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October 28, 2004

Leslie J. Girard
Assistant City Attorney
City of San Diego
Office of the City Attorney
1200 Third Avenue Suite 1620
San Diego, CA 92101

Re: Additional Investigation

Dear Mr. Girard:

We believe a constructive discussion between the City of San Diego (the "City") and its independent auditor, KPMG, will be greatly advanced by: (a) correction of numerous misimpressions and misunderstandings by KPMG regarding our Report of Investigation (the "Report") made in the October 11, 2004 letter to you and (b) clarification by KPMG of various statements made in their correspondence, as well as identification of the specific audit standards KPMG believes applicable to any issues delaying the completion of its audit of the City's 2003 financial statements. Such clarifications would, assuming KPMG's good faith cooperation, allow us to undertake additional procedures, beyond the scope of our initial investigation, addressing whatever remaining concerns KPMG may have. As always, we remain ready to assist the City in any manner appropriate for us.

KPMG has demanded broad and unspecified assurances that the City and its officials have not committed "illegal acts" before it will render its audit opinion. The effort to propose additional procedures that will satisfy KPMG has been complicated by KPMG's failure to articulate either the "possible illegal acts" it believes may have occurred or how the identification and analysis of any such acts should be addressed as audit issues. Further, its demands for additional information or procedures have been highly changeable within short periods of time. For example, in a meeting of October, 14, 2004, a KPMG officer stated to you and numerous others present that KPMG would not demand that City counsel provide a legal opinion as to all potential claims that might be asserted against the City, as KPMG has requested in the past. In its letter of October 27, 2004, however, KPMG reversed that position.

This point is of critical importance because KPMG's current position would require counsel to speculate on an unbounded universe of unasserted claims. This would go far beyond the established requirements of the auditing profession, and would violate a long-standing protocol agreed upon between the American Institute of Certified Public Accountants and the American Bar Association for the provision of information by client's counsel to auditors. For this reason, it would not be permissible under Vinson & Elkins' firm policies or, in all likeli-

hood, those of any other national law firm. The representations KPMG is now demanding also go beyond the categories presented in any independent report of investigation of which we are aware.[1]

In the KPMG letter to you of October 11, 2004, KPMG alternately expresses its concerns regarding "likely illegal acts" (page 1, paragraph 1, line 3), "potential illegal acts" (page 1, paragraph 2, line 2), "possible illegal acts" (page 1, paragraph 2, lines 6 & 7), and "illegal acts likely to have occurred" (page 4, carry-over paragraph, line 2). The October 11, 2004 letter also refers to "evidence of possible illegal acts by the City or persons whose acts are attributed to it" (page 3, last paragraph, lines 2 & 3). KPMG, however, has yet to identify *any* "likely," "possible," or "potential" illegal acts about which it seeks further information, despite numerous requests from the City that it do so.[2]

Because our Report addressed possible misstatements and omissions in the City's public disclosure as to the funding of its retirement system, we must assume, in the absence of a statement from KPMG to the contrary, that its concerns center around this area. In considering potential violations of the securities laws by the City, it is important to note that the provisions applicable to municipalities are much narrower that those that apply to public companies, being limited exclusively to the so-called "antifraud provisions." Municipal governments are expressly exempt by statute from the reporting, internal controls and recordkeeping provisions applicable to public companies, including those added by the Sarbanes-Oxley Act of 2002, and their auditors are not subject to Section 10A of the Securities Exchange Act of 1934, which requires auditors of public companies to establish procedures to detect fraud and to report possible illegal acts they detect in the course of an audit.

A finding of a violation of the anti-fraud provisions, on a very general level, requires proof of material misstatements and omissions in connection with securities transactions, made with an intent to defraud or a reckless indifference to the accuracy of statements made. Thus a finding that the City violated the anti-fraud provisions would require convincing proof that individuals acting on behalf of the City intentionally misrepresented aspects of its financial situation.[3]

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[1] We have requested an example from KPMG of a report of investigation that it would deem adequate in scope. To date, it has provided us with no such example.

