GRAIS & ELLSWORTH LLP

MEMORANDUM

To: Councilman Paul Koretz

From: Bradley Miller
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Date: June 27, 2014

Re: Potential Claims for the City of Los Angeles

Please accept this in response to your request for a legal memorandum "relative to any legal or other avenues for renegotiating the swaps deals for the City of Los Angeles." I am attaching a memorandum we earlier provided Americans for Financial Reform (AFR) on possible enforcement actions against underwriters by the Securities and Exchange Commission related to "synthetic" fixed-rate financings by public issuers under the Municipal Securities Rulemaking Board's (MSRB) fair dealing rule, Rule G-17.

We cannot advise on the specific financings at issue without closely reviewing the financings and all related transactions, and the representations made by underwriting banks and others to City personnel. In general, however, based upon the description of the transactions in your Motion and in the memorandum dated May 30, 2014, from the Chief Administrative Council to the Council, the financings appear similar to the synthetic fixed-rate public financings described in the attached memorandum to AFR. Certainly the circumstances that resulted in the swaps becoming very disadvantageous to the City are similar to circumstances that led such swaps to become disadvantageous to other public issuers.

In general, variable rate debt obligations or bonds (VRDOs or VRDBs) paired with an interest rate swap were marketed by underwriting banks to conservative public issuers averse to interest rate risk as a "synthetic" fixed rate that would be cheaper for the issuer than a traditional, "natural" fixed rate. The manner by which the interest rate on the debt was determined, however, was very different from the manner by which Libor, the index used for the swaps, was determined. The interest rates diverged dramatically instead of moving in tandem as represented. The interest rate on the debt increased greatly while Libor collapsed and then was held very close to zero by the conscious policy of the Federal Reserve. The potential for a mismatch between the variable-rate payments on the bonds and the floating payments on the swaps was a known, material risk that underwriters failed to explain adequately to public issuers. The long term swaps were radically "off market" compared to swaps in the private sector and effectively deprived the City of the ability to refinance or "call" the outstanding debt on reasonable terms, which has been a significant problem for the City.

I expect Wallace Turbeville to address such financings in general and the City's financings in particular in greater detail on Monday.

The attached memorandum outlines the legal argument that underwriters may have violated the requirements of MSRB Rule G-17 in similar financings, for which the SEC can seek disgorgement as an equitable remedy without regard to the statute of limitations for actions for "a fine, penalty, or forfeiture." AFR would welcome your support in urging the SEC to pursue actions for disgorgement. It is uncertain at best whether the SEC will seek disgorgement, and whether any such action would include the City's financings. Many other public issuers were far less sophisticated than the City's personnel.

We believe, however, that public issuers may well have a remedy for violation of MSRB Rule G-17 in arbitration under the Financial Industry Regulatory Authority (FINRA). Any measure of damages that FINRA arbitrators likely would adopt would result in a significant recovery, and likely would include damages on the portion of the financing that the City already has refinanced.

The City should act quickly, however. FINRA Rule 12206 provides that "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim." FINRA arbitrators generally have not interpreted "the occurrence of event" that gives rise to the claim to be the date that the transaction was entered, but rather the date on which a claimant discovered the wrongful conduct. FINRA arbitrators also may find that "a continuing occurrence or event" gave rise to the dispute. In the Baldwin County Sewer Authority arbitration award, which is discussed in the attached memorandum, the arbitrators found that the private debt issuer could not reasonably have been aware of its claim until at least October 2008, when Libor rates collapsed and payments on the issuer's interest rate swaps increased dramatically. Under that logic, the City arguably has until October 2014 to file claims for violation of MSRB Rule G-17, but after then, may be at significant risk of losing its claims.

I look forward to seeing you on Monday.