



THE CITY OF SAN DIEGO
COUNCILMEMBER DONNA FRYE
SIXTH DISTRICT

December 2, 2010

Mr. Kelly Bowers
Senior Assistant Regional Director
Securities and Exchange Commission
5670 Wilshire Boulevard, 11th Floor
Los Angeles, CA 90036-3648

Dear Mr. Bowers,

Please see the attached communication regarding recent events that I believe you should be aware of. City of San Diego Audit Committee member, Charles Sellers, shares my concerns and we would appreciate you looking into this matter. If you have any further questions or concerns, please feel free to contact me or Audit Committee member Sellers at the phone numbers provided below:

City of San Diego Councilmember Donna Frye: [REDACTED]

City of San Diego Audit Committee Member Charles Sellers: [REDACTED]

Thank you for taking the time to examine this issue.

Sincerely,

Donna Frye
Councilmember
Sixth District

DF/ks





COUNCILMEMBER DONNA FRYE
AUDIT COMMITTEE MEMBER, CHARLES SELLERS
City of San Diego

Dear Mr. Bowers:

We are writing to bring to your attention a situation regarding the City of San Diego's financial operations and external reporting about which we feel obliged to inform you. The following timeline illustrates the sequence of events and the parties involved:

November 2, 2010: Chief Financial Officer Mary Lewis issues a memorandum (see attachment 1) to the City Council informing it that issuance of the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2010 will be delayed by approximately six months due to unanticipated problems with implementation of the City's new enterprise resource planning software. This delay will cause the City to miss its contractually mandated 270 day post year-end disclosure deadlines.

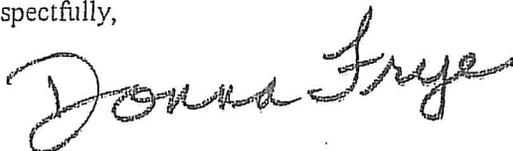
November 9, 2010: At the behest of the Audit Committee, Chairman Kevin Faulconer sends a letter (see attachment 2) to John McNally, the City's outside disclosure counsel, requesting guidance "as to how the City of San Diego should best notify regulators and other applicable entities (e.g. the SEC) about these delays."

November 16, 2010: Chief Operating Officer Jay Goldstone issues a memorandum (see attachment 3) to the City Council and Audit Committee notifying them of a "Message to Investors from the Chief Financial Officer of the City of San Diego" which has been approved by the Disclosure Practices Working Group and posted to the City's Investor Webpage. This statement describes the delay in issuance of the City's Fiscal Year 2010 CAFR and refers readers to the Mary Lewis memorandum described above.

November 23, 2010: John McNally of Hawkins, Delafield & Wood issues a memorandum (see attachment 4) in response to the letter from Audit Committee Chair Faulconer. It states that the City has no contractual obligation to notify the securities markets of any impending delay until a deadline has actually been missed, even though it has voluntarily chosen to do so. It furthermore states that the City has no legal requirement whatsoever to notify either the SEC or any other regulatory agency of these developments. City Management has made clear that it has no intention of contacting the SEC.

As we strongly disagree with this position and in light of San Diego's very recent release from monitored status and our stated objective of "maintaining its hard-earned reputation as a transparent and trustworthy municipality that is setting a nationwide standard for sound financial practices," we believe that the simple courtesy of notifying you about these events is the very least that could be expected of us.

Respectfully,

A handwritten signature in cursive script that reads "Donna Frye". The letters are fluid and connected, with a prominent initial "D".

Councilmember Donna Frye

A handwritten signature in cursive script that reads "Charles Sellers". The letters are fluid and connected, with a prominent initial "C".

Audit Committee Member, Charles Sellers



THE CITY OF SAN DIEGO

MEMORANDUM

DATE: November 2, 2010
TO: Honorable Members of the City Council
FROM: Mary Lewis, Chief Financial Officer *Mary Lewis*
SUBJECT: Financial Reports for Fiscal Years 2010 and 2011

This memorandum is to provide you with an update on the status of financial reporting for both Fiscal Years 2010 and 2011 and to describe the causes for these delays, give you the status on the resolution of these problems and the timeframes on when the expected reports will be available.