[2] The one specific legal issue ever articulated as a concern by KPMG is, as stated in its October 11, 2004 letter, the possibility of IRS sanctions for the apparent failure of the San Diego City Employees Retirement System ("SDCERS") to segregate funding for it healthcare benefit from basic pension assets. The practice at issue ceased in 1997 and has not been the object of an IRS inquiry. Nevertheless, if KPMG is concerned that this matter represents a potential contingent claim against the City, we see no reason the City should not retain tax counsel to opine on the likelihood and potential magnitude of such a claim.

[3] However, negligent conduct under some circumstances would suffice for a finding of a violation of certain provisions of the federal securities laws applicable to municipalities. *See* Securities Act of 1933, § 17(a)(2) and (3).

Our Report found numerous misstatements and omissions in the City's public disclosure. We concluded that: "City disclosure since 1996 has failed to provide investors and other interested readers with adequate information to enable them to clearly understand the relationship between SDCERS and the City's General Fund and to fully evaluate the credit-worthiness of the City." We did not conclude, however, that the City's failures could be attributed, at least on the basis of information available to us, to intentional misconduct on the part of individual employees.[4] Factors compelling this conclusion included the complex and technical nature of the disclosure at issue and the extensive involvement in that disclosure of outside professionals with no motive to mislead.

Reports of investigation rarely, if ever, reach ultimate legal conclusions, and ours did not do so.[5] Reasons for this include:

- The factual record from a private inquiry is often unavoidably incomplete, contradictory or subject to more than one interpretation. Our investigation encountered such impediments to our ability to obtain relevant information as the refusal of certain key individuals to speak with us. Also, critical issues may turn on the undocumented, unexpressed intentions of particular individuals.

- Even when the factual record is clear, the legal implications of particular actions may be uncertain. Here, for example, it is hard to predict whether a court would determine that *any* of the misstatements and omissions detailed in our Report are material under the highly subjective standard of the federal securities laws. This is particularly the case given that the matters at issue had no significant effect on the City's balance sheet for any fiscal period, and the price of the City's bonds does not appear to have declined as a result of any of the negative information (not all accurate) that has been made public about the City's finances over the last year.

To date, KPMG has not, to our knowledge, challenged a single statement of fact in our Report, nor has it provided any information that would support a conclusion that any City employee engaged in fraudulent conduct. We have asked KPMG to direct us to anything in the Report that it believes might indicate intentional wrongdoing. The only incident its employees have mentioned concerns a February 1998 letter from SDCERS actuary Rick Roeder to former San Diego accountant Mike Phillips. In that letter, Mr. Roeder (not a City employee) suggested that the City could adopt a different amortization period for purposes of reporting its unfunded actuarially accrued liability than for calculating its contributions to SDCERS. Under governmental accounting rules, however, this practice is permissible. This has been confirmed to Vinson & Elkins by the actuarial firm Towers Perrin, the City's former auditors Caporicci & Larson and KPMG. Moreover, in our Report we concluded that the City's disclosure concerning

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[4] It is not correct, as stated in KPMG's letter of October 11, 2004, that the scope of our investigation excluded issues of intent.

[5] As mentioned, we have asked KPMG for examples to the contrary and it has provided none.

its amortization of its liability to its retirement system was incomplete and misleading until remedied by the City's January 27, 2004 voluntary disclosure.

Although KPMG has stated that it has concerns about leads not followed in our investigation and contradictions in witness statements not resolved in our Report, it has yet to specify any such instances.[6] Further, after an audit that has gone on for approximately eight months, and complete access to all the documents available to Vinson & Elkins and to government investigators, it has not brought to our attention any possible violations of law concerning any matter, whether inside or outside the scope of our Report.

At bottom, KPMG appears to seek assurances that there are no claims that may be asserted against the City with respect to matters considered in our Report or, for that matter, generally. It demands that the City establish to KPMG's satisfaction that "illegal acts with relevance to the City's financial reporting have not occurred or that appropriate remedial action has been taken with respect to any conduct which the City cannot definitively conclude was not illegal." The governing accounting and auditing standards recognize that such absolute assurances do not exist in the real world.[7] Realizing that KPMG was not following established auditing standards, a Vinson & Elkins attorney asked KPMG's William Haegele to explain the standards that KPMG believes appropriate to this situation. He responded to the effect that "there is no standard I can give or point you to. It's a work in progress."

