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Federal Financial Institutions Examination Council
Program Coordinator
3501 Fairfax Drive, Room 3086
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Dear Sir or Madam:

KPMG LLP is pleased to respond to the request for comments from the Federal Financial Institutions Examination Council (the "Council") on its proposed *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, published in the Federal Register on May 10, 2005 (70 Fed. Reg. 24,576 (May 10, 2005)) (the "proposal").

KPMG LLP is dedicated to ensuring that its practices satisfy all legal, regulatory, and professional requirements. Although we believe that the proposal's core objectives – promoting external auditors' objectivity, impartiality, and performance – are laudable, we are concerned that the proposal would restrict the use of agreements that are beneficial and that pose no threat to safety and soundness. We are also concerned that the proposal would produce unfair, unjustified, and harmful consequences.

A. The Proposal May Increase Audit Costs Without Improving Safety And Soundness

According to the proposal, "financial institutions should not enter into external audit arrangements that include any limitation of liability provisions."[1] The proposal, if adopted, would prohibit many contractual terms commonly used in American business transactions that cap damages, limit the period to file a claim, restrict the transfer or assignment of legal claims, or otherwise allocate risk between contracting parties.[2] The proposal would also strongly

1 70 Fed. Reg. at 24,578.

2 *Id.* at 24,579-80. Not all of the contractual terms covered by the proposal are ordinarily considered "limitation of liability" provisions, demonstrating the breadth of the proposal.

discourage the use of alternative dispute resolution ("ADR") agreements. Without setting forth any evidence in its proposal, the Council has concluded that all of these contractual terms "*may* weaken an external auditors' objectivity, impartiality, and performance," thereby raising "safety and soundness" concerns.[3]

Of the specific contractual terms identified for criticism in the proposal, some are already prohibited by the SEC for those entities subject to SEC regulation.[4] Other contractual terms, however, are fully permissible and widely in use as tools to allocate risk.[5] Companies may compensate service providers for assuming risk by paying them more money; or they may agree to share risk. Presumably, the Council would not consider it a safety and soundness concern if an auditor charged more for assuming increased risk; there is no reason why permissible limitation on liability provisions should be treated any differently. To the extent the proposal would limit auditors' ability to use such common risk allocation tools – which, in effect, would compel auditors to assume more risk – there would be obvious and unavoidable economic consequences that are not addressed in the proposal, with no countervailing showing of benefit, such as improved audits.

Permissible limitation of liability and ADR provisions help audit clients, as well as auditors, manage risk. Such contractual terms lower the cost of audit services, provide greater assurance to the parties that any disputes will be handled efficiently, and also provide greater certainty to the parties about the limits of costs and risks in the contractual relationship. All

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[3] *Id.* at 24,577 (emphasis added).

[4] *See* SEC's Codification of Financial Reporting Policies, § 602.02.f.i (independence is impaired "when an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission"); SEC's December 13, 2004, FAQ on Auditor Independence (independence is impaired when an agreement provides "the accountant immunity from liability for his or her own negligent acts, whether of omission or commission," or where "a registrant would release, indemnify or hold harmless [an accountant] from any liability and costs resulting from knowing misrepresentations by management"). The AICPA permits such agreements.

[5] The common limitation of liability provisions – including the contractual terms that cap damages, limit the period to file a claim, or restrict the transfer or assignment of legal claims – that are not prohibited by the SEC, PCAOB, or AICPA are referred to herein as the "permissible limitation on liability provisions."

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companies, professionals, even the government, have tools to manage risk, and there is nothing inappropriate about auditors similarly managing their risk using common contractual terms, unless those terms somehow implicate the auditors' special functions. We suggest that these do not.

The proposal largely ignores the interest that financial institutions have in obtaining professional and independent audit services within a framework of allocated risk. The proposal instead presupposes that permissible limitation of liability and ADR provisions work to the detriment of those institutions. But those institutions – well-funded, well-advised, and already thoroughly regulated – routinely exercise their freedom of contract to adopt contractual terms that are criticized in the proposal, as a means to control costs and manage risk.