Both the City Comptroller and I have stated numerous times at Council Committees that the Fiscal Year 2010 year-end close and the CAFR were delayed. Ken Whitfield has been keeping the Audit Committee apprised of the 2010 year end close and the CAFR schedule. As he has explained, these delays are due to staff working through a detailed and complex correction of labor distribution charges posted in the financial system. The same issues affecting the data for fiscal year 2010 are also affecting the current fiscal year, albeit to a lesser degree, but nonetheless are delaying the completion of the First Quarter Fiscal Year 2011 Budget Monitoring Report and Charter 39 Reports as well. Budget monitoring reports and fiscal year 2010 year end information will be delayed until there is assurance that all postings of labor charges are correct.

I want to point out that the problems are in the posting of labor charges in the financial system and that accuracy of payroll checks is not affected.

Problem

The data issues that are being corrected involve labor distribution charges that were either entered inaccurately by employees at the start of the new payroll system (which went live in January 2010) or are the result of unique configurations of labor charges posting in the financial system that need to be corrected. As issues were identified in fiscal year 2010, staff began implementing a series of fixes, and the posting errors decreased, but were not completely eliminated.

There were many timecard entry errors introduced by our employees (i.e., time being charged to one account when it should have been charged to another account) when the new payroll system went live, and these certainly contributed to the amount of errors that needed to be resolved. In response we identified the need for additional safeguards at the point of data entry to limit erroneous entries. These safeguards subsequently have been designed and tested and are in place. Again, these entry errors did not affect the accuracy of individual paychecks, but did affect the posting of charges in the financial system, such the expense and revenue affecting grants, CIP projects and the General Fund.

Page 2

Honorable Members of the City Council
November 2, 2010

Resolution

Since payroll go-live last January, we have been making individual fixes and staff have been resolving problems due to unique configurations of labor charges, benefits and overhead charges applied to grants and CIP programs. However, this fall we determined that a different approach was needed and a comprehensive reprogramming effort was developed and implemented.

At this point, the City Comptroller's Office has identified all of the issues to be resolved and has worked with OneSD Support to write the specifications to reprogram a critical component of how the payroll data is posted to the financial accounts. This is a program which takes the expense from home cost centers, distributes the expense, and captures the revenue. The Comptroller's department will be heavily involved in testing the new program.

It is important for you to understand that the fixes to the system that are being implemented are permanent and comprehensive. This is a onetime action that will resolve the identified issues in fiscal years 2010, the current year and going forward, and will not need to be repeated.

This is a labor intensive process that relies on Comptroller's staff who have (in addition their regular primary job assignments) the responsibility to test and validate results. The development work and technical program changes are being completed by OneSD support staff. The City Comptroller and OneSD maintain a detailed schedule that tracks development and testing of results. This schedule indicates that labor postings for both fiscal year 2010 and 2011 will be corrected by mid January. As a result, the City's financial reports will be released according to the attached schedule.

These issues have proven to be complex and labor intensive to resolve, but we have a detailed plan that is being worked by many dedicated staff. I want to make sure that it is understood that data integrity is the most important goal, and while the delays in reporting are difficult to accept, there is no alternative but to make the permanent corrections and report only with reliable information. The alternative runs counter to the reforms we have all worked so hard to put in place. We are committed to working through the validation and testing process to ensure that the City's financial information is accurate.

I will keep you updated as progress is being made and will be happy to meet at any time.

