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October 10, 2005

Michael J. Aguirre, City Attorney
Office of the City Attorney
City of San Diego
Civic Center Plaza
1200 Third Avenue, Suite 1620
San Diego, California 92101

Re: SEC Investigation of the City of San Diego Bond Offerings

Dear Mr. Aguirre:

I understand that you intend to participate in representing the City of San Diego in connection with discussions with the staff of the Securities and Exchange Commission (the "SEC") in the above-referenced matter. I am writing on behalf of Councilmember Jim Madaffer to express our serious reservations about your participation in those discussions.

I. Introduction.

We do not believe that you have the qualifications or the objectivity to represent the City in the SEC investigation. Apart from your lack of experience in SEC investigations, your frequent, unfounded accusations against the City Council demonstrate your profound lack of objectivity. Indeed, you have repeatedly and wrongfully accused the City Council of committing fraud or engaging in other corrupt conduct, without any credible supporting evidence. In a recent television broadcast, you went so far as to blame any securities violations arising from the City's bond disclosures on the City Council, notwithstanding the fact that many professionals inside and outside the City, including the City Attorney's Office, wrote those disclosures and assured the City Council of their accuracy.¹

¹ You made the following statement on KUSI on September 21, 2005:

What's really at stake here is spending millions and millions and millions and millions of dollars to try to defend the indefensible behavior of the council that authorized all these securities offerings that did not contain proper disclosure.

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We believe that your so-called “investigative reports” are incomplete, misleading and politically motivated. They incorrectly apply legal standards concerning the liability of city officials for any securities laws violations and deliberately ignore critical facts that are pertinent to an assessment of individual conduct, including the fact that the City Attorney’s Office repeatedly gave unqualified advice to the City Council that the bond disclosures were complete and accurate.²

Apart from these legal issues, the City is facing serious challenges for which Councilmember Madaffer and others are trying to find real, practical solutions. Based on my experience as the former head of litigation in the SEC’s Los Angeles Office and now in representing clients in numerous SEC investigations, I am certain that the resolution of those challenges is not advanced – and indeed, is hindered – by the delay and confusion fostered by your unfounded accusations and polarizing, politically motivated reports.

The purpose of this letter is to identify some of the serious factual and legal issues that have not been discussed in your “reports,” public statements and proposed consent decree, including:

- The City Council properly relied on numerous professional experts from inside and outside the City, including your office, to advise it on securities law compliance and disclosure issues with respect to the City’s bond offerings.
- For the bond offerings at issue, the many professional experts on whom the City Council relied advised the Council that the disclosures in the bond offering official statements were accurate and complete.
- The City Attorney’s Office prepared the City Council resolutions authorizing the bond offerings in question and assured the City Council of their legality. If the bond disclosures in the official statements were inadequate, why did the City Attorney’s Office fail to so advise the City Council?
- Each bond offering contained accurate disclosures regarding the two most salient pension funding facts known to the City Council – the current amount of the underfunding, and the information from which the percentage of the pension

² Indeed, that your office gave such advice creates an irreconcilable conflict of interest that disqualifies you from representing the City in the SEC investigation.

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fund's underfunding was calculated (*i.e.*, SDCERS' current assets allocated to funding and current total actuarial accrued liability).