For example, credit unions may choose to accept caps on damages in negotiating service contracts in order "to assure that the liability risk is fairly balanced" between the credit union and the service provider.[6] Further, under Labor Department guidance, an actuarial firm may include limitation of liability and indemnification clauses in an engagement letter with an ERISA-covered pension fund. The Labor Department, after noting that such provisions were "becoming increasingly popular," advised that it "does not believe that, in and of themselves, most limitation of liability and indemnification provisions in a service provider contract are either per se imprudent . . . or per se unreasonable [under ERISA]." Indeed, the Department acknowledged that provisions limiting damages or even indemnifying a service provider for negligent acts "may be consistent with [ERISA] when considered in connection with the reasonableness of the arrangement as a whole and the potential risks to participants and beneficiaries."[7]

Similarly, the federal government and the private sector have both embraced ADR. A recent study conducted by the American Arbitration Association ("AAA study") found that 95% of companies surveyed had used some form of ADR in the past three years.[8]

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[6] Brian R. Will, *Negotiating Technology Contracts*, CREDIT UNION MAGAZINE, July 2002.

[7] Dep't of Labor, Advisory Op. 2002-08A (Aug. 20, 2002). By permitting these types of provisions, the Labor Department implicitly recognized that the SEC's guidance prohibiting similar agreements in a different context need not be adopted. The Council similarly should conclude that these limitation of liability provisions do not pose a threat to the safety and soundness of financial institutions not subject to SEC regulation.

[8] *See* American Arbitration Association, *Dispute-Wise Business Management: Improving Economic and Non-Economic Outcomes in Managing Business Conflicts* 15-16 (2003). Significantly, 9% of the companies surveyed were banking or financial services companies.

[Footnote continued on next page]

The widespread use of these risk management tools is not surprising, given their significant advantages. By agreeing to limit certain types of liability or to submit disputes to an efficient dispute resolution process, the parties eliminate or reduce uncertainty and the risk of costly and potentially frivolous court litigation, or disproportionate and unforeseen jury awards. An important result is reduced costs for audit services, as well as potentially reduced costs to the client in the event of a dispute. Moreover, these provisions have numerous benefits beyond cost savings. Companies, for example, report that ADR provides a more satisfactory process, leads to more satisfactory settlements, and results in a more durable resolution compared to litigation. Limitation of liability provisions provide certainty and permit companies to engage in more accurate business planning. The general satisfaction of companies with these provisions, as demonstrated by their common use, undermines the proposal's suggestion that they are detrimental to contracting parties.[9]

By labeling permissible limitation of liability and ADR provisions "unsafe and unsound," the proposal will limit parties' access to legitimate risk management tools, distort private contracts, and impose significant costs on audit clients. Because the Council's member agencies "have primary federal supervisory jurisdiction over 18,558 domestically chartered banks, thrift institutions, and credit unions," the aggregate cost of the proposal's restriction, while impossible to determine with precision, could be substantial.[10]

Increased audit costs could affect the regulated financial institutions in a number of ways. Institutions that are required to obtain external audits – *e.g.*, publicly owned financial institutions – will have no choice but to absorb the increased cost of the audit services. On the other hand,

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[Footnote continued from previous page]
See also David B. Lipsky and Ronald L. Seeber, *The Appropriate Resolution of Corporate Disputes: A Report on the Growing Use of ADR by U.S. Corporations* (1998). Like the AAA study, the 1998 study confirmed that ADR was widely used and provided significant benefits over litigation for companies across a broad spectrum of the economy.

9 As acknowledged in the proposal, ADR often, in comparison to litigation, "expedite[s] case resolution and reduce[s] costs." 70 Fed. Reg. at 24,579; *see also id.* ("The Agencies recognize that ADR procedures and jury trial waivers may be efficient and cost-effective tools for resolving disputes in some cases."); AAA study at 17. Similarly, limitation of liability provisions reduce costs by discouraging the "lottery" effect – *i.e.*, suits by plaintiffs seeking windfall compensatory and punitive damages.

