

REDUCING FINANCIAL RISK

MANY OF YOU SPEND LOTS OF TIME IN YOUR PERSONAL AND PROFESSIONAL LIVES DOING THINGS TO REDUCE FINANCIAL RISK—WHETHER IT BE DIVERSIFYING YOUR PERSONAL RETIREMENT INVESTMENTS OR HEDGING YOUR UTILITY'S FUEL OR PURCHASED POWER PRICE RISKS. AN ADDITIONAL AREA OF FINANCIAL RISK ARISES, PRINCIPALLY ON THE INSTITUTIONAL SIDE BUT UNFORTUNATELY ON THE PERSONAL SIDE AS WELL, WHEN YOU PARTICIPATE IN THE PREPARATION OF THE OFFICIAL STATEMENT FOR A BOND ISSUE OR AN ANNUAL DISCLOSURE DOCUMENT. TODAY WE WILL DISCUSS TWO AREAS WHICH HAVE BEEN DRAWING ATTENTION RECENTLY AS AREAS WHERE FINANCIAL RISKS MAY BE ARISING BECAUSE OF DEFICIENT DISCLOSURE PRACTICES—THE STATUS OF FUNDING OF PENSION OBLIGATIONS AND DEVELOPING ENVIRONMENTAL REGULATION AND THE RISKS AND COSTS THEREOF. WHILE PENSION ISSUES HAVE RECEIVED MORE PRESS AND ATTENTION RECENTLY, ENVIRONMENTAL ISSUES MAY BE A GREATER CONCERN FOR THE ELECTRIC UTILITY INDUSTRY. AS AN ASIDE, ONE COMMENTATOR IN A PIECE IN THE BOND BUYER WITHIN THE PAST FEW MONTHS RAISED A RED FLAG ABOUT LACK OF DISCLOSURE ABOUT DECAYING INFRASTRUCTURE AND THE COSTS OF REPLACING IT AS THE NEXT GREAT DISCLOSURE ISSUE. TODAY I WILL FOCUS ON THE PENSION LIABILITY ISSUES AND BOB WILL FOCUS ON THE ENVIRONMENTAL ISSUES AND WE WILL LEAVE CONCERN ABOUT THE INFRASTRUCTURE FOR ANOTHER DISCUSSION. I WOULD POINT OUT AT THE START THAT BOTH THE PENSION AREA AND THE ENVIRONMENTAL AREA ARE AREAS WHERE THE DIRECT RISK TO YOUR UTILITY OF MEETING THE COSTS INVOLVED ARE POTENTIALLY MUCH GREATER THAN THE COSTS OF ARISING FROM ANY DISCLOSURE DEFICIENCIES, BUT UNFORTUNATELY WE CANNOT BE OF MUCH HELP TO YOU IN SOLVING THE DIRECT COST ISSUES. BUT WE HOPE TO GIVE YOU SOME GUIDANCE ON WAYS TO AVOID THE UNNECESSARY ADDITIONAL COSTS OF DISCLOSURE PROBLEMS.

PENSION OBLIGATION DISCLOSURE: LESSONS OF THE NJ ORDER:

- I. WHILE PROPER DISCLOSURE ABOUT PENSION OBLIGATIONS HAS BEEN AN SEC CONCERN FOR MANY YEARS DATING BACK AT LEAST TO THE PROBLEMS EXPERIENCED BY THE CITY OF SAN DIEGO, LAST YEAR'S SEC CEASE AND DESIST ORDER INVOLVING THE STATE OF NJ BROUGHT CONCERNS ABOUT PENSION DISCLOSURE BACK TO THE FOREFRONT. THE NJ ORDER IS A MESSAGE TO MUNICIPAL ISSUERS, AND ALL MUNICIPAL MARKET PARTICIPANTS, THAT THEY ARE AT RISK IF THEIR PENSION DISCLOSURE IS NOT ADEQUATE. MORE BROADLY THE ORDER IS JUST ONE OF A NUMBER OF ITEMS WHICH INDICATE THAT THE SEC IS CONTINUING ITS INCREASED FOCUS ON MUNICIPAL FINANCE TRANSACTIONS CREATING A RISK FOR ALL ASPECTS OF YOUR

FINANCINGS AND PROBABLY SHOULD BE VIEWED AS APPLICABLE TO DISCLOSURE MATTERS GENERALLY, INCLUDING DISCLOSURE OF ENVIRONMENTAL CONCERNS AND OTHER AREAS. A COMPLETE COPY OF THE NEW JERSEY ORDER WHICH PROVIDES AN EXCELLENT VIEW OF THE SEC'S THINKING IS ATTACHED HERETO.

II. BEFORE GETTING INTO THE DETAILS OF WHAT HAPPENED IN THE NEW JERSEY MATTER AND WHAT IT MEANS FOR YOU, I WANT TO SPEND A FEW MINUTES ON SOME THINGS WE DISCUSS IN THE SECTION OF TRAINING SESSIONS WE DO FOR ISSUERS AND OTHERS ON SECURITIES LAW COMPLIANCE WHERE WE TRY TO GET PEOPLE'S ATTENTION BY SCARING THEM A LITTLE.

A. WHILE I DO NOT PLAN TO GIVE YOU A LONG LIST OF HORROR STORIES OF THE RESULTS OF BAD DISCLOSURE PRACTICES, A FEW ITEMS ARE WORTH NOTING. FIRST, THERE IS THE STATEMENT ATTRIBUTED TO A FORMER SEC ENFORCEMENT OFFICIAL IN CONNECTION WITH THE SEC INVESTIGATION OF ORANGE COUNTY, CALIFORNIA: "WE ARE GOING TO TACK A FEW HIDES TO THE SHED DOOR". IT IS ALSO WORTH REMEMBERING THAT SEC INVESTIGATIONS OF DISCLOSURE PROBLEMS INVOLVING STATE AND LOCAL GOVERNMENT SECURITIES HAVE LED TO PEOPLE GOING TO JAIL - WHILE THE JAIL TERMS HAVE GENERALLY RELATED TO STATE AND NOT FEDERAL CHARGES, THIS IS LITTLE CONSOLATION TO THE PERSON SERVING THE TIME. AND, WHILE FEDERAL BUDGET ISSUES MAY SLOW THINGS DOWN A LITTLE, THE NEWS OUT OF WASHINGTON FOR AN EXTENDED PERIOD, SEEMS TO INDICATE THAT STATE AND LOCAL SECURITIES AND DISCLOSURE PRACTICES WILL REMAIN AMONG THE SEC'S PRIMARY CONCERNS. INDEED, THE SEC CREATED FIVE NEW SPECIALIZED ENFORCEMENT UNITS IN EARLY 2010 WITH ONE FOCUSED ON MUNICIPAL AND PUBLIC PENSION FUND ABUSES. IN LATE JUNE THE SEC ANNOUNCED IT WAS CREATING A NEW FIVE PERSON OFFICE OF MUNICIPAL SECURITIES. IN THE RECENT MONTHS, IT HAS BEEN REPORTED THAT SEC IS LOOKING AT PENSION DISCLOSURE IN ILLINOIS, RHODE ISLAND AND POSSIBLY CALIFORNIA. AS REPORTED IN THE PRESS AND ON AT LEAST ONE LATE NIGHT NEWS REPORT IN THE NYC AREA, THE FBI AND THE JUSTICE DEPARTMENT ARE ALSO TAKING AN AGGRESSIVE STANCE AGAINST THE MUNICIPAL SECURITIES INDUSTRY GENERALLY AS EVIDENCED BY THE ARREST EARLIER THIS YEAR OF THE FORMER CO-HEAD OF MUNICIPAL BOND REINVESTMENT AT UBS AS HE GOT OFF A FLIGHT FROM EUROPE AT JFK AIRPORT.

