SEC Charges State of New Jersey with Securities Fraud Involving Pension Funding

In an historic first, the Securities and Exchange Commission (SEC) charged the State of New Jersey with securities fraud for misrepresenting and failing to disclose to investors in its municipal bond offerings that it was underfunding the state's two largest pension plans. The SEC's order also found that New Jersey failed to provide certain present and historical financial information regarding its pension funding in its bond disclosure documents. While the enforcement action focused on the bond offering disclosures, a number of findings could be viewed as calling into question the pension plans' use of certain approved actuarial and accounting methodologies. Some are concerned that the SEC's perceived problems in this area could have an impact on the Governmental Accounting Standards Board's current review of governmental standards.

On August 18, 2010, the SEC announced its settlement with New Jersey, which is the first state ever charged by the SEC for violations of the Federal securities laws. No individuals were charged in connection with the case, and New Jersey agreed to settle without admitting or denying the SEC's findings. The SEC's order requires the State of New Jersey to cease and desist from committing or causing any violations and any future violations of the anti-fraud provisions of securities law (Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933).

While State and local governments are exempt from the registration and reporting provisions of the Securities Act and the Exchange Act, and the SEC's authority to establish rules for accounting and financial reporting does not extend to municipal securities issuers, State and municipal securities issuers are nevertheless still subject to the antifraud provisions of Securities law. That is, any disclosures and other statements made to the market in connection with the offer or sale of securities cannot contain misrepresentations or omissions of material facts, and the SEC can take enforcement action if such misrepresentations or omissions are done with the intent to deceive, manipulate or defraud.

According to the SEC, the official statements that New Jersey used to offer and sell more than $26 billion worth of municipal bonds between 2001 and 2007 "created the false impression that the Teachers' Pension and Annuity Fund (TPAF) and the Public Employees' Retirement System (PERS) were being adequately funded," according to a press release accompanying the SEC's announcement . (An "official statement" is a document prepared by an issuer of municipal bonds that discloses material information regarding the issuer and the particular offering.)

The SEC claimed that this action masked the fact that the state "was unable to make contributions to TPAF and PERS without raising taxes, cutting other services or otherwise affecting its budget." As a consequence, the SEC found that investors were not provided adequate information to evaluate the state's ability to fund the pensions or assess their impact on the state's financial condition.

While the SEC's order primarily deals with New Jersey's failures to adequately disclose pension underfunding and its potential effects on the state's financial health, some of the findings in the SEC's cease and desist order (see Findings Nos. 41, 42 and 43) suggest that certain accounting methodologies—currently permissible under existing GASB standards—are nevertheless problematic.

For example, the SEC said the state's five-year smoothing method produced net unsmoothed losses, and the resulting difference between the actuarial value of assets and their market value reduced the State's pension contributions. However, smoothing, by its very nature, virtually always produces actuarial values different from market values. Furthermore, smoothing could have produced net unsmoothed gains, depending on whether gains or losses were being smoothed, thereby increasing pension contributions. Nevertheless, the SEC faulted New Jersey for failing to adequately disclose the (presumably only negative impact) that smoothing can have.

The SEC also found New Jersey's use of a closed 30-year amortization period meant that the state "has been unable to and will continue to be unable to effectively amortize" its pension plans' unfunded actuarial accrued liability. Some actuaries have questioned this finding, noting that the use of a closed 30-year amortization will not cause the unfunded actuarial liability to rise indefinitely. Rather, it will be reduced to zero over a 30-year period. What the SEC really appears to have problems with is the use of a rolling 30-year amortization, which is not uncommon in the public sector for amortizing gains and losses.

If so, this could be very problematic for public plans, as the SEC, while acknowledging that this was a "recognized actuarial method," still found that the disclosure of this methodology's impact on funding was inadequate.

Finally, the SEC complained that the bond offering documents did not provide asset and funded ratio information on a market value basis, although it noted they were available in the state plans' actuarial reports. Again, due to the significant difference between the actuarial value and market value of plan assets, the SEC found "the actuarial value did not accurately present the current value of the pension plans." What this essentially appears to be saying is that the actuarial value is not "accurate," and therefore it must be false and misleading unless it is acknowledged to be inaccurate?

The SEC has historically had problems with smoothing. Their staff expressed serious reservations in a June 2005 staff report prepared pursuant to the Sarbanes-Oxley Act of 2002, and seemed to suggest that additional disclosures would not necessarily solve the problem:

"The Staff also believes that the complex series of smoothing mechanisms, and the disclosures to explain them, render financial statements more difficult to understand and reduce transparency. SFAS No. 87 does require certain disclosures that help explain the effect of SFAS No. 87's many netting and smoothing provisions. In this case, however, the disclosures seem designed to compensate for less than desirable accounting. A recent FASB project revised the disclosure requirements to provide even more information. While the disclosures are quite detailed, the Staff notes that it has long been accepted that 'good disclosure doesn't cure bad accounting.' The combination of the accounting and disclosure provisions contribute to the length and complexity of financial statements, a common complaint among users and preparers alike. Revisions to the guidance that eliminate optional smoothing mechanisms would allow significant reduction in disclosures without a loss of important information." (Emphasis added.)