10 Federal Financial Institutions Examination Council, *Annual Report* 17 (2004).

many of the financial institutions regulated by the Council's member agencies are not required to obtain external audits by those institutions or the SEC.[11] For institutions that elect to have such audits performed, any increase in the cost of audit services may cause them to forego these voluntary external audits (or limit their frequency), reducing the number of private financial institutions that obtain external audits on a voluntary basis. Thus, the proposal creates perverse, but real and foreseeable, incentives that could actually have an *adverse* impact on safety and soundness.

In addition, some of the increased costs associated with heightened litigation risk will almost certainly be borne by auditors. If external audits of financial institutions become relatively unprofitable or riskier due to an increased risk of liability, some audit firms may choose to withdraw from these types of engagements and focus their resources in other, more profitable areas, just as some firms have made business decisions recently to discontinue auditing higher risk clients. Accordingly, the proposal may limit the availability of services to regulated institutions.

In the face of these foreseeable negative consequences, the Council's proposal cites no evidence that the elimination of such contractual terms will yield significant safety and soundness benefits. Under these circumstances, whether to agree to such contractual terms properly should be left to financial institution management. Management can consider the benefits and drawbacks of including permissible limitations of liability in an engagement letter just as they consider any other provision in the course of their negotiations.[12] The Council should not substitute its judgment for the judgment of institutional managers and other sophisticated contracting parties in the absence of convincing evidence that liability limitations pose an identifiable and serious risk to independence or safety and soundness.

B. Permissible Limitation On Damages Provisions Do Not Affect Safety And Soundness

Of the contractual terms identified in the proposal, which should remain broadly permissible, we wish to address punitive damages and damage caps in particular.

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[11] 70 Fed. Reg. at 24,579.

[12] Significantly, there is no suggestion that financial institutions are somehow coerced into contractual agreements that they find objectionable, as reflected in the proposal's acknowledgement that a majority of financial institution audit engagement letters *do not* contain any limitation of liability provisions. *Id.* at 24,577.

1. Limitations On Punitive Damages Should Remain Permissible

The proposal states that the absence of punitive damages as a remedy is sufficient to make an auditor's engagement not independent.[13]

Punitive damages do not serve a compensatory purpose. Rather, they are "quasi-criminal," intended solely to punish the wrongdoer – on behalf of society – for reprehensible conduct.[14] Because punitive damages do not compensate a plaintiff for its losses or damages, they cannot be considered necessary for "safety and soundness," the purpose of which is to ensure that a financial institution's practices do not expose it to an "abnormal risk of *loss or damage*."[15] If the Council concludes that a financial institution is *entitled* to seek punitive damages (which are a windfall to the plaintiff) as a matter of safety and soundness, it will have transformed the safety and soundness standard into an obligation to seek windfall recoveries – an irrational standard that no regulated entity could reliably plan on satisfying.

Moreover, punitive damages are unnecessary as a deterrent in this context. Compared to other methods available to punish reprehensible auditor conduct – including potential license revocation, loss of business, professional discipline, and criminal liability – punitive damages are imprecise, arbitrary, and disfavored by the courts.[16]

2. Limitations On Make-Whole Relief Should Be Permissible

The proposal fails to distinguish between immunity provisions (where the auditor may not be held liable for losses) and limitations on make-whole relief (where the auditor, except to

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13 *Id.* at 24,579.

14 *Cooper Industries Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001).

15 Lawrence G. Baxter, *The Rule of Too Much Law? The New Safety/Soundness Rulemaking Responsibilities of the Federal Banking Agencies*, 47 Consumer Fin. L.Q. Rep. 210, 211 (1993) (quoting John E. Horne, Memorandum Submitted to the Chairman of the Senate Comm. on Banking and Currency, 112 Cong. Rec. 26,474 (1966)) (emphasis added).

16 *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 417 (2003) (expressing concerns over the "imprecise manner in which punitive damages systems are administered" and stating that "[p]unitive damages pose an acute danger of arbitrary deprivation of property") (internal quotations omitted).

the extent such limitations are already prohibited in engagements with SEC registrants, may be held liable for losses up to a predetermined amount). The Council should consider fully the potential benefits of damage caps before it determines to prohibit them in every instance.

