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Chicago, IL

111 West Monroe Street
Chicago, IL 60603
(312) 845-3000
FAX: (312) 701-2361

San Francisco, CA

595 Market Street
San Francisco, CA 94105
(415) 541-0500
FAX: (415) 541-0506

Salt Lake City, UT

201 South Main Street
Salt Lake City, UT 84111
(801) 533-0066
FAX: (801) 533-9595

www.chapman.com

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Municipal Disclosure Alert

SEC Charges San Diego Municipal Officers with Securities Fraud

On April 7, 2008, the Securities Exchange Commission (SEC) filed a civil complaint in federal court against five former San Diego city officials in connection with the offer and sale of over \$260 million in municipal bonds in 2002 and 2003. The SEC allegations generally involve the defendants' failure to fully and accurately disclose the city's concerted plan to use current city moneys to pay increased pension and OPEB benefits at the expense of the long term funding of the city's pension program.

The SEC seeks payment of a civil penalty and a judgment permanently enjoining the defendants from further securities law violations. This extraordinary action raises individual financial stakes and signals an effort by the SEC to hold individual municipal finance officers personally responsible for faulty disclosure.

The San Diego officials named as defendants in the suit include the former City Manager, Deputy City Manager for Finance, Auditor and Comptroller, Assistant Auditor and Comptroller and the City Treasurer. Among

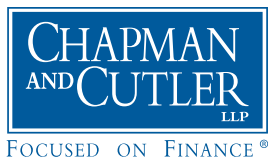
the SEC's specific allegations in connection with the bond offerings are:

- Signing a closing letter falsely representing that an official statement did not contain any false or misleading statements;
- Certifying that the city's audited financial statements were accurate;
- Providing inaccurate continuing disclosures; and
- Making false and misleading statements to investors and rating agencies.

The SEC alleges that failure to disclose material information regarding the underfunded pension obligations denied investors the opportunity to make an informed investment decision. Specifically, the SEC claims the defendants violated Section 17(a) of the Securities Act of 1933 (Securities Act) and Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 (Exchange Act), which generally prohibit the use of the means of interstate commerce to defraud or deceive purchasers of securities.

The defendants each face potential civil penalties under Section 20(d) of the Securities Act and Section 21(d)(3) of the Exchange Act. The SEC typically enforces its regulations through administrative proceedings rather than civil court and generally has not sought civil penalties from municipal officials.

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National Public Finance
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Municipal Disclosure Alert

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The SEC previously sanctioned the city in connection with the 2002 and 2003 offerings in a 2006 administrative order that required the city to cease and desist from future securities fraud and to take certain remedial measures. Specifically, the order required the city to educate its officers and city council members on disclosure matters and to implement the recommendations of an independent consultant after a review of the city's disclosure practices. Subsequently, the SEC settled with the independent accountants responsible for producing the audited financial statements used in the 2002 and 2003 offering documents.

Counsel for the defendants in the most recent federal court suit have argued that the defendants "relied on professionals, including financial advisers and inside and outside bond and disclosure counsel, at every stage in the bond offerings," "acted in good faith with honest intention," and that "no individual lost money with regard to investment in San Diego bonds." Presumably, the defendants hope that a federal court will be more receptive to these arguments, which were unsuccessful at the administrative level.

A decision in this case is unlikely to come soon. However, legal proceedings related to the pension crisis have already exacted a significant toll on the city of San Diego. The city's defense in proceedings against the SEC has cost millions of dollars and innumerable

hours over the last several years. Presently, it is unclear whether the city, and ultimately its taxpayers, or the individual defendants will pay the costs of defending the federal court suit. Additionally, the city has been unable to access the public municipal market since its initial disclosure of the pension funding crisis.

The SEC is sending a clear message to the city of San Diego and other bond issuers in the public finance market that it is

demanding better disclosure by attempting to hold individuals responsible for their own errors and omissions. Public officials with responsibilities for securities law disclosure should review their obligations, practices and procedures in consideration of the current plight of the San Diego defendants.

“ Prudent municipal bond issuers fully interact with knowledgeable disclosure counsel in any securities offering. This recent SEC action reinforces the need for officials to seek experienced counsel to help better understand their disclosure obligations. ”

Officials should take extra precaution to avoid making inaccurate or misleading statements in offering documents, continuing disclosure documents or financial statements. These documents should be subjected to careful review by officials of the issuer.

For additional information on the recent SEC suit against the San Diego defendants, please contact John Trofa, Practice Group Leader of Chapman and Cutler LLP National Public Finance Group, at (312) 845-3777 or trofa@chapman.com.