Mary Lewis
Chief Financial Officer

Attachment: 1. Revised Financial Reporting Schedule

cc: Honorable Mayor Jerry Sanders
Jay M. Goldstone, Chief Operating Officer
Kevin Casey, Director of Council Affairs
Andrea Tevlin, Independent Budget Analyst
Mark Leonard, Financial Management Director
Ken Whitfield, City Comptroller

Revised Financial Reporting Schedule

First Quarter Budget Monitoring Report: We will not issue a First Quarter Budget Monitoring Report. Fiscal year -to -date information and analysis will be included in the Fiscal Year 2011 Mid-Year Budget Monitoring Report

<u>Fiscal Year 2011 Mid-Year Budget Monitoring Report</u>	February 23, 2011
<u>Charter 39 Report Issued for FY2011 Period 6</u>	February 23, 2011
<u>Fiscal Year 2010 Year End Report</u>	February 23, 2011
<u>Fiscal Year 2010 CAFR Opinion & Issuance</u>	Fourth Quarter Fiscal Year 2011

Financial Management will issue an updated report on major revenues by November 19, 2010.



COUNCIL PRESIDENT PRO TEM KEVIN L. FAULCONER

SECOND DISTRICT
CITY OF SAN DIEGO

November 9, 2010

Mr. John McNally
Hawkins Delafield & Wood, LLP
601 Thirteenth Street, NW
Suite 800 South
Washington, DC 20005

Dear Mr. McNally:

The San Diego City Council and City Audit Committee were recently made aware that financial reporting for Fiscal Years 2010 and 2011 will be delayed due to problems with implementation of the new City SAP data management system. Specifically, the FY2010 year-end close will be delayed, pushing back the issuance of the audited FY2010 Comprehensive Annual Financial Report (CAFR) from the second quarter of FY2011 to the fourth quarter of FY2011. FY2011 Budget Monitoring Reports will be delayed as well.

On behalf of the Audit Committee, I request your opinion as to how the City of San Diego should best notify regulators and other applicable entities (e.g., the Securities and Exchange Commission) about these delays. I believe that erring on the side of increased disclosure can only help the City maintain its hard-earned reputation as a transparent and trustworthy municipality that is setting a nationwide standard for sound financial practices.

I have every confidence that the City's financial management team, led by Chief Financial Officer Mary Lewis, is doing all it can to resolve the data management problems so the FY2010 CAFR can be audited and issued as soon as possible. I do not have any doubts that Ms. Lewis will handle all necessary disclosure of these delays in a

Mr. John McNally
Page 2
November 9, 2010

forthright manner. The Audit Committee believes that as the City's disclosure counsel, your independent analysis will assist the City in the months to come.

Sincerely,

A handwritten signature in cursive script, appearing to read "Kevin L. Faulconer". The signature is written in dark ink and is positioned above the printed name.

Kevin L. Faulconer
Chair, Audit Committee

KF:mta

Encl: November 2, 2010, Mary Lewis memo

cc: Honorable Mayor Jerry Sanders
Honorable City Councilmembers
Honorable City Attorney Jan Goldsmith
Audit Committee members
Jay Goldstone, Chief Operating Officer
Mary Lewis, Chief Financial Officer
Ken Whitfield, City Comptroller
Kevin Casey, Director of Council Affairs
Mark Leonard, Financial Management Director
Andrea Tevlin, Independent Budget Analyst



THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: November 16, 2010

FROM: Jay M. Goldstone, Chief Operating Officer

A handwritten signature in black ink, appearing to read "Jay M. Goldstone".

TO: Council President Hueso, Honorable Members of the City Council, and
Members of the Audit Committee

SUBJECT: City's Financial Statements

The attached communication is being posted today on the City's Investor Webpage regarding the delay in the City's financial statements. The Disclosure Practices Working Group discussed with John McNally, the City's disclosure counsel, how best to communicate this information to investors and developed and approved this brief communication.

