993 | 1,101.9 | 1,220.8 | 90.3 | 118.9 | 340.7 | 34.9 |
| 1994 | 1,184.1 | 1,338.2 | 88.5 | 154.1 | 360.2 | 42.8 |
| 1995 | N/A | N/A | N/A | N/A | N/A | N/A |

REQUIRED SUPPLEMENTARY INFORMATION - REVENUE SOURCES
LAST TEN FISCAL YEARS
(IN THOUSANDS)

| Fiscal Year Ended June 30 | Employee Contributions | Employer Contributions | Investment Income | Charges For Current Services | Total | Employer Contributions As a Percentage Of Covered Payroll |
|---|---|---|---|---|---|---|
| 1986 | $ 4,917 | $ 30,051 | $ 64,922 | $ 46 | $ 99,936 | 17.5% |
| 1987 | 4,959 | 31,763 | 92,330 | 47 | 129,099 | 16.3 |
| 1988 | 5,781 | 31,545 | 65,665 | 43 | 103,034 | 14.4 |
| 1989 | 7,262 | 29,291 | 87,676 | 47 | 124,276 | 12.1 |
| 1990 | 10,760 | 30,230 | 63,652 | 71 | 104,713 | 11.1 |
| 1991 | 11,442 | 36,899 | 86,833 | 67 | 135,241 | 12.2 |
| 1992 | 13,855 | 29,579 | 107,825 | 76 | 151,335 | 8.9 |
| 1993 | 14,014 | 34,150 | 102,374 | 105 | 150,643 | 10.0 |
| 1994 | 14,495 | 37,233 | 92,323 | 127 | 144,178 | 10.3 |
| 1995 | 18,413 | 40,644 | 114,394 | 157 | 173,607 | 10.9 |

REQUIRED SUPPLEMENTARY INFORMATION - EXPENSES BY TYPE
LAST TEN FISCAL YEARS
(IN THOUSANDS)

| Fiscal Year Ended June 30 | Benefits | Administrative Expenses | Refunds | Total |
|---|---|---|---|---|
| 1986 | $ 36,365 | $ 1,113 | $ 1,186 | $ 38,957 |
| 1987 | $ 29,370 | $ 1,297 | $ 997 | $ 31,664 |
| 1988 | 31,323 | 1,443 | 979 | 33,745 |
| 1989 | 34,093 | 1,951 | 943 | 36,987 |
| 1990 | 38,025 | 3,116 | 1,097 | 42,238 |
| 1991 | 41,685 | 3,789 | 1,094 | 46,568 |
| 1992 | 42,315 | 4,931 | 1,021 | 48,267 |
| 1993 | 48,873 | 5,439 | 1,193 | 55,505 |
| 1994 | 54,380 | 6,308 | 1,174 | 61,862 |
| 1995 | 57,176 | 7,049 | 1,516 | 65,741 |

***July 23, 1996.*** Date of Memorandum from Cathy Lexin, the City's Labor Relations Manager, to Retirement Administrator Lawrence Grissom containing the final expression of the MP1 proposal.

***July 31, 1996.*** The City returned to the municipal securities market with an offering of $11,720,000 City of San Diego, California Certificates of Participation (Balboa Park and Mission Bay Park Capital Improvement Program) Series 1996B. The disclosure relating to the pension system was unchanged from that contained in the July 16, 1996 Official Statement.

***November 1996.*** City Charter amended to provide post-retirement health insurance as a SDCERS benefit.

***December 12, 1996.*** The City offered $68,425,000 Public Facilities Financing Authority of the City of San Diego Taxable Lease Revenue Bonds Series 1996A (San Diego Jack Murphy Stadium) (the "Stadium Bonds"). The disclosure relating to the pension system for this offering was substantially unchanged from the July 31, 1996 Official Statement, with the exception that the information provided under Appendix B, Excerpts from the City's CAFR for FY 1996, was one year later. The disclosure made no mention of <u>the changes to come or already implemented</u> as part of MP1. Fifteen days later, on December 27, 1996, a memorandum from the City Manager was sent to City employees that read:

> In July 1996, the City Council approved a complex proposal to make changes to the San Diego City Employees' Retirement System, after negotiating with all four labor organizations. At the same time, FY98 MOU extensions with Local 145, MEA and Local 127 were approved by Council, contingent on the final approvals of the Retirement Proposal.
>
> The Proposal includes a number of benefit improvements, including improvements to the formulae for General and Safety members. The proposal also transfers the cost and responsibility for administering retiree health insurance to the Retirement System. The Manager's Office is working with a Task Force including all four labor organizations to develop and recommend to the City

> Council a level of benefit for retiree health insurance. Final implementation of the entire Proposal is contingent upon completing the transfer of retiree health insurance to CERS. Also, before the changes in benefits can be finalized, ordinances detailing the changes must be finalized and adopted by City Council, and a vote of Retirement System members is required by City Charter.
>
> It is now apparent that this process will not be completed prior to January 1, 1997. However, the Mayor and Council have expressed their intent to implement benefit improvements retroactive to retirements effective on or after January 1, 1997 ***IF*** the necessary approvals are completed.

This memorandum provides a telling marker of the status of MP1 and the changes it would bring. While readers of the local press were informed of these changes, those who only read the City's disclosures were not.

**1997 Disclosures**

***January 9, 1997***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ending June 30, 1996, which included the following analysis of the pension system:

> The System experienced a sizable actuarial gain of $59.6 million. Prior to the Manager's Proposal, the funded ratio increased from 93.5% to 97.1% and the contribution rate decreased significantly from 9.20% to 8.44%. The actuarial gain was primarily attributable to a sizable gain from investments and relatively low pay increases. (Comment A p. 17.)
>
> The Manager's Proposal increases the overall System contribution from 8.44% to 10.45% if the Normal Cost associated with the benefit increases is shared equally between the City and affected employees. The City's rate increased from 8.71% to 10.87%. The funded ratio is reduced to 92.3%. If the City pays a contribution rate of 7.33% for the 96-97 fiscal year, this would be less than the actuarially computed rates. If projected City payroll is 381.5 million for 98, the shortfall would be roughly 5.25 million prior to the Manager's Proposal. The estimated shortfall would increase to 13.5 million if the Manager's Proposal is implemented. City employees, on average, will pay an increased employee rate of 0.90% of pay . . . . (Comment B p. 17.)
>
> Overall, we believe the City's Retirement System to be in sound condition in accordance with actuarial principles of level-cost financing. (Conclusion p. 19.)

***Annual Reports, January 10, 1997 and April 9, 1997***. Although the Continuing Disclosure Certificate for the Series 1996B Refunding Certificates of Participation and the Form of Continuing Disclosure Agreement for the Taxable Lease Revenue Bonds, Series 1996A (as well as the actual documents) did not require commencement of filing of annual reports until

mid-April 1998, the City chose to file such reports on April 9, 1997 and January 10, 1997, respectively. The January 10, 1997 filing was a "wrap-around" of the Official Statement dated just a few weeks earlier. [Two supplements to the Official Statement, dated January 24, 1997 and January 30, 1997, were also separately filed.] The April 9, 1997 filing contained a section captioned "Pension Plan" that was unchanged from the Official Statement of December 12, 1996. The first paragraph of the April 9, 1997 Annual Report states that a copy of the City's CAFR for FY 1996 is also included in the filing.[431]

The full FY 1996 CAFR (the December 12, 1996 Official Statement contained "excerpts") begins with a cover letter on the letterhead of the Office of the Auditor and Comptroller, dated November 27, 1996, addressed to "Honorable Mayor Susan Golding, City Council and Citizens of the City of San Diego." The letter is signed by both the Auditor and Comptroller and the City Manager. The first paragraph of the letter states:

> Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the City and its related agencies. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the City and its related agencies. All disclosures necessary to enable the reader to gain an understanding of the City's, and its related agencies, financial activities have been included.

The CAFR includes sections such as "Economic Condition and Outlook," "Major Accomplishments/Activities," both for the year and after the fiscal year, and "Financial Information," containing a section captioned "Pension Trust Fund Operations." Under the section "Other Information," the first of two paragraphs under the heading "Independent Audit" provides a brief description of the services provided by its independent auditors, but provides an incorrect date, FY 1992, for the commencement of the services. The second paragraph states:

> [I]n addition to the independent accountants, the City maintains its own Internal Audit Division. Along with its duty of assisting the independent accountants, they are responsible for strengthening and reviewing the City's internal controls. Internal Audit performs its own independent operational and financial audits of the City's many funds, departments, and divisions. We believe that the City's internal accounting controls adequately safeguard assets and provide reasonable assurance of proper recording of all financial transactions.

[431] Upon completion of the CAFR and prior to or contemporaneously with its filing with the rating agencies, the City's CAFR typically was distributed to a limited number of recipients and was made available to the public at the City's main library.

No explanation of the assistance provided to the independent accountants is provided, although, while not stated in the CAFR, the contract with the firm was available to the public and might be retrieved by an interested party in spite of the incorrect date. The remainder of the section describes the GFOA Certificate of Achievement Award and the CSFMO Award received by the City (copies of which follow the letter).

The City's CAFR for FY 1996 did not contain any information relating to MP1.

***June 7, 1997.*** The City returned to the municipal securities market six months later with $82,000,000 City of San Diego, California 1997-98 Tax Anticipation Notes Series A. The disclosure for this offering provides an updated third paragraph under "PENSION PLAN" containing information from the City's last valuation of SDCERS, dated June 30, 1996:

> The City's last annual valuation dated June 30, 1996 stated the funding ratio (Net Assets available for Benefits to Pension Benefit Obligation) of the CERS fund to be 92.3%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $129.3 million as of June 30, 1996. The UAAL is the difference between total actuarial accrued liabilities of $1.682 billion and assets allocated to funding of $1.553 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 1996 there were 25 years remaining in the amortization period.

Once again, although the list under the caption "GENERAL PURPOSE FINANCIAL STATEMENTS" contained in Appendix B includes "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Ten Years," such information was not provided.

**1998 Disclosures**

***January 16, 1998***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ending June 30, 1997, which included the following analysis of the pension system:

> The System experienced a sizable actuarial gain of $38.5 million. The funded ratio increased from 92.3% to 94.2%. This increase occurred despite a contribution of less than the computed actuarial rate per implementation of the Manager's Proposal. The actuarial gain was primarily attributable to a sizable gain from investments and relatively low pay increases. Our calculations indicate that the excess of the actuarially computed City contributions over actual contributions was close to 7 million dollars. (Comment A p. 15.)

> Since [the] funding method [under the Manager's Proposal] is not one of the six approved funding methods under rules set by the Government Accounting Standards Board, there will be an accrued pension expense to reflect the difference. Later this year we will see if GASB will approve the City's funding method for expensing purposes. (Comment B p. 15.)
>
> The average benefit for the 138 new retirees increased markedly by 19% over the average benefit for the 148 new retirees in the June 30, 1996 valuation…. An educated guess as to why this relationship exists: The impact of the Manager's Proposal on both benefit levels and when retirement was elected. (Comment J p. 17.)
>
> Overall, we believe the City's Retirement System to be in sound condition in accordance with actuarial principles of level-cost financing. (Conclusion p. 17)

***Annual Reports, April 2, 1998.*** In 1998, the City filed an Annual Report with the Disclosure Repositories for the Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, and Taxable Lease Revenue Bonds, Series 1996A under cover of a transmittal letter dated April 2, 1998. The Annual Report states that a copy of the City's CAFR for FY 1997 was also included in the filing. The Annual Report contains a section captioned "Pension Plan," as did the Annual Report of April 9, 1997, containing the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 1997. A parenthetical points out, however, that "the assumptions or calculations made therein are not formally approved by the SDCERS Board of Administration":

> The City's last actuarial valuation dated June 30, 1997 (the assumptions or calculations made therein are not formally approved by the CERS Board of Administration), stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 94.2%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $105.6 million as of June 30, 1997. The UAAL is the difference between total actuarial accrued liabilities of $1.822 billion and assets allocated to funding of $1.717 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 1997 there were 24 years remaining in the amortization period.

The cover letter to the CAFR, dated November 21, 1997 and signed by the City Auditor and Comptroller, but not the City Manager, is similar to that of the FY 1996 CAFR, except that the text under "Pension Trust Fund Operations" attributes a large portion of the increase in realized revenues to the "recognition of the market value of investments in accordance with GASB 25 combined with an increased asset pool available for investment." The correct date for commencement of the contract with the independent auditor, FY 1993, is provided.

The Independent Auditor's Report, dated November 7, 1997, states; "as discussed in Note 2 and Note 21 to the general purpose financial statements, as of July 1, 1996 the City adopted Governmental Accounting Standards Board Statement Nos. 25, 27, and 28."

The presentation of SDCERS information under footnote 9 is updated through year end June 30, 1997 and contains a table similar to that in prior CAFRs comparing actuarially required contributions (ARC) to contributions made, concluding with the statement: "There is no Net Pension Obligation at year end (FY 1997) as Actuarially Required Contributions and contributions made have always been identical during the three-year period." This statement is, at best, incomplete and misleading. In FY 1997, the City was no longer contributing at the full actuarial rate, but had begun to make the reduced contributions agreed to under MP1. Viewed in the best possible light, this statement may have assumed the operation of the offset to the reduction in contribution purportedly achieved from the City and Port Reserves for Retirement Changes, as described elsewhere. However, as is also described elsewhere, those funds lay dormant and were never employed as an offset. Moreover, the City's disclosure at this late date still provides no description whatsoever of the changes brought about by MP1. That disclosure was not to occur until footnote 9 was revised in the FY 1998 CAFR. In the FY 1998 CAFR, the Annual Pension Cost for FY 1997 was reported as $34,036,000, of which 82.4% was contributed, creating a Net Pension Obligation of $5,975,000. The City tried but failed to comply with the requirements of GASB Statement No. 27 regarding disclosure of its NPO for the previous three years, including incorrect information that it had no NPO for FY 1997. In a related misstatement, the amortization of the long-term liability to SDCERS was not accurately reflected.

The CAFR included a cross-reference to the stand-alone financial report issued by SDCERS. This cross-reference was incorporated in all of the City's CAFRs through 2003.

***June 3, 1998.*** The City returned to the municipal securities market with $88,500,000 City of San Diego, California 1998-99 Tax Anticipation Notes Series A. The pension-related disclosure for this offering contains no new information beyond that provided in the April 2, 1998 Annual Report. No mention of MP1 is found in the discussions of prior or proposed fiscal year budgets, in the Labor Relations sections, or under the heading "Pension Plan."

Once again, although the list under the caption "GENERAL PURPOSE FINANCIAL STATEMENTS" contained in Appendix B includes "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Six Years," (though now reduced to six years), such information was not provided.

***May 21, 1998***. In a letter to Retirement Administrator Lawrence Grissom regarding MP1, actuary Rick Roeder provided the following discussion of the corridor funding method:

While Corridor funding is not one of the six funding methods formally sanctioned by GASB for expensing purposes, we believe this is an excellent method for the City for the following reasons:

- Contributions are predictable due to the schedule in place.

- If there is sufficient adverse actuarial experience to drop the funded ratio below 83.2%, Projected Unit Credit contribution rates will go into effect, protecting the beneficiaries of the Fund.

- By the end of the eleven year agreement the scheduled rate will be above the Projected Unit Credit contribution rate. This excess will ease the transition to the Entry Age Normal funding method. This method is preferable to the Projected Unit Credit method because contribution rates are generally less subject to flux.

In the long term, we believe corridor funding will be SUPERIOR to Projected Unit Credit funding because higher reserves to satisfy fund commitments will ultimately be built up.

***September 1, 1998***. The City sold $205,000,000 Convention Center Expansion Facilities Authority Lease Revenue Bonds Series 1998A (City of San Diego, California, as Lessee). Once again, the disclosure for this offering provides no mention of MP1.

**1999 Disclosures**

***Annual Reports filed April 9, 1999.*** The City filed an Annual Report for its Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, and Taxable Lease Revenue Bonds, Series 1996A under cover of a transmittal letter dated April 9, 1999. The City also filed an Annual Report for the Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A, on the same date. Both Annual Reports state that a copy of the City's CAFR for FY 1998 was also included with these filings.

Under the caption "Pension Plan," both Annual Reports contain the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 1997, the same information that was included in the Annual Report of April 2, 1998.

The cover letter for the FY 1998 CAFR, dated November 25, 1998 again resembles that of earlier CAFRs. Although it does not discuss MP1 in any detail, in a discussion of the pension system, the letter alludes to increased benefits, including the DROP and buy-back programs, as a cause of increased operating expense for SDCERS:

**Pension Trust Fund Operations.** The City Employees' Retirement System (CERS) continued to maintain a sound financial status in Fiscal Year 1998.

> Operating revenues of approximately $366,182,000 were realized as compared to $322,334,000 in Fiscal Year 1997. Included in these amounts were approximately $86,803,000 and $66,148,000 in contributions for Fiscal Year 1998 and 1997, respectively. This increase was due to the new Deferred Retirement Option Plan (DROP) and increased participation in the employee buy back program.
>
> Operating expenses for the year were approximately $88,964,000 as compared to approximately $71,931,000 in Fiscal Year 1997. This increase in operating expenses is generally the result of annual cost of living adjustments, adjustments in benefits, and normal growth in the number of retirees.

The first reflection of MP1 in any City disclosure document occurs in footnote 9.b. Funding Policy of the Notes to Financial Statements of the City's General Purpose Financial Statements. The last two paragraphs of the footnote are new and the three year table showing the City's and District's required contributions and the percentage contributed for the current year and each of the two preceding years has been moved to footnote 9.d. Three-Year Trend Analysis. A new section under footnote 9.c. Annual Required Contribution, describes (incorrectly) the means by which the ARC for the current year was determined as well as the actuarial assumptions used. As included in the FY 1998 CAFR, new footnotes 9.b., 9.c., and 9.d. read:

> SDCERS' funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are designed to accumulate sufficient assets to pay benefits when due. The normal cost and actuarial accrued liability are determined using the projected unit credit actuarial funding method. Unfunded actuarial accrued liabilities are being amortized as a level percent of payroll over a period of 30 years (23 years remaining).
>
> Employees are required to contribute a percentage of their annual salary to the Plan. Contributions vary according to age at entry into the plan and salary. The City and the District contribute a portion of the employees' share and the remaining amount necessary to fund the system based on an actuarial valuation at the end of the preceding year under the projected unit credit method of actuarial valuation. Prior to June 30, 1993, contributions were based on the entry age normal cost method of valuation.
>
> During the period July 1, 1997 to June 30, 1998 contributions totaling $57,018,000 ($32,800,000 employer and $24,218,000 employee) were made. Of the employer contributions, $26,142,000 was applied to normal cost and $6,658,000 was applied to unfunded accrued liability. All of the employer offset contributions were applied to normal cost.
>
> In 1996 the City Council approved proposed changes to the San Diego City Employees' Retirement System (SDCERS) which included changes to retiree

health insurance, plan benefits, employer contribution rates and system reserves. The proposal included a provision to assure the funding level of the system would not drop below a level the Board's actuary deems reasonable in order to protect the financial integrity of the SDCERS. A citizen required vote on the changes related to retiree health insurance passed overwhelmingly in 1996. In 1997, the active members of the SDCERS voted and approved the changes. Portions of the proposal requiring SDCERS Board approval (employer rates and reserves) were approved after review and approval by its independent fiduciary counsel and consultation with the actuary. The San Diego Municipal Code was then amended to reflect the changes.

The changes provide the employer contribution rates be "ramped up" to the actuarially recommended rate in .50 percent increments over a ten year period at such time it was projected that the Projected Unit Credit (PUC) and Entry Age Normal (EAN) rates would be equal and the SDCERS would convert to EAN. The actuary calculated the present value of the difference between the employer contribution rate and actuarial rates over the ten year period and this amount was funded in a reserve. This "Corridor" funding method is unique to the SDCERS and therefore is not one of the six funding methods formally sanctioned by the Governmental Accounting Standards Board for expending purposes. As a result for June 30, 1998, the actuary rates are reported to be $5,975,000 more than paid by the City which, technically per GASB 27 effective for periods beginning after June 15, 1997, is to be reported as Net Pension Obligation (NPO) even though the shortfall is funded in a reserve. The actuary believes the Corridor funding method is an excellent method for the City and that it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method which would then eliminate any reported NPO.

c. Annual Required Contribution

The annual required contribution for the current year was determined as part of the June 30, 1996 actuarial valuation using the projected unit credit actuarial funding method. The actuarial assumptions included (a) an 8.0% investment rate of return and (b) projected salary increases of 5% per year. Both (a) and (b) included an inflation rate of 4.5%. The actuarial value of assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a five-year period. The unfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on an open basis. The remaining amortization period at June 30, 1998 was 23 years.

d. Three-Year Trend Analysis

The following table shows the City and the District's required contributions and the percentage contributed for the most current year available and preceding years (in thousands):

| Fiscal Year Ending | Annual Pension Cost (APC) | Percentage of APC Contributed | Net Pension Obligation |
|---|---|---|---|
| 6/30/96 | $26,122 | 100.0% | $ – |
| 6/30/97 | 34,036 | 82.4 | 5,975 |

As described in detail elsewhere, this new language contained numerous misleading statements. Contrary to the last two sentences of the third paragraph, these changes to the Municipal Code affecting employer rates were never made.

The CAFR included a cross-reference to the stand-alone financial report issued by SDCERS. This cross-reference was incorporated in all of the City's CAFRs through 2003.

***May 15, 1999***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ending June 30, 1998, which included the following analysis of the pension system:

> The overall funded ratio slightly increased this year to 95% due to an actuarial gain from investments of 101 million dollars. This more than offset losses due to low employee turnover, assumption changes, and data refinements from 1997. There was an overall actuarial gain of 31 million dollars. This favorable experience offered a significant buffer against data issues and actuarial losses in other areas. The City's funded ratio is 94%. (Comment C p. 10.)
>
> We are requesting a point be clarified. The contribution rates pursuant to the Manager's Proposal will not be increased unless the funded ratio is at least 82.3%. Does this refer to the funded ratio for the System as one entity or solely to assets and liabilities attributable to the City? While this point will likely be moot, it would be useful to avoid any potential ambiguity. (Comment C p. 10.)
>
> [The Manager's Proposal] rate schedule shall remain in place unless the funded ratio falls below 82.3% or there are insufficient monies from Surplus Undistributed Earnings to cover the shortfall between the City-Paid Rate and the actuarially computed rate. (Comment H p. 11.)
>
> Since this funding method is not one of the six approved funding methods under rules set by the Government Accounting Standards Board, our understanding is that the pension expense will result. (Comment H p. 11.)
>
> Overall, we believe the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. (Conclusion p. 11.)