- Although your proposed consent decree alludes to the SEC's Orange County investigation, issues concerning the San Diego bond disclosures are far different from those in the Orange County investigation. In the Orange County investigation, for example, County officials reportedly failed to disclose information that was highly material to Orange County's short-term ability to repay the bonds. No one has ever questioned San Diego's ability to repay any of the bonds issued in the past few years and, in fact, San Diego has paid every penny due under those bonds to date.
- Prior to September 2003, none of the professional experts on whom the City Council relied ever advised the City Council that the pension fund disclosures in the bond offering official statements were inaccurate or that any additional disclosures were required.
- Each bond offering statement refers the reader to the publicly available SDCERS annual reports that contained additional detailed disclosures concerning the pension fund, the pension fund's funding status, the effects of Manager's Proposal I ("MPI"), Manager's Proposal II ("MPII"), and other pension issues.
- During the time period in question, there was rigorous public debate about MPII and other pension funding issues such that no one with even a passing interest in San Diego's financial condition could credibly claim to have been unaware of these issues. For example, the City Council and SDCERS had numerous public debates on MPII and pension funding issues in 2002 and 2003. In addition, the media frequently reported on these debates as well as other MPII and pension funding issues.
- During these debates, the City Council frequently questioned and received assurances from City and SDCERS officials concerning pension funding issue.
- While you have claimed that the City Council's adoption of MPII was illegal, the City Attorney's Office advised the City Council at the time that MPII was legal and prepared the City Council resolution adopting it.

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- Before the City Council approved MPII, the SDCERS' fiduciary counsel issued a 13-page opinion that concluded that the pension board was acting within its fiduciary obligations when it approved MPII.
- The SEC has never imposed sanctions on any municipality or municipal official over pension fund disclosures, or otherwise provided guidance to municipalities on such issues.
- The City Council has taken the lead in directing and approving many of the remediative efforts that the City has undertaken to remedy the pension underfunding issue and cooperate with the SEC and U.S. Attorney's investigations, which you commend in your proposed consent decree.
- San Diego's pension underfunding issues are far from unique among municipalities in California or nationwide. For example, the Daily News of Los Angeles recently reported that the pension funds for Los Angeles County and the City of Los Angeles are underfunded by \$5.6 billion and \$1.1 billion, respectively, and \$17.6 billion and \$3.2 billion, respectively, when unfunded retiree health benefits are included.³
- Further evidence of the utter unreliability of your so-called investigative reports is the fact that you have purported to make conclusive determinations concerning Councilmember Madaffer's state of mind concerning bond disclosures *without ever having interviewed him about this issue.*

II. The City Council Properly Relied Upon the Advice of Professionals.

As you know, San Diego City Councilmembers have come from all walks of life. Few are attorneys, and none are securities professionals. Consequently, the City Council properly relies on many respected professional experts from inside and outside the City to advise it on the highly complex and regulated areas of securities compliance and disclosure. Contrary to your conclusory assertions and misleading version of the facts, the City Council could not and did not approve any municipal bond documents in a vacuum without professional advice, including advice from your office. This process in San Diego is no different from that of any other municipality that accesses the public financial markets.

³ See "A Pension Time Bomb; Billions in Benefits Promised from Government Coffers," The Daily News of Los Angeles, September 25, 2005, at N1.

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Indeed, on disclosure and pension funding issues alone, the City Council received expert advice or information from at least the following specially trained professionals and experts:

- City Attorney's Office;
- City Auditor;
- City Manager;
- SDCERS;
- Office of the City Treasurer;
- Outside bond counsel;
- Disclosure counsel;
- Outside auditors; and
- Financial consultants.

Each of these highly trained professionals, *including your own office*, was responsible for advising and informing the Councilmembers through every step of the bond offering process, particularly concerning disclosures and securities law compliance. Until September 2003, *no one advised the City Council of any disclosure inadequacies in the official statements for any of the bond offerings.*

III. Each of the Professionals Charged with Advising the City Council Independently Agreed at the Time That the Bond Disclosures Were Adequate.

Your office has recognized that the City Council is properly entitled to rely on city employees and outside professionals in approving municipal bond offerings. As recently as June 2005, your office gave advice to the Mayor and City Council concerning public officials' due diligence responsibilities in issuing municipal bonds. Specifically, your office informed the Councilmembers that:

The SEC has advised that public officials may rely upon employees, bond counsel, disclosure counsel or other professionals to assure that they are in compliance with the antifraud provisions of the federal securities laws so long as such reliance is reasonable.

