UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9389 / March 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15237

In the Matter of **STATE OF ILLINOIS,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), against the State of Illinois (the "State," "Illinois," or "Respondent").

II.

In anticipation of the institution of these proceedings, the State has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, the State consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and the State's Offer, the Commission finds that:

Summary

1. In connection with multiple bond offerings raising over $2.2 billion from approximately 2005 through early 2009, the State of Illinois misled bond investors about the

adequacy of its statutory plan to fund its pension obligations and the risks created by the State's underfunding of its pension systems.[1]

2. The State omitted to disclose in preliminary and final official statements material information regarding the structural underfunding of its pension systems and the resulting risks to the State's financial condition. Enacted in 1994, the Illinois Pension Funding Act (the "Statutory Funding Plan") established a pension contribution schedule that was not sufficient to cover both (1) the cost of benefits accrued in the current year and (2) a payment to amortize the plans' unfunded actuarial liability. This methodology structurally underfunded the State's pension obligations and backloaded the majority of pension contributions far into the future. The resulting systematic underfunding imposed significant stress on the pension systems and on the State's ability to meet its competing obligations.

3. During this same time period, the State also misled investors about the effect of changes to the Statutory Funding Plan, including substantially reduced pension contributions in 2006 and 2007 ("Pension Holidays"). Although the State's preliminary and final official statements disclosed the fact of the Pension Holidays and other legislative amendments to the plan, Illinois did not disclose the effect of those changes on the contribution schedule or on the State's ability to meet its pension obligations.

Respondent

4. Illinois possesses all powers, functions, rights, privileges, and immunities authorized by the United States Constitution, the Illinois Constitution, and the State's laws, including the power to issue debt.

Pension Funding in Illinois

5. The pension systems of Illinois currently are among the lowest-funded plans in the nation. As of 2011, the systems collectively were underfunded by $83 billion, and system assets covered only 43 percent of system liabilities. The State's current funding deficit was created in significant part by the State's historical failure to fund its pension systems in a manner to avoid the growth of the unfunded liability.

6. The State of Illinois provides funding for five retirement systems that pay pension benefits upon retirement, death, or disability to public employees and their beneficiaries. The five systems are the Teachers' Retirement System of the State of Illinois, the State Universities Retirement System of Illinois, the State Employees' Retirement System of Illinois, the Judges' Retirement System of Illinois, and the General Assembly Retirement System, State of Illinois. Generally speaking, the systems are all defined-benefit plans that require contributions by employees and employers, with a significant portion funded by the State.

[1] These bonds are general obligation bonds, which are backed by the full faith and credit of the State.

7. Until 1981, the State funded pensions by covering the out-of-pocket costs associated with benefits as they came due. Employee contributions and investment income funded a reserve for future benefits. This approach had no relation to actuarial calculations of liability and was abandoned in 1982 during a period of fiscal stress. Without a remedial plan in place, state contributions were held relatively constant from 1982 to 1995. As a result of level contributions and rising costs, by 1995 the pension systems were significantly underfunded. In the aggregate, system assets covered only 50 percent of actuarial accrued liabilities, which had grown to approximately $20 billion.

8. In an effort to address this imbalance, the Illinois General Assembly enacted the Statutory Funding Plan in 1994. Effective in 1995, this Statutory Funding Plan established a fifty-year schedule intended to achieve a 90 percent funded ratio for each system by 2045.[2] The Statutory Funding Plan called for the State to meet this target by contributing a level percentage of payroll each year sufficient to reach this goal. Under the level percentage of payroll method, amortization payments are calculated so that they are a constant percentage of the projected payroll of active plan members over a given number of years. Each year, actuaries for each pension system would use demographic and other data and various assumptions to calculate actuarial value of assets, actuarial accrued liability, and the State's contributions based on the statutory requirements and objectives. Rather than requiring the immediate funding of plan contributions calculated in this manner, the legislature phased in the State's contribution over a fifteen-year "ramp" period. During the ramp period, the Statutory Funding Plan required that the percentage of payroll increase each year such that, by 2010, the State would be contributing the level percentage of payroll required under the plan for 2011 to 2045. At the conclusion of the ramp period in 2010, the Statutory Funding Plan required the State to contribute a level percentage of state payroll in order to achieve the 2045 target.