***June 10, 1999.*** The City returned to the municipal securities market with $99,500,000 City of San Diego, California 1999-00 Tax Anticipation Notes Series A. The disclosure for this

offering in Appendix A contained a third paragraph under the heading "Pension Plan" reflecting the SDCERS valuation dated June 30, 1998:

> The City's last actuarial valuation dated June 30, 1998 stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 93.6%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $127.5 million as of June 30, 1998. The UAAL is the difference between total actuarial accrued liabilities of $1.98 billion and assets allocated to funding of $1.85 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 1998 there were 23 years remaining in the amortization period. The assumptions and calculations made in the above actual [sic] valuation have not yet been formally approved by the CERS Board of Administration.

Although near the anniversary of the close of the prior fiscal year at which the valuation occurred, the disclosure stated that the assumptions or calculations made in the actuarial valuation has not yet been approved by the Board of Administration.

**2000 Disclosures**

***February 14, 2000***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ending June 30, 1999, which included the following analysis of the pension system:

> The computed actuarial rate has increased from 11.48% to 11.96%. Due to the agreement in the Manager's Proposal, the amount funded was again significantly less than the computed rate. The City contribution rate (exclusive of the offset contribution of a portion of the employee contribution) was 8.33% for the 1999 fiscal year end and is 8.83% for the 2000 fiscal year. (Comment A p.10.)
>
> Four factors having nothing to do with actual experience since the 1998 valuation put upward pressure on the computed rate: In addition to contributing less than the computed rate, 34 million dollars was set aside for supplemental (a.k.a. "STAR") COLA benefits. Also, the second year of a three-year phase-in regarding lower employee turnover assumptions is in place. City-negotiated offsets against employee contribution rates continue to use much higher assumed employee turnover than indicated by 1990s experience. If none of these four factors existed, the computed rate would have been 10.75%. (Comment A p.10.)
>
> As we indicated at last year's presentation, the computed rate will again increase next year if actuarial nirvana occurs whereby actual and assumed experience exactly coincide. (Comment A p.10.)

> The City's funded ratio slightly decreased this year from 94% to 93%. Factors in Comment A more than offset a slight overall actuarial gain of 29.8 million. The investment gain of 74.9 million dollars was largely offset by actuarial losses in other areas, such as low employee turnover and accelerated retirements. (Comment B p. 10.)
>
> [The Manager's Proposal] rate schedule shall remain in place unless the funded ratio falls below 82.3% or there are insufficient monies from Surplus Undistributed Earnings to cover the shortfall between the City-Paid Rate and the actuarially computed rate. (Comment H p. 11.)
>
> Since this funding method is not one of the six approved funding methods under rules set by the Government Accounting Standards Board, our understanding is that the pension expense will result. (Comment H p. 11.)
>
> Overall, we believe the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. (Conclusion p. 11.)

***Annual Reports filed April 5, 2000.*** The City filed an Annual Report with the Disclosure Repositories for the Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, and Taxable Lease Revenue Bonds, Series 1996A under cover of a transmittal letter dated April 5, 2000. The City also filed an Annual Report for the Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A, on the same date. Both Annual Reports state that a copy of the City's CAFR for FY 1999 was also included with these filings.

Both Annual Reports contain a section captioned "Pension Plan" containing the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 1998. That section also includes, under the heading "OTHER MATERIAL INFORMATION," the following discussion of the *Corbett* litigation relating to the pension system:

> **Potential Settlement Litigation [sic] Related to Pension Plan**
>
> In July of 1998, the City Employees' Retirement System ("CERS") was sued by four retirees, challenging the method by which their retirement pay was calculated. The City was named as a Real Party In Interest. Relying on the California Supreme Court's holding in *Ventura County Deputy Sheriffs' Association v. Board of Retirement of Ventura County Employees' Retirement System*, 16 Cal. 4th 483 (1997), the retirees alleged that CERS had failed to include several items of compensation, such as accrued annual leave and certain kinds of specialty pay, in the "final compensation" upon which the retirees' retirement benefit was calculated. The matter was subsequently certified as a class action, joining all active and retired City employees eligible for City retirement benefits. Although the City's definition of "final compensation"

differs from that which was at issue in *Ventura*, CERS and the City entered into mediation with the plaintiff classes.

A tentative settlement has now been reached in this case, subject to court approval on May 12, 2000, and a vote of the CERS membership as required by the San Diego City Charter. Under the proposed settlement, additional benefits to be paid to retired employees will be paid from sources other than City's [sic] General Fund (or its enterprise funds). Active City employees will receive increased benefit payments to CERS commencing in the Fiscal Year ending June 30, 2001, which will represent an increase of 0.5% in the cost of benefits payable by the City from the General Fund and other funds of the City, in accordance with the current funding mechanism.

The City's disclosures do not appear to allude to this litigation again, and it is not mentioned in the Official Statement dated June 8, 2000, discussed below.

The cover letter for the FY 1999 CAFR, dated November 30, 1999, is similar to that of prior years. The CAFR included the standard cross-reference to the stand-alone financial report issued by SDCERS.

***June 8, 2000***. The City returned to the municipal securities market with $53,000,000 City of San Diego, California 2000-01 Tax Anticipation Notes Series A. The pension related disclosure for this offering updated the third paragraph under "Pension Plan," again noting that, while near the beginning of FY 2001, the SDCERS Board had yet to approve the assumptions underlying the actuarial valuation dated the close of FY 1999:

The City's last actuarial valuation dated June 30, 1999 stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 93.2%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $148.4 million as of June 30, 1999. The UAAL is the difference between total actuarial accrued liabilities of $2.18 billion and assets allocated to funding of $2.03 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 1999 there were 22 years remaining in the amortization period. The assumptions or calculations made in the above actual [sic] valuation have not been formally approved by the CERS Board of Administration.

The three-year trend analysis provided in footnote 9.d. of Appendix B included the following table, showing the growing NPO and the reduced percentage of Annual Pension Cost funded:

The following table shows the City and the District's required contributions and the percentage contributed for the most current year available and preceding years (in thousands):

| Fiscal Year Ending | Annual Pension Cost (APC) | Percentage of APC Contributed | Net Pension Obligation |
|---|---|---|---|
| 6/30/96 | $ 26,122 | 100.0% | $ – |
| 6/30/97 | 34,036 | 82.4 | 5,975 |
| 6/30/98 | 40,693 | 75.4 | 16,000 |

***July 1, 2000.*** *Corbett* settlement takes effect.

***September 19, 2000.*** The City returned to the municipal securities market with $24,000,000 City of San Diego, California 2000-01 Tax Anticipation Notes Series B. The pension-related disclosure for this offering is similar to that of the 2000-01 Tax Anticipation Notes, Series A, except that the text deleted the sentence stating that the Board of Administration had not yet formally approved the assumptions or calculations in the actuarial valuation.

***November 22, 2000.*** The SDCERS CAFR for its fiscal year ended June 30, 2000 was published under cover of a transmittal letter from Retirement Administrator Lawrence Grissom dated November 22, 2000. Initially part of the City's financial reports, SDCERS began in the late 1990s to produce its own separate audited financial reports, which we reviewed beginning with the SDCERS fiscal year 2000 CAFR. Although SDCERS' books were maintained by the City Auditor and the outside auditor for SDCERS was CJO, the same firm that performed the City's audits, the SDCERS CAFRs tended to contain more detailed and accurate descriptions of matters relating to the pension system than the City's own disclosures did. This is apparent in particular with regard to its descriptions of the *Corbett* settlement and the details and impacts of MP1 (and later MP2).

In the Introductory Section, the SDCERS CAFR described the impact of the *Corbett* case on SDCERS:

> Legal action was taken against SDCERS in 1998. The Plaintiff's [sic] in the case alleged that retirement benefits paid by SDCERS had not been calculated correctly in light of the Ventra [sic] County Deputy Sheriff's Association v. Board of Retirement of Ventura County Employees' Retirement Association. In the Ventura decision, the California Supreme Court ruled that the Retirement Board in that case was required to classify certain payments made by the County of Ventura to its employees over and above their basic salaries as "compensation earnable" and to include those payments in "final compensation" used to calculate the amount of monthly pension benefits payable to the retired employees under the County Employees' Retirement Law of 1937 ("CERL"). The Plaintiffs in the

> Corbett case alleged that the same rationale should be applied to certain payments made by SDCERS.
>
> On November 19, 1999, the Court signed an order certifying the case as a class action lawsuit. In March 2000, all of the parties and counsel in this case participated in mediation. As a result of this mediation, the parties and counsel were able to reach an agreement to settle the case.
>
> The terms of the settlement were effective as of July 1, 2000. A one-time, retroactive payment, for the period July 1, 1995 to June 30, 2000, totaling $23,623,562, was paid to retirees and DROP participants on November 17, 2000. Additional terms of the settlement, concerning retirees and members of SDCERS, going forward, can be found in the Notes to the Financial Statements on pages 38 – 43.

In language that remained substantially similar in following CAFRs, SDCERS described its funding policy relating to contributions required and contributions made in Note 3 to the financial statements:

> SDCERS' funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are designed to accumulate sufficient assets to pay benefits when due. The normal cost and actuarial accrued liability are determined using the projected unit credit actuarial funding method.
>
> Unfunded actuarial accrued liabilities are being amortized (closed amortization) as a level percent of payroll over a period of 30 years (20 years remaining), which began July 1, 1991.

In Note 8 to the Financial Statements for the years ended June 30, 2000 and June 30, 1999, the SDCERS CAFR provided more detailed disclosure regarding the *Corbett* settlement and its effect on the Waterfall of payments from surplus earnings:

> SUBSEQUENT EVENT DISCLOSURE CORBETT SETTLEMENT, EFFECTIVE JULY 1, 2000
>
> Legal action was taken against the San Diego City Employees Retirement System (SDCERS) in 1998 by William J. Corbett, Donald B. Allen, Leonard Lee Moorhead and Gordon L. Wilson alleging that retirement benefits paid by SDCERS had not been calculated correctly in light of Ventura County Deputy Sheriff's Association v. Board of Retirement of Ventura County Employees' Retirement Association. In the Ventura decision, the California Supreme Court ruled that the Retirement Board in that case was required to classify certain payments made by the County of Ventura to its employees over and above their basic salaries as "compensation earnable" and to include those payments in "final

compensation" used to calculate the amount of monthly pension benefits payable to the retired employees under the County Employees' Retirement Law of 1937 ("CERL"). The Plaintiffs in the Corbett case alleged that the same rationale should be applied to certain payments made by SDCERS.

On November 19, 1999, the Court signed an order certifying the case as a class action lawsuit. In March 2000, all of the parties and counsel in this case participated in mediation. As a result of this mediation, the parties and counsel were able to reach on agreement to settle the case.

The terms of the settlement were effective as of July 1, 2000. A one-time, retroactive payment, for the period July 1, 1995 to June 30, 2000, totaling $23,623,562, was paid to retirees and DROP participants on November 17, 2000. Additional terms of the settlement, going forward, are described below.

**Description of Settlement**

Retired Members:

- Retired Members who are covered by the Settlement Agreement received a one time lump sum payment in November, 2000, which represented a seven percent (7%) retroactive increase to their Base Retirement Benefit for the period covering July 1, 1995 (or the effective date of retirement after July 1, 1995) through June 30, 2000. The Base Retirement Benefit includes the annual two percent (2%) COLA. It does not include the 13th check or the Supplemental COLA adjustment.

- As of July 1, 2000, and for each year thereafter, Retired Members began receiving a seven percent (7%) increase to their Base Retirement Benefit. The right to receive this increase each year accrues monthly. Payment [sic] are made annually in November. The payment is contingent upon the availability of Surplus Undistributed Earnings as described in San Diego Municipal Code Section 24.1502 (see section which follows on page 42).

- To the extent this increase is not paid in any year because there are insufficient Surplus Undistributed Earnings, the liability for this increase shall be carried forward as a contingent liability which will be paid in future years in which there are sufficient Surplus Undistributed Earnings to pay for the increase. Liabilities carried forward shall be paid in the order in which they accrued.

Active General and Safety Members:

- As of July 1, 2000, active General and Safety Members have the opportunity to CHOOSE at the time of retirement EITHER an increase to the Retirement Calculation Factor OR an increase to their Final Compensation as follows:

For Safety Members: An increase in the Retirement Calculation Factor from 2.2% (Lifeguard) or 2.5% (Police & Fire) to 3% @ age 50 and all ages after age 50 with no change in Final Compensation.

For General Members: An increase in the Retirement Calculation Factor from 2.0% to 2.25% at ages 55 through 59, increasing by .05% for each year of age after age 59, to a maximum of 2.55% at age 65 with no change in Final Compensation.

**OR**

A ten percent (10%) increase in Final Compensation, with the Base Retirement Benefit calculated by using the Retirement Calculation Factors in effect on June 30, 2000.

- Effective July 1, 2001, the employee contribution to the Retirement System will increase as follows:

  General Members + 0.49%
  Safety Members + 0.53%
  Lifeguards + 1.23%

- Effective July 1, 2000, the Employee Contribution to SDCERS will increase by an additional 0.16% to pay for the cost of providing active General and Safety Members the choice of the Retirement Calculation Factors in effect July 1, 2000, with no change in Final Compensation or the Retirement Calculation Factors in effect on June 30, 2000, with a ten percent (10%) increase to Final Compensation.

- The additional 0.16% increase will be paid from the Employee Benefit Reserve described in SDMC Section 24.1507 until the Reserve is exhausted, in approximately 20 years.

Active Legislative Members:

- As of July 1, 2000, active Legislative Members shall receive a ten percent (10%) increase to their Final Compensation with their Base Retirement Benefit calculated using the Retirement Calculation Factors in effect on June 30, 2000.

- Effective July 1, 2001, the Legislative Member's employee contribution to the Retirement System will increase by +0.49%.

- As of July 1, 2000, 0.16% of the employee contribution is paid from the Employee Benefit Reserve described in SDMC Section 24.1507.

Current DROP Participants:

- Current DROP Participants will receive a one-time lump sum payment in November, 2000, to their DROP account. This payment represents a seven percent (7%) increase to their Base Retirement Benefit for the period covering their date of DROP enrollment through June 30, 2000. The Base Retirement Benefit includes the annual 2% COLA. It does not include the 13th check.

- As of July 1, 2000, a current DROP Participant's Base Retirement Benefit was increased by ten percent (10%).

Future DROP Participants:

- Members who elect to participate in DROP on or after July 1, 2000, shall have the opportunity to irrevocably CHOOSE at the time of DROP participation EITHER an increase to the Retirement Calculation Factor OR an increase to their Final Compensation as follows:

  For Safety Members: An increase in the Retirement Calculation Factor from 2.2% (Lifeguard) or 2.5% (Police & Fire) to 3% @ age 50 and all ages after age 50 with no change in Final Compensation.

  For General Members: An increase in the Retirement Calculation Factor from 2.0% to 2.25% at ages 55 through 59, increasing by .05% for each year of age after age 59, to a maximum of 2.55% at age 65 with no change in Final Compensation.

  **OR**

  A ten percent (10%) increase in Final Compensation, with their Base Retirement Benefit calculated using the Retirement Calculation Factors in effect on June 30, 2000.

Currently Vested Deferred Members:

- Members who left City employment prior to July 1, 2000, who were vested when they left City employment, who left their contributions on deposit, and who deferred their retirement until a date on or after July 1, 2000, receive a seven percent (7%) increase to their Final Compensation.

- After retirement, currently vested deferred Members' right to receive this increase accrues monthly. Payment will be made annually in November. The payment is contingent upon the availability of Surplus Undistributed Earnings as described in SDMC 24.1502.

- To the extent this increase is not paid in any year because there are insufficient Surplus Undistributed Earnings, the liability for this increase shall be carried forward as a contingent liability which will be paid in future years in which there are sufficient surplus Undistributed Earnings to

pay for the increase. Liabilities carried forward shall be paid in the order in which they accrued.

Future Vested Deferred Members:

- Members who leave City employment on or after July 1, 2000, who are vested at the time they leave City employment, who leave their contributions on deposit, and who defer their retirement until a future date have the opportunity to CHOOSE at the time of retirement EITHER an increase to the Retirement Calculation Factor OR an increase to Final Compensation as follows:

  For Safety Members: An increase in the Retirement Calculation Factor from 2.2% (Lifeguard) or 2.5% (Police & Fire) to 3% @ age 50 and all ages after age 50 with no change in Final Compensation.

  For General Members: An increase in the Retirement Calculation Factor from 2.0% to 2.25% at ages 55 through 59, increasing by .05% for each year of age after age 59, to a maximum of 2.55% at age 65 with no change in Final Compensation.

  **OR**

  A ten percent (10%) increase in their Final Compensation, with their Base Retirement Benefit calculated using the Retirement Calculation Factors in effect on June 30, 2000.

Surplus Undistributed Earnings (SDMC Section 24.1502):

- Effective July 1, 2000, the right to receive the seven percent (7%) increase to the Base Retirement Benefit for Retired Members accrues monthly and is paid annually in November after the Retirement Board determines there are sufficient Surplus Undistributed Earnings to pay for the increase in accordance with SDMC Section 24.1502.

- SDMC Section 24.1502 sets forth the order of payments which must be made to determine the existence as well as the amount of Surplus Undistributed Earnings for the Retirement System for any given year. The funds remaining after the payments have been made is the surplus undistributed earnings for a fiscal year. The order of payments currently is as follows:

  1. An interest credit determined by the Retirement Board (currently 8%) to the contribution accounts of Retirement System Members, the City and the Unified Port District.

  2. Budgeted expenses and costs of operating the Retirement System.

3. Reserves recommended by the Board's Actuary.

4. Unified Port District's share of Retirement System earnings.

5. Health Insurance premiums for Post Retirement Health Benefits.

6. The Annual Supplemental Benefit (13th check).

7. The Reserves for the Supplemental COLA and Employee Contributions.

- The proposed settlement would insert the payment of the seven percent (7%) increase to the Base Retirement Benefit for Retired Members after the 13th Check and before the Reserves for the Supplemental COLA and Employee Contributions.

To the extent this increase is not paid in any year because there are insufficient Surplus Undistributed Earnings, the liability for this increase shall be carried forward as a contingent liability which will be paid in future years in which there are sufficient Surplus Undistributed Earnings to pay for the increase. Liabilities carried forward shall be paid in the order in which they accrued.

The notes to the SDCERS financial statements included a table detailing the City's funding progress over the past six years reflecting MP1.

San Diego City Employees' Retirement System

## Schedule of Funding Progress

For The Year Ended June 30, 2000

**CITY OF SAN DIEGO**

($ in Thousands)

| | | Continuation Indicators | | | | |
|---|---|---|---|---|---|---|
| **Valuation Date** | **Valuation Assets** | **AAL** | **Funded Ratio** | **UAAL** | **Member Payroll** | **Ratio to Payroll** |
| **6/30/99** | **$2,033,153** | **$2,181,547** | **93.2%** | **$148,394** | **$424,516** | **35.0%** |
| 6/30/98[1] | 1,852,151 | 1,979,668 | 93.6 | 127,517 | 399,035 | 32.0 |
| 6/30/97 | 1,632,361 | 1,748,868 | 93.3 | 116,507 | 382,715 | 30.4 |
| 6/30/96[2] | 1,480,772 | 1,620,373 | 91.4 | 139,602 | 365,089 | 38.2 |
| 6/30/95 | 1,316,903 | 1,421,150 | 92.7 | 104,247 | 350,584 | 29.7 |
| 6/30/94[1] | 1,216,063 | 1,290,927 | 94.2 | 74,864 | 338,440 | 22.1 |

AAL – Actuarial Accrued Liability

UAAL – Unfunded Actuarial Accrued Liability

[1]Reflects revised actuarial and economic assumptions

[2]After Manager's Proposal

The SDCERS CAFR also provided a schedule of employer contributions to SDCERS and noted the creation of "a reserve account, Net Pension Obligation." That reference would remain unchanged until SDCERS' 2003 CAFR.

## Schedule of Funding Progress

For The Year Ended June 30

| | 2000 | 1999 | 1998 | 1997 | 1996 | 1995 |
|---|---|---|---|---|---|---|
| Total Annual Employers' Contribution | $64,937,912 | $59,341,179 | $54,645,789 | $50,337,243 | $46,086,485 | $40,643,564 |

Pursuant to the City Manager's proposal of 1996, the City of San Diego has agreed to pay the following rates:

| Fiscal Year End | City-Paid Rate* |
|---|---|
| 2001 | 9.33% |
| 2002 | 9.83 |
| 2003 | 10.33 |
| 2004 | 10.83 |
| 2005 | 11.33 |
| 2006 | 11.83 |
| 2007 | 12.18 |
| 2008 | 13.00 |

*Note: City-Paid Rate is stated as a percentage of active payroll

This rate schedule will remain in place unless the City of San Diego's funded ratio falls below 82.3% or there are insufficient monies from Surplus Undistributed Earnings to cover the shortfall between the City-Paid Rate and the actuarially computed rate.

Since this funding method is not one of the six approved funding methods under rules set by the Governmental Accounting Board (GASB), a pension expense in the City of San Diego's Financial Statements will result. A reserve account, Net Pension Obligation, has been established to supplement the City of San Diego employer contributions to equal total City contributions as recommended by the actuary.