First, damage caps permit the contracting parties to allocate risk, and to price services properly in light of risk. Without such a tool, auditors might be unwilling to engage in audits where the perceived risk of liability is high, or they may be compelled to increase the price of their audit services to account for the additional risk they are forced to assume.

Second, damage caps often represent the parties' good faith attempt to anticipate potential harms and to stipulate in advance a measure of damages that may otherwise be hard or costly to quantify. Thus, in many cases, a damage cap may represent the best measure of damages available to the parties. Requiring parties to seek damages in excess of a damage cap that they would otherwise contractually accept, is requiring parties to seek unjustified windfall outcomes – surely not an appropriate regulatory goal.

Third, by establishing a finite and known range for damages, limitation provisions facilitate settlement. Defendants may be more willing to accept responsibility when their liability is known, and plaintiffs may be more willing to accept resolution when the opportunity for windfall outcomes is cut off. Thus, by narrowing the dispute, limitation provisions bring parties more quickly to an agreement, thereby minimizing the expenses of litigation.[17]

C. The Proposal's ADR Restrictions Are In Conflict With Federal Policy

The proposal casts a cloud over the use of ADR agreements, whether or not those agreements contain explicit limitations of liability provisions.

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[17] *See, e.g., McDermott, Inc. v. AmClyde*, 511 U.S. 202, 219 (1994) ("settlements frequently result in the plaintiff's getting more than he would have been entitled to at trial"); *Carson v. American Brands, Inc.*, 450 U.S. 79, 87 (1981) (in a settlement "parties waive their right to litigate the issues involved in the case and thus save themselves the time, expense, and inevitable risk of litigation"); *Wilson v. American Motors Corp.*, 759 F.2d 1568, 1571 (11th Cir. 1985) ("There is no question that courts should encourage settlements.").

Since 1925, the Federal Arbitration Act ("FAA") has embodied a national policy promoting the use of arbitration agreements between private parties.[18] Pursuant to the FAA, courts liberally construe contracts between private parties to promote arbitration of disputes where possible.[19] In 1998, after several years of experimenting with ADR in the judicial system, Congress put an additional "stamp of approval" on ADR by passing the Alternative Dispute Resolution Act of 1998, which requires all federal courts to adopt permanent ADR programs, in part to achieve "greater satisfaction of the parties" and "greater efficiency in achieving settlements."[20] As the Chairman of the House Judiciary Subcommittee on Courts and Intellectual Property recognized, the significant benefits of ADR are achieved without sacrificing a litigant's ability to vindicate its rights.[21]

Congress thus has clearly and repeatedly endorsed the use of ADR. The proposal, to the extent it forbids or discourages the formation of ADR agreements, is inconsistent with this federal policy.

Although we believe that ADR provisions are beneficial to both auditors and financial institutions and that the agencies should proceed cautiously before placing *any* limitation on their use, we are especially concerned that the proposal could be read to cast a cloud of regulatory disfavor over *all* ADR provisions in external audit engagement letters.

The proposal states that only those "certain alternative dispute resolution (ADR) provisions that also limit the external auditors' liability" raise independence concerns.[22] This seems to imply that there is a broad category of ADR agreements – *i.e.*, those that do not contain

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[18] 9 U.S.C. §§ 1-16.

[19] *See, e.g., EEOC v. Waffle House, Inc.*, 534 U.S. 279, 289 (2002) (noting the "liberal federal policy favoring arbitration agreements") (internal quotations omitted).

[20] Alternative Dispute Resolution Act of 1998, Pub. L. No. 105-315, 112 Stat. 2998 (codified at 28 U.S.C. §§ 651-658); *id.* § 651 note (Findings and Declaration of Policy).

[21] 144 Cong. Rec. H10, 458 (daily ed. Oct. 10, 1998) (statement of Rep. Coble) (stating that the Act "will provide the Federal courts with the tools necessary to present quality alternatives to intensive Federal litigation . . . while at the same time still guaranteeing their right to have their day in court.").