9. Rather than controlling the State's growing pension burden, the Statutory Funding Plan's contribution schedule increased the unfunded liability, underfunded the State's pension obligations, and deferred pension funding. This resulting underfunding of the pension systems ("Structural Underfunding") enabled the State to shift the burden associated with its pension costs to the future and, as a result, created significant financial stress and risks for the State.

a. For the majority of the years under the Statutory Funding Plan, the State's annual required contributions were insufficient to prevent the growth of its unfunded liability. Specifically, the statutory contributions were not sufficient to cover both (1) the cost of pension benefits earned by public employees by virtue of their service in the current year ("the normal cost") and (2) a payment to amortize the accumulated amount of pension liabilities that have been deemed earned but are not funded (the unfunded actuarial accrued liability, or "UAAL") for an identified group of plan participants. The normal cost and amortization payment collectively are referred to as the actuarially required contribution ("ARC"). The State's pension contributions were calculated in accordance with State law, not in accordance with the ARC, and therefore the

[2] The funded ratio, which is one measure of the financial health of a pension plan, is the actuarial value of assets expressed as a percentage of the actuarial accrued liability. A 100 percent funded ratio means that existing assets cover the present value of future benefits to be paid by the systems.

Statutory Funding Plan deferred funding of the State's pension obligations and compounded its pension burden.

b. The 90 percent funding target allowed the State to amortize the UAAL in a manner that would not eliminate it entirely. By failing to amortize the UAAL completely, the State was able to lower its contributions. However, by assuring that some portion of the UAAL would remain outstanding, it also increased the economic cost of the pensions and delayed the cash outlays necessary to fulfill its pension obligations.

c. The State's plan also spread costs over fifty years, in contrast to the thirty-year amortization period adopted by the pension plans of most other states. The longer amortization period extended the amount of time required to pay down the UAAL, reducing the State's annual statutory contributions while increasing the real cost of the pensions over time.

d. The State's phased contributions during the fifteen-year ramp period accelerated the growth of the UAAL during this time period and amplified the burden and risk associated with the State's plan.

e. In contrast to the ARC, which typically is calculated using the closed group approach, contributions under the Statutory Funding Plan are calculated using an open group method, which spreads the cost of providing benefits over existing and new entrants. The Illinois approach requires actuaries to estimate pension benefits for employees to be hired far into the future, particularly given the State's use of a 2045 target date.

f. The State's use of the projected unit credit ("PUC") actuarial cost method compounded the risk of the Statutory Funding Plan. The PUC method, used by Illinois and a minority of states, allocates a higher portion of retirement costs closer to retirement, while the entry age normal ("EAN") method, used by a substantial majority of public sector plans, averages those same costs evenly over the pensioner's period of employment. Compared to an EAN approach, the PUC method results in less funding for active employees, accumulates assets more slowly, produces more volatile measures of contribution rates, and results in rising rather than level contribution rates.

10. From 1996 to 2010, the State's unfunded liability increased by $57 billion. The State's insufficient contributions under the Statutory Funding Plan were the primary driver of this increase, outweighing other causal factors, such as market performance and changes in benefits. This Structural Underfunding created significant financial risks for the State:

a. Although the most significant effects of this Structural Underfunding materialize in the future, the pension shortfall already has imposed a severe strain on the finances of the Illinois government, and pension costs are affecting the State's ability to manage other significant obligations. In April 2012, the State acknowledged that the pension shortfall is "one of the most difficult problems that Illinois government has faced for more than three decades," and "[u]nsustainable pension costs are squeezing core programs in education, public safety, and human services, in addition to limiting [the State's] ability to pay [its] bills."

b. The State understood that the Structural Underfunding put the plan at serious risk and that the State likely would not be able to afford the level of contributions required to reach

90 percent funding. As explained by one of the system's actuaries in 2009, "[t]he perpetual underfunding puts the plan at serious risk for ultimate exhaustion of the trust, leaving the responsibility for the payment of benefits elsewhere." He observed further that "[t]he plan is in significant funding peril unless the contributions recommended under the actuarially required contribution can be made." Similarly, a pension consultant retained by the Governor's Office of Management and Budget ("GOMB") wrote in August 2009 that "the Illinois pension system is now so underfunded that the State likely [would] never be able to afford the level of contributions required to ever reach 90 percent funding." Other documents generated by GOMB reflected serious concerns about the financial strain produced by the State's unfunded pension obligations. This information was not disclosed to bond investors in bond offering documents.

c. The Structural Underfunding of the pension systems and the State's increasing inability to afford contributions created the significant risk that the State would be unable to satisfy its competing obligations. This underfunding also compromised the creditworthiness of the State and increased the State's financing costs.

