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U.S. Inquiry Said to Focus on California Pension Fund

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Federal regulators are investigating whether California violated securities laws and failed to provide adequate disclosure about its giant public pension fund, according to a person with knowledge of the investigation.

The Securities and Exchange Commission normally polices companies, but last year it brought its first enforcement action ever against a state, accusing New Jersey of securities fraud for misleading bond investors about the condition of its pension fund. The commission signaled, in its settlement with New Jersey, that it was going to look more broadly at the pension disclosures of states and cities.

The fund, the California Public Employees' Retirement System, known as Calpers, lost about a quarter of its total investment portfolio during the financial crisis, leaving the state responsible for replacing billions of dollars each year and contributing to its huge deficit. The question is whether California adequately disclosed in the preceding years how risky the pension investments were and how much money it might need to cover any shortfall.

But it is unclear whether investigators are focusing on those risks or on possible conflicts of interest in steering investments to related parties, the subject of a separate investigation by the attorney general of California.

S.E.C. officials declined to confirm an investigation, citing agency rules. But the person with knowledge of the investigation said it was among the agency's top priorities. A spokeswoman for Calpers, which is America's largest pension fund with assets of about $220 billion, said it had not been contacted by the S.E.C. about its accounting or about financial disclosures.

"The SEC has an ongoing look at pension funds in California" because of revelations about the use of placement agents who recommended investment managers, said Patricia Macht, a spokeswoman for Calpers.

Along with concerns about the use of placement agents, regulators have grown increasingly concerned about whether states may have hidden financial weaknesses, particularly in their pension portfolios, and whether investors who buy municipal bonds can fully appreciate the risks.

A spokesman for the California state treasurer's office, which is responsible for disclosures to bondholders, said "we provided all material information about pension fund issues at all times."

California has not defaulted on any debts and says its bonds are safe. But the state has been grappling with big, structural budget deficits every year, and cannot easily increase revenue because of voter-approved tax caps. The state's credit has been downgraded as these financial problems have intensified, and the downgrades have in turn lowered its bonds' value. Had investors been able to clearly see the pension risks, they might have steered clear of California's debt or demanded a higher yield.

If federal investigators are able to make a case that California misled investors about the risk in its pension fund, it would send a powerful signal to other public funds, which almost without exception base their financial reporting on average annual investment returns of about 8 percent a year, something hard to defend in today's markets, no matter what the investment mix.

The S.E.C.'s goal is to force public pension funds to be more open, not just about their investments but about how their risk may affect the finances of the state. It is unlikely that the S.E.C. would impose any penalty because that would force taxpayers to pay for wrongs they knew nothing about. In the New Jersey case, the S.E.C. imposed no penalty but publicized the case in hopes it would be a deterrent.

Any accusation of securities fraud could take years because public finance is a new area for the S.E.C. and any case would rely on novel legal theories. It would be a blow to Calpers, which has used its institutional clout for years to promote good corporate governance and truth in accounting. Calpers has recently pushed for boardroom reforms at JPMorgan Chase, Goldman Sachs, Apple, and BP, among others. And it has sued Moody's, Fitch and Standard & Poor's, accusing them of giving "untrue, inaccurate and unjustifiably high" ratings to structured investment vehicles that failed in the mortgage collapse.

Its activism has served as a role model for smaller public pension funds that have also had losses, but might not have been able to challenge corporate governance practices on their own. But now the tables have turned, because S.E.C. investigators hope to use Calpers as an example in a case about of how misleading pension disclosures can amount to securities fraud, according to the person with knowledge of the investigation. Like most public plans, Calpers has maintained that its accounting methods are appropriate and that it is in full compliance.

Calpers has lately been under fire for a big benefit increase in 1999. At that time the fund ran various assumptions on how its investments might do. It discussed them in a public meeting but the state did not put them into its bond prospectus, which was the responsibility of the state treasurer, then Phil Angelides, who also sat on the board of Calpers.

In the years after that, Calpers stepped up its investments in real estate, riding the market up and then crashing when the housing bubble burst. The worst case, created by Calpers' staff, turned out to be oddly prescient. It said the state might have to come up with $3.95 billion a year in fresh money for the pension fund by the end of 2010. In fact, the state has to contribute $3.88 billion.

Mr. Angelides, now chairman of the Financial Crisis Inquiry Commission, was not available to comment Thursday because the commission was finishing its report.

David Crane, an aide to then Gov. Arnold Schwarzenegger, said last year in legislative testimony that he found it "nothing short of astonishing" that Calpers had "promoted the largest nonvoter-approved debt issuance in California history" without revealing the risks or conflicts of interest involved.

"Frankly, I've never seen anything like the Calpers sales document, which makes even Goldman Sachs's alleged nondisclosure look like child's play," said Mr. Crane, who testified at a time when the S.E.C. was suing Goldman Sachs over alleged disclosure violations in connection with mortgage-backed securities.

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