[22] 70 Fed. Reg. at 24,577.

explicit liability limiting provisions – that do not raise independence or safety and soundness concerns. Elsewhere, however, the proposal takes a much more expansive view of what ADR procedures may be problematic: "pre-dispute mandatory ADR agreements in external audit engagement letters present safety and soundness concerns when they incorporate additional limitations of liability, *or when mandatory ADR agreements operate under rules of procedure that* ***may*** *limit auditor liability*."[23] The Council further explains that by "agreeing in advance to submit disputes to mandatory ADR, the financial institution is effectively agreeing to waive the right to full discovery, limit appellate review, and limit or waive other rights and protections available in ordinary litigation proceedings."[24] Most ADR cases involve limited discovery and the absence of traditional appellate review, and it is almost universally true that ADR participants agree to "limit or waive other rights and protections available in ordinary litigation," most notably, the right to a jury trial. The proposal suggests (though it is not clear precisely how the suggestion implicates the safety and soundness of an institution) that "by waiving a jury trial the financial institution may effectively limit the amount it might receive in any settlement of the case."[25]

The view taken by the Council – that jury waivers and finite filing deadlines, discovery rules, and appellate review amount to problematic "limitations on liability" – is not supportable. These common ADR procedural rules could theoretically "reduce the value of the financial institution's claim in an audit dispute," though no evidence is cited for that proposition and we are not aware of any studies supporting it. But the evidence, discussed above, shows that ADR actually leads to more satisfactory settlements, results in a more durable resolution, and produces a higher rate of satisfaction among contracting parties than litigation.[26] The Council's speculation that ADR procedures could, in some cases, lead to lesser recoveries than more expensive, burdensome and time-consuming full-blown litigation, is not a sufficient justification for supplanting the judgment of private contracting parties, or for prohibiting these efficient procedures in all cases. Moreover, that speculation is directly at odds with the federal policy favoring ADR that has been embraced by both Congress and the courts.

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23 *Id.* at 24,579 (emphasis added).

24 *Id.*

25 *Id.*

26 *Id.*; AAA study at 17.

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D. The Proposal Provides No Basis For The Purported Extension Of Auditor Independence Standards

The proposal devotes a section to "auditor independence," citing the Codification and an SEC-issued Frequently Asked Question in support of its contention that liability limitation provisions in auditor engagement contracts would violate SEC auditor independence standards.[27] Significantly, however, these auditor independence standards govern only the audits of public companies and some financial institutions through FDIC and OTS regulations.[28] The proposal would extend them to audits of all financial institutions.

Moreover, as the Council acknowledges, SEC guidance prohibits provisions that provide full immunity to the auditor for his negligence or that release or indemnify him from liability resulting from management's knowing misrepresentations.[29] Waivers of punitive damages, which do not "deprive" a client of compensation for its losses or damages, do neither. Additionally, the proposal could also effectively prohibit any ADR provision in audit engagement contracts, even though no such prohibition exists under current auditor independence standards. Accordingly, the proposal's suggestion that it is merely adopting provisions that already exist cannot form a sound basis for adopting the proposal.[30] The Council's release, by proposing a standard that will apply only to financial institutions' audits, will unnecessarily complicate the existing regulatory structure without any demonstrated benefit.

E. The Proposal Must Comply With Rulemaking Standards

The proposal must comply with the legal constraints on federal agency rulemaking. Among the many laws and orders governing agency rulemaking are the Administrative

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27 70 Fed. Reg. at 24,579-80.

28 *Id.* at 24,579.

29 § 602.02.f.i.; SEC's December 13, 2004, FAQ on Auditor Independence. Several of the "illustrative" contractual terms that would be prohibited by the proposal are not covered by the SEC's guidance. 70 Fed. Reg. at 24,580.

30 *See also* Sarbanes-Oxley Act of 2002, § 209.

Procedure Act ("APA") and Executive Order 12,866.[31] Both of these impose important obligations on the Council that have not been met in this rulemaking.