B. IN THE VIEW OF THE SEC, INDIVIDUAL OFFICERS AND STAFF MEMBERS INVOLVED IN THE APPROVAL AND PREPARATION OF MUNICIPAL DISCLOSURE MATERIALS BEAR RESPONSIBILITY FOR

CONFIRMING THAT DISCLOSURE COMPLIES WITH FEDERAL SECURITIES LAWS. THERE ARE NUMEROUS EXAMPLES OF INDIVIDUALS BEING FOUND TO HAVE VIOLATED FEDERAL SECURITIES LAWS BECAUSE OF THEIR INVOLVEMENT, OR THEIR OPPORTUNITY TO BE INVOLVED, IN THE DRAFTING OF THE OFFICIAL STATEMENT. ***THE FACT THAT AN INDIVIDUAL OFFICER OR STAFF MEMBER DOES NOT DIRECTLY INTERACT WITH POTENTIAL INVESTORS OR HAVE EDITORIAL CONTROL OF THE OFFICIAL STATEMENT DOES NOT MEAN THAT THE INDIVIDUAL IS IMMUNE FROM A CHARGE OF VIOLATING THE ANTIFRAUD RULES.***

C. THE IMPACTS ON AN ISSUER OF A FEDERAL SECURITIES LAW VIOLATION OR ALLEGED FEDERAL SECURITIES LAW VIOLATION CAN BE SEVERE. THESE CAN INCLUDE:

- SEC, DEPARTMENT OF JUSTICE AND OTHER INVESTIGATIONS WHICH ARE UNPLEASANT, TIME CONSUMING AND ***COSTLY***;
- CIVIL OR CRIMINAL PENALTIES;
- INJUNCTIONS OR CEASE AND DESIST ORDERS;
- OTHER SEC SANCTIONS;
- JUDGMENTS IN CIVIL LAWSUITS;
- RATINGS DOWNGRADE OR WITHDRAWAL;
- LOSS OF MARKET ACCESS; AND
- POLITICAL TURMOIL.

D. THE IMPACTS ON INDIVIDUALS OF A FEDERAL SECURITIES LAW VIOLATION CAN BE EQUALLY SEVERE. THESE CAN INCLUDE:

- SEC, DEPARTMENT OF JUSTICE AND OTHER INVESTIGATIONS—AN EXPERIENCE YOU WOULD LIKE TO AVOID EVEN IF NO VIOLATION IS EVENTUALLY FOUND;
- CIVIL OR CRIMINAL SANCTIONS BOTH UNDER FEDERAL AND STATE LAW (INCLUDING PRISON TERMS OR FINES);
- INJUNCTIONS OR CEASE AND DESIST ORDERS;
- JUDGMENTS IN CIVIL LAWSUITS;
- PROHIBITION FROM FUTURE INVOLVEMENT IN PUBLIC SECURITIES OFFERINGS;
- DISMISSAL FROM EMPLOYMENT; AND
- DAMAGE TO REPUTATION AND POLITICAL HARM.

III. HISTORY OF HOW THE NJ PROCEEDING STARTED IS PART OF UNDERSTANDING THE RISKS THE ORDER REVEALED.

A. WHILE THE SEC DOESN'T REGULARLY READ MUNICIPAL DISCLOSURE DOCUMENTS AS IT DOES IN THE CORPORATE WORLD,

THEY WILL READ ITEMS ABOUT ACTIVITIES IN THE MUNICIPAL WORLD THAT ATTRACT THEIR ATTENTION.

- i) THIS INVESTIGATION STARTED WITH A SERIES OF NY TIMES ARTICLES THAT IN PART FOCUSED ON CONFUSION BETWEEN PENSION AND OPEBS DISCLOSURES.
- ii) IN THE CASE OF A TBTA TENDER, THE SEC PICKED UP ON NOTICE IN WALL STREET JOURNAL.
- iii) IN THE CASE OF A SMALL EXEMPT CORPORATE OFFERING FOR A NEW ENGLAND IOU, SEC PICKED UP ON SOME COMMENTS BY A CORPORATE EXECUTIVE ON A RADIO TALK SHOW.

B. AN ISSUER OR TRANSACTION DOESN'T NEED TO MISS A PAYMENT, OTHERWISE DEFAULT OR SUFFER A RATINGS DOWNGRADE TO BECOME AN INVESTIGATIVE TARGET. AT THE TIME OF THE COMMENCEMENT OF THE NJ PROCEEDING NONE OF THESE THINGS HAD OCCURRED. THE CITY OF MIAMI A NUMBER OF YEARS AGO WAS SIMILAR—BONDS WERE NOT THEN DEEMED TO BE AT RISK AT ALL DUE TO BOND INSURANCE BUT SEC STILL LAUNCHED AN INVESTIGATION.

C. ONCE THE SEC STARTS AN INVESTIGATION, THEY WILL LOOK AT EVERYTHING THEY CAN FIND—EVEN ITEMS WHICH WERE NOT PREPARED AS DISCLOSURE DOCUMENTS AND WHICH PEOPLE PROBABLY DIDN'T CONSIDER IN DILIGENCE OR PREPARATION OF OFFICIAL STATEMENT. IN THE CASE OF NJ, THIS INCLUDED A 2001 OFFICE OF LEGISLATIVE SERVICES ANALYSIS OF BILLS WHICH BECAME 2001 LEGISLATION AND A 2005 BENEFITS REVIEW TASK FORCE REPORT. (SEE PARAGRAPHS 21, 23 AND 24 OF ORDER.)

D. WHILE THE PAST HAS SHOWN A LOT OF UPS AND DOWNS WITH SEC FOCUS ON MUNICIPAL MARKET, THIS TIME WE MAY NOT BE ABLE TO EXPECT THE FOCUS ON MUNICIPAL MARKET TO GO AWAY. CREATION OF MUNICIPAL SECURITIES AND PUBLIC PENSIONS UNIT, STATEMENTS AND SPEECHES BY COMMISSIONERS AND STAFF AND ROADSHOW HEARINGS, COMBINED WITH THE INCREASING NUMBER OF MUNICIPAL ISSUERS EXPERIENCING CREDIT TROUBLES, POINT TO A HIGHER LEVEL OF SERIOUSNESS AND A HIGHER POSSIBILITY OF SEC ACTIONS.

IV. SEC WILL GO AFTER MAJOR ENTITIES – THIS IS THE FIRST CASE THAT INVOLVED A STATE.

- V. SEC WILL BRING A FORMAL CEASE AND DESIST ORDER PROCEEDING EVEN IF ALL THEY CAN ALLEGE IS NEGLIGENCE AND NOT INTENTIONAL WRONGDOING AND EVEN IF IT IS CLEAR THAT THE ALLEGED VIOLATIONS ARE IN THE PAST AND HAVE CEASED.
- A. THIS ORDER DOES NOT ALLEGE A SECTION 10b5 AND RULE 10b-5 VIOLATION WHICH REQUIRES A FINDING OF SCIENTER--MEANING INTENT OR RECKLESSNESS BY THE TARGET.
 - B. IT ALLEGES A SECTION 17(a) VIOLATION WHICH ONLY REQUIRES A FINDING OR ALLEGATION OF NEGLIGENCE.
 - C. THERE IS A PRIVATE RIGHT OF ACTION ASSOCIATED WITH SECTION 10(b) AND RULE 10b5 AND AN ALLEGATION OF SCIENTER—THIS MEANS AN INVESTOR CAN SUE YOU EVEN IF THE SEC DOES NOT INSTITUTE ACTION.
 - D. IF ONLY NEGLIGENCE CAN BE ALLEGED ONLY THE SEC CAN INSTITUTE PROCEEDING UNDER SECTION 17(a).
 - E. THE TIME PERIOD COVERED BY THE AUGUST 2010 SEC NJ ORDER IS AUGUST 2001 TO APRIL 2007.
- VI. SIMPLIFIED VERSION OF ALLEGATIONS AS SPECIFIED IN THE ORDER:
- A. “STATE DID NOT ADEQUATELY DISCLOSE THAT IT WAS UNDERFUNDING [TWO PENSION PLANS], WHY IT WAS UNDER FUNDING...,OR THE POTENTIAL EFFECTS OF THE UNDER-FUNDING.”
 - B. “...DISCLOSURE DOCUMENTS FAILED TO PROVIDE ADEQUATE INFORMATION FOR INVESTORS TO EVALUATE THE STATE’S ABILITY TO FUND [THE TWO PLANS] OR THE IMPACT OF THE STATE’S PENSION OBLIGATIONS ON THE STATE’S FINANCIAL CONDITION.”
 - C. THESE ALLEGATIONS CAN EASILY BEN GENERALIZED TO COVER ENVIRONMENTAL DISCLOSURES OR OTHER AREAS.
- VII. ONE OF THE MESSAGES IN THE NJ ORDER WHICH POINTS TO ACTIONS WHICH CAN PROVIDE SOME PROTECTION AND RISK REDUCTION FOR YOU AND YOUR UTILITY RELATES TO THE SEC’S FOCUS ON DISCLOSURE PROCEDURES AND TRAINING. THE SEC SAID NJ DIDN’T HAVE PROCEDURES AND TRAINING IN PLACE TO PREVENT THE DEFICIENT DISCLOSURE THE SEC ALLEGED. THE SEC SAID STATE PENSION OFFICIALS DID THEIR UPDATING AS A “ROUTINE PROCESS” MERELY REQUIRING SUBSTITUTING NEW NUMBERS IN EXISTING DOCUMENTS AND THE NJ OFFICE OF PUBLIC FINANCE OFFICIALS