Underfunding of the State's Pension Obligations

11. In its bond offering documents from 1995 to 2010, the State disclosed that Illinois funded its pension obligations through the Statutory Funding Plan, which according to the State provided for funding "necessary" or "sufficient" to achieve 90 percent funding of liabilities in 2045. Specifically, official statements disclosed that the Statutory Funding Plan "created a 50-year funding schedule of the Retirement Systems which requires the State to contribute each year, starting with Fiscal Year 2011, the level percentage of payroll sufficient to cause the assets of the Retirement Systems to equal 90 percent of the total accrued liabilities by the end of Fiscal Year 2045. In Fiscal Years 1997 through 2010, contributions as a percentage of payroll are increased each year such that by Fiscal Year 2010, the contribution rate is at the same level as required for years 2011 through 2045."

12. The State also disclosed statistics regarding the systems' assets and liabilities and other information. Among other things, the State provided, for an historical five-year period, the actuarial assets and liabilities for each of the pension systems, as prescribed by state law; the UAAL, which is one measure of the funded status of pension plans; the funded ratio, which is the actuarial value of assets as a percentage of the actuarial accrued liability; and summary financial statements for each of the pension systems. The State's official statements also reviewed recent legislation affecting pension funding and demographic data for participants in the pension systems.

13. The State did not disclose that contributions required by the Statutory Funding Plan significantly underfunded the State's pension obligations and deferred pension funding into the future.

a. The State did not disclose in its official statements its failure to contribute to the full amount of the ARC and the consequences of not funding the full amount of the ARC.[3]

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[3] The State's comprehensive annual financial reports ("CAFRs"), which the official statements incorporated by reference, compared the calculation of the contribution under the

b. The State also did not disclose that multiple aspects of the Statutory Funding Plan deferred pension contributions and increased the burden associated with the pension plans. For instance, the State did not explain the implications of its decision to spread costs over fifty years, the fifteen-year ramp period, and 90 percent funding target.

c. The State did not inform investors that other aspects of the State's funding method, such as the State's use of the PUC method, delayed contributions and increased the unfunded liability.

d. In its official statements, the State cited a number of factors that, in the past, contributed to the increase in unfunded pension liability, such as statutory benefit enhancements and market performance, but did not disclose that the State's insufficient contributions were the primary driver of the increase.

e. The State disclosed that its UAAL could increase in the future by virtue of a variety of factors, such as a decrease in the performance of investments and changes in legislation, actuarial assumptions, inflation, benefits, or the State's contribution rate. However, the State misleadingly omitted to disclose the primary driver of the increase—the insufficient contributions mandated by the Statutory Funding Plan.

14. The State also failed to disclose the risks created by the Structural Underfunding.

a. The State failed to disclose the effect of its unfunded pension systems on the State's ability to manage other obligations. The State also did not inform investors that rising pension costs could continue to affect its ability to satisfy its commitments in the future. In contrast, the State included multiple metrics to assist potential investors' evaluation of the burden associated with the State's bond offerings and obligations.

b. Although the State understood that the Structural Underfunding could risk the eventual exhaustion of the pension systems' funds and that the State likely would not be able to afford the level of contributions required by the Statutory Funding Plan, it did not disclose that the State's inability to make its contributions increased the investment risk to bondholders. The State did not identify or discuss how this underfunding compromised the State's creditworthiness or increased its financing costs.

Failure to Adhere to the Statutory Funding Plan

15. As described above, the Statutory Funding Plan set contribution requirements at a level that failed to control the growth of the unfunded liability until the latter years of the plan. Nevertheless, the State did not meet the requirements of the plan as enacted in 1995. Beginning in 2005, the State amended the Statutory Funding Plan, lowering these already deficient contributions, or borrowed to cover its payments. This modification to the original Statutory

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Statutory Funding Plan to a contribution calculated in accordance with generally accepted accounting principles. However, the CAFR disclosures did not describe the risks and implications of the Statutory Funding Plan and deviations from that plan.

Funding Plan created further risk to the pension systems and the financial condition of the State. The State misled investors about the effect of these changes on the State's financial condition and, in particular, the impact of the Pension Holidays instituted in 2006 and 2007.