Administrative Procedure Act: The APA prohibits agency action that is, among other things, "arbitrary and capricious."[32] In the context of rulemaking, the Supreme Court has concluded that agencies "must examine the relevant data and articulate a satisfactory explanation for its actions including a 'rational connection between the facts found and the choice made.'"[33] The prohibition on "arbitrary and capricious" action requires an agency to have an adequate evidentiary basis for its decisions. "[S] peculation is an inadequate replacement for the agency's duty to undertake an examination of the relevant data and reasoned analysis."[34]

Executive Order 12,866: Executive Order 12,866 provides that when a federal agency engages in rulemaking, it must first determine whether a rule is necessary.[35] An agency should reach this conclusion by: (i) identifying the problem that it intends to address; (ii) demonstrating the significance of that problem; (iii) demonstrating the failure of private or public institutions to address the problem; and (iv) adopting rules only where there exists "a compelling public need, such as material failures of private markets to protect or improve the health and public safety of the public, the environment, or the well-being of the American people."[36] If an agency

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[31] *See* 5 U.S.C. § 551 *et seq.*; Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (1993), as amended by Exec. Order No. 13,258, 67 Fed. Reg. 9835 (2002) ("Exec. Order. No. 12,866").

[32] *See* 5 U.S.C. § 706(2)(A) (reviewing courts shall "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law").

[33] *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983) (finding an agency order to be arbitrary and capricious because of inadequate agency analysis).

[34] *Horsehead Resource Dev. Co. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994).

[35] Components within cabinet departments, such as OTS and OCC, are required to comply with Executive Orders, while any "independent" agencies are encouraged to do so. *See* Letter from Andrew Card to Heads of Executive Agencies, http://www.whitehouse.gov/news/releases/20010123-4.html (last visited May 26, 2005).

[36] Exec. Order No. 12,866, § 1(a).

determines that a rule is necessary, it may proceed with the regulation "only upon a reasoned determination that the benefits of the intended program justify its costs."[37]

Measured against this legal background, it is evident that the Council has failed to justify or explain its proposal adequately.

1. The Council Has Not Demonstrated A Need For The Proposal

The proposal states that "[t]he agencies have observed an increase in the types and frequency of provisions in certain financial institutions' external audit engagement letters that limit the auditor's liability," and that "[t]he agencies also have observed that some financial institutions are agreeing in their external audit engagement letters to submit disputes over external auditor services to mandatory and binding alternative dispute resolution, binding arbitration, or some other binding non-judicial dispute resolution process (collectively referred to as mandatory ADR)."[38] But the Council offers *no evidence* that these contractual provisions – let alone any marginal increase in their use – has led to a decrease in audit quality, or is likely to do so in the future.[39] Other than speculating, the Council has made no showing that limitation of liability or ADR provisions in financial institutions' audit engagement letters generally affect the safety and soundness of financial institutions.

For a significant regulatory change to be made, there should be a significant need. The Council has failed to make such a showing.

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[37] *Id.* §§ 1(b)(5)-(8).

[38] 70 Fed. Reg. at 24,577, 24,579.

[39] The proposal suggests that auditor independence is a motivating factor behind the proposed advisory. 70 Fed. Reg. at 24,578. Auditor independence may be left to other regulators. *See* Executive Order 12,866, § 1(a) (discouraging additional regulation where another institution has addressed the problem). To the extent that the Council issues any final advisory, it should merely reference existing SEC guidance for financial institutions already subject to SEC regulations. Moreover, concerns raised in the proposal appear to involve primarily audit quality, not auditor independence. The Council has demonstrated no correlation between audit quality and limitation of liability or ADR provisions in auditor engagement letters; accordingly, there is no basis for the proposal's general prohibition on such provisions.

2. The Proposal Gives Inadequate Attention To Potential Harms And Lacks Cost-Benefit Analysis

The Council must consider costs and benefits that would result from the proposal.[40] Yet, here, the Council engages in no substantive analysis of potential harms that would result, even as it makes no showing of a need for such a significant regulatory change. As discussed above – but not discussed in any substance in the proposal – a prohibition on limitation of liability and ADR provisions likely would have harmful effects on financial institutions and the general public. Among other things:

- The proposal would exceed existing prohibitions and fragment the regulatory regime.
- The proposal will deny auditors tools they need to limit risk. Without those tools, costs for audit clients may increase, with no increase in audit quality.
- Certain types of services may become unprofitable if auditors cannot manage their liability. Accordingly, auditors may be forced to withdraw from those business lines, denying services to clients.