INSERTED NEW INFORMATION WITHOUT VERIFYING IT. FOR THOSE OF YOU WHO WORK DIRECTLY ON OFFICIAL STATEMENTS FOR BOND DEALS, THE SEC IS ALLEGING THAT THE NEW JERSEY OFFICIALS JUST MARKED UP THE DOCUMENT FROM A PRIOR DEAL WITHOUT THINKING. THE SEC WENT ON TO REFER TO SUBSEQUENTLY ADOPTED PROCEDURES AND TRAINING AS REMEDIAL ACTIONS WHICH AFFECTED THEIR ULTIMATE CONCLUSION. NOTE THAT THERE WERE NO FINES, NO PENALTIES, NO INDIVIDUAL SANCTIONS AND NO ONGOING OVERSIGHT—ALTHOUGH THE ENTIRE PROCEDURE IS NOT ONE NEW JERSEY WOULD EVER WANT TO REPEAT. TECHNICALLY THE SEC DIDN'T EVEN MANDATE THAT NJ CONTINUE THE REMEDIAL ACTIONS INSTITUTED BY THE STATE WHICH THE SEC REFERRED TO AND GAVE WEIGHT TO IN ITS ORDER. THE STATE WAS MERELY TOLD NOT TO VIOLATE SECTION 17(a) ANY MORE. ***THE FIRST RISK MITIGATION PROCEDURE FOR YOU IS TO HAVE PRACTICES AND PROCEDURES IN PLACE CONSISTENT WITH THE NATURE, SIZE AND COMPLEXITY OF YOUR ENTITY AND THAT YOU SHOULD BE CONDUCTING OR PARTICIPATING IN APPROPRIATE TRAINING.***

- VIII. ONE OF THE THINGS THE SEC IS ALSO SAYING DIRECTLY FOR PENSION INFORMATION (AND IMPLICITLY FOR OTHER INFORMATION) IS THAT YOU NEED TO FOCUS ON THE SIGNIFICANCE OF THINGS DISCLOSED AND THE ULTIMATE IMPACT ON THE FINANCIAL CONDITION OF YOUR UTILITY CURRENTLY AND IN THE FUTURE. PART OF THAT MESSAGE IS STANDARD AND NOTHING NEW, AND PART OF IT APPEARS TO BE AN INDICATION THAT THE SEC WANTS DISCLOSURE DOCUMENTS TO CONNECT THE DOTS BOTH HISTORICALLY AND POSSIBLY INTO THE FUTURE ON A MUCH MORE DETAILED AND DIRECT LEVEL. THE NJ ORDER ALLEGED THAT THERE WERE INADEQUACIES IN NJ'S EXPLANATION OF HOW THE STATE'S FUNDING OF THE PENSION PLANS ULTIMATELY IMPACTED OR WAS IMPACTED BY THE STATE'S BROADER FINANCIAL CONDITION. ***THE SECOND RISK MITIGATION GUIDELINE FOR YOU IS TO KEEP THIS CONCEPT IN MIND IN PREPARING YOUR DISCLOSURE DOCUMENTS AND MAKE SURE THE IMPLICATIONS OF WHAT YOU ARE DISCLOSING ARE MADE CLEAR – SOMETIMES A VERY DIFFICULT TASK.***
- IX. ANOTHER THING THAT THE SEC IS ALSO SAYING DIRECTLY FOR PENSION INFORMATION AND IMPLICITLY FOR OTHER INFORMATION IS THAT DISCLOSURE DOCUMENTS NEED TO EXPLAIN THE POTENTIAL IMPACTS OF CERTAIN EVENTS AND ACTIONS. IN THE CASE OF THE PENSIONS THE SEC FELT THAT NJ SHOULD HAVE EXPLAINED THE POTENTIAL IMPACTS OF 2001 LEGISLATION WHICH ENHANCED BENEFITS, RETROACTIVELY REVALUED PENSION PLAN ASSETS AND DEPARTED FROM PRIOR PRACTICES OF SMOOTHING INVESTMENT

GAINS AND LOSSES OVER FIVE YEARS. IN REACHING THE CONCLUSIONS REGARDING THE STATE THAT IT DID, ONE MAY ASK WHETHER THE SEC IS RAISING THE STANDARD FOR YOU BY CHARGING ISSUERS AND THEIR STAFF WITH THE RESPONSIBILITY TO DISCLOSE UNLIKELY OR UNKNOWN IMPACTS THAT ONLY MATERIALIZE WITH FUTURE DEVELOPMENTS WHETHER DEALING WITH PENSION OBLIGATIONS OR A HOST OF OTHER DISCLOSURE ITEMS INCLUDING THE ENVIRONMENTAL ISSUES BOB WILL BE DISCUSSING NEXT. THIS WOULD BECOME PARTICULARLY PROBLEMATIC WHEN THE CONSEQUENCES OF AN EVENT OR A DEVELOPMENT ARE WIDE RANGING AND BECOME APPARENT ONLY WITH TIME. WITH NJ, FEW PEOPLE COULD HAVE ENVISIONED THE COMBINATION OF SCENARIOS THAT WOULD NEED TO OCCUR FOR THE STATE'S PENSION PLANS TO BE IN THE CONDITION THEY WERE AT THE TIME OF THE ORDER. YET, IN A SENSE, THE SEC HOLDS NJ RESPONSIBLE FOR UNDERSTANDING AND DISCLOSING THOSE CONSEQUENCES. ***THERE IS NO EASY GUIDELINE FOR RISK MITIGATION IN THIS SITUATION, ALL YOU CAN DO IS TRY TO ANALYZE REASONABLY LIKELY POSSIBILITIES AND CONSIDER DISCLOSING THE RISKS INVOLVED IF THEY OCCUR.***

- X. LOOKING AT THE NJ ORDER IN THE CONTEXT OF OTHER SEC STATEMENTS ABOUT PENSIONS, IT ALSO APPEARS THAT THE SEC MAY BE PUSHING ISSUERS, IN CONTEXTS INCLUDING PENSION DISCLOSURE AND OTHER ITEMS, TO UNDERTAKE AND DISCLOSE MORE SENSITIVITY ANALYSES IN DISCUSSING THE POTENTIAL IMPACT OF CERTAIN ACTIONS AND EVENTS. IT MAY BE DIFFICULT TO DETERMINE OTHER THAN IN RETROSPECT WHAT SENSITIVITY ANALYSES TO CONDUCT—AN EVEN MORE DIFFICULT TO DECIDE WHICH ONES TO DISCLOSE. HERE WHAT YOU CAN DO TO REDUCE RISK WILL BE AFFECTED BY WHETHER YOUR PENSION IS YOUR UTILITY'S PLAN OR PART OF A BIGGER CITY-WIDE OR OTHER SYSTEM. ***TO REDUCE RISK, SOME MEMBER OF YOUR DISCLOSURE TEAM SHOULD AT LEAST READ THE FINANCIAL STATEMENTS AND ACTUARIAL REPORTS FOR THE PLAN AND IF POSSIBLE TALK TO AND QUESTION THE ACTUARIES.***

- XI. FINALLY, FOCUSING ON THE ISSUE OF PENSION OBLIGATION DISCLOSURE AND TRYING TO PROVIDE SOME GENERAL GUIDANCE ON THINGS YOU SHOULD CONSIDER, I CAN BRIEFLY DESCRIBE SOME OF THE TYPES OF QUESTIONS YOU NEED TO CONSIDER IN DEVELOPING YOUR PENSION DISCLOSURES. THIS LIST IS NOT INTENDED TO BE A CHECKLIST THAT IF YOU FOLLOW YOU HAVE DONE ALL THAT YOU SHOULD AND IT SHOULDN'T BE VIEWED AS SUCH, BUT AT LEAST IT CAN GIVE YOU A PLACE TO START.