**2001 Disclosures**

***March 8, 2001***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ending June 30, 2000, which included the following analysis of the pension system:

If Corbett analysis is restricted to non-contingent liabilities, the funded ratio is 97% and the overall, beginning-of-year computed rate is 12.58%. If contingent

> liabilities were to be included, the funded ratio would drop to 94% and the beginning-of-the-year computed rate would increase to 13.69%. (Comment D p. 16.)
>
> Ongoing, increased benefits to current retirees and current vested deferreds, due to the Corbett decision, are based on "excess" investment earnings. Since the magnitude of such increases are large, this could have an impact on the appropriate rate of investment earnings assumed. If extra benefits are conferred during the "good years," then the median, "after-the-fact" investment return should theoretically be correspondingly lower. (Comment E p. 16.)
>
> Overall, the financial condition of the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. (Comment L p. 18.)
>
> ***April 2001.*** Appointment of Blue Ribbon Committee.

***Annual Report filed April 9, 2001.*** The City filed an Annual Report with the Disclosure Repositories for the Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, and Taxable Lease Revenue Bonds, Series 1996A under cover of a transmittal letter dated April 9, 2001. The City also filed an Annual Report for the Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A, on the same date. Both Annual Reports state that a copy of the City's CAFR for FY 2000 was also included in the filing.

The Annual Reports contain a section captioned "Pension Plan" containing the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 1999.

The cover letter for the FY 2000 CAFR, dated November 30, 2000, is similar to that of prior years. The CAFR included the standard cross-reference to the stand-alone financial report issued by SDCERS.

***June 6, 2001.*** The City returned to the municipal securities market with $73,000,000 City of San Diego, California 2001-02 Tax Anticipation Notes Series A. The pension-related disclosure for this offering provided a revised paragraph three reflecting the June 30, 2000 actuarial valuation:

> The City's last actuarial valuation dated June 30, 2000 stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 97.3%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $68.959 million as of June 30, 2000. The UAAL is the difference between total actuarial accrued liabilities of $2.528 billion and

assets allocated to funding of $2.459 billion. The UAAL is amortized over a 30 year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 2000 there were 21 years remaining in the amortization period.

Once again, although the list under the caption "GENERAL PURPOSE FINANCIAL STATEMENTS" contained in Appendix B includes "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Six Years," such information was not provided. In addition, however, the omissions to the General Purpose Financial Statements contained in Appendix B also included the Notes to Financial Statements.

***November 30, 2001.*** The CERS CAFR for fiscal year 2001 was published under cover of a transmittal letter from Retirement Administrator Lawrence Grissom dated November 30, 2001. Under the caption "Changes in SDCERS' Provisions," the Introductory section contained an expanded discussion of the *Corbett* settlement:

> Legal action was taken against SDCERS in 1998 by William J. Corbett, Donald B. Allen, Leonard Lee Moorhead and Gordon L. Wilson (the Corbett Case). The Plaintiffs alleged that retirement benefits paid by SDCERS had not been calculated correctly in light of the decision in Ventura County Deputy Sheriff's Association v. Board of Retirement of Ventura County Employees' Retirement Association. In the Ventura decision, the California Supreme Court ruled that the Retirement Board in that case was required to classify certain payments made by the County of Ventura to its employees over and above their basic salaries as "compensation earnable" and to include those payments in "final compensation" used to calculate the amount of monthly pension benefits payable to the retired employees under the County Employees' Retirement Law of 1937 (CERL). The Plaintiffs in the Corbett Case argued that the same rationale should be applied to certain payments made by the City of San Diego to its employees.
>
> On November 19, 1999, the Court signed an order certifying the case as a class action lawsuit. In March 2000, all of the parties and counsel in this case participated in mediation. As a result of this mediation, the parties and counsel were able to reach an agreement to settle the case.
>
> The terms of the settlement were effective as of July 1, 2000 (FY 2001). SDCERS paid a one-time, retroactive payment, for the period July 1, 1995 to June 30, 2000, totaling $23,623,562, to retirees and DROP participants on November 17, 2000. In addition, $7,041 was paid out during the year in increased benefits in conjunction with the settlement. Corbett benefit payments totaled $23,630,603 during FY 2001 and is listed as a deduction in the Comparative Statement of Plan Net Assets in the Financial Section of this CAFR. Additional terms of the settlement concerning retirees and members of SDCERS going forward are

discussed in the Notes to the Financial Statements in the Financial Section of this CAFR.

Note 7 to the SDCERS financial statements for fiscal years 2001 and 2000 repeated the language relating to *Corbett* provided in the previous year's CAFR, adding statements that $7,041 was paid out in increased benefits during the year in conjunction with the settlement and that *Corbett* benefit payments totaled $23,630,603 in fiscal year 2001. It repeated the description of the settlement terms in language substantially similar to that provided in the previous CAFR, but the description of *Corbett*'s effect on the Waterfall incorporated the effect of the settlement:

> San Diego Municipal Code, Section 24.1502 sets forth the order of payments which must be made to determine the existence as well as the amount of Surplus Undistributed Earnings for the Retirement System for any given year. The funds remaining after the payments have been made is the surplus undistributed earnings for a fiscal year. The order of payments is as follows:
>
> 1. An interest credit determined by the SDCERS Board (currently 8%) to the contribution accounts of SDCERS members, the City and the District.
> 2. Budgeted expenses and costs of operating SDCERS.
> 3. Reserves recommended by the Board's Actuary.
> 4. District's share of SDCERS earnings.
> 5. Health Insurance premiums for Post Retirement Health Benefits.
> 6. The Annual Supplemental Benefit (13th check).
> 7. Corbett Settlement - 7% Increase to the Base Retirement Benefit for retired members.
> 8. The Reserves for the Supplemental COLA and employee contributions.
>
> To the extent accruals from Item #7 are not paid in any year because there are insufficient Surplus Undistributed Earnings, the liability for this increase shall be carried forward as a contingent liability which will be paid in future years in which there are sufficient Surplus Undistributed Earnings to pay for the increase. Liabilities carried forward shall be paid in the order in which they accrued.

Before repeating the previous year's language regarding the trigger and the NPO, the SDCERS CAFR provided a revised table showing the City's employer contributions as compared to the actuarially required levels:

| | 2001 | 2000 | 1999 | 1998 | 1997 | 1996 |
|---|---|---|---|---|---|---|

| | | | | | | |
|---|---|---|---|---|---|---|
| Actuarially Calculated, Required Contributions | $50,772,110 | $45,809,229 | $41,562,858 | $39,685,147 | $33,480,756 | $29,105,861 |
| Contributions Made to SDCERS | 44,337,715 | 39,364,162 | 34,467,454 | 30,979,325 | 28,060,503 | X25,471,498 |
| Difference – Over/(Under) Contributed | ($6,434,395) | ($6,445,067) | ($7,095,394) | ($8,705,822 | ($5,420,253) | ($3,634,363) |
| Percentage Contributed | 87.33% | 85.93% | 82.93% | 78.06% | 83.81% | 87.51% |

The SDCERS CAFR included an update to the Schedule of Funding Progress reflecting the non-contingent benefit increases resulting from the *Corbett* settlement:

San Diego City Employees' Retirement System

## Schedule of Funding Progress

FOR THE YEAR ENDED JUNE 30, 2001

**CITY OF SAN DIEGO**

($ in Thousands)

| | | Continuation Indicators | | | | |
|---|---|---|---|---|---|---|
| **Valuation Date** | **Valuation Assets** | **AAL** | **Funded Ratio** | **UAAL*** | **Member Payroll** | **Ratio to Payroll** |
| **6/30/00[3]** | **$2,459,815** | **$2,528,774** | **97.3%** | **$68,959** | **$448,502** | **15.4%** |
| 6/30/99 | 2,033,153 | 2,181,547 | 93.2 | 148,394 | 424,516 | 35.0 |
| 6/30/98[1] | 1,852,151 | 1,979,668 | 93.6 | 127,517 | 399,035 | 32.0 |
| 6/30/97 | 1,632,361 | 1,748,868 | 93.3 | 116,507 | 382,715 | 30.4 |
| 6/30/96[2] | 1,480,772 | 1,620,373 | 91.4 | 139,602 | 365,089 | 38.2 |
| 6/30/95 | 1,316,903 | 1,421,150 | 92.7 | 104,247 | 350,584 | 29.7 |
| 6/30/94 | 1,216,063 | 1,290,927 | 94.2 | 74,864 | 338,440 | 22.1 |
| 6/30/93 | 1,137,019 | 1,178,311 | 96.5 | 41,292 | 320,624 | 12.9 |

AAL – Actuarial Accrued Liability

UAAL – Unfunded Actuarial Accrued Liability

[1]Reflects revised actuarial and economic assumptions

[2]After Manager's Proposal

[3]Reflects non-contingent Corbett benefit increases

*NOTE: Actuarial gains and losses reduce or increase the unfunded actuarial accrued liability which is being amortized over a closed 30-year period which began July 1, 1991 (20 years remaining).

The SDCERS CAFR also added a discussion of the City's schedule of funding progress in a Note to the Schedules of Trend Information:[432]

> A schedule of funding progress presents a consolidated snapshot of a retirement system's ability to meet current and future liabilities with the assets of the system. Of particular interest to most is the funded status ratio. This ratio quickly conveys a retirement system's level of assets to liabilities, which is important in determining the financial health of a retirement system. The closer a retirement system is to a 100% funded status, the better position it is in to meet all of its liabilities.
>
> As of June 30, 2000, the date of the last actuarial valuation, the City of San Diego (City) has a 97.3% funded status. The San Diego Unified Port District (District) has a 137.1% funded status. Overall, the financial condition of SDCERS continues to be in sound condition in accordance with the actuarial principles of level-cost funding.
>
> *City of San Diego*
>
> In this schedule, eight years of historical information is presented with respect to the funding progress of the City, a participating employer of SDCERS. The City has maintained, on average, a 94% funded status over the past eight years. This is an important accomplishment for the City, as a consistent funded status provides for level and predictable employer contributions from year to year. This consistency has been achieved through solid earnings on invested assets provided by a well-diversified investment program administered by SDCERS Board. This consistent funded ratio has also been achieved during a time when the City's employee base increased to meet the service needs of San Diego citizens, which increases the future liabilities of SDCERS to provide future benefits to an increased number of SDCERS members.
>
> The City currently has an unfunded accrued actuarial liability (UAAL), resulting from actuarial accrued liabilities (AAL) exceeding the valuation of assets. The UAAL is being amortized by the City over a closed 30-year period, which began July 1, 1991 (20 years remaining). A majority of retirement systems have a UAAL, as they are not at a 100% funded status. In the opinion of most actuarial firms, a funded status in excess of 90% indicates that a retirement system is financially positioned to meets its current and future liabilities to its members.

Following that, a discussion of the employer contribution policies (including the role of the 82.3% trigger) and history of the City was provided:

> The sources of revenues that fund a retirement system are: employer contributions, employee contributions and investment earnings on plan assets.

[432] Discussions relating to the San Diego Unified Port District's participation in SDCERS have been omitted.

Each year, SDCERS' actuary determines the amount of employer contributions required to fund a given schedule of benefits (current and future liabilities). This benefit schedule is calculated from: SDCERS benefit structure for the City or District, statistical data about the City's or District's employees that are members of SDCERS and current and predicted future retirees and beneficiaries of SDCERS. Assumptions must be made to estimate how many employees (SDCERS members): terminate employment, leave on a disability retirement or service retirement and the average ages of employees (members) at retirement and at mortality. Finally, the preceding data is combined with an actuarially assumed investment rate of return and assumed salary increases of the City's and District's employees (members). All of this information taken together is presented in an annual actuarial valuation in which the actuary recommends an employer contribution rate (percentage) to the participating employers. This contribution rate percentage is applied to the actuarially determined valuation payroll for each of the participating employers' employees. The resulting dollar amounts, as depicted in this schedule, are the actuarially calculated required employer contributions necessary to fund the promised benefits to SDCERS members.

*City of San Diego*

This schedule contains six years of historical information with respect to the City's actuarially calculated, required contributions versus the actual employer contributions made by the City, on an annual basis. Over the past six years, the City has contributed, on average, approximately 84% of the amount recommended by the actuary. This 16% difference is due in part to the City assuming that more employees will terminate employment with the City prior to vesting in SDCERS than has been estimated by the actuary. Since employer contributions are not refundable to the employer if an employee terminates, the City discounts their actuarially calculated, required contributions to account for this assumption variance.

Beginning in 1996, the City negotiated with SDCERS to contribute a "City-Paid Rate" which is essentially a fixed contribution rate schedule. The annual fixed contribution rates through 2008 are depicted in a schedule on the preceding pages. Because this fixed rate arrangement is not one of the six approved funding methods under the rules set forth by the Governmental Accounting Standards Board (GASB), a pension expense in the City of San Diego's financial statements results. The advantage of a fixed schedule of employer contributions is that the City can effectively budget for annual employer contributions while continuing to provide cost-effective services to San Diego citizens without adversely impacting taxpayers. Since the City currently has a 97.3% funded status, this fixed rate contribution arrangement benefits City's employees (SDCERS members) by keeping SDCERS funded and at the same time benefits San Diego taxpayers by minimizing employer contributions paid from City tax revenues. Should the City's funded status fall below 82.3%, the City has agreed to make the necessary contributions, over time, to bring the funded status back to an acceptable level.

**2002 Disclosures**

***February 2002.*** The Blue Ribbon Committee issued its report noting future financial risks from enhanced retirement benefits and healthcare costs and recommending that the City fully fund the actuarially determined cost of the retirement system, including the healthcare benefit, and that it obtain a comprehensive analysis of projected pension and healthcare expenses to determine their future impact on City finances.

***February 12, 2002***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ending June 30, 2001, which included the following analysis of the pension system:

> Valuation results indicate that there was a large experience loss of $193.2 million. Losses were primarily due to lower investment returns and higher pay increases than projected. (Cover letter.)
>
> Half the experience loss can be attributable to investment losses of $95.6 million. To give some flavor for the precipitous change in investment return, the return on the actuarial value of assets was 21.4% for the year ended June 30, 2000. The rate dropped all the way to 4.1% in 2001, well below the 8% assumption. The System was well served by the 5-year smoothing of the actuarial value of assets due to the terrific performance in the previous four years. However, there will be larger investment losses on an actuarial basis next year unless the markets improve over the next five months. (Comment C p. 14.)
>
> We have NOT included any Corbett contingent liabilities in the valuation. If we had included the value of such liabilities, estimated to be in the $70-76 million range, the funded ratio would drop in the 2-2.5% range. We offer comment related to disposition of Surplus Undistributed Earnings. Suppose that the System earns 0% in the current fiscal year and 16% next year. Our understanding is that a contribution to Surplus Undistributed Earnings will be made for the 16% year even though there will be no net gain from investments over the two-year period. If extra benefits are conferred in the "good" years, then the median, "after the fact" investment return to finance all other benefits should theoretically be correspondingly lower. We will revisit this issue in the experience investigation. (Comment E p. 15.)
>
> Advocates of the 1996 Manager's Proposal felt that there would be cost savings due to an anticipated reduction of the average age of the non-DROP active member work force. For funding, DROPs have been treated as retirants at the date they initiate their DROP period. This has clearly not come to pass. The average age of actives was 41.3 years as of the 1996 valuation. In this valuation, the average age of the non-DROP actives is 42.1. This is evidence of low employee turnover in the past five years, not surprising in view of the high level of offered pension benefits. (Comment F p. 16.)

> We note that there was no adjustment to [the Manager's Proposal] in light of the significant 2001 Corbett benefit increases. (Comment G p. 16.)
>
> We have been requested to complete an Entry Age Normal valuation annually. In the Manager's Proposal, it was contemplated that City rate increases would eventually be enough to support an Entry Age Normal. This prospect seems more unlikely in view of subsequent benefit increases. This year's Entry Age rate is 17.75% (Comment L p. 16-17.)
>
> Overall, the financial condition of the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. However, we want all parties to be acutely aware that the current practice of paying less than the computed rate of contribution or pickup will help foster an environment of additional declines in the funding ratios in absence of healthy investment returns. (Comment M p. 17.)

***February 14, 2002.*** The City sold its $169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 (Ballpark). The disclosure for this offering received a higher level of review than typical financings of the City as described elsewhere.

The section relating to the pension plan included the information from the June 3, 2000 actuarial valuation. Appendix B contains the financial statements for FY 2001. Section 10.c. provides:

> Annual Required Contribution
>
> The annual required contribution for the current year was determined as part of the June 30 actuarial valuation using the projected unit credit actuarial funding method. The actuarial assumptions included (a) an 8.0% investment rate of return and (b) projected salary increases of 4.75% per year. Both (a) and (b) included an inflation rate of 4.5%. The actuarial value of assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a five-year period. The unfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on an open basis. The remaining amortization period at June 30, 2001 was 20 years.

***Annual Reports filed April 9, 2002.*** The City filed an Annual Report with the Disclosure Repositories for the Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, and Taxable Lease Revenue Bonds, Series 1996A, under cover of a transmittal letter dated April 9, 2002. The City also filed an Annual Report for the Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A, on the same date. Both Annual Reports state that a copy of the City's CAFR for FY 2001 was also included in the filing.

In the standard section on Labor Relations, the Annual Reports include a statement that the City is currently negotiating labor agreements with all four of its labor organizations.

The Annual Reports contain a section captioned "Pension Plan" containing the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 2000, together with an additional paragraph reflecting the June 30, 2001 actuarial valuation:

> The CERS Retirement Board has received the Actuary's report on the results of the actuarial valuation for the year ended June 30, 2001. In that report, the new UAAL as of June 30, 2001, is $283.89 million. That reflects actuarial accrued liabilities of $2.809 billion and assets allocated to funding of $2.526 billion. The assumptions and calculations made in the June 30, 2001, actuarial valuation are subject to review, approval, or revisions by the Retirement Board. As a consequence of which the UAAL as of June 30, 2001 may change.

The discussion of UAAL amortization in paragraph three gives the impression that the UAAL is being amortized over the remaining period without modification and provides no discussion of how this payment is affected by the mechanics of MP1 or will likely be increased by the benefits granted in Meet and Confer (also not mentioned under Labor Relations). The fourth paragraph discloses an increase in the UAAL to $283.89 million as of June 30, 2001, a significant increase from $68.959 million the previous year.

Under the heading "**OTHER MATERIAL INFORMATION**," the Annual Reports include a discussion of the FY 2002 adopted budget. They state that the adopted budget assumes that the City will experience slower economic growth than in prior years due to declining consumer confidence and higher energy prices, and that in February 2002 the City Manager reported to the City Council that revenue collections to date had failed to meet budget estimates due to September 11 and the slowing economy.

The SDCERS CAFR included the standard cross-reference to the stand-alone financial report issued by SDCERS.

In addition, the City filed an Annual Report for the Public Facilities Financing Authority Lease Revenue Bonds, Series 2002, on that date, which incorporated by reference the Official Statement relating to those bonds. That Annual Report omitted the above discussion of the FY 2002 adopted budget.

***May 10, 2002.*** The City provides its "Summary of the City's Final Position" on MP2 to the municipal unions.

***June 4, 2002.*** The City returned to the municipal securities market with $93,200,000 City of San Diego, California 2002-03 Tax Anticipation Notes Series A. The disclosure for this offering repeated the pension information that was disclosed in connection with the issuance of the Public Facilities Financing Authority Lease Revenue Bonds Series 2002 on February 14, 2002, and in the Annual Reports filed April 9, 2002.

Once again, although the list under the caption "GENERAL PURPOSE FINANCIAL STATEMENTS" contained in Appendix B includes "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Six Years," such information was not provided.

***June 12, 2002.*** The City issued $25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002B (Fire and Safety Project). The disclosure for this offering contained the same description under "Pension Plan" as provided in the June 4, 2002 Official Statement. It continues to note that the UAAL described in the June 30, 2001 actuarial evaluation may change because the actuary's report has not yet been approved by the Retirement Board, even though only a few days remained in the succeeding fiscal year.

Once again, although the list under the caption "GENERAL PURPOSE FINANCIAL STATEMENTS" contained in Appendix B includes "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Six Years," such information was not provided.

***November 1, 2002.*** The SDCERS CAFR for fiscal year 2002 was published under cover of a transmittal letter from Retirement Administrator Lawrence Grissom dated November 1, 2002, which noted that as of June 30, 2001, SDCERS had a funded ratio of 89.9% for the City.

The transmittal letter addressed losses to the retirement system:

> The most recent year's actuarial valuation results indicated that there was a sizable City experience loss of $193.2 million for the Retirement System. This loss was primarily attributable to worse than expected investment performance and unanticipated pay increases.

Under the caption "SUBSEQUENT EVENT DISCLOSURE – Benefit Enhancements" Note 8 to the financial statements for the fiscal years ended June 30, 2002 and June 30, 2001 provided a detailed discussion of the changes resulting from that year's Meet and Confer agreement:

> As the result of the City of San Diego's collective bargaining process known as Meet and Confer, the retirement benefits for General Members were increased

effective July 1, 2002 (FY 2003). The Retirement Benefit Calculation factor was increased from 2.25% to 2.50% per year of creditable service. The new rates, effective July 1, 2002, are as follows:

| Retirement Age | Retirement Calculation Factor |
|---|---|
| 55-59 | 2.50% |
| 60 | 2.55% |
| 61 | 2.60% |
| 62 | 2.65% |
| 63 | 2.70% |
| 64 | 2.75% |
| 65 | 2.80% |

In conjunction with the new Retirement Calculation Factor, a maximum of 90% of a member's high one-year salary will be paid as a Service Retirement, based on the years of service calculation for the City's General Members. The 90% "cap" will be applicable to all City General Members hired or rehired on or after July 1, 2002. In addition, the 90% cap will also apply to City General Members hired on or before June 30, 2002, *with some exceptions*.

Further, the payment of the retirement contribution offset was increased for City Safety Members from 7.3% to 9.0%, effective July 6, 2002. The increase to this payment will be paid out of Reserves for Employers' Contributions.

In addition, the maximum amount to be paid on behalf of, or reimbursed to, a Health Eligible Retiree for retiree-only Medicare eligible or non-Medicare eligible health insurance premiums, for coverage effective August 1, 2002, was increased from the HMO rate to the PPO rate. The rate is adjusted annually thereafter based on the Centers for Medicare and Medicaid Services, Office of the Actuary, projected increase for National Health Expenditures for the full year period ending in the January preceding the start of the new plan year, with such adjustment not to exceed 10% for any given year.

