



**BILL LOCKYER**  
TREASURER  
STATE OF CALIFORNIA

May 5, 2010

Mr. James P. Gorman  
President and CEO  
Morgan Stanley  
1585 Broadway, 40<sup>th</sup> Floor  
New York, NY 10036

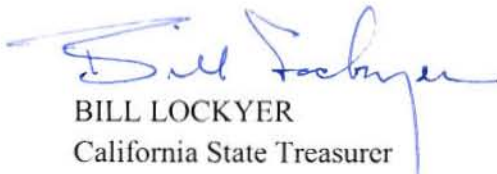
Dear Mr. Gorman:

Thank you for responding to the questions and concerns I raised in my March 29, 2010 request for information about your firm's trading of municipal credit default swap (CDS) in general and State of California CDS in particular. Your response provided my office, and the public, important information about this market. The facts, data and additional background you provided has helped me and my staff better understand the CDS market from your company's point of view.

After reviewing and analyzing the responses from your firm and others, we have concluded we need answers to additional questions about the nature of the municipal CDS market and the participants in that market. Based on your earlier response, these are questions your company is well situated to answer. Your answers will help us determine the best way for our office to deal with the municipal CDS market and its participants going forward.

Once again, thank you for helping inform the ongoing discussion about the operation of the municipal CDS market, the impact on taxpayer costs, the adequacy of regulation and oversight, and how to avoid ethical conflicts. I ask that you submit to my office your response to the follow-up questions no later than close of business on Wednesday, May 26, 2010. For further clarification or information on this request, please don't hesitate to call me or Deputy Treasurer Katie Carroll at 916-653-2995.

Sincerely,

  
BILL LOCKYER  
California State Treasurer

Enclosure

**STATE OF CALIFORNIA**  
**Follow-up Questions on Credit Default Swaps**

In answering the questions below, the following definitions apply:

“Proprietary trading” means any and all trading of State of California (State) credit default swaps (CDS) conducted for your firm’s own account which is not undertaken (a) to hedge specific, identified State credit exposures held by your firm, such as State general obligation (GO) bonds, credit facilities or derivative credit exposures, or (b) pursuant to your firm’s ongoing, client-driven market-making activities.

“Speculative position” applies to your firm’s clients and includes any State CDS that does not hedge a specific, identified credit exposure to the State, such as State GO bonds, credit facilities or derivative credit exposures.

“Short credit protection” means selling State CDS, and benefiting if the State’s perceived credit improves and price spreads on State CDS tighten.

“Long credit protection” means buying State CDS, and benefiting if the State’s perceived credit deteriorates and price spreads on State CDS widen.

1. Please provide additional details about your firm’s proprietary trading of State CDS from January 1, 2007 to present. Your answer should include:
  - a. The gross notional amount of State CDS traded.
  - b. The three highest net notional amounts outstanding in State CDS at any time during this period. The answer should specify the dates on which the three highest net notional amounts were outstanding, and whether the net notional positions were long credit protection positions or short credit protection positions.
  - c. A list of all time periods during which your firm held net long credit protection positions, and the amount of the net long credit protection during each identified time period.
  - d. The net notional amount of your firm’s current position, and whether the net position is short credit protection or long credit protection.
2. If the answer to Question No. 1 indicates your firm, on a proprietary trading basis, took a net long credit protection position at any time, please explain why your firm considers that action appropriate, given that your firm represents California in the marketing of its State GO bonds and is employed by California taxpayers to sell those bonds.
3. Regardless of the answer to Question No. 1, what are your firm’s future plans with respect to taking, on a proprietary trading basis, net long credit protection positions on State CDS?

4. For the period from January 1, 2007 to present, please provide information about the extent to which counterparties to your firm's market-making trades of State CDS entered into the CDS in order to take a speculative position on State CDS spreads. Your answer should:
  - a. Provide the aggregate total notional amount of all speculative credit protection positions; the aggregate total notional amount of speculative long credit protection positions; and the aggregate total notional amount of speculative short credit protection positions.
  - b. Identify – by type, not name (e.g., dealers, banks, insurance companies, hedge funds, etc.) – clients that have taken speculative credit protection positions on State CDS.
  - c. For each category of client identified in response to (b), provide: the total number of all speculative credit protection positions and aggregate total notional amount of all speculative credit protection positions; the total number of speculative short credit protection positions and total notional amount of those positions; total number of speculative long credit protection positions and total notional amount of those positions; and the time periods for which the speculative short credit protection positions and speculative long credit protection positions were held open.

If your firm cannot provide all the information requested by Question 4 (a), (b) or (c), please answer to the best of your firm's ability. Also, please fully explain the reasons your firm cannot provide all the information requested. And please explain the conditions, including changes in internal or external procedures or restrictions, which would give your firm the ability to provide all the information requested.

5. For the period from January 1, 2007 to present, please provide detailed information about any instances in which your firm recommended that clients take speculative long or short credit protection positions on State CDS. Unless your firm already has provided such documents, please provide copies of all research prepared by your firm and distributed to clients regarding municipal CDS generally and State CDS specifically.
6. For the period from January 1, 2007 to present, please provide the following information about income your firm received for market-making trades of State CDS: aggregate income for all trades; total income for trades of State CDS that hedged a specific, identified credit exposure to the State; and total income for trades of State CDS in which the counterparties took a speculative position on the State's credit.
7. If the answer to Question No. 4 indicates your firm engaged in market-making for clients who took speculative long credit protection positions, please explain why your firm considers that action appropriate, given that your firm represents California in the marketing of its State GO bonds and is employed by taxpayers to sell those bonds.

8. Regardless of the answer to Question No. 4, what are your firm's future plans with respect to making markets for clients who want to take speculative long credit protection positions on State CDS, i.e. clients who want to bet against the State's bonds?
9. Does your firm believe California taxpayers benefit from speculative trading of State CDS? Please explain your answer. If your answer is yes, please tell us how any perceived benefit could outweigh the potential financial harm speculative trading could inflict on taxpayers.