- A. WHAT TYPE OF PENSION PLAN DOES YOUR UTILITY HAVE—DEFINED BENEFIT PLAN OR DEFINED CONTRIBUTION PLAN? A LOT OF QUESTIONS GO AWAY WITH A DEFINED CONTRIBUTION PLAN; FOCUS BECOMES COMMITMENTS TO INCREASED CONTRIBUTIONS.
- B. IF IT IS A DEFINED BENEFIT PLAN, IS IT CONTROLLED BY YOUR UTILITY OR SOME SORT OF MULTI-EMPLOYER PLAN CONTROLLED BY SOMEONE ELSE? IF SO, SOME QUESTIONS ABOUT MAKING REQUIRED CONTRIBUTIONS GO AWAY, BUT YOU STILL NEED TO BE CONCERNED ABOUT INDICATIONS OF SIGNIFICANTLY INCREASING COSTS. ON THE FLIP SIDE, AS APPARENTLY HAS BEEN THE CASE FOR LOCAL GOVERNMENTAL BODIES IN CALIFORNIA PARTICIPATING IN A STATE-WIDE PLAN, YOU MAY FIND YOURSELF UNABLE TO OBTAIN NEEDED INFORMATION ON A TIMELY BASIS.
- C. DOES THE DISCLOSURE INCLUDE ALL HISTORICAL FINANCIAL INFORMATION ABOUT THE PENSION FUNDING? NJ EXCLUDED A TABLE CALLED “REQUIRED SUPPLEMENTARY INFORMATION SCHEDULE OF FUNDING PROGRESS” WHICH WAS PART OF ITS ANNUAL FINANCIAL STATEMENTS. IN PART BECAUSE OF THE SIZE OF THE FINANCIALS, THEY WERE INCLUDING IT IN THE PRINTED DOCUMENT.
- D. WHAT INFORMATION DOES YOUR UTILITY HAVE ABOUT THE FUTURE TREND OF YOUR CONTRIBUTIONS AND HOW FIRM AND CURRENT IS SUCH INFORMATION?
- E. IS YOUR UTILITY MAKING THE ACTUARIALLY RECOMMENDED CONTRIBUTIONS? IF NOT, BY HOW MUCH HAS IT BEEN MISSING AND FOR HOW LONG AND, MOST IMPORTANTLY, WHY?
- F. HOW AGGRESSIVE ARE THE PENSION PLAN’S ASSUMPTIONS AND METHODOLOGIES?
 - i. UAAL (UNFUNDED ACTUARIAL ACCRUED LIABILITY) AMORTIZATION METHOD
 - ii. ASSUMED INVESTMENT RETURN—IS IT REALISTIC IN CURRENT MARKETS? I WOULD SUSPECT WE WILL SEE A LOT A MOVEMENT DOWNWARD IN ASSUMED INVESTMENT RETURNS UNLESS SET BY STATUTE.
 - iii. BY WAY OF EXAMPLE, THE CITY OF SAN DIEGO ENTERED INTO AN AGREEMENT WITH ITS PENSION PLAN THAT FROZE THE DEMOGRAPHIC AND ECONOMIC ASSUMPTIONS SHORTLY BEFORE MAJOR DEMOGRAPHIC CHANGES OCCURRED WITHIN THE PENSION PLAN AS A RESULT OF BENEFIT INCREASES.
- G. HAS THE PENSION PLAN BEEN CONSISTENT IN ITS METHODOLOGIES?

- i. DOES THE PENSION PLAN SUSPEND SMOOTHING OF GAINS WHEN THE MARKET IS UP AND RESUME IT WHEN THE MARKET IS DOWN?
 - ii. DOES THE PENSION PLAN FREQUENTLY CHANGE ITS UAAL AMORTIZATION METHOD?
 - H. IS THERE EVIDENCE OF INCREASING OR DECREASING CONTRIBUTIONS?
 - i. IS THE FUNDED RATIO OF THE PENSION PLAN LOW AND BECOMING LOWER? SEC ORDER: "THE TREND IN THE FUNDED RATIO PROVIDES INFORMATION AS TO WHETHER THE FINANCIAL STRENGTH OF A PENSION PLAN IS IMPROVING OR DETERIORATING OVER TIME." FUNDED RATIOS SHOULD BE EVALUATED USING BOTH ACTUARIAL VALUE AND MARKET VALUE.
 - ii. WHAT IS THE NET UNSMOOTHED LOSS OR GAIN OF THE PENSION PLAN?
 - iii. HAVE THERE BEEN MAJOR INVESTMENT LOSSES?
 - iv. HAS THERE RECENTLY BEEN AN EXPERIENCE STUDY THAT INDICATES MATERIAL DEMOGRAPHIC OR ECONOMIC ASSUMPTION CHANGES WILL BE COMING?
 - v. HAVE THERE BEEN RECENT INCREASES IN THE LEVEL OF BENEFITS PROVIDED?
 - I. WHAT IS THE BUDGETARY IMPACT OF PENSION PLAN CONTRIBUTIONS AND WHAT IS THE IMPACT ON PENSION CONTRIBUTIONS OF BUDGETARY STRESSES?
 - i. IS YOUR UTILITY'S BUDGET OR LEVEL OF RATES UNDERGOING STRESS AS A RESULT OF PENSION PLAN CONTRIBUTIONS? WHAT SHARE OF YOUR EXPENSE BUDGET DOES THE ACTUARIALLY REQUIRED CONTRIBUTION REPRESENT? IF SMALL, FEW CONCERNS. IF LARGE OR GROWING, MORE OF AN ISSUE.
 - ii. HOW WILL THE BUDGETARY SITUATION CHANGE IF KNOWN TRENDS OF INCREASED ACTUARIALLY REQUIRED PENSION PLAN CONTRIBUTIONS OCCUR?
 - iii. HOW PRECARIOUS IS THE CURRENT SITUATION OF THE BUDGET AND HOW WELL WOULD IT ABSORB ANY TRENDS OF INCREASED PENSION PLAN CONTRIBUTIONS? HOW EASILY AND EFFECTIVELY (IN PRACTICE AND NOT JUST BASED ON LEGAL POWERS) COULD YOU RAISE RATES TO COVER INCREASED CONTRIBUTIONS?

iv. ARE OTHER BUDGETARY STRESSES AND THE NEED TO HOLD DOWN RATES CAUSING PRESSURE ON PENSION CONTRIBUTIONS?

J. FINALLY, ASK THOSE WHO KNOW ABOUT PENSION PLANS AN OPEN-ENDED QUESTION—IS THERE ANYTHING ELSE WE SHOULD KNOW? REMEMBER, THEY ARE THE EXPERTS NOT YOU.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9135 / August 18, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14009

In the Matter of

STATE OF NEW JERSEY,

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 8A OF THE SECURITIES ACT
OF 1933, MAKING FINDINGS, AND
IMPOSING A CEASE-AND-DESIST
ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), against the State of New Jersey (the “State,” “New Jersey” or “Respondent”).

II.

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

III.

On the basis of this Order and the State’s Offer, the Commission finds that:

Summary

1. This matter involves New Jersey’s violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act in connection with the offer and sale of over \$26 billion in municipal bonds from August 2001 through April 2007. In 79 municipal bond offerings, the State misrepresented and failed to disclose material information regarding its under funding of New Jersey’s two largest

pension plans, the Teachers' Pension and Annuity Fund ("TPAF") and the Public Employees' Retirement System ("PERS"). More specifically, the State did not adequately disclose that it was under funding TPAF and PERS, why it was under funding TPAF and PERS, or the potential effects of the under funding.

2. In disclosure documents prepared in connection with each of the bond offerings, including preliminary official statements, official statements,¹ and Treasurer's Annual Reports² (collectively, "disclosure documents" or "bond offering documents"), the State made material misrepresentations and omissions regarding: (1) legislation adopted in 2001 (the "2001 legislation") which increased retirement benefits for employees and retirees enrolled in TPAF and PERS; (2) special Benefit Enhancement Funds ("BEFs") created by the 2001 legislation initially intended to fund the costs associated with the increased benefits; (3) the State's use of the BEFs as part of a five-year "phase-in plan" to begin making contributions to TPAF and PERS; and (4) the State's alteration and eventual abandonment of the five-year phase-in plan. These misrepresentations and omissions created the fiscal illusion that TPAF and PERS were being adequately funded and masked the fact that New Jersey was unable to make contributions to TPAF and PERS without raising taxes or cutting other services, or otherwise impacting the budget. Accordingly, disclosure documents failed to provide adequate information for investors to evaluate the State's ability to fund TPAF and PERS or the impact of the State's pension obligations on the State's financial condition.

Respondents and Related Entities

3. New Jersey possesses all powers, functions, rights, privileges and immunities authorized by the New Jersey Constitution and the State's laws, including the power to issue debt. The State has approximately 8.7 million residents, and is the second wealthiest State based on per capita personal income.