More recently, James Kroeker, the SEC's chief accountant, said in May of 2009 that the Commission would look "very skeptically" at pension funds that change accounting methods to "smooth out" losses incurred in response to the financial crisis. Kroeker reportedly said at the 28th annual SEC Financial Reporting Institute Conference that the SEC would also be scrutinizing any attempt to reduce the transparency of a pension fund's assets by changing amortization schedules.

It therefore would appear that there is more going on here than simple problems with inadequate disclosure. It is well-known that the SEC has concerns with GASB and feels that they should have control over it in the same way they have effective control of FASB, thanks to Sarbanes-Oxley. This indirect criticism of methodologies currently permitted by GASB could be seen as an effort to further this cause.

Will GASB potentially see this as a message to "clean up their act" or lose their independence? Does the New Jersey settlement send a message to GASB that its current plans to restrict amortization, eliminate smoothing, and move to a market valuation of assets—as expressed in its recent "Preliminary Views" on making changes to public pension accounting and disclosure—is the right direction to follow?

Finally, what does the SEC's action in this area portend? The Enforcement Division of the Securities and Exchange Commission (SEC) has a new "Municipal Securities and Public Pensions Unit," which was responsible in part for the New Jersey action. This unit's purpose is to look at problems in the municipal securities market and at public pension funds; and when it was created, it was specifically announced that the unit would “focus on misconduct in the $2.8 trillion municipal securities market and at public pension funds.” (Emphasis added.) The unit’s director, Elaine Greenberg, has also said that her focus will be on “public pension accounting and disclosure violations,” along with pay-to-play and public corruption violations.

It is clear from the New Jersey case that Ms. Greenberg’s office has begun its efforts in this regard. Also, a “confidential informal inquiry” into “Certain Public Pension Fund Activities” that was sent from her office to a number of NCTR and NASRA members last year is another sign. While this inquiry dealt with a range of issues, including pay-to-play payments as well as solicitations, and conflict of interest policies, there was also a lengthy section of questions dealing with “Disclosure of Unfunded or Underfunded Liabilities,” in which plans were asked about disclosure documents (“Official Statements”) prepared in connection with their State’s general obligation bonds or similar State-supported bond issues.

These questions dealt with such things as changes in actuarial asset valuation methods, actuarial cost methods, or amortization methods, and asked for both the effect of those changes and “how the change was disclosed in the Official Statements of the bond issuer.” Other questions in this section asked for detailed information about what had been included in these Official Statements, and then inquired if the State has changed its Official Statements in the last five years to include or exclude any of this information. If so, the SEC also asked the plans to provide an explanation as to why such information was excluded or included.

Clearly, based on these kinds of questions, it would seem that the SEC is assuming that the pension plan is directly involved with both the preparation of these Official Statements, as well as the decision-making process involving what is or is not contained in them. This apparent blurring of the distinction between the plan and the employer/bond issuer was made even clearer in a series of questions in the survey asking about “pension holidays” and payments of less than the annual required contribution (ARC), and the reasons the employer made these decisions. Unfortunately, given the broad appointment powers of a New Jersey governor, the recent action there may only serve to bolster this misimpression.

Therefore, it now appears clear that the SEC’s inquiries were indeed attempting to determine possible links between pension plans’ funded status and potential misrepresentations or omissions regarding this status that are contained in disclosure documents prepared in connection with their sponsor’s bond issues.

Of course, this ultimately raises the question of how “accuracy” is measured. Misrepresentations can clearly occur if the issuer simply fails to accurately disclose information provided to it by the pension plan. But what if the real question is whether the pension plan itself failed to accurately measure its funded status in the first place, which then produced the inaccuracies in the issuer’s public disclosures—even though the information provider to the issuer was otherwise accurately disclosed? Findings 41, 42 and 43 in the New Jersey settlement suggest that this may indeed be the case.

Therefore, is this recent action, in part, about the SEC’s interest in positioning itself to become the arbiter of such judgment calls? Is Ms. Greenberg’s unit part of the SEC’s efforts to acquire the same type of statutory authority over financial accounting and reporting standards for State and local governments as it has over publicly held companies? Is the SEC beginning to try to do indirectly what it is not permitted to do directly?