The actuarial valuation to be performed as of June 30, 2002, will incorporate these benefit enhancements and will include any associated liability of SDCERS.

**Employer Contribution Increases**

The City of San Diego has agreed to increase their annual employer contribution rate to fund the increased benefits discussed above beginning in FY 2004; payment will be advance funded to SDCERS July 1, 2003.

Furthermore, the percentage contribution rates in the "City Paid Rate" schedule, as identified in the Schedule of Employers' Contributions, beginning on page 49 of this CAFR, will be increased beginning in FY 2004. Exact contribution rates

are being finalized with the City and SDCERS. For the City's current employer contribution rates, please refer to the Schedule of Employer Contributions.

The actuarial valuation to be performed as of June 30, 2002, will incorporate these increased contributions and any impact on the funded status of SDCERS for the City of San Diego.

The SDCERS CAFR included an updated table reflecting the City's funding progress over the past eight years:

San Diego City Employees' Retirement System

## Schedule of Funding Progress

FOR THE YEAR ENDED JUNE 30, 2002

**CITY OF SAN DIEGO**

($ in Thousands)

| | | Continuation Indicators | | | | |
|---|---|---|---|---|---|---|
| **Valuation Date** | **Valuation Assets** | **AAL** | **Funded Ratio** | **UAAL** | **Member Payroll** | **UAAL Ratio to Member Payroll** |
| **6/30/01** | **$2,525,645** | **$2,809,538** | **89.9%** | **$283,893** | **$481,864** | **58.9%** |
| 6/30/00[3] | 2,459,815 | 2,528,774 | 97.3 | 68,959 | 448,502 | 15.4 |
| 6/30/99 | 2,033,153 | 2,181,547 | 93.2 | 148,394 | 424,516 | 35.0 |
| 6/30/98[1] | 1,852,151 | 1,979,668 | 93.6 | 127,517 | 399,035 | 32.0 |
| 6/30/97 | 1,632,361 | 1,748,868 | 93.3 | 116,507 | 382,715 | 30.4 |
| 6/30/96[2] | 1,480,772 | 1,620,373 | 91.4 | 139,602 | 365,089 | 38.2 |
| 6/30/95 | 1,316,903 | 1,421,150 | 92.7 | 104,247 | 350,584 | 29.7 |
| 6/30/94[1] | 1,216,063 | 1,290,927 | 94.2 | 74,864 | 338,440 | 22.1 |
| 6/30/93 | 1,137,019 | 1,178,311 | 96.5 | 41,292 | 320,624 | 12.9 |

AAL – Actuarial Accrued Liability

UAAL – Unfunded Actuarial Accrued Liability

[1]Reflects revised actuarial and economic assumptions

[2]After Manager's Proposal

[3]Reflects non-contingent Corbett benefit increases

NOTE: Actuarial gains and losses reduce or increase the unfunded actuarial accrued liability which is being amortized over a closed 30-year period which began July 1, 1991 (19 years remaining).

Before repeating the standard disclosure of the City's contribution rates, the SDCERS CAFR included a revised schedule of employer contributions:

## City of San Diego

| | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|
| Actuarially Calculated, Required Contributions | $56,421,530 | $50,772,110 | $45,809,229 | $41,562,858 | $39,685,147 | $33,480,756 |
| Contributions Made to SDCERS | 49,743,747 | 43,385,069 | 39,364,162 | 34,467,454 | 30,979,325 | 28,060,503 |
| Difference – Over/(Under) Contributed | (6,677,783) | (7,387,0421) | (6,445,067) | (7,095,394) | (8,705,822) | (5,420,253) |
| Percentage Contributed | 88.16% | 85,45% | 85.93% | 82.93% | 78.06% | 83.81% |

The Schedule of Funding Progress was substantially similar to that provided in the previous year's SDCERS CAFR, updated to reflect the City's then-current 89.9% funded status and its maintenance of an average funded status of 93.5% over the previous nine years. It also stated: "Beginning in FY 2004, July 1, 2003, the City has agreed to increase the 'City-Paid Rate' annual contributions. The actual year by year details of the rate schedule have not yet been finalized."

Estimates regarding the system's losses relating to investments and other matters were also disclosed:

> Estimated Gain (Loss) Attributed to Investment Experience – $(95,647,385) out of total $(193,168,984).
>
> Estimated Gain (Loss) Attributed to Pay Increases - $(37,000,000)
>
> Estimated Gain (Loss) Attributed to Employee Turnover, Pre-Retirement Mortality, Retirement Incidence, Data Corrections, and Miscellaneous Factors - $(60,521,599).
>
> The net losses of $193.6 million were as a result of the decreasing market values of invested assets and more than expected employee pay increases, combined with less than expected employee turnover and pre-retirement mortality.

***November 5, 2002***. In a letter to the SDCERS Board, actuary Rick Roeder provided his comments on MP2:

> The Agreement provides for better funding of SDCERS than does the existing Manager's Proposal, if the 82.3% funding ratio trigger point is not hit.

If the 82.3% funding ratio trigger point is hit, then under some interpretations of the current Manager's Proposal higher contributions would be received from the City.

It is likely that the 82.3% trigger point will be hit by June 30, 2003, because of the way that SDCERS' assets are valued for the actuarial valuation.

The higher the City's contribution levels, the better for the funding status of SDCERS.

The current drop in the market asset values has contributed substantially to the drop in SDCERS' funding ratio. This drop cannot be made up in full in any short period by an actuarially determined increase in the City's contributions rates, but steady contribution increases would be best.

The sooner that the City's contribution rate is at the full PUC rate the better. The sooner that the City's contributions rate is at the full EAN rate the better.

From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger (particularly if one of the "high contribution rate" interpretations of the effects of hitting that trigger were to prevail).

From a pure actuarial viewpoint, the actuary would prefer it if the Board did not have to provide a transition period to the City to reach the full PUC rate and then move to the full EAN rate.

The Board must exercise its judgment in deciding whether a transition period is needed to ramp up contributions to the PUC and/or EAN rate.

If the Board decides that a transition period is needed, then the transition period chosen is reasonable as the City will commit to contribute an additional amount each year starting in July 2004; if the 82.3% accelerated funding trigger is hit the ramp up to full PUC rates will be accelerated; the City will contribute the full PUC rate starting in July 2008; the entire agreement will sunset on June 30, 2010; and the City agrees to use its best efforts to contribute at the rate determined under the EAN funding method.

***November 18, 2002.*** The City and SDCERS enter into an agreement providing for the implementation of MP2. At the City Council's open meeting on that date, in support of the proposed ordinance enacting the changes to the retirement system, the City Manager's Office provided information regarding the anticipated fiscal impact of those changes:

The conversion of Annual Leave to service credit in the Retirement System or extension of the Member's DROP participation period may result in an increase to the Retirement System's unfunded liability and a corresponding increase to the

City's contribution rate over and above the scheduled rates in the Manager's Proposal.

The amount of any increase to the System's unfunded liability and City's contribution rate will depend upon the usage of Annual Leave accrued after July 1, 2002 that is converted to service credit in the Retirement System or to extend the Member's DROP participation period. There is no fiscal impact associated with the provision allowing 5 year purchase of service.

**2003 Disclosures**

***January 9, 2003***. SDCERS actuary Rick Roeder provided the annual actuarial valuation for the fiscal year ended June 30, 2002, which included the following analysis:

Losses were primarily due to lower investment returns than anticipated. (Cover letter)

Elements of Experience Gain (Loss) – shows $312,953,654 loss attributable to investment experience as the most significant factor contributing to $364,815,155 total loss for the year. (p. 10.)

The computed actuarial rate increased from 15.59% to 21.13% primarily due to significant investment losses. (Comment A p. 14.)

Using the actuarial value of assets, there were investment losses of $312.9 million. For this purpose, losses are calculated relative to the 8% investment assumption NOT zero. (Comment B p. 14.)

There were additional benefits conferred as a result of the amended Manager's Proposal. Because both the ratification date and effective date of such increases were after June 30, 2002, they were not incorporated in this valuation. However, this will serve to put upward pressure on the computed rate and downward pressure on the funded ratio when such increase commence to be reflected. (Comment C p. 14.)

The 21.13% contribution rate is calculated using principles of "level" funding . However, since the Manager's Proposal rate for the current fiscal year is 10.33%, the 21.13% rate is predicated on roughly $59 million more in funding in fiscal year end 2003 than will occur under the Manager's Proposal. (Comment C p.14.)

At direction from the Retirement Board, we continue to NOT include any Corbett contingent liabilities in the valuation. If we had included the value of such liabilities, the funded ratio would drop roughly 2%…. If extra benefits are conferred during the "good" years, then the median, "after the fact" investment return to finance all other benefits should theoretically be correspondingly lower. We have addressed this issue in the experience investigation. (Comment E p. 15.)

> The gap between the City-paid rate and the computed rate has significantly increased in each of the past two valuations. The gap is large enough that even if all assumptions are exactly met, other factors equal, the computed rate will increase each year as long as a contribution shortfall from the computed actuarial rate exists. (Comment G p. 16.)
>
> Overall, the financial condition of the retirement system is in adequate condition in accordance with actuarial principles of level-cost financing. However, all parties should be acutely aware that the current practice of paying less than the computed rate of contribution will help foster an environment of additional declines in the funding ratios in the absence of healthy investment returns. (Comment L p. 17.)

***February 5, 2003.*** The SDCERS Board provides its report on the pension system to the City Council in response to the Blue Ribbon Committee Report.

***The 2002 CAFR.*** The City filed its 2002 CAFR in connection with Annual Report for the Public Facilities Financing Authority's Sewer Revenue Bonds, Series 1995, Series 1997A and Series 1997B, and Series 1999A and 1999B under cover of a transmittal letter dated March 7, 2003.

Under the heading "Labor Relations," that Annual Report includes, in addition to the standard discussion, new information relating to retirement benefits:

> In addition to increases in paid compensation, MEA, Local 127, and Local 145 will also receive increases in the amount of employee retirement contributions paid by the City on behalf of the employees. Including these retirement benefit increases, over the three-year period of the labor agreements total compensation will increase by 12.6% for MEA and Local 127, and by 15.7% for Local 145. A labor agreement with POA is in place through June 30, 2003.

The Annual Report contains the section captioned "Pension Plan" containing the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 2002. The first sentence of the first of the standard paragraphs relating to the Pension Plan was revised to replace the reference to "full-time City employees" with "benefited City employees." The third paragraph attributed the increase in the UAAL primarily to investment returns:

> The City's last actuarial valuation dated June 30, 2002 stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 77.3%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $720.7 million as of June 30, 2002, which represents a $436.8 million increase in the UAAL since the previous actuarial calculation dated June 30, 2001. The UAAL is the difference between total

actuarial accrued liabilities of $3.169 billion and assets allocated to funding of $2.448 billion. The increase in the UAAL as of June 30, 2002, results primarily from the lower than anticipated investment returns. The UAAL is amortized over a 30-year period, which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 2002, there were 19 years remaining in the amortization period.

The cover letter for the FY 2002 CAFR, dated November 27, 2002 again resembles that of earlier CAFRs.

Under footnote 13, Post Retirement Health Insurance, the Notes state:

In addition to providing pension benefits, the City of San Diego Municipal Code provides certain health care insurance benefits for retired general and safety members of SDCERS who retired on or after October 6, 1980. At June 30, 2002, approximately 3,327 eligible retirees received benefits.

Certain health care insurance benefits were established during Fiscal Year 1995 for eligible retirees who retired prior to October 6, 1980 or who were otherwise not eligible to receive City-paid health care insurance as of June 30, 1994. At June 30, 2002, approximately 536 eligible retirees received benefits.

Currently, expenses for post-employment healthcare benefits are recognized as they are paid. For the fiscal year ended June 30, 2002, expenditures of approximately $8,882,138 were recognized for such health care benefits.

Substantially all of the City's general and safety members of SDCERS may become eligible for those benefits if they reach normal retirement age and meet service requirements as defined while working for the City.

The November 18, 2002, agreement relating to MP2 was not discussed.

The SDCERS CAFR included the standard cross-reference to the stand-alone financial report issued by SDCERS.

***Annual Reports filed April 8, 2003.*** The City filed an Annual Report with the Disclosure Repositories for the Certificates of Participation, Series 1996A, Refunding Certificates of Participation, Series 1996B, Taxable Lease Revenue Bonds, Series 1996A, and the Public Facilities Financing Authority Lease Revenue Bonds, Series 2002B, under cover of a transmittal letter dated April 8, 2003. The City also filed separate Annual Reports for the Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A, and the Public Facilities Financing Authority Lease Revenue Bonds, Series 2002, on the same date. All

three of the Annual Reports state that a copy of the City's CAFR for FY 2002 was filed previously.

The Labor Relations section contains the same information provided in the Annual Report filed on March 7, 2003. It also states: "POA received a 2% pay increase and a 1.7% increase in retirement compensation effective July 2002."

The section captioned "Pension Plan" contains the standard three paragraphs, with the third containing information from the actuarial valuation dated June 30, 2002.

Under the heading "OTHER MATERIAL INFORMATION," the Annual Reports discussed continuing revenue pressures on the City and issues relating to the state budget deficit and the vehicle license fee reduction and their potential effect on City revenues. Under "Other Litigation and Claims," they also contain two paragraphs describing the *Gleason* litigation:

> On January 16, 2003, a class action complaint (*Gleason v. City of San Diego, et al.*) for declaratory relief was filed in the Superior Court against the City, the City's [sic] Employees' Retirement System (SDCERS), and certain named members of the SDCERS board of administration. The plaintiffs, former City employees who receive City retirement benefits, allege that as a result of recent actions taken by the defendants, the SDCERS trust fund has an unfunded accrued liability of $720 million, and that by 2009, the City will owe approximately $2.8 billion to SDCERS, with an annual City budget expense of more than $250 million. In addition to the declaration of their rights, plaintiffs ask for restitution to the SDCERS trust fund, an injunction prohibiting the City from unlawfully underfunding the trust fund in the future, money damages, attorneys' fees, and other relief.
>
> As noted under the heading "Pension Plan" above, the City's unfunded accrued actuarial liability as of June 30, 2002 is approximately $720 million. The City is defending the case and believes it has complied with applicable law in the funding of the SDCERS trust fund. The case is still in the early stages, and the City has not completed its assessment of the claim. The City cannot predict the outcome of the litigation at this time, but if the plaintiffs are successful, there potentially may be additional expense to the General Fund in the funding of the SDCERS trust fund and otherwise, over and above the City's expected expense in the funding of its pension obligations.

***April 30, 2003.*** The City issued $15,255,000 City of San Diego/MTDB Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding) with disclosure that repeats the discussion of the increase in retirement benefits and the pension system information contained in the April 8, 2003 Annual Reports. The section relating to the pension system also included a cross-reference to the ongoing litigation.

The City's last actuarial valuation dated June 30, 2002 stated the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund to be 77.3%. The CERS fund has an Unfunded Actuarial Accrued Liability (UAAL) of $720.7 million as of June 30, 2002, which represents a $436.8 million increase in the UAAL since the previous actuarial calculation dated June 30, 2001. The UAAL is the difference between the total actuarial accrued liabilities of $3.169 billion and assets allocated to funding of $2.448 billion. The increase in the UAAL as of June 30, 2002, results primarily from the lower than anticipated investment returns. The UAAL is amortized over a 30-year period, which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 2002, there were 19 years remaining in the amortization period. See "**LITIGATION POTENTIALLY AFFECTING THE GENERAL FUNDS OF THE CITY – Other Litigations and Claims**" for a discussion of a pending litigation relating to the funding of the UAAL.

Under Labor Relations, the pay increases resulting from the 2002 Meet and Confer process are disclosed, but no mention is made of benefits increases. The discussions of the budgets for FY 2002, 2003, and 2004 make no mention of the adoption of MP2 and its related consequences.

Appendix B to the Official Statement contains several changes from prior official statements of the City. As noted in the Independent Auditors' Report dated November 27, 2002, and Note 1 to the basic financial statements of the City, the City adopted GASB statements 34, 37 and 38. The letter is followed by the Management's Discussion and Analysis from the FY 2002 CAFR which mentions benefit increases for the first time under the heading "ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES." The text states: "Labor negotiations resulted in compensation and benefit increases of an average of 3.75% over the next three years. Salaries and Benefits account for approximately 75.6% of the total General Fund budget and 19.5% of the Non-General Funds in fiscal year 2003." No mention is made in the Independent Auditors' Letter of the changes to the pension plan and other measures collectively known as MP2.

The list of included statements previously provided under the caption "GENERAL PURPOSE FINANCIAL STATEMENTS" contained in Appendix B, of which "Required Supplementary Information – Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses by Type – Last Six Years," was so frequently omitted is now dropped.

***May 29, 2003.*** The City issued $17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding) Evidencing Undivided Proportionate Interest in Lease Payments to be Made by the City of San Diego Pursuant to a

Lease with the San Diego Facilities and Equipment Leasing Corporation, with disclosure [unchanged from that in the April 30, 2003 offering]. It included the discussion of the *Gleason* litigation provided in the Annual Reports filed on April 8, 2003.

> On January 16, 2003, a class action complaint (*Gleason v. City of San Diego, et al.*) for declaratory relief was filed in the Superior Court against the City, the City's Employees' Retirement System (SDCERS), and certain named members of the SDCERS board of administration. The plaintiffs, former City employees who receive City retirement benefits, allege that as a result of recent actions taken by the defendants, the SDCERS trust fund has an unfunded accrued liability of $720 million, and that by 2009, the City will owe approximately $2.8 billion to SDCERS, with an annual City budget expense of more than $250 million. In addition to the declaration of their rights, plaintiffs ask for restitution to the SDCERS trust fund, an injunction prohibiting the City from unlawfully underfunding the trust fund in the future, money damages, attorneys' fees, and other relief.
>
> As noted under the heading "**PENSION PLAN**" above, the City's unfunded accrued actuarial liability as of June 30, 2002 is approximately $720 million. The City is defending the case and believes it has complied with applicable law in the funding of the SDCERS trust fund. The case is still in the early stages, and the City has not completed an assessment of the claim. The City cannot predict the outcome of the litigation at this time, but if the plaintiffs are successful, there potentially may be additional expense to the General Fund in the funding of the SDCERS trust fund and otherwise, over and above the City's expected expense in the funding of its pension obligations

***June 2003 Rating Agency Presentations.*** In June 2003, in connection with the planned issuance of tax anticipation notes, City staff made presentations to the rating agencies, which included several slides containing information relating to the City's pension obligations under the heading "Pension System Issues":

> **Current Status**
>
> As of June 30, 2002, the City's retirement system had a funded ratio of 77.3% and a total Unfunded Accrued Actuarial Liability (UAAL) of $720.7 million, compared with a funded ratio of 89.9% and UAAL of $284 million as of June 30, 2001. Approximately 85% of the increase in UAAL was due to investment losses. All public pension systems are facing actuarial losses and almost all have new unfunded liabilities.
>
> Based on a survey of other pension systems in California conducted by the City's retirement system, 16 of 20 respondents reported investment losses during 2001, and 15 of 16 respondents reported investment losses during 2002.

According to the 2003 Wilshire Report on State Retirement Systems, the funded ratio for all state pension plans combined declined from 106% in 2001 to 91% in 2002, a drop of 14%, which is the same as the percentage decline in San Diego's ratio.

In 1996, with the approval of the Actuary and Fiduciary Counsel, the Retirement Board entered into an agreement called "the Manager's Proposal". Under this agreement the employer annual contribution rates were based on a fixed increase each year. The plan was to ramp up over a ten year period to the Entry Age Normal (EAN) rate at which time the City would convert from Projected Unit Credit (PUC) to EAN. EAN provides for a more predictable increase which provides greater budgetary control.

Until the investment downturn beginning in 2001, the Manager's Proposal provided adequate contribution amounts sufficient to maintain the City's funded ratio above, or near the 90% level.

In 2002, a second agreement (the "Contribution Agreement") provided a transition period for the contribution amounts with the contributions to be brought to full actuarial rates by Fiscal Year 2009.

The Contribution Agreement also has a provision that if the funding ratio fell below 82.3% accelerated contributions rates would come into effect.

The new contribution rates under the Contribution Agreement are in the form of a phased series of increasing rates intended to achieve full actuarial contribution rates by Fiscal Year 2009.

Since the June 30, 2002, Actuarial Report reflected a funding ratio of 77.3%, the Contribution Agreement is in effect and the City is paying accelerated contribution rates.

**City Manager's Analysis to Identify Options**

The City Manager is in the process of completing a major review and analysis of all aspects of the City's pension system for the purpose of providing the City Council with various options to ensure that funding is provided at an appropriate long-term rate.

**Confidential Information**

Manager's recommendations to the City Council could include

Adoption of full actuarial contribution rate by City beginning in Fiscal Year 2005 for all Funds or Non Governmental Funds.

Issuance of Pension Obligation Bonds to extinguish all, or a portion of the outstanding UAAL.

Consideration of a special "retirement tax" to provide a source of funding to meet future contribution requirements. A preliminary legal opinion based on the existing provisions in the City Charter indicates that the retirement tax could be imposed by the City Council.

**Litigation Matters**

In January, a class action complaint was filed with the Superior Court against the City, Retirement System and certain members of the Retirement Board

Plaintiffs seek restitution to the Retirement Fund and require the City to pay actuarial contribution amounts in the future.

The case is still in early stages and the City cannot predict the outcome of the litigation.

It appears that the June 2003 presentations were the first of the City's presentations to the rating agencies to contain such detail regarding pension issues.

***June 16, 2003.*** The City returned to the municipal securities market with $110,900,000 City of San Diego, California 2003-04 Tax Anticipation Notes Series A. The disclosure for this offering contained the standard paragraphs relating to the pension system and included information from the June 30, 2002 actuarial valuation.