4. Teachers' Pension and Annuity Fund is a defined benefit plan³ operated by the

¹ An official statement is a document prepared by an issuer of municipal bonds that discloses material information regarding the issuer and the particular offering. A preliminary official statement is a preliminary version of the official statement which is used to describe the proposed new issue of municipal securities prior to the determination of the interest rate(s) and offering price(s). The preliminary official statement may be used to gauge interest in an issue and is often relied upon by potential purchasers in making their investment decisions.

² Treasurer's Annual Reports are continuing disclosures filed by the State with the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system ("EMMA") under Rule 15c2-12 of the Securities Exchange Act of 1934 ("Exchange Act").

³ A defined benefit plan is a pension plan that specifies the amount of pension benefits to be provided at a future date based on various factors, including age, years of service, and compensation.

State to provide retirement, death, and disability benefits to its members.⁴ TPAF is the State's largest pension plan, and, as of June 30, 2009, had an actuarial value of assets of more than \$34 billion. As of June 30, 2009, TPAF had an active membership of 157,109 as well as 78,782 retirees and beneficiaries receiving annual pensions totaling more than \$2.8 billion.

5. Public Employees' Retirement System is a defined benefit plan operated by the State to provide retirement, death, and disability benefits to its members. PERS is the State's second largest pension plan, and, as of July 1, 2009, had an actuarial value of assets of more than \$28 billion. In addition to the State, local governments within New Jersey participate as employers. As of July 1, 2009, the State portion of PERS had assets of more than \$10 billion. As of July 1, 2009, PERS had an active membership of 316,849⁵ as well as 136,957 retirees and beneficiaries⁶ receiving annual pensions totaling more than \$2.2 billion.

State Law Requires Certain Annual Calculations and Measures of New Jersey's Pension Plans

6. State law regulates the administration of New Jersey's pension plans. The Division of Pensions and Benefits ("DPB"), a division of New Jersey's Department of the Treasury ("Treasury"), administers all aspects of TPAF and PERS, except the investment of pension plan assets. Plan assets consist of contributions by employers, including the State, contributions by TPAF's and PERS' members, and investment returns. Liabilities of the plans consist of pension benefits owed to current and retired TPAF and PERS members based on past years of service and the plans' administrative expenses.

7. State law requires that TPAF and PERS engage actuaries to conduct actuarial valuations at the end of each fiscal year – June 30. These valuations include calculating the "annual required contribution" and the "statutory contribution." While the annual required contribution is governed by industry standards,⁷ the statutory contribution is calculated in accordance with State law. According to State law and as disclosed in bond offering documents, employers are required to contribute to TPAF and PERS at an actuarially determined rate.

8. In addition to calculating both the annual required contribution and the statutory contribution, an actuarial valuation also calculates the actuarial accrued liability and the actuarial

⁴ Plan members include employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits.

⁵ This includes 93,283 State employees and 223,566 employees from local employers.

⁶ This includes 43,764 State employees and 93,193 employees from local employers.

⁷ The annual required contribution is calculated in accordance with Statements 25 and 27 of the Governmental Accounting Standards Board ("GASB").

value of assets of each of the pension plans.⁸ The actuarial accrued liability estimates on the basis of demographic and economic assumptions the present value of pension benefits TPAF and PERS owe to their active and retired members based on past years of service. The actuarial value of assets is the value of cash, investments, and other property belonging to a pension plan using a five-year smoothing method that smoothes the difference between the market value of assets and the actuarial value of assets over a five-year period to prevent short-term fluctuations that may result from economic and market conditions. For each year, this method recognizes 20 percent of the investment gains or losses for the prior five years.

9. The actuarial valuations compare the actuarial accrued liability with the actuarial value of assets for TPAF and PERS and any excess of that liability over the assets forms an unfunded actuarial accrued liability (“UAAL”). The UAAL is the State’s unfunded obligation to TPAF’s and PERS’ members for past service. The actuarial valuations also express the percentages that the plans are funded through a “funded ratio” which represents the quotient obtained by dividing the actuarial value of assets of TPAF and PERS by the actuarial accrued liability of each plan. The trend in the funded ratio provides information as to whether the financial strength of a pension plan is improving or deteriorating over time. The financial strength of a pension plan is generally improving if the funded ratio is increasing. During the relevant time period, New Jersey’s funded ratio decreased significantly. As of June 30, 2001, TPAF had a funded ratio of 108 percent and the State portion of PERS had a funded ratio of 112.5 percent. As of June 30, 2009, TPAF had a funded ratio of 63.8 percent and an unfunded actuarial accrued liability of \$18.7 billion, and the State portion of PERS had a funded ratio of 56.4 percent and an unfunded actuarial accrued liability of \$8.2 billion.⁹

10. The statutory contribution for TPAF and PERS consists of two main components: (1) the normal cost, which represents the portion of the present value of pension benefits that are allocated to active members’ current year of service, and (2) an amortized portion of the UAAL. TPAF and PERS use a statutorily set closed 30-year amortization period¹⁰ for calculating the amount of the UAAL that is included in the statutory contribution.¹¹

⁸ The actuarial valuations calculate the actuarial accrued liability and actuarial value of assets in accordance with New Jersey statutes and Statements 25 and 27 of GASB.

⁹ Although contributions by State and local governments to PERS are invested together, PERS segregates the actuarial accrued liabilities between the State and local governments.

¹⁰ As of the June 30, 2006 actuarial valuations, the State used an open 30-year amortization period.

¹¹ The State’s amortization method amortizes the UAAL over a 30-year period as a level percentage of the projected payroll or “level percent of pay.” Under this method, the UAAL amortization payments are calculated so that they are a constant percentage of the projected payroll of active members over the 30-year period. Because the actuarial valuations assume a payroll growth rate of 4 percent each year, the amortization payments increase over time.

11. Although bond offering documents disclosed that the State was required to contribute to TPAF and PERS at an actuarially determined rate and discussed the budget process generally, bond offering documents did not adequately disclose that the amount actually contributed to the pension plans is subject to the Governor's budget request and annual appropriations by the State legislature. Each year, the Governor, based on recommendations received from Treasury, presents a budget request to the legislature, which may include a request for the State's pension contribution. Once the legislature adopts the budget, it is signed into law as the Appropriations Act for the coming fiscal year. In adopting the budget, the legislature is not required to follow the recommendations of the actuaries or the Governor in determining the State's contribution to the pension plans. The appropriations for the State contribution to the pension plans are credited to "Contingent Reserve Funds," existing funds within TPAF and PERS.

12. State law requires members of TPAF and PERS to contribute annually to the pension plans. Member contributions are based on a percentage of compensation. The State legislature must approve any changes to employer or member contributions. State law also provides that any changes in the pension benefits for TPAF's and PERS' members or any changes in the funding methods of the plans must be approved by the State legislature. In addition, each pension related bill submitted to the State legislature must be accompanied by a fiscal note stating the cost of the proposal.

New Jersey Has Access to the National Public Markets through Municipal Bond Offerings

13. From August 2001 through April 2007, New Jersey issued over \$26 billion in municipal bonds in approximately 79 offerings. The State's preliminary official statements and official statements contained an appendix with several subsections, three of which provided information relating to the State's funding of TPAF and PERS (the "State Appendix"). Appendix I provided financial and other information relating to the State, including a section titled "Financing Pensions." The Financing Pensions section provided a description of the State's pension plans, a description of pension related legislation, a summary of the State's contributions to its pension plans for the current and upcoming fiscal years, and a table setting forth the actuarial accrued liability and the actuarial value of assets from the most recent actuarial valuations for each of the State's pension plans. Appendix I-A, which was an excerpt from the State's most recent Comprehensive Annual Financial Report ("CAFR"),¹² contained a footnote to the financial statements titled "Retirement Systems" that provided general information regarding the State's pension plans, including significant legislation and contribution requirements, as well as a table setting forth statistical information relating to the pension plans. Appendix I-D, an unaudited appendix found in the back of the State's disclosure documents, contained statistical tables for each of the State's three largest pension plans, including TPAF and PERS, that provided the actuarial value of assets and accrued liabilities, and the funded ratio for the previous six years.