It will be posted later today and you can access the statement at this link:
www.sandiego.gov/investorinformation/. Please contact me if you have any questions.

cc: Mayor Jerry Sanders
City Attorney Jan Goldsmith
Chief Financial Officer Mary Lewis
Independent Budget Analyst Andrea Tevlin

November 16, 2010

Message to Investors from the Chief Financial Officer of the City of San Diego

As part of the City's efforts toward strengthening its internal controls over financial reporting, we have implemented a new enterprise resource planning (ERP) system. The implementation of the ERP system has delayed the preparation of the City's financial statements for fiscal year 2010. For a detailed explanation of the reasons for this delay, please see my November 2, 2010 memorandum to the City Council, entitled "Financial Reports for Fiscal Years 2010 and 2011." As a result of the delay, the City expects that it will not file its fiscal year 2010 audited financial statements with the municipal market's repository, the Electronic Municipal Market Access (EMMA) system, by the deadlines required under the City's various continuing disclosure agreements (beginning 270 days after the end of the respective fiscal year).

The City currently expects to receive an unqualified audit opinion on the fiscal year 2010 financial statements from Macias Gini and O'Connell LLP in the fourth quarter of fiscal year 2011 (June 2011), but does not expect the audited financial statements for fiscal year 2011 to experience a delay.

Error! AutoText entry not defined.

MEMORANDUM

TO: Kevin L. Faulconer
Chair, Audit Committee

CC: Mayor Jerry Sanders
Council President and Members of the City Council
Jan I. Goldsmith, City Attorney
Audit Committee
Jay M. Goldstone, Chief Operating Officer
Mary Lewis, Chief Financial Officer
Ken Whitfield, City Comptroller
Kevin Casey, Director of Council Affairs
Mark Leonard, Financial Management Director
Andrea Tevlin, Independent Budget Analyst

FROM: John M. McNally 
Hawkins Delafield & Wood LLP
General Disclosure Counsel

DATE: November 23, 2010

RE: Delayed Release of the FY10 Audit; Federal Securities Law Implications

This is in response to your recent request for an analysis as to how to notify “regulators and other applicable entities” regarding the delayed release by the City of its fiscal year 2010 (“FY10”) audited financial statements.¹ This memorandum provides such analysis, and addresses more generally the federal securities law implications of the delayed release and the contractual provisions triggered by such delayed release.

Facts

The City’s fiscal year runs from July 1- June 30, and fiscal year 2010 ended on June 30, 2010. The City now estimates that the fiscal year 2010 audit will be complete in the fourth

¹ Letter from Kevin L. Faulconer, Chair, Audit Committee, to Mr. John McNally, dated Nov. 9, 2010.

quarter of fiscal year 2011 (June 2011).² The reasons for such delay are described in a recent memorandum of the Chief Financial Officer.³ The City does not expect the delay in the completion of the fiscal year 2010 audit to affect a timely completion of the fiscal year 2011 audit.⁴

Disclosure to Market

There is currently no new bond offering of the City that would include the FY10 audited or unaudited financials, and thus no "primary" disclosure to be made about the delay.

In addition, the Continuing Disclosure Agreements to which the City is a party do not require disclosure of the delay until such time as the deadline is missed.

Despite no federal securities law or contractual obligation to advise the market now of the delay in the release of the FY10 audited financials, the City, at the recommendation of the Disclosure Practices Working Group ("DPWG"), concluded that the best practice was to advise the market once the delay was confirmed. That recommendation was implemented by the November 16, 2010 "Message to Investors from the Chief Financial Officer of the City of San Diego" referenced above,⁵ which was posted on the Investor Information webpage of the City's website.

The DPWG further concluded (and I concurred) that there was no reason to directly contact the Securities and Exchange Commission ("SEC") on this point, particularly in light of the "message" and its posting described in the preceding paragraph.

Federal Securities Law Analysis

In securities law parlance, the City makes primary market disclosures and secondary market (or continuing) disclosures. By primary market disclosures is meant the Preliminary and final Official Statements the City prepares in connection with its bond offerings. By continuing disclosures is meant those disclosures to bondholders and the financial markets made by the City

² See "Message to Investors from the Chief Financial Officer of the City of San Diego," dated Nov. 16, 2010, and posted on the Investor Information webpage of the City's website.

³ See Memorandum of Mary Lewis, Chief Financial Officer, to Honorable Members of the City Council, dated Nov. 2, 2010, and entitled "Financial Reports for Fiscal Years 2010 and 2011."

