

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.