***August 26, 2003.*** The City published a Preliminary Official Statement dated August 26, 2003 for the proposed offering of $505,550,000 Public Facilities Financing Authority of the City of San Diego Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B. This document contained a revised description of the retirement system that eliminated the statement that state law requires full actuarial funding of the system, included a discussion of the anticipated growth of the UAAL for the coming fiscal year, and referred to the creation of the Pension Reform Commission:

**City Employees' Retirement System**

All benefited City employees participate with the full-time employees of the Airport Authority (the "Airport Authority") and the San Diego Unified Port District (the "District") in the City Employees' Retirement System ("CERS"). CERS is a public employee retirement system that acts as a common investment and administrative agent for the City, and the Airport Authority and the District. Through various City benefit plans, CERS provides retirement benefits to all general, safety (police and fire), and legislative members.

The CERS plans are structured as defined benefit plans in which benefits are based on salary, length of service, and age. City employees are required to contribute a percentage of their annual salary to CERS. The obligation to make

contributions to CERS is based on the San Diego City Charter and the San Diego Municipal Code and, to the extent that available CERS assets are less than vested benefits, is an obligation imposed by law upon the City.

CERS' last actuarial valuation for the City dated June 30, 2002 stated that the funding ratio (Valuation of Assets available for Benefits to Total Actuarial Accrued Liability), of the CERS fund was 77.3%. The CERS fund had an Unfunded Actuarial Accrued Liability (the "UAAL") of $720.7 million as of June 30, 2002, which represented a $436.8 million increase in the UAAL since the previous actuarial calculation dated June 30, 2001. The UAAL is the difference between total actuarially accrued liabilities of $3.169 billion and actuarially calculated assets allocated to funding of $2.448 billion. The increase in the UAAL as of June 30, 2002 resulted primarily from lower than anticipated investment returns as compared to an actuarially assumed rate of return on investments. The UAAL is amortized over a 30-year period, which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing the employer's contribution rate. As of June 30, 2002, there were 19 years remaining in the amortization period. The estimated portion of the UAAL attributable to employees of the Wastewater System amounted to approximately $40 million as of June 30, 2002.

The City anticipates that the UAAL as of June 30, 2003 could approach $950 million of which approximately $52 million is estimated as attributable to employees of the Wastewater System. However, since the actuarial valuation has not been completed, the actuarially determined amount of the UAAL as of June 30, 2003 (and the amount relating to Wastewater System Employees) may be different from what the City anticipates. The estimated increase in the UAAL as of June 30, 2003 once again results primarily from lower than anticipated investment returns. The City is evaluating the fiscal status of CERS to determine the best course of action to improve the funding status. In addition, the Mayor and Council are in the process of forming a Pension Reform Commission to evaluate the operation and structure of the pension system.

Under the caption "Litigation Relating to the Retirement System," the Preliminary Official Statement provided additional disclosure relating to the *Gleason* litigation and its impact on the Wastewater System:

In January 2003, a putative class action complaint (*Gleason v. San Diego City Employees' Retirement System, et al.*) was filed in the San Diego Superior Court against the City and CERS. A class has not yet been certified. The complaint alleges that from the Fiscal Year ended June 30, 1997 to the present, the City has not contributed to CERS the annual amount required by certain provisions of the San Diego City Charter and the San Diego Municipal Code. Instead, the plaintiffs allege that the City has been contributing an annual amount to CERS that is based on two contracts that the City and CERS entered into in 1996 and 2002, respectively. Plaintiffs further allege that as a result of these violations, and the

> breaches of duty of the CERS board of administration, as of the date the complaint was filed, CERS was less than 68% funded and the UAAL was $720 million. (According to the CERS annual actuarial valuation, the funding ratio as of June 30, 2002 was 77.3%) As to the City, the plaintiffs seek (a) a judicial declaration that the City has violated the City Charter and Municipal Code provisions, and (b) a judicial declaration as to the appropriate remedies for the City's alleged violation of the City Charter and the Municipal Code.
>
> The plaintiffs allege that the City is obligated to make additional contributions to CERS on two bases. First, the plaintiffs allege that the City has failed to comply with a provision of the City Charter that requires the City to contribute to CERS an amount substantially equal to the amounts that employees contribute to CERS (this basis is referred to herein as the "substantially equal basis"). The plaintiffs allege that the difference between the amount of total employee contributions between Fiscal Years 1997 and 2002 and the amount of contributions by the City during the same period were not substantially equal. The amount of the difference alleged by the plaintiff which the City believes is attributable to employees of the Wastewater System is approximately $3 million. The City disputes the plaintiffs' calculations and maintains that the amount of its contributions between Fiscal Years 1997 and 2002 is substantially equal to the amount of employee contributions during the same period. Second, the plaintiffs allege that the City Charter and the Municipal Code require the City to contribute an amount not less than the amount determined by the reporting actuary to be necessary to accumulate sufficient assets to pay benefits when due (this basis is referred to herein as the "actuary basis"). In a separate lawsuit (Gleason v. San Diego City Employees' Retirement System), the plaintiff is attempting to invalidate the 2002 contract between the City and CERS based on certain conflict of interest allegations. The City contends that its contracts with CERS are lawful and binding contracts.

It also discussed the potential impact of the litigation on the Wastewater System's contributions to the pension system, which was described as minimal.

***September 2003***. The City pulled the offering for the Public Facilities Financing Authority Subordinated Sewer Revenue Bonds, Series 2003A and 2003B from the market following an e-mail alert from Diann Shipione alleging inaccurate disclosure in a footnote to the City's financial statements describing the funding of the pension system. The City has not attempted to access the public market for municipal securities since that time.

***December 1, 2003***. The SDCERS CAFR for fiscal year 2003 was published under cover of a transmittal letter from Retirement Administrator Lawrence Grissom dated December 1, 2003. The transmittal letter described changes to the SDCERS benefits and employer contribution rates resulting from the MP2 agreement between the City and SDCERS:

**Changes in SDCERS' Provisions and Employer Contributions**

Effective July 1, 2002, retirement benefits to SDCERS' general members (City employees only) were increased. Prior to July 1, 2002, general members had a choice of two formulas for calculating benefits, based on a scaled 2.00% per year of service (with a 10% increase added to final compensation) or 2.25% per year of service, with minimum eligibility at age 55 with twenty years of creditable service. Retirement benefits were increased for general members to a scaled 2.50% per year of service, beginning at age 55. With this enhancement, a 90% cap was also instituted. This means that a SDCERS' general member with 36 years of service at age 55 would have their retirement benefit capped at 90% of their high one-year salary. SDCERS' members can continue to work after reaching the 90% cap and continue to increase their high one-year salary that is used in the calculation of retirement benefits. Or, a SDCERS' general member (City employee) reaching the 90% cap can retire and enter DROP (Deferred Retirement Option Program) and can continue to work for the City. City Safety members also have a 90% cap, which was implemented in 1997. Safety members are eligible to retire at age 50 with 20 years of service. A summary of retirement benefits administered by SDCERS is included in the Actuarial Section of this CAFR. For further details about specific retirement benefits, please call SDCERS' offices at (800) 774-4977 or (619) 525-3600.

To fund the increased benefits to general members, the City has increased their annual fixed employer contribution rate to SDCERS by 1.06% in FY 2004. In addition to this increase, the City and SDCERS' Board agreed to a new annual fixed employer contribution schedule to replace the "City Manager's Retirement Proposal" (Manager's Proposal) dated July 23, 1996, with the "Agreement Regarding Employer Contributions" (Contribution Agreement), effective November 18, 2002. Under the Contribution Agreement, the City has agreed to increase their annual fixed employer contribution rate by 1.00% per year with the goal, by FY 2009, of raising the City's annual employer contribution rate to equal the annual employer contribution rate as calculated by SDCERS' actuary under the projected unit credit (PUC) funding methodology, based upon actuarial assumptions in effect as of the June 30, 2001 valuation. In addition, the City has agreed to pay an amortized amount of the difference between the annual fixed employer contribution rate and the actuarial contribution rate as calculated under the PUC methodology if the City's SDCERS' funded status is below 82.3% in any June 30 actuarial valuation, as detailed in the Contribution Agreement. This was the case as of the June 30, 2002 actuarial valuation, where the City's SDCERS' funded status was 77.3%. In FY 2004, the City made its first amortized payment, as a part of their July 1, 2003 advanced employer contribution, providing for a blended employer contribution rate of 13.43% of the City's FY 2004 payroll. In addition, on behalf of the City's Proprietary and Fiduciary Funds, the City made employer contributions based upon the full actuarial contribution rate.

In Note 4 to financial statements, under the caption "Contributions Required and Contributions Made," the SDCERS CAFR included several new paragraphs describing the effects of MP2:

> The City of San Diego entered into an "Agreement Regarding Employer Contributions" (Contribution Agreement) with SDCERS' Board, adopted November 18, 2002, and became effective with contributions for FY 2004, with an advanced payment made to SDCERS on July 1, 2003. This agreement sets forth increasing annual employer contribution rates stated as a percentage of the City's SDCERS' member actual payroll. This agreement replaces the "City Manager's Retirement Proposal" (Manager's Proposal) executed July 23, 1996. The City's employer contribution rates have increased under the Contribution Agreement, as compared to rates under the Manager's Proposal, with the overall objective of reaching the actuarially calculated, required contribution rates calculated using the PUC actuarial funding methodology by FY 2009, effective with contributions advanced on July 1, 2008. Certain provisions in the Contribution Agreement provide for additional annual City employer contributions to be made to SDCERS should the City's SDCERS' funded status drop below 82.3%. Additionally, the City's employer contributions were increased to fund additional retirement benefits granted to the City's SDCERS' general and safety members (employees). General benefit provisions are summarized in the Actuarial Section of this CAFR.
>
> On June 30, 2003, SDCERS received $15,472,900 as an additional City of San Diego plan sponsor (employer) contribution. This contribution was paid to SDCERS as an employer contribution (for fiscal years 1997 - 2003) based upon the difference between the Manager's Proposal contribution rates and the actuarially calculated, required contribution rates, under the PUC actuarial funding methodology, for the City of San Diego's Proprietary and Fiduciary Fund's employees that are covered members of SDCERS.
>
> Of the $70,099,844 in employer contributions received by SDCERS from the City, $60,176,306 was for employer contributions applicable to FY 2003; the City paid 100% of the actuarially required contributions (ARC) on behalf of the Proprietary and Fiduciary Funds in FY 2003. The remaining $9,923,538 represents payment of the Proprietary and Fiduciary Fund's portion of the City's net pension obligation applicable to fiscal years 1997 - 2002.
>
> In FY 2004, the City will continue to pay employer contributions for those SDCERS members who are employees of the City of San Diego's Proprietary and Fiduciary Funds, based on actuarially calculated, required employer contribution rates, as determined each year by SDCERS' actuary, under the PUC actuarial funding methodology. The remainder of the City's annual employer contributions will be based upon rates as disclosed in the Contribution Agreement; see the Schedules of Plan Sponsors' (Employers') Contributions in the Required Supplementary Information located in the Financial Section of this CAFR.

Under the caption "Subsequent Event Disclosure," Note 9 provided additional information regarding the changes to the City's contributions to SDCERS:

**Plan Sponsors' (Employers') Contributions to SDCERS**

As discussed in Note 4, Contributions Required and Contributions Made, and in the Schedule of Plan Sponsors' (Employers') Contributions in the Required Supplementary Information in the Financial Section of this CAFR, the City entered into a Contribution Agreement with SDCERS' Board on November 18, 2002. On July 1, 2003, SDCERS received an advance payment of the City's employer contribution in accordance with the new fixed-rate (blended) employer contribution schedule. As of the June 30, 2002 actuarial valuation, SDCERS' actuary calculated a City employer required blended contribution rate for FY 2004 of 21.13% of the City's valuation payroll. To date, the City's advanced employer contribution paid to SDCERS on July 1, 2003, for FY 2004, was $80,937,000. Included in this total is the City's Proprietary and Fiduciary Funds' share of the City's employer contribution in accordance with the actuarially calculated, required general member contribution rate of 15.41%, as compared to the amount when using the City's Contribution Agreement, fixed general member employer contribution rate of 9.75% used to calculate an annual employer contribution amount for this group.

Also included in the City's FY 2004 advanced employer contribution rate was the first amortization payment representing the difference between the actuarially calculated, required contribution rate and the City's Contribution Agreement, when the City's SDCERS' funded status fell below 82.3%, to its funded status of 77.3% as of the June 30, 2002, actuarial valuation. As a result, instead of making an employer contribution totalling 11.89% of the FY 2004 City estimated payroll, per the Contribution Agreement, the City made an advanced employer contribution to SDCERS totaling 13.43% of the FY 2004 City payroll.

The SDCERS CAFR updated the Schedule of Funding Progress:

San Diego City Employees' Retirement System

## Schedule of Funding Progress

FOR THE YEAR ENDED JUNE 30 (Ten Years 2002 –2003)

**CITY OF SAN DIEGO**

($ in Thousands)

| | | Continuation Indicators | | | | |
|---|---|---|---|---|---|---|
| **Valuation Date** | **Valuation Assets** | **AAL** | **Funded Ratio** | **UAAL** | **Member Payroll** | **UAAL Ratio to Member Payroll** |

| | | | | | | |
|---|---|---|---|---|---|---|
| **6/30/02** | **$2,448,208** | **$3,168,921** | **77.3%** | **$720,713** | **$535,157** | **134.7%** |
| 6/30/01[4] | 2,525,645 | 2,809,538 | 89.9 | 283,893 | 481,864 | 58.9 |
| 6/30/00[3] | 2,459,815 | 2,528,774 | 97.3 | 68,959 | 448,502 | 15.4 |
| 6/30/99 | 2,033,153 | 2,181,547 | 93.2 | 148,394 | 424,516 | 35.0 |
| 6/30/98[1] | 1,852,151 | 1,979,668 | 93.6 | 127,517 | 399,035 | 32.0 |
| 6/30/97 | 1,632,361 | 1,748,868 | 93.3 | 116,507 | 382,715 | 30.4 |
| 6/30/96[2] | 1,480,772 | 1,620,373 | 91.4 | 139,602 | 365,089 | 38.2 |
| 6/30/95 | 1,316,903 | 1,421,150 | 92.7 | 104,247 | 350,584 | 29.7 |
| 6/30/94[1] | 1,216,063 | 1,290,927 | 94.2 | 74,864 | 338,440 | 22.1 |
| 6/30/93 | 1,137,019 | 1,178,311 | 96.5 | 41,292 | 320,624 | 12.9 |

AAL – Actuarial Accrued Liability

UAAL – Unfunded Actuarial Accrued Liability

[1]Reflects revised actuarial and economic assumptions

[2]After Manager's Proposal

[3]Reflects non-contingent Corbett benefit increases

[4]Funded status was slightly overstated due to the unavailability and thus unincorporated liabilities resulting from purchases of service credit by members (City employees).

NOTE: Actuarial gains and losses reduce or increase the unfunded actuarial accrued liability which is being amortized over a closed, 30-year period which began July 1, 1991 (19 years remaining), as of the June 30, 2002 actuarial valuation.

The SDCERS CAFR updated the information regarding the City's employer contributions, and it revised the footnotes to the table showing the City's contribution rate to remove the reference to a "reserve" in the context of the City's Net Pension Obligation.

## City of San Diego

SDCERS' actuary calculates annual employer contribution rates using an actuarial funding methodology, currently based upon projected unit credit. The City's employer contributions made to SDCERS differ from the actuarially required contributions (ARC) recommended by SDCERS' actuary. This was approved by SDCERS' Board in accordance with their authority under the Charter of the City of San Diego, Article IX, Section 143, Contributions.

| | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 |
|---|---|---|---|---|---|---|
| Actuarially Required Contributions (ARC)[1] | $81,716,136 | $66,33,211 | $56,477,767 | $47,471,430 | $42,478,109 | $40,153,590 |
| Contributions Made to SDCERS | 70,099,844[2] | 49,743,747 | 43,385,069 | 38,700,769 | 34,467,464 | 30,979,325 |
| Difference – Over/ (Under) Contributed | (11,616,292) | (16,589,464) | (13,092,698) | (8,770,661) | (8,010,645) | (9,174,265) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Percentage Contributed | 85.78% | 74.99% | 76.82% | 81.52% | 81.14% | 77.15% |

[1]ARC figures provided by SDCERS' actuary; ARC calculated using actual payroll.

[2]Included in the City's FY 2003 Contributions Made to SDCERS is a contribution of $15,472,900 made on June 30, 2003. This contribution is comprised of net pension obligation payments, totalling $9,923,538, for fiscal years 1997 - 2002 resulting primarily from the differential amount of actuarially required contributions (ARC), as calculated by SDCERS' actuary, versus the "City-Paid Blended Rates" for employer contributions paid by the City on behalf of the Proprietary and Fiduciary Funds. Also included is a payment of $5,549,362, which the City paid for fiscal year 2003 that represents employer contributions for these Funds based on the full actuarial rate. The table below provides the year by year detail.

| Applies to Fiscal Year | Contribution Amount |
|---|---|
| 1997 | $835,942 |
| 1998 | 1,576,530 |
| 1999 | 1,441,167 |
| 2000 | 1,458,076 |
| 2001 | 1,560,521 |
| 2002 | 3,051,302 |
| 2003 | 5,549,362 |
| **Total Additional Contribution Made** | **$15,472,900** |

San Diego City Employees' Retirement System
SCHEDULE OF PLAN SPONSORS' (EMPLOYERS') CONTRIBUTIONS
For the Years Ended June 30 (Six Years 2003 - 1998) (continued)

| Fiscal Year | Minimum City-Paid Blended Rate | Payroll |
|---|---|---|
| 1997 | 7.33% | $381,954,779 |
| 1998 | 7.83 | 397,964,827 |
| 1999 | 8.33 | 412,710,301 |
| 2000 | 8.83 | 434,269,208 |
| 2001 | 9.33 | 465,646,255 |
| 2002 | 9.83 | 507,523,230 |
| 2003 | 10.33 | 530,991,232 |
| 2004 | 11.89 | not available |
| 2005 | 12.89 | not available |
| 2006 | 13.89 | not available |
| 2007 | 14.89 | not available |
| 2008 | 15.89 | not available |
| 2009 | Full projected unit credit contribution rates | |

[1]City-Paid Blended Rate is stated as a percentage of the City's actual payroll.

This City of San Diego's contribution rate schedule is applicable as long as the City's SDCERS' funded status is above 82.3%. If the funded status falls below this level, the City will make additional employer contributions as calculated under an amortized payment approach pursuant to the Contribution Agreement.

This employer contribution funding method is not one of the six recognized actuarial cost methods.

For every year that the Manager's Proposal and Contribution Agreement has been in effect, the City has made employer contributions to SDCERS in an amount less than has been recommended by SDCERS' actuary. As a result, a net pension obligation is disclosed in the City of San Diego's Comprehensive Annual Financial Report.

The Schedule of Funding Progress was updated to reflect the City's funded status of 77.3% and the City's average funded ratio of 91.4% over the past ten years. The Schedule of Employer's Contributions was revised to read as follows:

This schedule contains six years of historical information with respect to the City's actuarially required contributions (ARC) versus the actual employer contributions made by the City, on an annual basis. Over the past six years, the City has contributed, on average, approximately 79.57% of the amount recommended by SDCERS' actuary. This reduced City employer contribution was approved by SDCERS' Board in accordance with provisions under the Charter of the City of San Diego, Article IX, Section 143, Contributions.

Under the "City Manager's Retirement Proposal" (Manager's Proposal) dated July 23, 1996, the City negotiated with SDCERS' Board to contribute a "City-Paid Rate" according to a fixed employer contribution rate schedule. This agreement established a base rate in FY 1997 (advanced payment made to SDCERS on July 1, 1996) at 7.33% of that year's City's budgeted/actual payroll; the scheduled contribution rates increased by 0.50% each year, thereafter. This agreement between the City and SDCERS accounts for the average annual difference of 20.43% in employer contributions actually paid by the City versus the rate at which the actuary calculated required contributions under the projected unit credit (PUC) actuarial funding methodology. The Manager's Proposal set contribution rates through FY 2006, however, this agreement required contribution rate changes as the City's SDCERS' funded status dropped below 82.3%. The actuarial valuation of June 30, 2002, triggered a provision in the Manager's Proposal to increase annual required employer contributions from the City, based on the 82.3% trigger.

Additionally, as detailed in the Schedule of Plan Sponsors' (Employers') Contributions, under FY 2003 Contributions Made, an additional employer contribution was made by the City to SDCERS on June 30, 2003. Of the total $70,099,844 in employer contributions received by SDCERS from the City in FY 2003, as depicted in the June 30, 2003 audited financial statements, $60,176,306 of employer contributions were for FY 2003; the City made employer contributions on behalf of the Proprietary and Fiduciary Funds at the full actuarial contribution rate. The remaining $9,923,538 represented additional employer contributions (net pension obligation) paid to SDCERS on June 30, 2003, on

behalf of the City's Proprietary and Fiduciary Funds that apply to fiscal years 1997 through 2002. The Schedule of Plan Sponsors' (Employers') Contributions contains a table that details the year by year amounts contributed by the City on behalf of the Proprietary and Fiduciary Funds.

Effective November 18, 2002, the City entered into a new "Agreement Regarding Employer Contributions" (Contribution Agreement) with SDCERS' Board. Under this new agreement, the City increased its annual employer contribution rate by 1.06%, to 11.89%, in FY 2004, from the 10.33% contribution rate paid by the City in FY 2003 under the Manager's Proposal. The FY 2004 contribution rate was increased to pay for increased benefits granted to the City's SDCERS' general members. A discussion of the City's SDCERS' general member benefit increases can be found in the Actuarial Section of this CAFR. Beginning in FY 2005, and each year thereafter, the City's employer contribution rates will increase by 1.00% (minimum), versus the 0.50% per year increase that was in effect under the Manager's Proposal. The new Contribution Agreement rates are depicted in the City's portion of the Schedule of Plan Sponsors' (Employers') Contributions. The goal of increasing the City's annual employer contribution rate was to close the contribution rate gap between the City's fixed contribution rate schedule and the actuarially required contributions (ARC) as calculated by SDCERS' actuary under the PUC methodology, by FY 2009. At which time, the City has agreed to contribute employer contributions based on the full actuarially calculated contribution rate. Beyond FY 2009, the City has agreed to move to an Entry Age Normal (EAN) funding methodology as quickly as fiscally possible. The FY 2003 actuarially required contribution rate under PUC was calculated at 15.59% of the City's valuation payroll; under EAN, the FY 2003 actuarially calculated, required contribution rate would be 17.75% of the City's valuation payroll.