14. Various divisions and offices within Treasury were responsible for the pension funding disclosures in the State Appendix. The updating of the pension funding sections generally

¹² The State's CAFR included audited financial statements prepared pursuant to standards established by GASB.

occurred three times a year – following the issuance of the Governor’s budget message, after the passage of the Appropriations Act, and following the issuance of the actuarial valuations. At these times, various divisions and offices within Treasury updated their sections of the State Appendix. They viewed the updating of the pension funding sections as a routine process, requiring the insertion of new numbers or facts into an existing document. The DPB updated the pension disclosures at the request of the Office of Public Finance (“OPF”), another office of the Treasury. The OPF inserted the new information into the State Appendix without verifying the information. The Office of Management and Budget (“OMB”) included in the State’s CAFR the pension fund related excerpts which were also found in the State Appendix.

15. Prior to the release of an official statement, the State Treasurer, or his designee, signed a Rule 10b-5 certification, certifying that the official statement did not contain any material misrepresentations or omissions. During the relevant time period, the Treasurers did not read official statements, and relied on their staff to ensure the accuracy of information contained in the documents.

16. Treasury had no written policies or procedures relating to the review or update of the bond offering documents. In addition, Treasury did not provide training to its employees concerning the State’s disclosure obligations under the accounting standards or the federal securities laws. Accordingly, the State’s procedures were inadequate for ensuring that material information concerning TPAF and PERS or the State’s financing of TPAF and PERS was disclosed and accurate in bond offering documents.

New Jersey Did Not Adequately Disclose the Creation of the BEFs

17. On June 29, 2001, the State legislature approved legislation (P.L. 2001, c. 133) that, effective November 1, 2001, increased retirement benefits for employees and retirees enrolled in TPAF and PERS by 9.09 percent. In order to fund the enhanced benefits, without increased costs to the State or taxpayers, the legislation revalued TPAF and PERS assets to reflect their full market value as of June 30, 1999, near the height of the bull market.¹³ Bond offering documents did not disclose the retroactive mark-to-market revaluation of the pension assets under the 2001 legislation until March 2003 or the reason for the reevaluation. More specifically, bond offering documents did not disclose that the State used the market value as of June 30, 1999 in order to make it appear that the State could afford the benefit improvements.

18. The legislation contemplated that the increased assets resulting from the retroactive mark-to-market revaluation would be used to offset the additional liabilities created by the increased benefits. The additional liabilities included the accrued liability resulting from providing the increased benefits to existing members and retirees as well as the normal cost to ensure that the future liability for the benefit enhancement was funded.

¹³ In the actuarial valuations as of June 30, 1999 for TPAF and PERS, the actuarial value of assets was replaced with the market value of assets. Subsequent actuarial valuations, including actuarial valuations as of June 30, 2000 and June 30, 2001, applied the five-year smoothing method.

19. The legislation created “benefit enhancement funds” or BEFs in TPAF and PERS to set aside a portion of the increased assets or “excess valuation assets”¹⁴ to pay the future annual normal cost associated with the enhanced benefits. After the increased assets were used to fund the accrued liability, a portion of the remaining excess valuation assets were placed in the BEFs to cover the future costs associated with the enhanced benefits. Bond offering documents did not disclose the creation of the BEFs until March 2003.

20. The BEFs were special accounts within TPAF and PERS. Each of the BEFs was credited with excess valuation assets, from the Contingent Reserve Funds, which are existing funds within TPAF and PERS used to hold employer contributions, which excess valuation assets resulted from the revaluation in 2001.

21. On July 11 and 13, 2001, approximately two weeks after the passage of the 2001 legislation, the Office of Legislative Services (“OLS”)¹⁵ issued fiscal notes analyzing the impact of the Assembly and Senate bills which had been adopted as the 2001 legislation. The fiscal notes acknowledged that valuing the pension assets as of June 30, 1999 did not reflect recent market losses in TPAF and PERS. The fiscal notes further acknowledged that, had the 2001 legislation revalued the pension assets as of April 30, 2001 rather than June 30, 1999, the remaining balance of excess assets in TPAF and PERS would have been \$2.4 billion less. Bond offering documents did not disclose the \$2.4 billion decline in the market value of the pension assets used to create the BEFs.

22. Bond offering documents did not disclose the reason for and impact of the retroactive mark-to-market revaluation of the pension assets. By revaluing TPAF and PERS assets and creating the BEFs to fund the ongoing costs of the benefit enhancements, the State gave the false appearance that it could afford the increased benefits. The revaluation of the pension assets to reflect their full market value as of June 30, 1999 resulted in a significant difference between the actuarial value and market value of assets in TPAF and PERS. Because the State’s contributions to TPAF and PERS are based on the actuarial value of assets, the revaluation created the false appearance that the plans were “fully funded” and allowed the State to justify not making contributions to the pension plans despite the fact that the market values of the plans’ assets were rapidly declining.

23. On May 25, 2005, the State’s Acting Governor created the Benefits Review Task Force to examine and make recommendations regarding employee benefits. On December 1, 2005, the New Jersey Benefits Review Task Force issued its final report (the “Benefits Review Task Force Report”) which offered strong criticism of the State’s pension funding practices. In particular, the report recommended that the State stop using actuarial and valuation “gimmicks,” like the State’s alteration of the valuation method in the 2001 legislation. The report advised that

¹⁴ Excess valuation assets is a term defined by New Jersey statute (P.L. 1997, c. 115), which refers to the difference between the valuation assets and the actuarial accrued liability, and other enumerated deductions.

¹⁵ OLS is a nonpartisan agency of the State legislature that provides support services to the legislature and its members.

“[m]ethodologies for determining pension fund values and contribution requirements should not again be changed in order to mask the true cost of benefit enhancements.” The Benefits Review Task Force Report also concluded that the State must regularly contribute to its pension plans and end its use of “pension holidays” – not contributing to its pension plans.

24. The Benefits Review Task Force Report was publicly available and published on the Benefit Review Task Force’s website. New Jersey, however, did not disclose the existence of, or the findings from, the Benefits Review Task Force Report in its bond offering documents.

New Jersey Faced Financial Challenges Due, in Part, to Its Historical Failure to Contribute to TPAF and PERS

25. During fiscal year 2002, the State learned from the actuaries for TPAF and PERS that New Jersey would be required to begin contributing to the State’s pension plans in fiscal year 2004 based on the actuaries’ calculations.¹⁶ Between fiscal years 1997 and 2003, the State had made no or only minimal contributions to TPAF and PERS because based upon the actuarial value of assets, both plans were fully or over funded prior to fiscal year 2003. From 1997 through 2003, the State did not contribute approximately \$916.4 million and \$487.4 million to TPAF and PERS, respectively. During this period and continuing through 2006, in the context of the State’s budgetary process, the State viewed monies not contributed to pension funds as “savings” in that any monies not contributed could be used for other budgetary purposes.

26. Beginning in fiscal year 2003, TPAF and PERS experienced a significant increase in each plan’s UAAL and a decrease in the funded ratios. TPAF and the State portion of PERS went from being over funded to having UAALs of \$2.7 billion and \$1.1 billion, respectively. TPAF’s funded ratio decreased from 103.9 percent in fiscal year 1997 to 92.7 percent in fiscal year 2003. The funded ratio for the State portion of PERS decreased from 105.8 percent in fiscal year 1997 to 90.7 in fiscal year 2003. The significant change in the financial health of TPAF and PERS was due to a variety of factors, including, the State’s failure to contribute to the plans since 1997, market declines, and the enactment of various benefit enhancements, including the 2001 legislation.

27. After a seven-year pension holiday, during which virtually no monies were appropriated in the State’s budget for pensions, the State recognized that it would have to begin contributing to TPAF and PERS. The State, however, now faced significant budget pressures which made it difficult for New Jersey to fund its pension plans absent cutting other programs and services, or raising taxes. Following Treasury’s recommendation, the Governor requested and the legislature provided in the annual Appropriations Act that the BEFs be used in lieu of the State contributing to TPAF and PERS.

¹⁶ Actuarial valuations of TPAF and PERS are completed approximately 6 to 8 months after the end of a fiscal year. Because of the delay, the statutory contribution calculated by the actuaries applies not to the fiscal year immediately following the fiscal year covered by the actuarial valuations, but to the second fiscal year. For example, the statutory contribution in the actuarial valuations as of June 30, 2003 applied to the fiscal year ended June 30, 2005.