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In order for such reliance to be considered reasonable, the public official must (1) make complete disclosure to the appropriate professional of the potentially material mistake or omission at issue; (2) request the professional's advice as to what disclosure is proper; (3) receive advice regarding the appropriate disclosure; and (4) rely in good faith on that advice.

Here, it cannot be disputed that the City Council followed this standard at all times for all of the bond disclosures it approved. The professionals on which the City Council relied knew far more than the City Council about the city's fiscal condition and pension funding status and, indeed, were charged with keeping the Council informed of such matters. The City Council sought and received advice from these professional experts concerning the bond offerings, particularly concerning securities compliance and disclosure issues, and properly relied on that advice in good faith.

The "misleading" bond disclosures for which you believe the City Council should be responsible were approved by all of the professional experts charged with informing and advising the City Council in its deliberations. Indeed, for the bond offerings you have identified in your proposed consent decree as being "materially misleading," *your office* provided the following opinion:

No information has come to the attention of the City which causes us to believe that the Official Statement as of its date contained, or as of the date hereof contains, any untrue statement of a material fact or as of its date omitted, or as of the date hereof omits, to state any material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading...⁴

Likewise, the bond disclosures you have identified as "materially misleading" also contained the following representation by the City Manager:

⁴ See e.g. Exhibit 1 hereto: May 20, 2003 letter from Office of City Attorney of the City of San Diego Re: \$15,255,000 City of San Diego/MTBD Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding); July 1, 2002 letter from the Office of the City Attorney of the City of San Diego Re: \$93,000,000 City of San Diego, California 2002-03 Tax Anticipation Notes Series A; June 17, 2003 Letter from the Office of the City Attorney of San Diego re \$17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding).

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The information contained in the Official Statement is true and correct in all material respects and such information does not contain any untrue or misleading statement of a material fact or omit to state any material fact necessary to make statements therein, in light of the circumstances under which they were made, not misleading.⁵

These are but a few of the professional opinions, written and oral, assuring the Councilmembers and other interested parties that the disclosures at issue were accurate and complete. As your office has already opined, the City Council's reliance on these professionals was entirely appropriate and relieves them from any securities liability. For you now to assign any blame to the City Council for approving the bond offerings requires acceptance of the absurd notion that the City Council should have rejected the unqualified advice from every professional expert involved in the bond offerings, including those from the City Attorney's Office and respected outside law firms, when it had absolutely no reason to do so, and then somehow conclude on its own that the bond disclosures were inaccurate or incomplete. Such a belief can be harbored only by those who are more interested in political gamesmanship than objective and principled legal analysis.

IV. The City Council Repeatedly Inquired About the Pension System and Was Advised that the Underfunding was not an Imminent Problem and was Being Remedied.

The record is clear that throughout 2002 and 2003, the City Council repeatedly questioned City officials and SDCERS representatives concerning pension funding issues and was reassured that the pension fund was fiscally sound, and that any underfunding concerns were long-term and were being corrected.

In February 2002, the Mayor's Blue Ribbon Committee issued its Report on City of San Diego Finances ("Report"). The Report noted that the City of San Diego was fiscally sound and that the pension was almost fully funded at 97%, but that the City should begin paying the fully funded contribution rate because it had been underfunding the pension by \$6 to 8 million per

⁵ See e.g. Exhibit 2 hereto: Closing Certificate of City for \$15,255,000 City of San Diego/MTBD Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding); Closing Certificate of the City for the \$17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding).

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year. As to the City's municipal bonds, the Blue Ribbon Committee commended the City for having "favorable bond ratings" and noted that the "City's debt levels are low compared to other major California Cities."

The City Council took the Blue Ribbon Committee's recommendations concerning pension funding seriously and promptly requested that the City Manager's office report back with an analysis of the pension system and recommendations on how to address the issues. In late March 2002, the City Manager provided an interim response to the Mayor and City Council and recommended that the SDCERS Retirement Board, rather than the City Manager, prepare a report and analysis of the pension system.