16. On June 1, 2005, the State legislatively enacted Pension Holidays, lowering the contribution in 2006 and 2007 by 56 and 45 percent, respectively. The Pension Holidays had the dual effect of increasing the UAAL and further delaying payment of the deferred portion of the contribution to a future fiscal year.

17. Contrary to the State's CAFRs, which stated that the Pension Holidays would be offset by increased contributions from 2008 to 2010, the 2005 amendment to the Statutory Funding Plan did not require increased contributions in 2008 through 2010 to offset the reduced contributions in 2006 and 2007. Instead, the statute required contributions from 2008 to 2010 to be "increased in equal annual increments from the required State contribution for State fiscal year 2007." In other words, the Illinois legislature mandated a resumption of the ramp period from the reduced 2006 and 2007 levels, not an increase in the 2008, 2009, and 2010 contribution levels to offset those reduced contributions.

18. Although the State disclosed the basic fact of these reduced contributions, the State did not disclose that each of these deviations exacerbated the Structural Underfunding, deferred contributions further into the future, impaired the ability of the State to meet its pension obligations, and negatively impacted the State's creditworthiness.

19. Due to the State's failure to adhere to the original Statutory Funding Plan prior to the conclusion of the ramp period, the State should have known that it likely would have significant difficulty making the required contributions in the future. In addition, the State should have known that its disclosures regarding the Structural Underfunding and the related risks were inadequate.

Significance to Potential Investors

20. The funding of pension obligations is a significant aspect of the State's budget and financial status. Reasonable investors would have considered information regarding the State's Structural Underfunding of its pensions, the risks created by that underfunding, and the financial condition of the pension plans to be important factors in the investment decision-making process. Reasonable investors would have viewed such information as significantly altering the total mix of information available regarding the State's financial condition and the State's future financial prospects. Such information allows investors to weigh and price the risk associated with the State's debt obligations.

21. Concern about the State's pension financing was a significant factor prompting downgrades of the State's credit rating from 2010 to 2012. For example, on June 4, 2010, Moody's lowered the State's general obligation bond rating based on the State's increased reliance on non-recurring measures. A significant factor cited by Moody's was the fiscal pressure caused by the State's pension funding burden, and, for the first time, Moody's provided additional detail regarding the State's funding challenges and difficulty complying with its pension law in recent years.

22. Certain events ultimately revealed the State's Structural Underfunding of pensions and the risks associated with the underfunding. For example, on January 21, 2011, the State included enhanced pension disclosures released in a preliminary official statement for a general obligation offering on February 11, 2011. Following this event and others, the risk premium associated with Illinois bonds rose, causing the spread between the yield on Illinois bonds relative to other AAA-rated municipal bonds to widen.

Institutional Failures

23. The State's misleading disclosures resulted from, among other things, various institutional failures. The State failed to adopt or implement sufficient controls, policies, or procedures designed to ensure that material information was assembled and communicated to individuals responsible for disclosure determinations, to train personnel involved in the disclosure process adequately, or to retain disclosure counsel. As a result, the State lacked proper mechanisms to identify and incorporate into its official statements relevant information held by the pension systems and other bodies within the State.

24. GOMB, which managed the issuance of debt for the State, coordinated the drafting, review, and revision of the bond disclosure documents, including the section regarding pension funding. GOMB's procedures were inadequate for ensuring that material information concerning State Pension Funds or the State's financing of State Pension Funds was disclosed and accurate in bond offering documents. The State failed to implement sufficient policies and procedures, to conduct adequate training, or to consult securities disclosure counsel to ensure adequate disclosure. Relying on prior "carryover" disclosures and "page-turn" reviews during group conference calls, the State and its advisors did not scrutinize the institutionalized description of the Plan adequately and made little affirmative effort to collect potentially pertinent information from knowledgeable sources—in particular, actuaries for the pension systems and the State's Commission on Government Forecasting and Accountability ("COGFA").

25. Within GOMB, the team responsible for managing the disclosure process purported to rely on its consultants, underwriters, underwriter's counsel, and bond counsel to identify and evaluate the need for additional disclosures. Those parties, however, relied on the State to do the same. The result was a process in which no one person fully accepted responsibility for identifying and analyzing potential pension disclosures.

