ILLINOIS STATE BOARD OF INVESTMENT
180 North LaSalle Street, Suite 2015
Chicago, Illinois 60601
(312) 793-5718

April 30, 2010

The Honorable NAME
Illinois State House of Representatives
ADDRESS
Springfield, IL 62706

Dear Representative NAME:

Draft legislation has been circulated under which the FY2011 pension obligations would be partially met through the private placement of state bonds with the state pension systems (the "Systems"), including the Illinois State Board of Investment (the "Board"). The bonds would be privately placed and issued directly to the Systems without the benefit of underwriting.

The Board has directed me to forward to you a resolution which it adopted on April 29, 2010. The resolution, enclosed, opposes this proposal and strenuously objects to any action which might place at risk the Systems' tax exempt status.

The Systems are qualified, tax exempt plans under the Internal Revenue Code ("Code"). As such, they are exempt from federal taxes on investment returns and must adhere to the standards set forth by the Internal Revenue Service in order to retain their tax exempt status. Based upon review by the Board's external counsel, the suggested legislation constitutes a "prohibited transaction" as defined in the Code. Under Code § 503(b) and (e), a qualified plan loses its tax exempt status if it engages in a prohibited transaction. Enclosed is a copy of applicable memoranda that describes this issue and other legal problems with the legislation. In addition, I am enclosing a copy of a resolution, adopted by the State Employees Retirement System on April 27, 2010, which opposes the suggested legislation.

This legislation differs greatly from historical funding which has involved the conventional sale of general obligation bonds in the public market and the subsequent transfer of the cash proceeds to the Systems. Furthermore, and of most importance, the suggested legislation is fraught with risk of jeopardizing the Board's tax exempt status, which would further undermine funding status of the Systems.

Given the fact that the draft legislation is setting forth a funding scheme which has yet to be attempted by any other state, the Board is confident that you appreciate the consequences associated with such risk.

If you have any questions or comments regarding this matter, please do not hesitate to contact me directly.

Sincerely,

William R. Atwood
Executive Director

Enclosures.

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"BE IT RESOLVED, the Illinois State Board of Investment ("ISBI") opposes any borrowing plan which transfers assets other than cash or has the remote possibility of jeopardizing the retirement systems' qualified, tax-exempt status under the Internal Revenue Code. ISBI advocates for the funding of the State's retirement systems by use of conventional means which are open and transparent, and which have been proven to be historically successful."

Adopted: April 29, 2010

SRS STATE RETIREMENT SYSTEMS
• State Employees' Retirement System of Illinois
• General Assembly Retirement System
• Judges' Retirement System of Illinois
Internet: http://www.state.il.us/srs E-Mail: ser@mail.state.il.us
2101 South Veterans Parkway, P.O. Box 19255, Springfield, IL 62794-9255

STATE EMPLOYEES' RETIREMENT SYSTEM
BOARD OF TRUSTEES
RESOLUTION 2010-1
Adopted April 27, 2010

WHEREAS, the State of Illinois' public pension systems (Systems) have among the highest unfunded liabilities in the nation,

WHEREAS, even though the Systems are qualified government retirement plans under the federal Internal Revenue Code (Code), and therefore exempt from ERISA, they are still subject to the prohibited transaction rules of the Code,

WHEREAS, a violation of the prohibited transaction rules of the Code could result in the revocation of the tax-exempt status of the Systems by the IRS with catastrophic financial and legal results for the Systems,

WHEREAS, various proposals to pay for the employer contribution to the Systems through the use of private placement of general obligation bonds with the Systems are being considered as part of the FY11 budget negotiations,

WHEREAS, the proposals for private placement of general obligation bonds with the Systems appear to be prohibited transactions under the Code,

WHEREAS, in 2009 similar proposals for the private placement of general obligation bonds with the Systems were rejected because of these legal concerns, and

WHEREAS, the Members of the Board of the State Employees Retirement System (SERS Board) have a fiduciary obligation to the members of SERS;

NOW THEREFORE, the Members of the SERS Board do hereby RESOLVE,

RESOLVED, they are opposed to the private placement of general obligation bonds with SERS as payment of the employer contribution to SERS,

RESOLVED, they support payment of the full statutorily mandated employer contribution to SERS for FY11 in the form of cash, and

RESOLVED, they are opposed to any "pension holiday" in FY11 that would result in additional unfunded liabilities for the SERS.

Daniel Hynes, Chairman

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

CLIENT MEMORANDUM

CONFIDENTIAL ATTORNEY-CLIENT COMMUNICATION

To: William Atwood, Linsey Schoemehl

From: Keith Johnson and Alicia Mohn

Date: April 23, 2010

Client: Illinois State Board of Investment ("ISBI") (048464)

Subject: Revisited - Prohibited Transaction Issues Related to ISBI Acquiring General Obligation Bonds from the State of Illinois

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The state of Illinois ("State") is again considering issuing bonds to assist in its funding obligation to the three state retirement systems, including ISBI. The State previously considered this option in 2009, and we drafted the enclosed memorandum discussing why direct issuance of the bonds from the State to ISBI could result in ISBI losing its tax-exempt status as a qualified plan.

While the 2010 proposed legislation does not include the precise language proposed in 2009, the same issues present in 2009 still apply to the 2010 proposal. The proposed revisions to section 7.2(b) of the Illinois General Obligation Bond Act provide that the bonds "shall be issued to the designated retirement systems to fulfill the State's Fiscal Year 2011 required contributions to those systems." 30 ILCS 330/7.2. In addition, the amendments to the specific retirement system codes state that the state contribution will be made to the system "through transfer of bonds to the System." 40 ILCS 5/14-131(e).

