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New Jersey Settles With SEC But Question Remains: Who's Next?

On August 18, 2010 the US Securities and Exchange Commission issued Release No. 33-9135, a cease and desist order (the Order) settling claims against the state of New Jersey as a result of what the SEC determined was inadequate disclosure of the financial condition of New Jersey's pension funds. The SEC's investigation took more than three years and reportedly cost New Jersey several million dollars in legal fees, although no fine was levied by the SEC against the state. According to the SEC, New Jersey violated securities laws in connection with the offering of some 79 bond transactions over a period of six years totaling in excess of $26 billion. This case is significant because it is the first SEC enforcement action against a state and because it relied on Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, 15 USC Sec. 77q, which allow the SEC to bring enforcement actions against issuers and others based on negligence, without a showing of fraudulent intent. The Order is viewed by some in the marketplace as a "shot across the bow" to state and local governments with regard to pension fund disclosures and more aggressive SEC enforcement regarding municipal securities generally, including enforcement actions based on negligence rather than actual fraud. Public pension and accounting disclosure is one of the five areas of particular SEC enforcement focus announced in January.

New Jersey's disclosure regarding the condition of its pension funds was, according to the SEC, both outdated and incomplete, and, therefore, misleading. New state

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pension legislation affecting the valuation and funding of the pension funds was not addressed in bond offering documents, and market and actuarial valuation information was outdated, according to the SEC. The SEC cited as mitigating factors the remedial actions the state took after the disclosure issues came to light, specifically the hiring of outside disclosure counsel, adoption of formal disclosure policies and procedures, and in-house securities law education programs, as well as enhanced pension fund disclosure.

The New Jersey case may be a harbinger of more aggressive enforcement by the SEC in the area of municipal securities generally and pension fund disclosure specifically. With that in mind, it is a good time for state and local governments to review their pension fund disclosure (and other financial disclosure), as well as their internal disclosure policies and procedures. The following questions are designed to aid in this review.

1. Has the method/process of determining annual funding contributions been changed recently? One of the actions taken by New Jersey and cited by the SEC was changing the valuation of the pension funds from actuarial to market value as of a date when the market was high (i.e., it "back valued" its pension fund portfolio).

2. Are annual actuarially required contributions to pension funds subject to the budget and annual appropriation process? The SEC specifically noted that this was the case in New Jersey but was not disclosed in the offering documents.

3. Have there been any independent reviews of the financial condition of the pension funds? In New Jersey, a separate task force empanelled to review pension practices issued a scathing report that was available publicly but not mentioned in the offering documents.

4. Do the contribution amounts listed in any tables include amounts that flow through the pension funds but are not intended as part of the annual contribution? In New Jersey, according to the Order, the tables in the offering documents showed historical contributions that included payments for other benefits (OPEB) as well as pension contributions.

5. Does the disclosure include information regarding the actuarial methodology used to calculate accrued liabilities?

6. Does the pension disclosure include asset and funded ratio information on a market basis (as opposed to just an actuarial basis)?

7. Are the financial and legislative sections of the offering document reviewed by appropriate department heads at regular intervals throughout the fiscal year or at the time bonds are issued? Have those department heads been provided educational opportunities with respect to securities law liability?

A copy of the full text of the Order can be found on the SEC website.