Another commitment under the Contribution Agreement is that additional employer contributions will be made by the City to SDCERS, based on an amortized formula, in any year that the City's SDCERS' funded status is below 82.3%. This formula is based upon the difference between the fixed City employer contribution rates and the employer contributions rates as calculated by SDCERS' actuary under the PUC actuarial funding methodology based upon actuarial funding assumptions in effect as of the June 30, 2001 valuation. This difference is then divided by the number of years remaining until FY 2009, to establish a pro-rated additional employer contribution to be made in a particular fiscal year in which the City's SDCERS' funded status is below 82.3%. A complete copy of the Contribution Agreement can be obtained from the City of San Diego Clerk's Office or SDCERS' Offices. This Contribution Agreement funding arrangement is not one of the six recognized employer contribution (actuarial cost) funding methods. For every year that the Manager's Proposal and Contribution Agreement has been in effect, the City has made contributions to SDCERS in an amount less than has been recommended by SDCERS' actuary. As a result, a net pension obligation is included in the City of San Diego's Comprehensive Annual Financial Report's Financial Statements.

> The advantage of a fixed schedule of employer contributions is that the City can effectively budget for employer contributions based upon a pre-established annual employer contribution rate while continuing to provide cost-effective services to San Diego citizens without adversely impacting taxpayers. Since the City currently has an average funded status of 91.94% over the past ten years, the Contribution Agreement benefits City employees (SDCERS' members) by keeping SDCERS adequately funded, and at the same time benefits San Diego taxpayers by minimizing employer contributions paid from City tax revenues. Given the practice of fixed City employer contribution rates over the past several years, and the declines in the financial markets, SDCERS' actuary opined in the June 30, 2002, actuarial valuation, that the City is in adequate condition in accordance with actuarial principals of level-cost financing. However, SDCERS' actuary further noted that the current practice of paying less than the computed actuarial contribution rate will foster an environment of additional declines in the funded status, absent strong investment returns.

**2004 Disclosures**

***January 27, 2004.*** The City issued a voluntary disclosure report to the four nationally recognized municipal securities information repositories, the rating agencies, municipal bond insurers, and professionals related to the City.

***May 18, 2004***. SDCERS actuary Rick Roeder provided a letter to the Pension Reform Committee containing his thoughts on the analysis of the decrease in the funded ratio:

> When we discussed what period to analyze, the PRC felt it was best to go back to the point in time when Manager's Proposal #1 was just implemented. Thus, we used July 1, 1996 as our starting point for analysis and included the impact of the benefit increases under Manager's Proposal #1. We concur with this approach since the subsequent seven year period encompasses some very good investment years and some very poor ones – not atypical with what a retirement system would typically encounter.
>
> If it is appropriate to attribute the majority of the recent decrease in the funded ratio on investments, the corollary to this argument is that the terrific investment markets of the 1990s should have resulted in steadily increasing funded ratios. This did not happen due to a series of benefit increases, both contingent and non-contingent. . . . Taking a long-term view leads us to the following conclusion: the existing level of unfunded liability is primarily due to elements other than investment activity.
>
> Pie charts attribute 39-41% of the unfunded liability to benefit increases, 31-29% to non-investment actuarial losses, 10-14% to undercontributions, 12% to contingent benefits, and 6% to investment loss using a seven-year look back period.

Pie charts attribute 62-65% of the unfunded liability to investment losses, 16-17% to other actuarial losses, 6-10% to undercontributions, 8% to contingent benefits, and 4% to benefit increases using a three-year look back period.

# 2.
# Articles Index

1. 06/21/96 Philip J. LaVelle, *City has deal, but will pension trustees buy it*? San Diego Union-Tribune.

2. 06/22/96 Philip J. LaVelle, *Pension trustees OK parts of plan to ease city's ills,* San Diego Union-Tribune.

3. 06/28/96 Ray Huard, *Optimistic budget approved for city; Includes funds to fix streets, sewer lines*, San Diego Union-Tribune.

4. 10/18/96 Philip J. LaVelle, *Shift in health benefit sought; Election 1996; San Diego Area Ballot, San Diego City Prop. D,* San Diego Union-Tribune.

5. 10/22/96 Editorial, *Two good measures; Propositions B and D merit support; Election 1996,* San Diego Union-Tribune.

6. 11/06/96 Philip J. LaVelle, *Easy victory a green light to savings; Election 1996; City & County; Proposition D.*, San Diego Union-Tribune.

7. 07/16/00 *City audit finds dead retirees paid*, San Diego Union-Tribune.

8. 01/25/02 Ray Huard, *Pension funds may be used on ballpark; City hunts ways to restart project*, San Diego Union-Tribune.

9. 04/05/02 Ray Huard, *Pension fund lost millions last year; Unions say city retirees are in no financial peril*, San Diego Union-Tribune.

10. 07/11/02 Ray Huard, *With eye on stocks, city seeks retirement funding shift; Falling market put pinch on reserves*, San Diego Union-Tribune.

11. 12/04/02 Diann Shipione Shea, *San Diego Steers a Dangerous Course by Underfunding Workers' Pension Plan*, The Daily Transcript.

12. 12/06/02 Andrew Donohue, *Concerns raised over city's ability to finance employee retirement fund*, The Daily Transcript.

13. 12/21/02 Philip J. LaVelle, *Financial realities come crashing down on San Diego pension fund,* San Diego Union-Tribune.

14. 01/11/03 Don Bauder, *Late,* San Diego Union-Tribune.

15. 01/18/03 *Retirees sue City Hall over pension fund (Editions vary),* San Diego Union-Tribune.

16. 01/20/03 Andrew Donohue, *Suit brought against city over shortfall in retirement fund,* The Daily Transcript.

17. 02/09/03 Philip J. LaVelle, *City pension gap looms; underpayments, slump in stocks strain system,* San Diego Union-Tribune.

18. 02/12/03 Philip J. LaVelle, *City pension system seen under siege, under-funded- New report shows threat to San Diego for decades,* San Diego Union-Tribune.

19. 02/13/03 Philip J. LaVelle, *Retirement quagmire might require cuts in services, mayor says,* San Diego Union-Tribune.

20. 02/15/03 Philip J. LaVelle, *Donor gives $100,000 for oldest city retirees; Valentine's Day gift is anonymous,* San Diego Union-Tribune.

21. 02/16/03 Editorial, *City's pension mess; Politicians prefer to delay day of reckoning,* San Diego Union-Tribune.

22. 02/21/03 *Retiree sues city's retirement system,* The Daily Transcript.

23. 02/22/03 Philip J. LaVelle, *Suit alleges city retirement board won't let go of records,* San Diego Union-Tribune.

24. 02/26/03 Andrew Donohue, *Actuary's report estimates $59 million shortfall in city retirement fund,* The Daily Transcript.

25. 03/08/03 Ronald W. Powell, *Port seeks retirement fund assurances; Money is in S.D. system, which faces huge deficit,* San Diego Union-Tribune.

26. 04/09/03 Diann Shipione, *The city retirement system: under funding makes it a disaster waiting to happen,* San Diego Union-Tribune.

27. 04/15/03 Andrew Donohue, *City pension fund to undergo independent audit,* The Daily Transcript.

28. 04/15/03 Letter, *City pension system needs immediate repairs,* The San Diego Union-Tribune.

29. 04/17/03 Letters, *City pensioners aghast at pension fund shortfall,* San Diego Union-Tribune.

30. 04/17/03 Editorial, *City retirement board to discuss retiree vote,* The Daily Transcript.

31. 04/22/03 *Council delays report on city retirement,* The Daily Transcript.

32. 04/23/03 Editorial, *Many in path of state budget tax,* San Diego Union-Tribune.

33. 04/27/03 Larry Stirling, *No more negative wedges,* The Daily Transcript.

34. 05/02/03 Luis Monteagudo, Jr., *Reduced pension contributions OK'd,* San Diego Union-Tribune.

35. 05/10/03 Philip J. LaVelle, *Pension fund could face $2 billion deficit by 2009; Report blames city's policy of under-funding for system's problems,* San Diego Union-Tribune.

36. 05/14/03 Editorial, *Pension dilemma; City leaders fail to hear the piper warming up,* San Diego Union-Tribune.

37. 05/16/03 Alex Roth, *City officials' stake in pension hike focus of suit; Retiree contests four board members' votes,* San Diego Union-Tribune.

38. 05/16/03 Letter, *How (not) to get pension funds straightened out,* San Diego Union-Tribune.

39. 05/21/03 Catherine Saillant, **[S*weet pension deals now haunt counties elected officials gave public workers and themselves better benefits packages during boom times. The bill is coming due*.]** The Los Angeles Times.

40. 05/23/03 Neil Morgan, *City Hall sweep made for some startled readers,* San Diego Union-Tribune.

41. 05/23/03 *City retirement system hires PR firm,* The Daily Transcript.

42. 05/30/03 Neil Morgan, *Why the city pension fund hired Nuffer [Corrected 06/05/03]*, San Diego Union-Tribune.

43. 06/01/03 Neil Morgan, *A lighter view of (what else?) the consternation at City Hall*, San Diego Union-Tribune.

44. 06/04/03 Neil Morgan, *Bit by bit, tiptoeing through a wary city*, San Diego Union-Tribune.

45. 06/22/03 Philip J. LaVelle, *Problems in city workers' pension plan unaddressed; Mayor pledged quick action, but that was in February*, San Diego Union-Tribune.

46. 07/01/03 Andrew Donohue, *Deposition details retirement board's pension boost*, The Daily Transcript.

47. 07/06/03 Philip J. LaVelle, *Pension audit firm search is criticized; Underfunding is city basis of suit by retirees*, San Diego Union-Tribune.

48. 07/06/03 Philip J. LaVelle, *Pension audit firm search is criticized: Under funding by City basis of suit by retirees*, San Diego Union-Tribune.

49. 07/09/03 Neil Morgan, *A letterbox crammed with civic concerns*, San Diego Union-Tribune.

50. 07/12/03 Philip J. LaVelle, *Mayor wants reform panel to study city pension plan*, San Diego Union-Tribune.

51. 07/15/03 Andrew Donohue, *Retirement board launches first PR volley*, The Daily Transcript.

52. 07/20/03 Philip J. LaVelle, *Evaluation of troubled retirement fund looms; Murphy seeks commission to study pension system*, San Diego Union-Tribune.

53. 07/21/03 *Changes ahead*. Pensions & Investments.

54. 07/22/03 Editorial, *Appoint panel; Confront city's pension fund shortage now*. San Diego Union-Tribune.

55. 07/23/03 Andrew Donohue, *Committee approves sketch of reform commission for city pension plan*, The Daily Transcript.

56. 07/23/03 Neil Morgan, *Insider's report shows pension deficit growing*, San Diego Union-Tribune.

57. 07/24/03 Philip J. LaVelle, *San Diego moves forward on pension study panel; Reform-commission proposal receives initial approval*, San Diego Union-Tribune.

58. 07/26/03 Luis Monteagudo, Jr., *County retirement officials to pay for PR*, San Diego Union-Tribune.

59. 07/28/03 Andrew Donohue, *Port schedules hearing to determine future of retirement plan*, The Daily Transcript.

60. 07/30/03 Ronald W. Powell, *Port commission airs pension concerns*, San Diego Union-Tribune.

61. 07/30/03 Arden Dale, *Pension filings often fall short of giving clear picture*, Dow Jones News Service (DJNS)

62. 08/03/03 *Study of retirement system sought*, San Diego Union-Tribune.

63. 08/06/03 *Pension reform guidelines get approval*, The Daily Transcript.

64. 08/07/03 Philip J. LaVelle, *City panel OKs pension reform commission; Critics contend ills sidestepped*, San Diego Union-Tribune.

65. 08/10/03 *Pension reform panel gets nod*, San Diego Union-Tribune.

66. 08/16/03 Ronald W. Powell, *Port seeks spot on pension board – Employees' assets in retirement plan*, San Diego Union-Tribune.

67. 08/20/03 Neil Morgan, *Reader network tells us state of the city*, San Diego Union-Tribune.

68. 09/08/03 *Council to discuss pension reform committee,* The Daily Transcript.

69. 09/10/03 Jennifer Vigil, *Plan for pension commission OK'd; retirement system will be examined,* San Diego Union-Tribune.

70. 09/14/03 *New panel to evaluate pension plan,* San Diego Union-Tribune.

71. 09/14/03 Neil Morgan, *Things to ponder about life in San Diego,* San Diego Union-Tribune.

72. 09/17/03 Neil Morgan, *Thoughts from readers, and of course Epictetus,* San Diego Union-Tribune.

73. 09/25/03 Don Bauder, *City Pension Funds in Red,* The San Diego Reader.

74. 09/25/03 Andrew Donohue, *Mayor recommends members for pension reform commission,* The Daily Transcript.

75. 09/26/03 Bruce Herring, *What you should know about the city's retirement fund,* San Diego Union-Tribune.

76. 09/29/03 *City Council OKs committee,* The Daily Transcript.

77. 10/01/03 Ray Huard, *Council Oks nine for pension panel – Group will study troubled system,* San Diego Union-Tribune.

78. 10/09/03 *Breaking Stories,* San Diego Reader.

79. 10/24/03 Neil Morgan, *A last call for coming clean on city woes,* San Diego Union-Tribune.

80. 12/03/03 Ray Huard, *City Council reappoints retirement board chairman,* San Diego Union-Tribune.

81. 12/04/03 Philip J. LaVelle, *Roberts announces mayoral bid with a swipe at Murphy; 3rd run at city's top job for supervisor, ex-councilman [Corrected 12/11/03],* San Diego Union-Tribune.

82. 12/11/03 *Shipione receives award,* The Daily Transcript.

83. 12/20/03 Philip J. LaVelle, *Troubles continue for San Diego's pension fund, San Diego Union-Tribune*.

84. 12/28/03 Editorial, *SAN DIEGO TIME BOMB. City pension fund in crisis. First of three parts. Pension avalanche; Retirement costs could crush San Diego,* San Diego Union-Tribune.

85. 12/29/03 Editorial, *SAN DIEGO TIME BOMB City pension fund in crisis. Second of three parts. Gravy train City retirees enjoy lush benefits, double dips,* San Diego Union-Tribune.

86. 12/30/03 Editorial, *SAN DIEGO TIME BOMB City pension fund in crisis. Last of three parts. Road to recovery: How to avoid financial disaster*, San Diego Union-Tribune.

87. 01/13/04 Scott Lewis, *Pension fund's problems become political football in election season*, The Daily Transcript.

88. 01/22/04 Philip J. LaVelle, *Roberts offers plan to fix city finances*, San Diego Union-Tribune.

89. 01/22/04 Ray Huard, *Fund-raiser's host not a conflict, candidate says; Lawyer suing city to hold reception*, San Diego Union-Tribune.

90. 02/02/04 Scott Lewis, *Pension system contributes to city's negative outlook from credit rating service*, The Daily Transcript.

91. 02/03/04 Ray Huard, *San Diego's financial outlook is downgraded; Firm's action prompted by retirement fund, state woes*, San Diego Union-Tribune.

92. 02/03/04 *Markets; San Diego may suffer drop in bond rating from Bloomberg news,* Los Angeles Times.

93. 02/04/04 Philip J. LaVelle, *City pension woes called 'significant'; Moody's official sees great challenges ahead*, San Diego Union-Tribune.

94. 02/05/04 Philip J. LaVelle, *Mayor warns of dire ways to cut pension deficit*, San Diego Union-Tribune.

95. 02/05/04 Don Bauder, *Our Enron-Style Scandal*, San Diego Reader.

96. 02/05/04 Scott Lewis, *Pension's liabilities becoming political lightning rod*, The Daily Transcript.

97. 02/06/04 Philip J. LaVelle, *Roberts want probe of city pension woes*, San Diego Union-Tribune.

98. 02/06/04 Editorial, *SAN DIEGO TIME BOMB. City pension fund in crisis. One in a series. Billions in hole; Wall Street notes pension fund's woes*, San Diego Union-Tribune.

99. 02/06/04 Neil Morgan, *Shipione defies city to protect innocents*, San Diego Union-Tribune.

100. 02/07/04 Ronald W. Powell, *Port seeks pension fund assurances; Consultant hired to examine finances*, San Diego Union-Tribune.

101. 02/10/04 Ray Huard, *New Library, expansion of old branch OK'd*, San Diego Union-Tribune.

102. 02/12/04 Scott Lewis, *City drop bonds; tabs former SEC director to restore fiscal confidence*, The Daily Transcript.

# 3.
# An Overview of Pension Regulation

This Appendix provides a general introduction to the manner in which pension plans are regulated under federal, State, and local law. The first part of the Appendix explains the difference between defined benefit plans and defined contribution plans, because the two are, in many respects, subject to different legal standards. The second part of this Appendix discusses the federal laws applicable to defined benefit plans as well as the impact of State and local laws on such plans. Significantly, because SDCERS is sponsored by a governmental entity, it is exempt from many of the federal laws that apply to most private sector pension plans. Nonetheless, a discussion of such federal laws is included in order to facilitate an understanding of how the regulatory environment in which governmental plans operate differs from that in which most private sector plans operate.

The third and fourth parts of this Appendix focus on how the benefits and funding requirements, respectively, are determined for defined benefit plans. Finally, the fifth part of this Appendix explains the role of actuaries and actuarial assumptions in calculating the obligations arising from defined benefit plans.

## I. Defined benefit versus defined contribution plans

The world of retirement plans is divided into two basic categories — defined benefit plans and defined contribution plans. The SDCERS is a defined benefit plan. Defined benefit plans are traditional pension plans under which retirement benefits are based on a formula indicating the exact benefit that one can expect upon retiring.[433] Contributions to a defined benefit plan (considered together with projected earnings and gains) are tailored to provide the promised benefits. However, because a defined benefit plan provides a guaranteed retirement benefit to employees, the risk inherent in investing the assets used to fund the plan is borne by the employer, not the employees. That is, the employees' promised benefit is not reduced even if investment earnings are lower than anticipated.

In contrast, a defined contribution plan provides an individual account for each participating employee. The retirement benefits provided under a defined contribution plan are a function of the value of the account, which is determined by the amount contributed to the account, as adjusted by investment gains and losses. Therefore, the employee bears the risk associated with the investment of the assets in his individual account. Defined contribution plans include, for example, 401(k) plans and profit sharing plans.

[433] The term "pension plan" is often used interchangeably with the term "defined benefit plan."

## II. Regulatory environment

### A. Internal Revenue Code requirements

Both defined benefit plans and defined contribution plans can qualify for special tax treatment under the Internal Revenue Code if certain qualification requirements are met. In particular, a "qualified plan" is a plan that meets the qualification requirements of section 401(a) of the Internal Revenue Code, which in turn incorporates numerous other sections of the Internal Revenue Code.[434]

If a plan is "qualified" under the Internal Revenue Code, the employer gets an immediate tax deduction for its plan contributions, participants are not taxed on their benefits until the benefits are distributed, and the plan's income and investment gains are generally tax exempt while such amounts remain in the plan.[435] Both public and private plans must be qualified in order for this special tax treatment to apply. However, governmental plans are exempt from many of the Internal Revenue Code's current qualification requirements under section 401(a). Instead, the tax qualification rules applicable to governmental plans are, broadly speaking, the limited requirements that existed prior to the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA").

Notably, a retirement plan does not have to be qualified under the Internal Revenue Code. Private sector employers receive substantial tax benefits by maintaining the qualification of their plans because they are entitled to an immediate deduction for contributions despite the fact that employees do not immediately recognize the contributions as taxable income. In the governmental context, the employer gains no advantage by satisfying the qualification requirements because the employer is not subject to tax. However, most governmental employers design their retirement plans to meet the applicable Internal Revenue Code qualification requirements for the benefit of their employees, allowing them to defer taxation until the benefits provided under the plan are actually received.

---

[434] These qualification requirements were amended in 1974 by title II of the Employee Retirement Income Security Act ("ERISA") to include minimum funding standards, vesting requirements, participation requirements, and benefit payment standards. *See infra* Part II.B.1 (discussing the regulatory framework of ERISA).

[435] As a technical matter, most qualified plans have an accompanying trust document creating a trust where the plan assets are held. The trust is exempt from tax under section 501(a) of the Internal Revenue Code if the plan that it funds satisfies the qualification rules of section 401(a). Throughout this discussion, references are made to the plan, but the reader should be mindful of the separate existence of the trust as well.

## B. ERISA

### 1. In general

In general, defined benefit and defined contribution plans are also governed by ERISA, a federal statute enacted in 1974. However, the various provisions of ERISA do not apply uniformly to all plans. In particular, governmental plans such as SDCERS are exempt from ERISA.[436]

In order to understand how ERISA is administered, it is important to understand the regulatory framework provided by ERISA. The statute is comprised of four titles: (1) title I contains protections of employee benefit rights; (2) title II amends the requirements for retirement plans to qualify for special tax treatment under the Internal Revenue Code;[437] (3) title III contains jurisdiction, administration, and enforcement provisions; and (4) title IV contains provisions regarding plan termination insurance (which are applicable only to defined benefit plans).[438] As a result of this framework, three U.S. agencies are involved in administering ERISA – (1) the Internal Revenue Service (the "IRS"), (2) the Employee Benefits Security Administration ("EBSA") of the Department of Labor, and (3) the Pension Benefit Guaranty Corporation (the "PBGC"). EBSA is responsible for administering the reporting, disclosure, and fiduciary responsibility requirements of title I. The IRS is responsible for administering the funding, participation, vesting, and benefit payment requirements of title II (and the corresponding provisions of title I). Finally, the PBGC is responsible for administering the federal government program insuring defined benefit plans subject to title IV of ERISA.