The legislation still contains the same structure which would have the State transferring bonds directly to ISBI to sell under the 2010 proposal, rather than selling the bonds and transferring the funds to ISBI to fulfill its funding obligation as it did in 2003. This raises the same legal issues and concerns discussed in the attached memorandum. As with the 2009 legislation, the 2010 proposal could result in ISBI losing its tax exempt status. The legal analysis is further described in the attached memorandum. Please feel free to contact us if you have any other questions.

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

CLIENT MEMORANDUM

CONFIDENTIAL ATTORNEY CLIENT COMMUNICATION

To: William Atwood, Linsey Schoemehl

From: Keith Johnson and Alicia Mohn

Date: June 23, 2009

Client: Illinois State Board of Investment ("ISBI") (048464)

Subject: Prohibited Transaction Issues Related to ISBI Acquiring General Obligation Bonds from the State of Illinois

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The state of Illinois ("State") is considering options it can pursue to fulfill its funding obligation to the three state retirement systems, including ISBI. The three options include:

- The State issues general obligation bonds, sells them directly in the marketplace, and distributes the proceeds to the retirement systems.
- The State issues general obligation bonds, transfers them to ISBI in exchange for its current debt obligation to ISBI, and ISBI sells the bonds in the marketplace.
- The State issues a note directly to ISBI in exchange for its current debt obligations to ISBI, and ISBI has the authority to securitize that debt into a State general obligation bond, and ISBI sells them in the marketplace.

This memo addresses issues related to the second and third option listed above.

The current proposals present many issues which raise serious questions if used to resolve the funding issues of the ISBI and could result in ISBI losing its tax-exempt status as a qualified plan. Following is a discussion of the prohibited transaction issues associated with the proposal.

1. Prohibited Transactions.

(a) Code Section 503. A qualified government retirement plan under Internal Revenue Code ("Code") § 401(a) is subject to the prohibited transaction rules of Code § 503. This section applies to qualified plans that are government plans even though the plan is not subject to ERISA. Under Code § 503(a), a qualified plan loses its tax exempt status if it engages in a prohibited transaction.

Code § 503(b) defines prohibited transactions. A qualified plan engages in a prohibited transaction when it completes the following transactions:

> (1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;
>
> (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
>
> (3) makes any part of its services available on a preferential basis to;
>
> (4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;
>
> (5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to:

the creator of such organization (if a trust). . .

Code § 503(e) provides a limited exception to the prohibition for loans under § 503(b)(1). Under Code § 503(e), a bond, debenture, note or certificate or other evidence of indebtedness shall not be treated as a loan made without the receipt of adequate security if the following requirements are met:

(i) Price. If the debt obligation is purchased directly from the issuer, the maximum purchase price is a price not less favorable than the price paid currently for a substantial portion of the same issue by persons independent of the issuer.

(ii) Percentage of Issue. Immediately following acquisition of the debt obligation, no more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of the acquisition can be held by the plan trust. In addition, at least 50 percent of the aggregate amount must be held by persons independent of the issuer.

(iii) Percentage of Plan Assets. Immediately following acquisition of the debt obligation, no more than 25 percent of the assets of the plan trust can be invested in obligations of related persons.

See *Fuqua International, Inc. v. United States*, 334 F. Supp. 1116 (S.D. Georgia 1971) for a discussion of Code sections 503(b) and 503(e).

(b) Analysis. ISBI is a qualified governmental retirement plan under Code § 401(a) and is subject to the prohibited transaction rules in § 503. Under the State's proposal, the bonds transferred to ISBI will not be registered and they will not be underwritten. We have been advised that, because of this unusual structure of the bonds, the value of the bonds will be subject to a discount when ISBI attempts to sell them. As such, ISBI will be required to sell the bonds for significantly less than the fair market price that the State would be able to obtain if it sold the bonds directly. This scenario will result in ISBI receiving significantly less from the sale of bonds than the State's debt obligation which it has forgiven.

The above described transaction likely qualifies as a prohibited transaction under Code § 503(b)(1) and (6). If the transfer of bonds from the State to ISBI is considered a loan, ISBI is not receiving adequate security and a reasonable rate of interest. The transfer would fail to qualify for the exemption allowed in § 503(e). Under the transaction, more than 50 percent of the issued bonds would be held by related parties if the State transfers all of the issued bonds to the state retirement systems, as currently planned. In addition, ISBI may hold more than 25 percent of the bonds depending upon how the bonds are divided between the three retirement systems. Also, ISBI would not be able to prove that the purchase price is not more favorable than that offered to independent parties if the State does not sell any bonds to independent parties.

The transaction may also violate § 503(b)(6). Because of the apparent discount in the value of the bonds because they will not be registered or underwritten, ISBI will receive less value in selling the bonds than the value of the State's debt obligation that it has forgiven. In essence, there has been a diversion of the value of the trust fund to the State as part of the transaction, creating a prohibited transaction.

The current proposal is notably different than the bonds issued and sold by the State in 2003. In 2003, the State issued general obligation bonds and sold them in the marketplace to fund its pension obligations. While ISBI purchased some of the bonds within its investment guidelines, it did so in a market where independent persons established a market value for the bonds. Conversely, in the current proposal, the bonds will not have an established market value because they are transferred directly to ISBI and will be undervalued in the market due to the underwriting and registration issues discussed above

2. <u>Additional Issues</u>. The focus of this memorandum is the potential prohibited transaction issues inherent in the State's proposal. However, additional issues exist should the State proceed with its proposal. ISBI may be subject to liability with regard to the bonds it sells that it would not be subject to if the State sold the bonds directly. In addition, ISBI does not have expertise in marketing and selling bonds and notes, unlike the State. As such, ISBI would have to expend significant time and financial resources in establishing a program to market and sell the bonds.