Moreover, the accounting and legal professions have a well-established protocol for the type of representations that can and should be made by counsel for an issuer to its auditor.[8] These reflect, among other things, the practical impossibility of estimating the outcome of many unadjudicated claims, particularly those not yet asserted. KPMG's Mr. Haegele has stated to Vinson & Elkins, however, that KPMG will not be bound by those protocols.

It is worth noting that no claims against the City involving its financial disclosure have been asserted or, to our knowledge, even threatened. Litigation involving claims against SDCERS by certain classes of its members was resolved this August through a settled legal action. As KPMG knew at the time it accepted the audit engagement, the City's financial disclosure is under investigation by the SEC and the Office of the US Attorney for the Southern District of California. We do not represent the City in the US Attorney's investigation and have received no indications from the SEC staff what the result of its inquiry will be. We note,

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[6] Of course, there were occasional disparities in the way in which different witnesses remembered prior events, some many years in the past. To the extent the differences were significant and could be resolved through information available to us, we did so.

[7] The basic guidance is provided by Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 5* ("Accounting for Contingencies") and American Institute of Certified Public Accountants, *Codification of Statements on Auditing Standards*, § 337 ("Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments").

[8] American Bar Association, "Statement of Policy Regarding Lawyers' Responses to Auditor's Requests for Information," 31 Business Lawyer 3109 (1976).

however, that the SEC in the past has not made a practice of assessing fines against governmental entities that it knows will ultimately be borne by taxpayers.

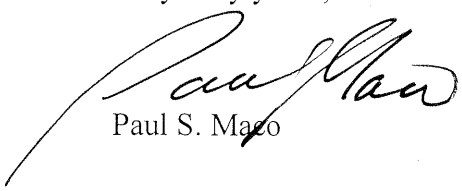
Moreover, should the SEC determine the City has violated any provisions of the federal securities laws, we believe it would consider the following facts in determining what remedies are appropriate:

- in January 2004, the City voluntarily disclosed it's footnote errors and factors relating to its obligation to fund its pension liability;
- the City commissioned an investigation of its disclosure practices (the Report), prior to any indication of an SEC or US Attorney inquiry, *the first instance of any US municipality making such an undertaking;*
- the City has, and continues to, cooperate with the SEC's investigation; and
- the City has adopted amendments to its Municipal Code of Sarbanes-Oxley type measures, *again, the first and to date only instance of a US municipal government having undertaken such measures.*

Equally as troubling as KPMG's inability to relate general concerns about unspecified "illegal acts" to specific audit issues is its failure to provide any practical guidance as to what additional investigative procedures it would find satisfactory. Its October 11, 2004 letter to you describes as inadequate (for its specific purposes) the scope of the Vinson & Elkins investigation but makes no proposals for expanding the matters examined. Subsequently, the City proposed a work plan for additional procedures responding to suggestions from KPMG. By letter dated October 27, 2004, KPMG rejected the draft plan without proposing an alternative approach. Further, as mentioned, KPMG has yet to state what auditing standards it intends to apply in determining when and if it has attained an acceptable comfort level to issue its audit report. Unless KPMG assists its audit client, the City, through clear identification of standards it will accept, the City cannot effectively tailor its efforts to meet those standards.

This firm has conducted a thorough and painstaking inquiry into the City's public disclosure concerning the funding of its retirement system. Our Report provides detailed findings of fact that assisted the City in reforming its disclosure controls. We stand ready to aid the City and KPMG in developing additional information to support KPMG's audit of the City's financial statements. For any such effort to be productive, however, KPMG must go beyond vague allusions to unspecified illegal acts and indicate particular audit concerns and the investigative procedures that would allay them.

Very truly yours,



Paul S. Maco