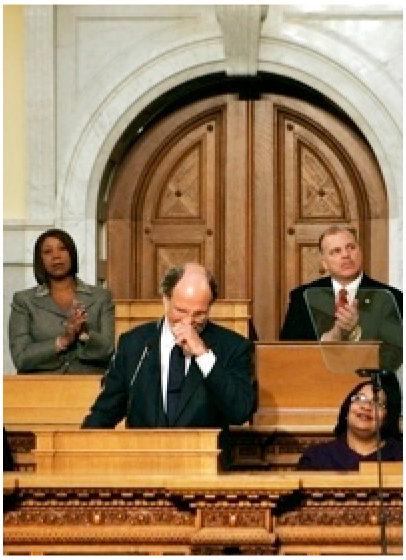
SEC Charges NJ With Cooking the Books



Notable in the statement from the Securities and Exchange Commission (SEC) last week that it was charging the State of New Jersey with securities fraud was the lack of fines, punishment, or names of the guilty. The fraud began in 2001 and wasn't uncovered until the New York Times exposed it in April of 2007.

What the SEC did say was that New Jersey failed to make disclosures 79 times in the sale of $26 billion worth of municipal bonds, creating "the false impression that the Teachers' Pension and Annuity Fund (TPAF) and the Public Employees' Retirement System (PERS) were being adequately funded, [while] masking the fact that New Jersey was unable to make contributions to TPAF and PERS without raising taxes, cutting other services, or otherwise affecting the budget." Robert Khuzami, Director of the SEC's Division of Enforcement, said:

> All issuers of municipal securities, including states, are obligated to provide investors with the information necessary to evaluate material risks. The State of New Jersey didn't give its municipal investors a fair shake, withholding and misrepresenting pertinent information about its financial situation.

New Jersey got into trouble in 2001 when the legislators increased retirement benefits for employees and retirees in both plans but failed to provide funding for those increases. Instead, a paper account created "Benefit Enhancement Funds (BEF)" into which monies were to be placed to pay for the increases. But no funds were ever placed into those accounts, even though the state budgets showed that amounts of either $551 million, $56 million, or nothing at all were set aside, depending upon which state documents were considered. According to the *Times*, New Jersey said the state contributed $551 million to the BEF in 2005, according to a bond offering statement. The $56 million figure appeared in an audited financial statement for the BEF. In fact, nothing was ever placed in the BEF, and the whole paper game folded 5 years later.

The SEC's Chief of Municipal Securities and Public Pensions Unit, Elaine Greenberg, said "Issuers of municipal bonds must be held accountable when they seek to borrow the public's money using offering documents [which contain] false and misleading information. New Jersey hid its financial challenges from the very people who are most concerned about the state's financial health when investing in its future." However, nowhere in the SEC press release was a single name mentioned, not even those who did the auditing of the books or those who sold the bonds.

They do have names, however. Frederick Beaver, director for the Division of Pensions and Benefits in the New Jersey Treasury Department, when pressed by the *Times* for an explanation about various questionable practices involved in hiding the truth, pointed out that "other places had taken similar steps occasionally when dealing with a budget crunch." He said, "The problem we had was doing it on a repeat basis." Donald DiFrancesco, acting governor of New Jersey in 2001, when the pension increases were approved, said he recalled "people thought it was good public policy," which was devised to attract the best people. He said he did not think the measure was financially unsound and "did not recall" anyone challenging it or calling it improper.

Jon Corzine (above, former chairman of Goldman Sachs) took office in January 2006 and warned that the pension funds were in bad shape, saying publicly that "It's impossible for us to stay on the course that we are on today, and deliver what people are asking for. The money will not be there." Although Corzine succeeded in persuading the legislature to increase contributions to the funds, they were not nearly enough to restore them to financial health.

John Megariotis, the Deputy Director of New Jersey's Division of Pensions and Benefits, claimed innocence: "We were [only] the bean-counters…Those are not my numbers." And then he assured the*Times* that New Jersey would not fudge the numbers ever again.

John Bennett, majority leader of the Republican State Senate at the time of the increase, blamed DiFrancesco's administration which had pushed for the increase, assuring him that "there would be money to cover it."

Those responsible for promoting the fraud to bond investors include Citigroup, J. P. Morgan, Morgan Stanley, Bank of America, Merrill Lynch, Barclays Capital, and, of course, Corzine's former employer, Goldman Sachs.

The SEC said its action was its first ever against a state government, and that its order "requires the State of New Jersey to cease and desist from committing or causing any violations and future violations … New Jersey consented to the issuance of the order without admitting or denying the findings."

In a separate interview, Greenberg said that "Hopefully, [the SEC's action] will send a message to other states or local governments." However, it may just be too late for New Jersey. As noted here, it is going to take much more than "conjuring magic" and "pension fairies" to restore the state's fiscal balance sheet. As CNBC put it,

> By the time Gov. Chris Christie took office this year, the pension funds had been deprived of contributions for so long that it had become near[ly] impossible to catch up. The state needs to come up with billions of dollars every year, something it cannot do without raising taxes, cutting public services or going even deeper into debt.

Ian Mathias, writing for the *Daily Reckoning*, hopes that some lessons have been learned: "Now you have all but absolute proof that State administrators are not only unable to balance their books, but they're willing to cook 'em too." Because the action came without pain, punishment or exposure, it provides little incentive for those administrators to change their ways. In fact, only one state has ever defaulted on its bonds: Arkansas defaulted on its obligations back at the bottom of the Great Depression, in 1934.

So, he adds, "The odds are still in your favor [if you own municipal bonds]. But reason is not. Now ethics aren't, either."

Photo: Former New Jersey Gov. Jon S. Corzine delivers his last State Of The State address on Jan. 12, *2010, at the New Jersey Statehouse in Trenton: AP Images*