### 2. PBGC and Title IV of ERISA

Title IV of ERISA was enacted and the PBGC was created thereunder for two major purposes: (1) to provide minimal guarantees to participants and beneficiaries in defined benefit plans as to the receipt of benefits under such plans and (2) to provide a mechanism for administering and distributing to participants and beneficiaries of defined benefit plans the benefits to which they are entitled in case the plan is unable to pay such benefits upon a plan termination.[439] Employers sponsoring defined benefit plans that are subject to title IV of ERISA are required to pay premiums to the PBGC to provide insurance as to the benefits guaranteed to

---

436 ERISA §§ 4(b), 4021(b). A "governmental plan" is a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. ERISA §§ 3(32), 4021(b). A number of other types of retirement plans are also exempt from ERISA, including church plans that have not elected to be covered by ERISA and plans maintained outside the United States primarily for the benefit of nonresident aliens. ERISA §§ 4(b), 4021(b).

437 *See supra* Part II.A (discussing the plan qualification requirements under the Internal Revenue Code).

438 *See infra* Part II.B.2 (discussing title IV and the authority of the Pension Benefit Guaranty Corporation).

439 *See* Michael J. Canan, 1 *Qualified Retirement Plans* 1006 (2004 ed.).

participants and beneficiaries by the PBGC. The amount of the premium depends on the unfunded vested benefit, which is, generally, the unfunded current liability for vested benefits under the plan over the value of the plan's assets.[440]

The insurance provided by the PBGC protects only the participants and beneficiaries, not the employer.[441] If a plan terminates and the assets in the plan are inadequate to cover the basic benefits that are guaranteed by the PBGC, the PBGC pays the difference to the participants using funds received from premiums and, if necessary, borrowing from the U.S. Treasury.[442] However, it will collect from the employer as much of these payments as legally possible.[443]

Because of its responsibility for guaranteeing certain benefits to plan participants and beneficiaries, the PBGC keeps a close check on various factors relating to the financial condition of the plans it insures.[444] The statute lists certain occurrences that are "reportable events" that must be reported to the PBGC within 30 days.[445] The plan administrator must also file an annual report with the PBGC.[446]

Title IV contains specific procedures that must be followed in order for an employer to terminate a defined benefit plan. These procedures include various reporting and disclosure requirements. In addition, title IV describes the circumstances under which the PBGC itself may terminate a defined benefit plan.[447] It may do so when a plan has not met the minimum funding standards under section 412 of the Internal Revenue Code (as described in Part IV.A below), when the plan is unable to pay benefits when due, when a reportable event has occurred, or when the possible long-run loss to the PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.[448]

As noted above, governmental plans are not subject to title IV of ERISA or the authority of the PBGC.[449]

---

440 *See id.* at 1018-19.

441 *See id.* at 1008.

442 *See id.*

443 *See id.*

444 *See id.*

445 *See id.*

446 *See id.* at 1009.

447 ERISA § 4042.

448 *Id.*

449 *See supra* Part II.B.1.

C. State and local regulation

ERISA is intended to provide uniform, national standards for pension plans that are subject to its provisions. As a result, ERISA preempts most State and local laws that might otherwise regulate non-exempt private sector plans.

In contrast, because governmental plans are exempt from ERISA's reach, such plans are not covered by its preemptive effect. In fact, other than the limited qualification rules applicable to governmental plans under the Internal Revenue Code, the regulation of governmental plans is left largely to State and local law. The level of statewide regulation varies from state to state, with some states providing a more comprehensive set of requirements and others having constitutional principles embodied through varieties of local plans.

As a result of the divergent legal standards applicable to governmental plans, it is to be expected that such plans will vary significantly in their design, administration, and operation. While wide variations also exist among private sector plans, the uniform legal standards applicable to private sector plans limit the range of permissible differences. Because governmental plans are not subject to such uniform standards, there tend to be greater differences among governmental plans than among private sector plans.

III. Determination of benefits for defined benefit plans

The benefit formulas used to determine retirement benefits under a defined benefit plan vary from plan to plan. In the private sector, the employer usually dictates the applicable formula, subject to the participation, vesting, and benefit payment requirements of the Internal Revenue Code and ERISA. The formula selected by the employer is set forth in a written plan document and is an enforceable obligation under ERISA. In the public sector, benefit formulas are typically established by the governmental entity sponsoring the plan and are embodied in applicable State statutes or local ordinances. In both public and private collective bargaining settings, the formulas may be the subject of negotiations between the union and the employer.

Pursuant to State or local law, most governmental plans use a "unit benefit" formula. A unit benefit formula provides greater benefits for employees who have performed longer service for the employer. An example of a unit benefit formula is one that provides a participating employee with a lifetime annual pension equal to a specified percentage of his average annual compensation multiplied by the employee's years of service with the employer. A common formula would be 2.5% of the employee's average annual compensation multiplied by the employee's years of service. Thus, if an employee worked for 25 years and his average annual compensation was $50,000, his annual benefit would be $31,250 for life. This is the type of formula employed by SDCERS.

Applicable State or local law may provide for the use of a different type of benefit formula. For instance, some governmental plans employ a "flat benefit" formula that depends solely on the employee's level of compensation. A typical flat benefit formula would provide that each participating employee is entitled to a monthly pension, commencing at a normal retirement date and then payable for life, of a given percentage of the employee's average monthly compensation.

Governmental defined benefit plans also sometimes have relatively unique features that provide for additional benefits that are contingent on the existence of a funding surplus for a plan year.[450]

## IV. Funding

### A. Funding standards for private plans under the Internal Revenue Code and ERISA

Private sector defined benefit plans, generally, are subject to minimum funding standards. The minimum funding standards are designed to guarantee that the plan has sufficient assets to provide the benefits promised to employees based on actuarial assumptions.[451] Both the Internal Revenue Code and ERISA require that an employer must make a minimum contribution or face a penalty.[452] Internal Revenue Code section 412 sets forth the minimum funding rules for qualified plans and Part 3 of title I of ERISA provides overlapping, parallel provisions for a variety of qualified and nonqualified "employee benefit plans."[453]

The minimum funding requirements of Internal Revenue Code section 412 and ERISA do not force private sector employers to fund their plans according to any particular actuarial funding method.[454] However, the cost of the benefits may not be provided on a pay-as-you-go basis as they become due.[455] The cost of the benefits must be funded incrementally over the service of the employees.[456] The process of incremental funding requires the use of an "actuarial cost method" to assign the value of promised benefits and anticipated expenses to individual plan

---

450 *See infra* Part V.A (discussing the actuarial implications of such contingent benefit features).

451 *See infra* Part V.A (discussing the actuarial assumptions used to determine the sponsor's minimum funding obligation under section 412 of the Internal Revenue Code).

452 The PBGC can also institute proceedings to terminate a private sector defined benefit plan subject to title IV of ERISA if the plan has not met the minimum funding requirements of Internal Revenue Code section 412. *See* ERISA § 4042.

453 The Internal Revenue Code also imposes a limit on the amount an employer can deduct for contributions to a qualified retirement plan. For taxable private sector employers, this limit effectively operates as a cap on funding. I.R.C. § 404.

454 *See* Goldfield, 371-3rd T.M., *Employee Plans – Deductions, Contributions, and Funding*, A-56.

455 *See id.* at A-16(4).

456 *See id.*

years as an annual cost requiring an annual contribution.[457] For plans subject to ERISA, the employer may choose from any one of the six actuarial cost methods deemed reasonable under ERISA: (1) the unit credit method, (2) the entry age normal cost method, (3) the individual level premium cost method, (4) the aggregate cost method, (5) the attained age normal cost method, and (6) the frozen initial liability cost method.[458]

Once the employer selects an appropriate funding method, the minimum funding standards require that sufficient contributions be made to meet the costs generated by the funding method.[459] This is accomplished through the funding standard account.[460] This account is a ledger on which the annual costs required under the funding method are balanced against the contributions made to the plan.[461] If, at the end of any plan year, the ledger is not balanced because the amount actually in the plan does not equal the amount that should be in the plan, a "funding deficiency" occurs, and penalty taxes are imposed on this "funding deficiency"[462] (unless the plan sponsor applies for and obtains a waiver from the IRS). The actual mathematics of maintaining this account and determining whether there is a "funding deficiency" are quite complicated.[463]

Significantly, the minimum funding standards under the Internal Revenue Code do not require that defined benefit plans be 100% funded. That is, a plan may be underfunded without creating a "funding deficiency" and the employer incurring a penalty. Indeed, many corporate plans are and have been underfunded for some time without violating the law.[464] This is because the losses charged and the gains credited to the funding standard account are amortized over several years. As a result, the minimum funding standards permit underfundings to exist but are designed to ensure that they are corrected by increased contributions over time.

---

457 *See id.*

458 ERISA § 3(31).

459 *See supra* note 386, at A-56.

460 *See id.*

461 *See id.*

462 The existence of a "funding deficiency" is not equivalent to a plan being underfunded. Rather the term refers to a failure by the plan sponsor to meet the funding requirements of section 412 of the Internal Revenue Code.

463 *See supra* note 386, at A-56.

464 *See supra* Introduction (noting the recent CreditSights Ltd. study finding that 85% of defined benefit plans in the S&P 500 are underfunded).

B. Funding standards for governmental plans

Plans established and/or maintained by governmental entities are exempt from these minimum funding requirements.[465] However, in order to be treated as a qualified plan under section 401(a) of the Internal Revenue Code, a governmental defined benefit plan must meet the requirements of section 401(a)(7) of the Internal Revenue Code as in effect on September 1, 1974, immediately before the enactment of ERISA.[466] The pre-ERISA version of section 401(a)(7) required only that a qualified plan provide for full vesting on a plan termination or discontinuance of contributions and that it meet the current and/or anticipated near-future benefit payments.[467] Thus, as long as these two requirements are met, governmental entities generally are free, under federal law, to fund benefits in any manner they choose, provided that they employ some method of setting aside assets for that purpose.[468] Any other funding requirements are imposed only by applicable State or local law.

According to applicable State or local law, some governmental employers fund under the "pay-as-you-go" method in which contributions approximate current benefit payments and expenses.[469] Others fund on an actuarial basis to fund benefits well in advance of payment.[470]

V. Role of actuaries and actuarial assumptions

A. Actuarial considerations

As discussed above, for private sector plans subject to the minimum funding requirements under the Internal Revenue Code and/or ERISA, the cost of the benefits provided under a defined benefit plan must be funded incrementally over the service of the employees. This requires a calculation of the costs of the promised benefits and anticipated expenses allocable to a particular plan year. Actuaries are employed to perform this calculation using an "actuarial cost method." Governmental plans that, pursuant to State or local law, fund on an actuarial basis also employ an actuary to calculate such actuarial costs.

In computing the annual cost for a plan, the actuary will account for certain contingencies. For example, the actuary will factor in the fact that benefits will be provided partially through earnings on contributions. The actuary will also take into account life

---

465 I.R.C. § 412(h)(3); ERISA § 4(b)(1).

466 I.R.C. § 412(h).

467 GCM 36813 (8/16/76).

468 *See, e.g.*, Rev. Rul. 71-91 (concluding that plan that contained no funding arrangement but provided that the employer would pay monthly pension benefit to an employee directly did not qualify under section 401(a)).

469 *See* Powell, 372-2nd T.M., *Church and Governmental Plans*, at A-24 through A-25.

470 *See id.*

expectancies and, specifically, the fact that some employees may die or terminate employment before retirement with unvested benefits. The assumptions used to account for these contingencies are called "actuarial assumptions."[471] In short, the determination of the annual cost of a plan requires a determination of the costs of the promised benefits with assumptions as to rates of interest, mortality, future salary increases, disability rates, retirement age, and turnover, as well as an assignment of the costs to particular years of service.[472]

For non-exempt private sector plans, the Internal Revenue Code mandates that the actuarial assumptions used to compute annual costs be both reasonable in the aggregate and the actuary's best estimate of anticipated experience under the plan.[473] The actuary estimates the anticipated experience of the plan based on past experience data as well as expected future changes, much of which is unique to the particular plan at issue. For example, the assumption regarding future salary increases for a particular plan will depend on how the employer sponsoring the plan has increased salaries in the past and whether the employer expects to change its pattern of increasing salaries in the future. The actuarial assumptions distinct to each plan enhance the difficulty of comparing plans.

It is impossible for an actuary to accurately predict actual experience for a short-term period of time. Actuarial science is predicated on the concept that, although there may be certain years in which actual experience is lower than an assumption, the effect of this can be offset by years in which the actual experience is higher than the assumption. For this reason, actuarial assumptions are intended to reflect actual experience over the long run, not in any given year. When a plan contains contingent benefits paid out of surplus earnings, as some governmental plans (including SDCERS) do, the actuarial calculations are complicated because, when surplus earnings are paid out, they are unavailable to offset deficiencies that may arise in other years. Therefore, the use of surplus earnings to pay contingent benefits impacts the long-term accuracy of the plan's actuarial assumptions.

The actuarial assumptions determined by the actuary may need to be adjusted from time to time.[474] Such adjustments may be needed if long-term experience does not appear to be

---

471 *See supra* note 386, at A-16.

472 *Id.*

473 I.R.C. § 412(c)(3). Internal Revenue Code section 412(l) also sets forth the permissible interest rates and mortality assumptions that may be used to calculate the current liabilities for non-exempt private sector plans and to determine their annual costs. Until recently, the interest rate had to be within 10% of the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. The Pension Funding Equity Act of 2004 replaces the 30-year Treasury bond interest rate assumption with a composite of long-term corporate bond rates for the years 2004 and 2005. For mortality assumptions, plans must use mortality tables prescribed by the Secretary of the Treasury.

474 Defined benefit plans that are maintained by a single employer and subject to PBGC termination insurance may not change actuarial assumptions without the approval of the IRS if (i) the aggregated unfunded vested benefits of all underfunded plans maintained by the employer and members of the employer's controlled group exceed $50 million and (ii) the change in

matching the actuarial assumptions or if the circumstances upon which the actuarial assumptions were based change. Changes in the actuarial assumptions give rise to changes in the pension liabilities and resulting funding obligations.

Note that this relationship between actuarial assumptions and pension obligations makes pension obligations inherently different from other debt obligations. When an entity issues debt, the obligation is repaid according to a debt instrument that amortizes the amount owed over a period of time, with either a fixed or a variable interest rate. In general, the amount of the repayment obligation is predictable (except to the extent that the debt payments vary with changes in the interest rate). In contrast, pension funding obligations may increase or decrease tremendously due to changes in actuarial assumptions and other factors that are independent of payment or non-payment by the plan sponsor. As a result, pension funding obligations differ fundamentally from other debt obligations.

### B. Standards of actuarial practice

Standards of actuarial practice are promulgated by the Actuarial Standards Board. The enforcement of these standards is left largely to the actuarial profession. Specifically, the authority to enforce the standards of actuarial practice is vested in the Committee on Discipline of the American Academy of Actuaries.

Although actuarial practice is not governed by national legal standards in a manner equivalent to accounting, with respect to non-exempt private sector plans, a violation of the standards of actuarial practice could result in violations of the funding requirements of Internal Revenue Code section 412, which requires the use of reasonable actuarial assumptions in the aggregate. Governmental plans are not subject to federal minimum funding standards, and a failure to follow the standards of actuarial practice will be a legal violation only to the extent State or local law requires compliance with such standards.

## VI. Accounting standards

Accounting standards applicable to governmental plans reflect how difficult it is to analyze governmental plan liabilities on a comparative basis. The Governmental Accounting Standards Board ("GASB") focuses on the identification of assumptions and the employment of basic formulas for measuring assets held against benefits to be provided, two measures that themselves may fluctuate independent of action or inaction by the sponsor.

---

assumptions decreases the plan's unfunded current liability for the current plan year by more than $50 million, or more than $5 million and at least 5% of the current liability. *See* ERISA § 302(c); *supra* n.372 at 734.

# 4.
# Glossary

## GLOSSARY OF PENSION DISCLOSURE TERMS

**1.** **Actuarial Accrued Liability**: That portion, as determined by a particular actuarial cost method, of the actuarial present value of pension benefits and expenses that is not provided for by future normal costs.

**2.** **Actuarial Assumptions:** Estimates of future experience 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.

**3.** **Actuarial Cost Method:** A mathematical procedure used to allocate to particular time periods the dollar amount of the actuarial present value of the pension benefits to be paid from a pension plan.

**4.** **Actuarial Present Value:** The amount of funds currently required to provide a payment or series of payments in the future. It is determined by discounting future payments at predetermined rates of interest and by probabilities of payment based on actuarial assumptions.

**5.** **Actuarial Valuation:** The determination, as of a specified date, of the normal cost, actuarial accrued liability, actuarial value of the assets of a pension plan, and other relevant values for a pension plan based on certain actuarial assumptions.

**6.** **Actuarial Value of Assets**: 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.

**7.** **Amortization:** Paying or allocating an interest-bearing liability by gradual reduction through a series of installments over time, as opposed to one lump-sum payment or allocation.

**8.** **Annual Pension Cost or Annual Cost:** The normal cost of a pension plan and the amount necessary to amortize a pension plan's unfunded actuarial accrued liability over a certain period of time.

9. **Annual Required Contributions or Actuarially Required Contributions ("ARC"):** The annual contribution rate determined by the actuary as necessary to cover the annual pension cost of a pension plan.

10. **Benefit Formula:** For SDCERS, the mathematical equation used to calculate a member's pension benefit by multiplying (a) the member's number of years of creditable service, (b) the member's final compensation and (c) a retirement factor or multiplier set forth in the San Diego Municipal Code.

11. **Corridor Funding Method:** A term used to refer to the funding arrangement entered into between the City of San Diego and the Board of Administration for SDCERS pursuant to which the City was to contribute to the system at fixed annual rates that were below the actuarially required contribution rate but were to increase incrementally over time to equal the actuarially required contribution rate by a set date in the future. The "corridor funding method" is not a GASB-approved method.

12. **Deferred Retirement Option Program ("DROP"):** A voluntary program created to provide members flexibility when planning for retirement by providing members who are eligible for retirement but who are still employed by the City to elect to begin receiving their monthly retirement benefit allowance but to forgo accrual of all other benefits under SDCERS. The DROP member's monthly retirement benefit allowance is deposited into a DROP account, along with additional employee and employer contributions, and the account is credited with interest. A member must designate the length of time he or she wishes to participate in DROP (up to a maximum of five years) and must agree to terminate employment following the termination of participation in DROP. At the end of the DROP period, the member receives the amounts in his or her DROP account in a lump sum and begins receiving the monthly retirement allowance directly.

13. **Defined Benefit Plan:** A traditional pension plan under which retirement benefits are based on a formula indicating the specific amount that one can expect to receive during retirement and in which the employer bears the investment risk.

14. **Disclosure Repositories:** The nationally recognized municipal securities information repositories, as recognized from time to time by the Securities and Exchange Commission pursuant to the Securities Exchange Act Release No. 34-34961 (November 10, 1994), 17 CFR 240.

15. **Elected Officers:** For purposes of SDCERS, one of the three classes of SDCERS participants consisting of the Mayor, the members of the City Council, and the City Attorney.

16. **Entry Age Normal Cost Method ("EAN"):** One of the actuarial cost methods approved by GASB pursuant to which the actuary calculates the amount that would fund the pension benefit of each member participating in the retirement plan if paid from the date of hire to the date of retirement, spreading the cost evenly over a member's entire career.

17. **Final Compensation:** For purposes of SDCERS, a member's highest rate of compensation during any one-year period of membership in SDCERS.

18. **Funding Ratio**: The ratio of the actuarial value of the assets available to pay benefits under a pension plan to the total actuarial accrued liability of the pension plan.

19. **General Fund:** The general operating fund of the City used to account for all financial resources, except those required to be accounted for in another fund.

20. **General Members:** For purposes of SDCERS, one of the three classes of SDCERS participants consisting of those participants who are neither Safety Members nor Elected Officers.

21. **Governmental Accounting Standards Board ("GASB"):** The organization that establishes standards of state and local governmental accounting and financial reporting.

22. **GASB 5:** The GASB statement establishing standards for disclosure of certain pension information by public employee retirement systems and state and local governmental employers in notes to financial statements and in required supplementary materials. Most significantly, this statement requires the computation and disclosure of a standardized measure of a retirement system's pension obligation independent of the actuarial cost method, if any, used to determine contributions to the retirement system.

23. **GASB 25:** The GASB Statement establishing financial reporting standards for defined benefit pension plans and for the notes to the financial statements of defined contribution plans of state and local governmental entities.

24. **GASB 26:** The GASB Statement establishing financial reporting standards for post-employment healthcare plans administered by state and local governmental defined benefit pension plans. It is an interim statement pending completion of the GASB project on accounting and financial reporting of other post-employment benefits by plans and employers.

25. **GASB 27:** The GASB Statement establishing standards for the measurement, recognition, and display of defined benefit plan expenditures and related liabilities,

assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers.

**26.** **ERISA:** The Employee Retirement Income Security Act of 1974.

**27.** **Net Pension Obligation ("NPO"):** The cumulative difference between the annual pension cost of a pension plan and the employer's contributions to the pension plan.

**28.** **Normal Cost:** That portion of the actuarial present value of pension benefits and expenses that is allocated to a valuation year as determined by a particular actuarial cost method.

**29.** **Pension Obligation Bonds ("POBs"):** Bonds that are typically secured by the municipal issuer's general obligation pledge and that are issued in order to allow the issuer to take advantage of the interest rate differential between taxable municipal bonds and the assumed investment return on pension plan assets. Typically, POBs are issued to fund all or a portion of a pension plan sponsor's unfunded pension liability in the expectation that debt service on the bonds will be less than the contributions that would otherwise be required from the sponsor.

**30.** **Projected Unit Credit Cost Method ("PUC"):** One of the actuarial cost methods approved by GASB pursuant to which the actuary calculates the amount that would fund the benefit earned in a particular year by each member participating in a pension plan.

**31.** **Reserves:** Separate accounts of pension plan funds, which accounts are used for various purposes, including accounting for discrete liabilities on the plan's balance sheet. A public retirement system generally maintains at least three separate reserve accounts in order to function: one for employer contributions, one for employee contributions, and one for retiree benefits. Other reserve accounts are optional.