**New Jersey Continued to Forego Making Contributions to
Its Pension Plans Through the Use of the BEFs and the Five-Year Phase-In Plan**

28. In 2003, while preparing the 2004 fiscal year budget, the State, faced with increased UAALs and declining funded ratios, had to choose between making contributions to the pension plans, or raising taxes or reducing spending in other areas. Accordingly, Treasury recommended, and the State announced, a five-year phase-in plan, in conjunction with using the BEFs, designed to gradually put New Jersey on track to making the State's full statutory contributions to its pension plans. Under the initial five-year phase-in plan, the State would contribute, subject to Constitutional provisions restricting each legislature's ability to mandate spending by future legislatures, 20 percent of the required statutory contribution to its pension plans in fiscal year 2004, 40 percent in fiscal year 2005, 60 percent in fiscal year 2006, 80 percent in fiscal year 2007, and 100 percent in fiscal year 2008. Beginning with fiscal year 2008, the State would be making the full statutory contribution to its pension plans.

29. Disclosures in bond offering documents regarding the State's five-year phase-in plan and use of the BEFs likely falsely led investors to believe that: (1) the State would be contributing to TPAF and PERS in fiscal years 2004, 2005, and 2006; (2) the State had a plan for making its full statutory contributions; and (3) the State would begin making full statutory contributions in fiscal year 2008.

30. Rather than making phase-in contributions to the pension plans, beginning in fiscal year 2004, the State began using the BEFs in conjunction with the five-year phase-in plan. The State continued to use the BEFs as part of the phase-in plan in fiscal years 2005 and 2006. As a result, the State did not contribute any monies to TPAF and PERS in fiscal years 2004 and 2005. In fiscal year 2006, the State did not contribute to PERS, but did contribute a minimal amount to TPAF to cover the portion of the State's contribution not covered by the BEF.

31. Bond offering documents did not disclose that the State was not contributing to TPAF and PERS during this time. When assets from the BEFs were used to fund the State's pension contributions in fiscal years 2004, 2005, and 2006, funds were transferred from the BEFs back to the Contingent Reserve Funds, the original source of the assets in the BEFs. These inter-fund transfers created the false appearance that the State was making contributions to TPAF and PERS, when no actual contributions were being made. Bond offering documents did not disclose that the BEFs allowed the State to forego making contributions to TPAF and PERS. Rather, disclosures in bond offering documents created the false impression that the BEFs were being used to make New Jersey's pension contributions even though no incremental funds were being received by TPAF and PERS. Disclosure documents misleadingly referred to the BEFs as "reserves" that were being utilized to fund the State's contributions to TPAF and PERS which created the misleading impression that the State was making cash contributions to its pension plans.

32. Although bond offering documents referenced the BEFs in connection with the State's contributions, they never disclosed what they were, how they were being used, or why they

were being used. Bond offering documents did not disclose that the State was using the BEFs in conjunction with a five-year phase-in plan because of significant budgetary constraints, and was unable to contribute to TPAF and PERS. In addition, bond offering documents did not disclose the impact of using the BEFs as part of the five-year phase-in plan. The State recognized that delaying the resumption of the State's contributions could result in substantially increasing the pension plans' unfunded liabilities in the future. The State also recognized that by depleting the BEFs, the State would now be faced with paying the normal costs of the enhanced benefits granted by the 2001 legislation. More than \$704.2 million was used from the BEFs to fund the State's fiscal year 2004, 2005, and 2006 pension obligations, and thus this amount was no longer available to offset the future costs of the benefit enhancement legislation.

33. By the end of fiscal year 2006, the State had depleted the BEFs. Bond offering documents did not disclose that the State, during each budget cycle, intended to forego making contributions to TPAF and PERS until it had exhausted the BEFs. By disclosing that the State had adopted a five-year phase-in plan, the bond offering documents gave the impression that the State would be contributing its full statutory contributions to TPAF and PERS by fiscal year 2008.

New Jersey Altered and Then Abandoned the Five-Year Phase-In Plan Because of Financial Difficulties

34. Although New Jersey's bond offering documents referenced the five-year phase-in plan, the State treated the phase-in plan as a flexible plan that could be altered on a year-to-year basis depending on other budgetary demands. Because other budgetary priorities existed, the State's contributions to TPAF and PERS were reduced to 30 percent of the statutory contribution in fiscal year 2005 and 40 percent in fiscal year 2006. Bond offering documents did not disclose the changes to the phase-in plan or the reasons for the State's reduced contributions. These reduced contributions increased, in part, the UAALs for TPAF and the State portion of PERS by \$8.2 billion and \$3 billion, respectively.

35. Funding for TPAF and PERS was governed by the annual Appropriations Act. The Appropriations Act for fiscal years 2004, 2005, and 2006 also set forth the State's use of the BEFs. In fiscal year 2004, the Appropriations Act specified the amounts to be used from the BEFs in lieu of the State's contributions to TPAF and PERS. However, the Appropriations Act for fiscal years 2005 and 2006 did not identify the amounts to be used from the BEFs or the phase-in percentages. Rather, for those years, the Appropriations Act provided that the Treasurer would determine the amount to be used from the BEFs.

36. The language in the Appropriations Act for fiscal years 2005 and 2006 gave the Treasurer the flexibility to alter the amount of the BEFs to be used to cover the State's contributions to TPAF and PERS, up until the last day of the fiscal year when the contributions were due. In addition, this language gave the Treasurer the ability to alter the phase-in percentages under the phase-in plan. This was particularly important, since by adjusting the amount of the BEFs to be used in fiscal year 2005 and the phase-in percentage, the Treasurer was able to ensure that there were sufficient assets in the BEFs in fiscal year 2006 to cover all or almost all of the State's contributions to TPAF and PERS. In fiscal year 2005, the Treasurer exercised his authority

under the Appropriations Act by reducing the amount of the State's contributions to TPAF and PERS, and thus the phase-in percentage, following the enactment of the Appropriations Act. This change in the phase-in plan, however, was not disclosed in bond offering documents.

37. The State recognized that because of severe budgetary constraints, it would not be able to achieve full funding of its pension plans by fiscal year 2008 without cutting State services or finding other sources of revenue. In fact, the State only contributed 57.5 percent of the required statutory contribution to its pension plans in fiscal year 2007 and 50 percent in fiscal year 2008.

38. The State abandoned its five-year phase-in plan in approximately May 2006. Bond offering documents did not disclose that the State had abandoned the five-year phase-in plan. Rather, the State stopped using the term "five-year" when referring to the phase-in plan in disclosure documents. The State's continued use of the term "phase-in plan" gave the false impression that New Jersey still had a plan to achieve full statutory contributions. Moreover, bond offering documents did not disclose that New Jersey was unable to fully implement the five-year phase-in plan without causing New Jersey to suffer severe economic hardship.

New Jersey Failed to Provide Certain Present and Historical Financial Information Regarding Its Pension Funding

39. The State's bond offering documents contained inadequate information regarding the State's present and historical contributions to TPAF and PERS. Statistical tables for TPAF and PERS found in Appendix I-D set forth the amount of the State's contributions for the most recent fiscal year and the prior five fiscal years. This information, however, was misleading to investors because the amounts set forth included pension contributions, if any, as well as payments made by the State to members of TPAF and PERS for post-retirement medical benefits.¹⁷ This contribution information conflicted with other statistical information found in the Retirement Systems footnote of Appendix I-A, which showed the actual pension contributions made by the State, but did not include payments for post-retirement medical benefits, for the most recent fiscal year as well as the two prior fiscal years. In addition, the State's bond offering documents lacked sufficient information for investors to understand the State's historical failure – since 1997 – to contribute to TPAF and PERS.

40. Appendix I-A of the State's disclosure documents also excluded a key statistical table from the State's CAFR called the "Required Supplementary Information Schedule of Funding Progress" ("RSI Schedule"), which is defined by GASB. The RSI Schedule is designed to provide a long-term actuarial perspective on the State's funding of its pension plans. The RSI Schedule provided important financial information regarding TPAF and PERS for the three prior fiscal years, including the UAAL and the UAAL as a percentage of covered payroll.¹⁸ The ratio of

¹⁷ Under statutes for TPAF and PERS, the State's contributions for post-retirement medical benefits flowed through the pension plans.

¹⁸ Covered payroll includes all elements of compensation paid to active employees on which contributions to the pension plans are based.

UAAL to covered payroll is a measure of the significance of the UAAL relative to the capacity to pay it. The trend in the ratio provides information as to whether the financial strength of the pension plan is improving or deteriorating over time. The financial strength of a pension plan is generally improving if the ratio of UAAL to covered payroll is decreasing. In fact, from 2002 through 2007, the UAAL as a percentage of covered payroll steadily increased. The UAAL and the UAAL to covered payroll for TPAF and PERS is shown below.