The agencies' adoption of the proposal, without serious consideration of these and other harms, would violate rulemaking procedures.[41]

Because of the Council's failure to analyze these harms substantively, and because it identifies no other harms or costs in the proposal, the proposal lacks the rigorous cost-benefit analysis that is required under the APA and Executive Order 12,866. Proper use of the cost-benefit mechanism "requires that sufficient levels of time and resources be provided to permit

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40 *See, e.g.*, *Chemical Mfrs. Ass'n v. EPA*, 28 F.3d 1259, 1265-66 (D.C. Cir. 1994) (finding an EPA rule arbitrary and capricious where the agency inadequately addressed comments); *ALLTEL Corp. v. FCC*, 838 F.2d 551, 556 (D.C. Cir. 1988) (identifying as arbitrary and capricious an order of the FCC where, among other things, the FCC failed to provide a "reasoned explanation" for its actions by not responding to challenges).

41 The proposing release's discussion of the proposal's costs is limited to the following cursory statements: "While ADR may expedite case resolution and reduce costs . . . ."; and "The Agencies recognize that ADR procedures and jury trial waivers may be efficient and cost-effective tools for resolving disputes in some cases." 70 Fed. Reg. at 24,579.

careful, thorough, and technically and scientifically sound data-gathering and analysis."[42] Although the proposal seeks comment on issues bearing on costs, an agency does not satisfy its rulemaking obligations by merely requesting such comments when adopting a rule. Rather, the agency has an obligation to engage in an independent analysis and weighing of costs and benefits before adopting any rule.[43] The Council has not done so in the proposal.

F. Financial Institutions Should Not Be Encouraged To "Nullify" Limitation Of Liability Provisions In 2005 Engagement Letters

The proposal "strongly recommends that financial institutions take appropriate action to nullify limitation of liability in 2005 audit engagement letters that have already been accepted."[44] To the extent that the agencies adopt the proposal in any form, they should not encourage financial institutions to nullify components of 2005 audit engagement letters.

As an initial matter, limitation of liability provisions in 2005 engagement letters were not deemed to implicate "safety and soundness" when they were adopted. Such provisions were the product of good faith negotiations between financial institutions and their auditors. Retroactive nullification of permissible limitation of liability provisions would be patently unfair, seeking to change the "rules" under which auditors agreed to perform in mid-game. Any effort to encourage financial institutions to abandon lawful contract terms for which they bargained would lead to confusion and potential litigation over the legality and effects of nullification. Moreover, nullification of lawful contract terms by financial institutions would present serious issues regarding retroactivity, due process, and regulatory takings under the Constitution.

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42 OMB, Report to Congress on the Costs and Benefits of Federal Regulations, at 26 (1998), *available at* http://www.whitehouse.gov/omb/inforeg/costbenefitreport1998.pdf (internal quotations omitted) (last visited May 30, 2005).

43 *See, e.g.*, Executive Order 12,866, §§ 1(b)(5)-(8) (requiring a "reasoned determination that the benefits of the intended program justify its costs"); *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 52 ("the agency must exercise *its judgment* in moving from the facts and probabilities on the record to a policy conclusion") (emphasis added); *Public Citizen v. Federal Motor Carrier Safety Admin.*, 374 F.3d 1209, 1221 (D.C. Cir. 2004) (requiring an agency to estimate costs).

44 70 Fed. Reg. at 24,577.

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Conclusion

We support the Council's efforts to improve safety and soundness of the entities regulated by its members. We also support safeguards for audit quality and auditor independence. We believe that the proposed restrictions on audit engagement letters would have harmful effects without furthering any of these goals. The Council should withdraw the proposal and rely upon existing independence, audit quality, and safety and soundness standards and regulations. Only substantial additional factual development could justify such a wide-ranging and intrusive rule.

We look forward to working with the Council.

If you have any questions, please contact Michael J. Baum, Partner-in-Charge, Risk Management Group, at 212-909-5604.

Very truly yours,

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Via Facsimile and E-mail