⁴ *Supra* note 2.

⁵ *Supra* note 2.

either pursuant to a contractual agreement or voluntarily. In making either a primary market or a continuing disclosure, the standard is the same, which is provided by SEC Rule 10b-5:

It shall be unlawful . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

The City has postponed both its convention center and water refundings, and therefore there are no primary market disclosures currently being considered by the City.

There is no requirement under the federal securities laws requiring the City to make any particular disclosures about a bond issue subsequent to the primary market disclosure in an Official Statement. The SEC has no direct authority to require the City to make any particular secondary market disclosures.⁶ This is because the SEC has no direct authority to impose disclosure requirements on municipal issuers in either the primary or secondary market contexts. The SEC does have jurisdiction, however, over the SEC-registered brokers and dealers that serve as underwriters of the City's bonds. The SEC has used such jurisdiction to impose indirectly secondary market disclosure requirements on municipal issuers, through the operation of SEC Rule 15c2-12. That Rule provides that a broker-dealer may not underwrite the City's securities in a public offering unless the broker-dealer as underwriter has "reasonably determined" that the City has entered into a written agreement to provide certain specified secondary market disclosures about the securities being underwritten. Pursuant to underwritings that were done conditioned upon compliance with Rule 15c2-12, the City has executed numerous Continuing Disclosure Agreements ("CDAs") for various outstanding bond issues. The CDAs provide, in pertinent part, that the City will provide audited financial statements on an annual basis, generally by no later than 270 days after the end of the respective fiscal year.

If, as currently expected, the FY10 audited financial statements are not released until the fourth quarter of FY11, they would not be available for dissemination until after the contractually agreed-upon deadline. If that were to occur, then (1) the City would be required to file a notice with the national repository (the Electronic Municipal Market Access ("EMMA") maintained by the Municipal Securities Rulemaking Board) advising of the late filing once the

⁶ Absent a situation where a prior disclosure was incorrect when made, which may trigger a "duty to correct" once the mistake is discovered.

deadline was missed⁷, (2) the City would be required to file unaudited financial statements by the date in the respective CDAs if such statements were available⁸ (but only if the City were comfortable that there would not be material changes between the unaudited numbers and the final audited numbers), and (3) for a period of five years, the City would be required to disclose such failures to file in its Official Statements (primary market disclosure).⁹

Another point to note is that if, in connection with a future financing, a broker-dealer could not establish to its satisfaction a "reasonable determination" that the City would comply with the CDA to be entered into in connection with such financing, the broker-dealer would not be able to act as an underwriter by operation of Rule 15c2-12. In this regard, the SEC recently advised as follows:

the Commission believes that it is doubtful that an underwriter could form a reasonable basis for relying on the accuracy or completeness of an issuer's or obligated person's ongoing disclosure representations, if an issuer has a history of persistent and material breaches or has not remedied such past failures by the time the offering commences.¹⁰

In the case of the City, the reason for the delay in the release of the FY10 financials relates principally to the implementation of a new payroll system.¹¹ Thus, it is not the situation of "persistent and material breaches" being described in the above-quoted SEC release. Even with the problems experienced by the City relating to the unavailability of audited financials a few years ago, which necessitated the use of private placements rather than public bond offerings, the underwriters had no trouble satisfying their reasonable determination requirement once audited financials became available. In a similar fashion, we do not think this delay, in light of the explanation for the delay, will cause an underwriter not to reach the "reasonable determination" required by Rule 15c2-12.

⁷ Rule 15c2-12(b)(5)(i)(D). The City could file any such notice once it is known the deadline will be missed, but would not be required to do so.

⁸ Letter from Robert L.D. Colby, Deputy Director, SEC, to John S. Overdorff, Chair, Securities Law and Disclosure Committee, National Association of Bond Lawyers, dated June 23, 1995, response to question 6.

⁹ Rule 15c2-12(f)(3).

¹⁰ SEC Rel. No. 34-62184A (May 26, 2010).

¹¹ *Supra* note 3.