TPAF

Fiscal Year	UAAL	UAAL as a Percentage of Covered Payroll
2002	\$(1,654,591)	0.0%
2003	\$2,731,906,950	35.5%
2004	\$5,813,899,790	72.2%
2005	\$9,178,537,424	108.6%
2006	\$11,008,573,863	125.8%
2007	\$12,446,668,618	137.1%

PERS (State Portion)

Fiscal Year	UAAL	UAAL as a Percentage of Covered Payroll
2002	\$(312,599,482)	(8.9)%
2003	\$1,112,345,981	31.1%
2004	\$1,926,870,843	51.4%
2005	\$2,801,180,057	69.5%
2006	\$4,129,039,284	97.1%
2007	\$5,004,619,993	112.8%

41. The bond offering documents failed to provide information regarding the actuarial methodology used by the State to calculate the actuarial value of assets, and the impact of using this methodology on the State's funding of its pension plans. The bond offering documents did not disclose the effect of the State's use of a five-year smoothing method to measure the actuarial value of assets. As a result of the 2001 legislation and market declines, the actuarial value of assets exceeded the market value of assets for TPAF and PERS, resulting in net unsmoothed losses in both plans beginning in fiscal year 2002. The ratio of the actuarial value of assets to market value of assets for TPAF and PERS is shown below.

Actuarial Value as a Percent of Market Value

Fiscal Year	TPAF	PERS
2002	129.5%	126.8%
2003	131.0%	127.7%
2004	121.0%	118.3%
2005	117.4%	113.9%
2006	112.8%	106.7%

2007	104.7%	101.9%
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Since the State's contributions to TPAF and PERS are based on the actuarial value of assets, the significant difference between the actuarial value of assets and the market value of assets reduced the State's statutory contributions to the pension plans.

42. The bond offering documents also failed to provide information regarding the actuarial methodology used by the State to calculate the actuarial accrued liabilities of TPAF and PERS, and the impact of using this methodology on the State's funding of its pension plans. The bond offering documents did not disclose the effect of the State's use of a closed 30-year amortization period¹⁹ based on a level percent of pay for measuring the actuarial accrued liability. Under this recognized actuarial method, the UAALs of TPAF and PERS will continue to rise indefinitely even if the State were to contribute the full statutory contribution to the pension plans. Under New Jersey statute, if the UAALs for TPAF and PERS increase from one year to the next, the actuarial valuations will continue to use the full 30-year amortization period. As a result, the State has been unable to and will continue to be unable to effectively amortize TPAF's and PERS' UAALs.

43. In addition, although available in actuarial reports for TPAF and PERS, the bond offering documents did not provide asset and funded ratio information on a market value basis. Because of the significant difference between the actuarial value and market value of assets in TPAF and PERS, the actuarial value did not accurately present the current value of the pension plans. Rather, the actuarial value of assets for TPAF and PERS provided a limited measure of the pension plans' financial health since they did not fully reflect the effects of the 2001 legislation or market declines. Investors lacked sufficient information to assess the current financial health of TPAF and PERS as a result of the absence of asset and funded ratio information on a market value basis. New Jersey's historical funded ratios using actuarial value of assets and market value of assets are shown below:

TPAF

Fiscal Year	Actuarial Value of Assets	Market Value of Assets	Funded Ratio (actuarial value)	Funded Ratio (market value)
2002	\$35,148,246,433	\$27,121,744,264	100.0%	77.2%
2003	\$34,651,825,932	\$26,447,330,285	92.7%	70.7%
2004	\$34,633,790,549	\$28,618,463,144	85.6%	70.8%
2005	\$34,789,389,875	\$29,610,249,605	79.1%	69.0%
2006	\$35,531,294,790	\$31,495,000,296	76.4%	69.3%
2007	\$36,714,578,745	\$35,070,757,170	74.7%	72.9%

¹⁹ As of the June 30, 2006 actuarial valuations, the State used an open 30-year amortization period.

PERS (State Portion)

Fiscal Year	Actuarial Value of Assets	Market Value of Assets	Funded Ratio (actuarial value)	Funded Ratio (market value)
2002	\$11,073,156,965	\$8,727,927,022	102.9%	81.1%
2003	\$10,829,953,189	\$8,479,326,527	90.7%	71.0%
2004	\$10,693,508,592	\$9,038,299,523	84.7%	71.6%
2005	\$10,631,348,826	\$9,325,929,009	79.1%	69.4%
2006	\$10,668,645,162	\$9,996,185,459	72.1%	67.6%
2007	\$11,024,255,608	\$10,817,111,560	68.8%	67.5%

New Jersey Enhances Its Pension Funding Disclosures

44. Subsequent to an April 2007 news article that raised questions regarding disclosures in the State's bond offering documents relating to New Jersey's funding of its pensions, the State hired disclosure counsel to advise the State on an on-going basis regarding its disclosure obligations under the federal securities laws. During 2007 and early 2008, the State, with the assistance of disclosure counsel, reviewed its bond offering documents and enhanced its disclosures.

45. With the assistance of disclosure counsel, the State has reviewed, evaluated, and enhanced its disclosure process by instituting formal, written policies and procedures. In its written policies and procedures, among other things, the State established a committee comprised of senior Treasury officials, representatives from the Attorney General's Office, and disclosure counsel to oversee the entire disclosure process and to review and make recommendations regarding the State's disclosures and disclosure practices. In addition, the State has implemented an annual mandatory training program conducted by disclosure counsel for the State's employees involved in the disclosure process to ensure compliance with the State's disclosure obligations under the federal securities laws.

Legal Discussion

46. Municipal securities represent an important part of the financial markets available to investors. At the end of 2009, individual investors held approximately 35 percent of outstanding municipal securities directly and up to another 34 percent indirectly through money market funds, mutual funds, and closed end funds. There is also substantial trading volume in the municipal securities market — almost \$3.8 trillion of long and short-term municipal securities were traded in 2009 in over 10 million transactions. Issuers of municipal securities have an obligation to ensure that financial information contained in their disclosure documents is not materially misleading. Proper disclosure allows investors to understand and evaluate the financial health of the state or local municipality in which they invest.

47. New Jersey, as an issuer of municipal securities, is subject to the antifraud provisions of the federal securities laws. In addition, the Commission has promulgated a broker-dealer rule, Exchange Act Rule 15c2-12, which in general limits market access for certain municipal securities issues to those offerings in which the issuer agrees to file annual disclosures of

specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with certain repositories designated by the Commission.²⁰ The antifraud provisions apply to such disclosure and to any other statements made to the market.

48. Section 17(a) of the Securities Act prohibits the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Violations of Sections 17(a)(2) and (3) may be established by showing negligence. SEC v. Hughes Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

Violations

49. As a result of the negligent conduct described above, the State violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. Specifically, the State made material misrepresentations and omissions in preliminary official statements, official statements, and continuing disclosures regarding the State's under funding of TPAF and PERS. TPAF and PERS represent a significant and growing obligation for New Jersey. The State's misrepresentations and omissions were material in that they failed, over the course of an almost six-year period, to provide investors with adequate information regarding the State's funding of TPAF and PERS as well as the financial condition of the pension plans. Information regarding the State's under funding of TPAF and PERS and their financial health was important to investors in evaluating New Jersey's overall financial condition and future financial prospects.

50. The State was aware of the under funding of TPAF and PERS and the potential effects of the under funding. However, due to a lack of disclosure training and inadequate procedures relating to the drafting and review of bond disclosure documents, the State made material representations and failed to disclose material information regarding TPAF and PERS in bond offering documents.

Remedial Efforts

51. In determining to accept the State's Offer, the Commission considered the cooperation afforded the Commission's staff during the investigation and remedial acts taken by the State, referenced in paragraphs 44 and 45.

²⁰ On December 5, 2008, the Commission amended Rule 15c2-12 to require issuers to agree to file annual disclosures of specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with the Municipal Securities Rulemaking Board. Issuers are no longer permitted to use other repositories. Rule 15c2-12 was further amended on May 27, 2010 to eliminate the materiality determination for certain types of events and to make other changes to improve the quality and timeliness of municipal securities disclosure.

IV.

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

Accordingly, it is hereby ORDERED that pursuant to Section 8A of the Securities Act, the State shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

By the Commission.

Elizabeth M. Murphy
Secretary

Service List

Rule 141 of the Commission's Rules of Practice provides that the Secretary, or another duly authorized officer of the Commission, shall serve a copy of the Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), on the Respondent and its legal agents.

The attached Order has been sent to the following parties and other persons entitled to notice:

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