Remedial Measures

26. The State has taken significant steps to correct these process deficiencies and enhance its pension disclosures. Among other things, the State issued enhanced disclosures; retained disclosure counsel; instituted written policies and procedures, disclosure controls, and training programs; and designated a disclosure committee.

a. In the State's April 2009 bond offering documents, the State provided a hyperlink to a February 2009 COGFA monthly briefing in which COGFA provided certain negative information regarding, among other things, the decline in the State's pension system assets.

b. In June 2009, the State commissioned a Pension Modernization Task Force to evaluate the benefit structure, costs, and funding of the State's pension systems. The task force met from June to November 2009 and issued a report in November 2009. The report contained detailed information about the history of pension investments, benefits, and funding and reflected the views of various experts. In its official statement for the January 2010 offering, the State included a hyperlink to the task force report in the pension section.

c. In late 2009, the State made a series of personnel changes in the GOMB, including in its most senior positions. These new officers worked to formalize the disclosure and underwriting process.

d. In March 2010, COGFA produced a report on the funded status of the pension systems as of June 30, 2009. The report contained certain historical and projected information regarding the State's funding of its pensions.

e. Promptly following the Commission's settled action against the State of New Jersey in August 2010,[4] the State began to implement a series of remedial measures. The State retained disclosure counsel, significantly enhanced disclosures in the pension section of its bond offering documents, developed training materials, and added formal disclosure controls regarding pension disclosures. The State also designated a disclosure committee responsible for collecting information from relevant sources, evaluating the State's disclosure obligations, and approving bond offering disclosures. Prior to dissemination of official statements, the committee ensures that the disclosures are reviewed by the pension systems, COGFA, the Office of the Comptroller, the Office of the Treasurer, and the Office of the Illinois Attorney General.

f. These steps culminated with significant corrective disclosures in connection with an offering in February 2011, the State's first offering since the Commission's settled action against the State of New Jersey. In particular, the State disclosed contrasts between contributions determined under the Illinois Statutory Funding Plan and the costs implied by standard actuarial methods and assumptions and Government Accounting Standards Board ("GASB") Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. The State also discussed the effect of such deviations on the State's ability to meet its pension obligations and included the projected funded status of the pension systems. Finally, the State disclosed the effect of amendments to its Statutory Funding Plan on its ability to fund its pension obligations and the State's financial condition. The State's disclosures also included an extensive discussion of the background of the pension systems, history of contributions to the pension systems, the financial condition of the plans, projections of funded status, substantive references to additional sources of information, and a discussion of disclosure policies and procedures.

Legal Discussion

27. Issuers of municipal securities are responsible for the accuracy of their disclosure documents. Proper disclosure allows investors to understand and evaluate the financial health of the municipality in which they invest. The Commission has repeatedly emphasized that disclosure

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[4] *In re* State of New Jersey, Securities Act Release No. 33-9135 (Aug. 18, 2010).

in municipal debt offerings may be rendered materially misleading due to the omission of other material facts.

28. The antifraud provisions of Section 17(a) of the Securities Act prohibit fraudulent or deceptive practices in the offer or sale of securities by the issuers of municipal securities. Section 17(a) of the Securities Act prohibits obtaining money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. A fact is material if there is a substantial likelihood that a reasonable investor would have viewed the information as "having significantly altered the 'total mix' of information available." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). To the extent the omitted information relates to contingent future events, materiality depends upon "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of circumstances." *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988). Negligence is sufficient to prove violations of Section 17(a)(2) or (3) of the Securities Act. *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980).

Violations

29. As a result of the negligent conduct described above, the State violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. Specifically, in numerous bond offerings from approximately 2005 through March 2009, the State misled bond investors by omitting to disclose information about the adequacy of its statutory plan to fund its pension obligations and the risks created by the State's Structural Underfunding of its pension obligations. During this same time period, the State also misled bond investors about the effect of changes to that plan, including the Pension Holidays in 2006 and 2007.

30. The State was aware of the Structural Underfunding and the potential effects of the underfunding. However, due largely to institutional failures, the State misled investors by omitting to disclose material information, rendering certain statements misleading, in bond offering documents regarding the State's ability to fund its pension obligations or the impact of the State's pension obligations on the State's financial condition.

Remedial Acts

31. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by the State, as described in Paragraph 26, and cooperation afforded the Commission staff during the investigation.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the State's Offer.

Accordingly, it is hereby ORDERED that, pursuant to Section 8A of the Securities Act, the State of Illinois shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

By the Commission.

Elizabeth M. Murphy
Secretary