In November 2002, the City Council approved MPII. At the time, the professional experts advising the City Council unanimously endorsed MPII as an appropriate method to remedy the pension underfunding issues. For example, when one of the SDCERS board members raised concerns about MPII in November 2002 before the City Council voted to approve MPII, several respected City officials and professionals (including several SDCERS officials) publicly assured the City Council that MPII would correct the underfunding problem by, among other things, doubling the City's annual pension contribution.⁶ Also, the pension board's fiduciary counsel issued a 13-page opinion before the Council voted on MPII concluding that the pension board acted within its fiduciary obligations when it approved MPII.⁷

On February 12, 2003, several SDCERS representatives gave a presentation to the City Council Rules Committee regarding the state of the pension system. At this meeting, the SDCERS representatives informed the Rules Committee that the Retirement Fund had assets with a market value of \$2.4 billion dollars and that "[d]espite difficult market conditions, the SDCERS Retirement Fund has performed in the top 15% of performance for Public Funds for the past one year, three years and five years." (*See Exhibit 3*) The retirement officials reported

⁶ Indeed, at the City Council public meeting, it was represented on the record that you, Michael Aguirre, informed a SDCERS board member that you approved of MPII, as adopted, and would not file a private lawsuit that you had threatened if the SDCERS board had adopted an earlier version of MPII. That you found MPII to be an appropriate funding mechanism for the City is confirmed by the fact that you did not pursue your threatened lawsuit after MPII was approved.

⁷ Recent media reports have discussed an opinion provided to the SDCERS board by the law firm of Seltzer Caplan in 2003 concerning the inadvisability of MPII. It is worth noting that the letter was written months after the City Council and the pension board approved MPII and was not provided to the City Council until just last week, after the City Council publicly urged the pension board for months to waive the attorney-client privilege and release this document and others. Significantly, at the time the City Council passed MPII, it had been provided with only the favorable opinion of the then SDCERS' fiduciary counsel.

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that the UAAL had increased to \$720 million, but assured the Rules Committee that 85% of this amount was due to “poor investment performance.” Notwithstanding these assurances, the Rules Committee voted 5-0 to have the City Manager return in 60 days with a report regarding what additional corrective actions to take. That report and analysis was delayed and, eventually, the Mayor and the City Council appointed a Pension Reform Committee to complete the analysis.

In each instance when the City Council received information concerning the pension funding issues, Councilmembers asked the appropriate questions and sought recommendations from city employees and other professional experts. The message consistently presented to the City Council on numerous occasions was that the pension underfunding issue was more of a long-term concern than a short-term one. A memorandum from the then President of SDCERS and provided to the City Council in May 2003 exemplifies the message consistently communicated to the Council:

There is no reason to panic. Retirement plans by their very nature are long-term programs. Nevertheless, short-term volatility in the investment markets – particularly bear markets like the current environment – can generate pressure to make drastic changes. In this case, that would be a mistake. ***The \$2.5 billion in assets the system holds are sufficient to pay retirees’ vested retirement benefits for more than 20 years (at today’s payroll) without a single penny of additional contributions or earnings.***

“The Facts, Ma’am, Just the Facts by Frederick W. Pierce, IV President and Public Appointee, SDCERS (emphasis added) (See Exhibit 4).

Similarly, a February 5, 2003 report from the Retirement Administrator and the Assistant Retirement Administrator on behalf of SDCERS assured the City Council that any short-term pension underfunding would be remedied by the City’s increased pension contributions required by MPII and a return to historic investment performance:

[U]nder Manager’s Proposal II, the City is committed to achieving the full PUC actuarial rate contribution by 2009 and moving quickly to funding at the EAN actuarial rate thereafter. These steps will eventually improve the Retirement Fund’s funding ratio. While the short-term horizon may continue to bring “weak” investment returns, it’s important to remember that the Retirement Fund’s 10-year average annual return for the period ending June 2002 was at 9.26%. This is well above the actuarially assumed rate over this same period.