**32.** **Safety Members:** For purposes of SDCERS, one of the three classes of SDCERS participants consisting of individuals employed by the City as uniformed members of the City Fire Department, sworn officers of the City Police Department, Police Department recruits in the City's Police Academy, and full-time City lifeguards.

**33.** **SDCERS:** The San Diego City Employees' Retirement System.

**34.** **SDMC:** The San Diego Municipal Code.

**35.** **Surplus Undistributed Earnings:** A term defined in the San Diego Municipal Code as the amount of the system's investment earnings from the previous fiscal year that is not allocated to various system reserves, used to pay budgeted system expenses, or distributed to members as contingent benefits pursuant to section 24.1502(a) of the San Diego Municipal Code.

**36.** **Unfunded Actuarial Accrued Liability ("UAAL"):** The amount of any shortfall between the actuarial value of the assets of a pension plan and the actuarial accrued liability of the pension plan.

37. **Waterfall:** The procedure for allocating the investment earnings of SDCERS to various system reserves, budgeted system expenses, and contingent benefits pursuant to section 24.1502(a) of the San Diego Municipal Code.

# 5.
# Draft Ordinance

**Section 1: Financial Reporting Oversight Board**

BE IT ORDAINED, by the Council of the City of San Diego, as follows:

Section 1. That Chapter 2, Article 6, of the San Diego Municipal Code is amended by adding a new Division 17, titled "Financial Reporting Oversight Board;" and by adding new sections 26.1701, 26.1702, 26.1703, 26.1704, 26.1705, and 26.1706, to read as follows:

§26.1701. **Purpose and Intent**

It is the purpose and intent of the City Council to establish a Financial Reporting Oversight Board to serve as an advisory body to the Mayor and City Council and City Manager on matters which relate to achieving a high standard of quality in and efficacy of the City's financial reporting and disclosure, including but not limited to disclosures relating to the City's securities, disclosures relating to securities issued by the *related entities* as defined in Section 22.1702 of the Municipal Code, the selection of independent auditors, the conduct of audits, the operations of the Office of the City Auditor and Comptroller, the quality and efficacy of the City's financial reporting, with respect to the City Auditor and Comptroller and the City Manager, the City's internal controls and procedures, and with respect to the City Auditor and Comptroller, the City Manager, and the City Attorney, the quality and efficacy of the City's disclosure controls and procedures. It is the intent of the City Council that a high level of public confidence shall be maintained in the quality of the City's disclosures and financial statements and that the Financial Reporting Oversight Board shall assist the City in ensuring that the process of selecting an independent auditor to the City is insulated from political considerations. The City Council recognizes that selecting the members of the Financial Reporting Oversight Board is likely to require some time and it is the intent of the City Council that, if possible, the Financial Reporting Oversight Board shall be fully constituted and prepared to assume its duties not later than April 15, 2005.

§26.1702. **Financial Reporting Oversight Board**

Pursuant to City Charter section 43(a), there is hereby created a Financial Reporting Oversight Board consisting of three (3) members. The members shall

be appointed by the Mayor and confirmed by the City Council. Each of the members shall be a person of high moral character and integrity with extensive academic or professional experience in the fields of finance, accounting, or law, with at least one (1) expert in accounting and one (1) expert in federal securities law.

The members shall serve terms of four (4) years and each member shall serve until a successor is duly appointed and confirmed. Of the members appointed initially, one (1) member shall serve a term of two (2) years, and one (1) member shall serve a term of three (3) years, such that the terms of not more than one (1) member shall expire in any year. The expiration date of all terms shall be May 31. During June of each year, the Mayor may designate one (1) member as Chairperson; however, in the absence of such designation, the Board shall on or after July 15, select a Chairperson from among its members. Any vacancy shall be filled for the unexpired term of the member whose place becomes vacant. If any member misses three or more unexcused meetings in a calendar year, that member's Board position shall be deemed immediately vacated without further action by the Board or the City Council. The Board shall have no authority to restore such member to a position deemed vacated. Absences may be excused by unanimous vote of the remaining members of the Board and shall be granted only for personal emergencies as reasonably determined by the members of the Board voting on the absence.

§26.1703 **Duties and Functions**

The Board shall:

(a) Adopt rules consistent with the law for the government of its business and procedures, provided that such rules shall specify that a quorum shall at all times consist of at least two (2) members.

(b) Meet periodically and in separate meetings with the City Auditor and Comptroller, the City's Independent Auditor, and the representatives of the City's Disclosure Practices Working Group. The Board's meetings shall be subject to the California Brown Act.

(c) Establish procedures to receive and respond to any complaints or concerns regarding accounting, internal controls or auditing matters, including procedures for the confidential and anonymous submission by employees of any such complaints or concerns.

(d) Review and evaluate the annual report on the City's disclosure controls and procedures made by the Disclosure Practices Working Group and provide to the Disclosure Practices Working Group, the Mayor and the City Council any comments or recommendations it may have.

(e) Review the outside auditor's management letter, together with the City's response to that letter and review and evaluate the annual report on the City's internal controls made by the City Auditor and Comptroller and City Manager and provide to the Mayor and the City Council any comments or recommendations it may have.

(f) Review and evaluate the procedures, diligence, ability, and work product of the outside auditor and report annually to the Mayor and City Council on its findings and any recommendations it may have.

(g) Review and evaluate the City's exercise of its obligations under federal and state securities laws with respect to securities issued by the ***related entities*** and provide to the Disclosure Practices Working Group, the Mayor and the City Council any comments or recommendations it may have.

(h) Conduct such other studies, reviews, and public hearings on matters relating to or connected with the City's financings, disclosures, audits, and internal financial controls and procedures as it shall be directed by the Mayor and City Council, and report on its findings, together with such recommendations as the Board shall deem appropriate, to the Mayor and the City Council.

§26.1704. **Selection of Independent Auditors**

In preparation for the issuance of a Request for Proposals for an independent auditor for the City, the City Manager shall consult with the Board regarding its recommendations relating to appropriate expertise, experience and responsibility, and other factors on which candidates will be evaluated.

The Board shall review and evaluate all responses to a Request for Proposals for the independent auditor to the City, and shall recommend to the City Council a candidate to be selected. The City Council may approve or reject the Board's selection but the City Council shall not substitute a candidate of its own choice. In the event that the City Council rejects the recommendation of the Board, the Board shall provide another recommendation or, in its sole discretion, provide for

the issuance of a new Request for Proposals to encourage additional candidates to submit their proposals.

§26.1705. **Indemnification and Reimbursement for Expenses**

The members of the board shall be reimbursed for reasonable expenses incurred in the performance of their official duties, pursuant to City Administrative Regulations. The members of the Board shall be defended and indemnified with respect to the course and scope of their official duties as more fully set forth in state law.

§26.1706. **Board Resources; Independent Advisers**

The City Manager, the City Attorney, the City Auditor and Comptroller, and the City Treasurer shall fully cooperate with the Board and provide such assistance and resources as are reasonably necessary to allow it to carry out its responsibilities. In the City's Annual Budget, in addition to budgeting sufficient internal staff resources as described above, the City Manager shall propose expenditure of funds sufficient to engage such independent counsel or other independent advisers to assist the Board in carrying out its responsibilities as the Board shall reasonably request. The City Council shall appropriate monies as proposed by the City Manager sufficient to meet these needs.

**Section 2: City Attorney**

Section 2. That Chapter 2, Article 2, Division 3 of the San Diego Municipal Code is amended by adding new sections 22.0302, 22.0303, and 22.0304 to read as follows:

§22.0302 **Deputy City Attorney for Finance and Disclosure**

To assist in carrying out the responsibilities of the City Attorney under Division 41 of Chapter 2, Article 2, the City Attorney shall designate a Deputy City Attorney for Finance and Disclosure who shall be knowledgeable about federal and state securities laws relating to municipal finance to supervise those Deputy City Attorneys of the Office of the City Attorney who are responsible for matters relating to City financings and disclosure, to assist the City Attorney in carrying out the City Attorney's duties on the Disclosure Practices Working Group, and in the undertaking and coordination of such due diligence as is necessary in preparation for the issuance of the opinion of the City Attorney in connection with City financings.

§22.0303 **Disclosure Advisor to the City Council**

The City Attorney shall designate one or more Deputy City Attorneys to advise and assist the City Council in connection with matters related to financings, disclosures, and other matters, including advising and assisting the members of the City Council in meeting requirements under federal and state securities laws. The Deputy City Attorney designated pursuant to Section 22.0302 shall not be designated to advise and assist the City Council pursuant to this Section.

§22.0304 **Legal Advisor to the Financial Reporting Oversight Board**

The City Attorney shall designate one or more Deputy City Attorneys as legal advisors to the Financial Reporting Oversight Board to provide any necessary and appropriate advice to that Board. The Deputy City Attorneys designated pursuant to Sections 22.0302 and 22.0303 shall not be designated as legal advisors to the Financial Reporting Oversight Board pursuant to this Section.

**Section 3: Securities Disclosure**

Section 3. That Chapter 2, Article 2, of the San Diego Municipal Code is amended by adding a new Division 41, titled "Securities Disclosure;" and by adding new sections 22.1701, 22.1702, 22.1703, 22.1704, 22.1705, 22, 1706, 22.1707, 22, 1708, 22.1709, 22.1710, 22.1711, and 22.1712 to read as follows:

§22.1701 **Disclosure Practices Working Group Purpose and Intent**

The City Manager, the City Attorney, the City Auditor and Comptroller, and the City Treasurer are hereby directed to establish a Disclosure Practices Working Group, consisting solely of City officers, managers, and staff, with the assistance and advice of the City's disclosure counsel, which shall have the responsibilities set forth in this Division, in furtherance of the mandates of Section 32.1 of the Charter, to ensure the compliance of the City (and the City Council and City officers and staff in the exercise of their official duties) with federal and state securities laws and to promote the highest standards of accuracy in disclosures relating to securities issued by the City. It is the intent of the City Council that the Disclosure Practices Working Group be an internal working group of City staff and not a decision-making or advisory body subject to the Brown Act.

The responsibilities of the Disclosure Practices Working Group shall be: to design and implement the City's disclosure controls and procedures; to review the City's disclosures in connection with its securities; to ensure the City's compliance with federal and state securities laws; to ensure that City staff receive appropriate training regarding such controls and procedures; to evaluate the disclosure controls and procedures and compliance therewith on an annual basis and to make such recommendations as it shall see fit regarding such disclosure controls and procedures and related matters to the Manager, the City Council, and the Financial Reporting Oversight Board. The Disclosure Practices Working Group shall also ensure that the City Council and City officers and staff comply with the federal securities laws in the exercise of their official duties in connection with securities issued by the ***related entities.***

§22.1702 **Definitions**

"***Related entities***" means those independent agencies, joint power authorities, special districts, component units, or other entities created by ordinance of the City Council or by State law that issue securities, for which the City Council serves as the governing or legislative body, or for which at least one City officer

serves as a member of the governing or legislative body in his or her official capacity, or for which the City has agreed to provide disclosure. *Related entities* includes but is not limited to the Public Facilities Financing Authority of the City of San Diego, the San Diego Facilities and Equipment Leasing Corporation, the City of San Diego/MTDB Authority, the Convention Center Expansion Financing Authority, the Redevelopment Agency of the City of San Diego, the San Diego Open Space Park Facilities District No.1, and the reassessment districts and community facilities districts created by the City.

§22.1703 **Organization of the Disclosure Practices Working Group**

The Disclosure Practices Working Group shall consist of the City Attorney, the Deputy City Attorneys designated pursuant to Sections 22.0302, 22.0303, and 22.0304 of the Municipal Code, the City Auditor and Comptroller (and such other managers of the Office of City Auditor and Comptroller as the City Auditor and Comptroller deems necessary for the effective operation of the Disclosure Practices Working Group), the City Treasurer (and such other managers of Financing Services as the City Treasurer deems necessary for the effective operation of the Disclosure Practices Working Group), the Deputy City Manager responsible for the financial management functions of the City (and such other senior members of the City Manager's Office as the City Manager deems necessary for the effective operation of the Disclosure Practices Working Group), and the City's outside disclosure counsel. The City Attorney shall serve as chair of the Disclosure Practices Working Group.

§22.1704 **Meetings**

The Disclosure Practices Working Group shall meet as often as necessary to fulfill its obligations under this section but not less than once a month. Members of the Disclosure Practices Working Group may participate in meetings by telephone.

§22.1705 **Design and Implementation of Disclosure Controls and Procedures**

The Disclosure Practices Working Group shall conduct a thorough review of the City's current disclosure practices and shall recommend to the City Manager by December [ ], 2004 such new disclosure controls and procedures as shall be necessary to ensure the accuracy of the City's disclosures and the City's compliance with all applicable federal and state securities laws. Such disclosure controls and procedures shall be in writing and designed to ensure:

(a) that information material to the City's proposed and outstanding securities is accumulated and communicated to senior City officials, including the City Manager, City Auditor and Comptroller, City Treasurer, City Attorney, and the City Council, as appropriate, to allow timely decisions regarding disclosure;

(b) that such information is recorded, processed, and summarized in a timely manner to enable the requisite senior City officials to certify the accuracy of disclosures made in connection with City financings;

(c) the compliance with all applicable federal and state securities laws, including the disclosure of all material information with respect to the City's proposed and outstanding securities; and

(d) the preservation of an audit trail regarding information reviewed or prepared in connection with such disclosures.

Such disclosure controls and procedures shall address the accuracy of information disclosed by the City in connection with securities issued by the ***related entities***, and shall include those procedures established by the Financial Reporting and Oversight Board for employees and officials to submit complaints or concerns to the Financial Reporting Oversight Board confidentially and anonymously.

The City Manager shall implement the recommendations of the Disclosure Practices Working Group relating to disclosure controls and procedures together with any recommendations of the Financial Reporting Oversight Board relating to disclosure controls and procedures as soon as practicable or shall within 45 days of receiving such recommendations provide the City Council with a report as to why such recommendations should not be implemented.

§22.1706 **Annual Evaluation and Report**

Each year, beginning in 2005, the Disclosure Practices Working Group shall, in collaboration with the City Manager and the City Auditor and Comptroller, conduct an annual evaluation of the City's disclosure procedures and controls. In the course of that review, the Committee shall:

(a) meet with key managers and staff in the City Manager's Office (particularly those managers and key staff responsible for the financial management of the City), the City Treasurer's Office, and other relevant offices and departments to

discuss the elements of the City's disclosure materials for which they are responsible and to evaluate the effectiveness of the disclosure procedures;

(b) meet with the City's independent auditors and disclosure counsel to review the design and operation of the disclosure controls and procedures; and

(c) submit a written report on the Committee's work and findings to the City Council and to the Financial Reporting Oversight Board on or before [November 1] of each year, beginning [November 1, 2005].

Each of the City Manager and the City Auditor and Comptroller shall review such Annual Evaluation and Report, shall certify in writing within 14 days of the issuance of such Annual Evaluation and Report to the City Council that they have reviewed the Annual Report, and shall provide to the City Council any recommendations or dissenting opinions that they may have.

§22.1707 **Timely Preparation and Review of Disclosure Documents**

The Disclosure Practices Working Group shall be responsible for reviewing the form and content of all of the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to its securities, including without limitation, preliminary and final official statements and any supplements thereto, Comprehensive Annual Financial Reports, Annual Reports and other filings made with Nationally Recognized Municipal Securities Information Repositories, press releases, rating agency presentations, web-site postings and other communications reasonably likely to reach investors or the securities markets. The Disclosure Practices Working Group shall provide for the timely review of all disclosure materials requiring approval and certification by the City Manager, City Treasurer, and City Auditor and Comptroller.

The Disclosure Practices Working Group also shall be responsible for reviewing disclosure provided by the City in connection with securities issued by the ***related entities***, together with all of such documents and materials prepared, issued, or distributed in connection with such securities, to the extent that the City, the City Council, or City officers or staff are responsible for the form or content of such documents or materials. As appropriate, the Disclosure Practices Working Group shall provide for the timely review of all such disclosure materials requiring approval and certification by the City Manager, City Treasurer, and City Auditor and Comptroller.

§22.1708 **Promote Compliance with Securities Laws**

The Disclosure Practices Working Group shall promote the City's compliance with the federal and state securities laws relating to disclosure in connection with the City's securities and may make recommendations to the City Manager and the City Council regarding appropriate means for furthering such compliance by the City or the *related entities*.

§22.1709 **Training for City Employees**

The Disclosure Practices Working Group shall be responsible for arranging for mandatory training, on a regular basis, for City staff, officials, City Council members, and the Mayor regarding their obligations relating to disclosure matters under federal and state securities laws. The City Manager, the City Auditor and Comptroller, and the City Attorney shall ensure the attendance at such training of those persons for whom the Disclosure Practices Working Group recommends such training. Such training will include information on how to submit complaints or concerns to the Financial Reporting Oversight Board in a confidential and anonymous manner.

§22.1710 **Requests of the Disclosure Practices Working Group**

Officers and employees of the City and its component units and members of the Board of Administration, officers, and employees of the San Diego City Employees' Retirement System promptly shall provide such information, assurances, and/or certifications as the Disclosure Practices Working Group may at its sole discretion request in order to assure compliance with federal and state securities laws.

§22.1711 **Certifications by City Officials to the City Council**

In connection with the approval of offering documents for securities by the City Council, the City Manager and the City Attorney each shall certify personally to the City Council that to the best of his or her knowledge, such documents do not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. In the event that the City Manager or the City Attorney is absent, a deputy or other authorized designee of such officer may make the certification required by this Section.

Upon the issuance of the City's Comprehensive Annual Financial Report (the "CAFR") and in connection with the incorporation of all or portions of the CAFR in the disclosure documents of the City or the ***related entities***, the City Auditor and Comptroller shall make the certifications to the City Council required by Chapter 2, Article 2, Division 7 of the Municipal Code.

§22.1712 **Selection of Independent Auditors**

In preparation for the issuance of a Request for Proposals for an independent auditor for the City, the City Manager shall consult with the Disclosure Practices Working Group regarding its recommendations relating to appropriate expertise, experience and responsibility, and other factors on which candidates will be evaluated by the Financial Reporting Oversight Board.

**Section 4: Annual Report of CERS System**

Section 4. That Chapter 2, Article 4, of the San Diego Municipal Code is amended by amending and restating section 24.0911 to read as follows:

§24.0911 **Annual Report**

The Retirement Board will prepare an Annual Report at the end of each fiscal year to provide information to all Members concerning the System. Copies of the Annual Report are available to all Members upon request. The Retirement Administrator will keep a copy of the Annual Report in his or her office.

The President of the Board shall provide the Annual Report to the City Manager and the City Council and shall inform the City Manager and the City Council semi-annually of the funding status of the pension system, the impact of any demographic or actuarial issues, or other changes affecting the benefits or funding of the Retirement System, which have occurred since the date of the previous semi-annual report pursuant to this section.

The President of the Board and the Retirement Administrator promptly shall inform the City Manager and the City Council of all material facts or significant developments relating to all matters under the jurisdiction of the Board, except as may be otherwise controlled by the laws and regulations of the United States or the State of California. The President of the Board, the Retirement Administrator, and all officers and employees of the System shall comply promptly with all lawful requests for information by the City Council, the City Manager, the City Attorney, or their designees.

**Section 5: City Auditor and Comptroller**

Section 5. That Chapter 2, Article 2, Division 7 of the San Diego Municipal Code is amended by adding new sections 22.0708 and 22.0709, to read as follows:

§22.0708 **Annual Report on Internal Controls**

(a) On or before September 1 of every year, beginning with September 1, 2005, the City Auditor and Comptroller, in coordination with the City Manager, shall conduct an annual evaluation of the City's internal financial controls. In the course of that review, the City Auditor and Comptroller shall conduct a thorough review of the efficacy of the City's internal financial controls and their operation and meet with the City's independent auditors to review the design and operation of the City's internal financial controls.

(b) The City Manager and the City Auditor and Comptroller shall submit a written report on their findings to the City Council and the Financial Reporting Oversight Board on or before January 1 of every year, beginning with January 1, 2006. Accompanying such annual report shall be a certification signed by the City Manager and the City Auditor and Comptroller, certifying that they:

(1) are responsible for establishing and maintaining the City's internal financial controls;

(2) have designed such internal financial controls to ensure that material information relating to the City and its departments, offices, agencies, and affiliated and related entities is made known to the City Manager and/or the City Auditor and Comptroller by others within the City and its departments, offices, agencies, and affiliated and related entities, particularly during the period in which the annual report required by this section is being prepared;

(3) have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the annual report;

(4) have presented in the annual report their conclusions about the effectiveness of their internal controls based on such evaluation as of that date;

(5) have disclosed to the City's independent auditors and the Financial Reporting Oversight Board all significant deficiencies in the design or operation of internal controls which could adversely affect the City's ability to record, process, summarize, and report financial data and have identified for the City's independent auditors any material weaknesses in internal controls and any fraud, whether or not material, that involves management or other employees who have a significant role in the City's internal controls;

(6) have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

In the event that the City Manager or the City Auditor and Comptroller is absent, a deputy or other authorized designee of such officer may make the certification required by this Section.

§22.0709 **Certifications to the City Council**

(a) In connection with the issuance of the City's Comprehensive Annual Financial Reports (the "CAFR"), the City Auditor and Comptroller shall certify in writing to the City Council that to the best of his or her knowledge, as of its date, the information contained in the CAFR fairly presents, in all material respects, the financial condition and results of operations of the City as of, and for, the periods presented in the CAFR, and the CAFR does not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

(b) In connection with offerings of securities of the City or the ***related entities***, the City Auditor and Comptroller shall certify in writing to the City Council that to the best of his or her knowledge, as of the date of the offering documents or other relevant disclosure materials, the information contained in those sections of such offering documents or disclosure materials for which the City Auditor and Comptroller is primarily responsible fairly presents, in all material respects, the financial condition and results of operations of the City, that it does not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which

they were made, not misleading, and that the financial statements and other financial information from the CAFR included in such offering documents or disclosure materials fairly present in all material respects the financial condition and results of operations of the City as of, and for, the periods presented in the CAFR.

(c) In the event that the City Auditor and Comptroller is absent, his or her deputy or other authorized designee shall provide the certifications required by this Section.