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SEC enters cease-and-desist order against the State of New Jersey relating to disclosure regarding pension plan obligations – something new, something old and some possible hints at the future

On August 18, 2010, the United States Securities and Exchange Commission (the "SEC") entered a Cease-and-Desist Order, SEC Rel. No. 33-9135 (August 18, 2010) (the "Order") against the State of New Jersey (the "State") under Section 8A of the Securities Act of 1933, as amended, bringing to a conclusion an inquiry begun in April 2007. In the Order, the SEC asserts that during the period from August 2001 through April 2007 the State was negligent in the preparation of disclosure documents which resulted in material misrepresentations and omissions regarding the funding and financial condition of its two largest pension plans, the Teachers' Pension and Annuity Fund and the Public Employees' Retirement System (the "Pension Plans"). The essential allegation made by the SEC in the Order is that the State's bond offering documents over a six year period from 2001 to 2007 contained a number of material misrepresentations and omissions that "created the fiscal illusion that [the Pension Plans] were being adequately funded and masked the fact that [the State] was unable to make contributions to [the Pension Plans] without raising taxes or cutting other services, or otherwise impacting the budget." A complete copy of the Order is available on the SEC's website at www.sec.gov.

This is the first time that the SEC ever charged a state with violations of the federal securities laws. While not admitting or denying any of the SEC's findings in the Order, the State agreed not to commit or cause any future violations under Sections 17(a)(2) or 17(a)(3) of the Securities Act of 1933. The Order contains no claims of any violations of Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 thereunder which would have required a finding of intent or recklessness as opposed to negligence. Under the terms of the Order, the State was not required to pay any civil fines or penalties. While the Order specifically refers to enhancements and remedial actions the State implemented after April 2007, it does not require the State to undertake any specific remedial actions.

The SEC focused on two problems it believed existed in the State's bond offering disclosure process. First, the SEC asserted that the State did not have adequate disclosure procedures and training programs in place that may have prevented misrepresentations and omissions

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in the State's bond offering documents from occurring. Second, in the SEC's view, while the State had disclosed various developments regarding the Pension Plans, it did not explain the larger impact of those developments on the State's financial and budgetary condition. Neither of these items in itself reflects any new focus by the SEC, but some of the SEC's discussion about the second item may be cause for concern.

The Order does not provide state and municipal issuers with specific rules or guidelines regarding disclosure of pension plan obligations and liabilities. It does, however, offer state and municipal issuers insight into how the SEC believes they should prepare their disclosure about pension obligations and, by implication, other obligations and liabilities. The Order also provides underwriters with guidance as to evaluating pension plan disclosures and the type of due diligence questions they should ask. At a time of heightened focus by the SEC on the municipal marketplace and the expectation that additional SEC proceedings involving state and municipal issuers along with the underwriters of their securities are likely, it would appear appropriate for all participants in that marketplace to apply the SEC's views reflected in the Order more broadly to all of an issuer's disclosure.

Lessons and Concerns. The Order offers a number of lessons for state and municipal issuers as well as underwriters of their securities and also raises some concerns.

- In understanding their own duties in light of the SEC's views reflected in the Order, it would be prudent (a) for state and municipal issuers to develop disclosure procedures and to institute training programs for their employees involved in any element of the disclosure process and (b) for underwriters to inquire whether the state and municipal issuers, from whom they are accepting and relying upon various representations and covenants when purchasing securities, have such procedures and conduct such training. The SEC asserts that the cause of the inadequacies it believed existed in the State's disclosures was the failure of the State to implement sufficient processes for updating disclosure and to educate its employees about their role in satisfying the State's disclosure obligations. The SEC did not conclude that the State intentionally omitted any information, but rather maintained that the State did not exercise reasonable care in preparing its bond offering documents. The Order reiterates the SEC's expectation, which it has repeated over the years, that all state and municipal issuers should implement procedures and training that ensure that the issuer is properly disclosing all of its material facts and developments.

- State and municipal issuers need to consider, when preparing their disclosure regarding pension obligations or other matters affecting their finances, whether they have adequately explained the significance of the matters discussed to the overall financial condition of the issuer. Much of the SEC's criticism of the State's substantive disclosure relates to inadequacies the SEC thought existed in effectively explaining how the State's funding of the Pension Plans ultimately impacted or was impacted by the State's larger financial condition.

- State and municipal issuers may also need to evaluate how their governing bodies articulate policy decisions and whether the issuers need to re-articulate those decisions when describing them in bond offering documents to ensure that investors understand their full financial impact– potentially a very difficult task both practically and politically. Much of the SEC's criticism of the State's substantive disclosure relates to the presentation of the State's policy decisions in its bond offering documents. As the State made policy decisions regarding its Pension Plans, the SEC asserted that the State did

not clearly explain to investors in its disclosure documents the financial impact of those policy decisions.

- The SEC's assertion that the State should have explained the potential impact of State legislation should raise concerns for issuers. It was only in retrospect and in light of the investment portfolio performance of the Pension Plans that the State could understand the full impact of legislation and related developments on the State's larger financial condition. In making the assertions regarding the State that it does, one may ask whether the SEC is raising the standard for issuers by charging them with the responsibility to disclose unlikely or unknown impacts of developments that only materialize with future developments. This could apply to pension obligations or a host of other disclosure items.

- In light of recent statements from Mary L. Schapiro, the SEC Chairman, we may have some hints about the future regulatory environment of the municipal marketplace. In her remarks prepared for delivery at the Investment Company Institute 2010 General Membership Meeting on May 7, 2010, Ms. Schapiro included in a list of ideas for designing a new municipal securities regulatory regime the following: "Mandating scenario testing by municipal issuers and periodic disclosure of the impact certain key events may have on the issuer's ability to meet its public debt obligations." The Chairman expanded on this point, adding: "These disclosures should highlight an issuer's sensitivity to changes in its actuarial assumptions. Potentially significant variables to test include tax base changes and their impact on revenue; life span increases that might significantly increase pension obligations; and dramatic changes in interest rates or equity market returns which could affect either a municipality's portfolio returns or their obligations." If this is the future of municipal marketplace regulation, then state and municipal issuers may be required to comply with specific regulations that place an obligation on issuers to anticipate a broad range of impacts that legislative and financial developments may have on their larger financial condition. In some cases, these impacts may only become apparent in retrospect and state and municipal issuers should focus on regulatory proposals to ensure that the SEC does not place an unreasonable burden on them to project into the future what can only be clear in retrospect.

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