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**PERSONAL AND CONFIDENTIAL**

May 27, 2010

The Honorable William Lockyer  
California State Treasurer  
915 Capitol Mall, Room 110  
Sacramento, California 95814

Dear Treasurer Lockyer:

Thank you for meeting with me earlier this month in Oakland to discuss the global debt markets, the State of California's access to those markets, and the role of municipal credit default swaps ("CDS") in making those markets more liquid. I am pleased to respond on behalf of Goldman Sachs to the detailed questions posed in your letter dated May 5, 2010.

As you know, Goldman Sachs is a market-maker for an array of municipal products, contributing to orderly and liquid markets for tax-exempt bonds, Build America Bonds ("BABs") and various derivatives, including, but not limited to, CDS. We believe that our market-making activities help to expand the investor base for the State's borrowing needs, including by offering price transparency and risk management tools to investors. As we discussed at our meeting, CDS plays an important role in creating liquidity by promoting confidence among investors that they have alternatives in transferring or mitigating risk. CDS also enables Goldman Sachs and other broker-dealers to better manage their inventory of California bonds derived from making these markets, which further increases their own willingness to commit capital and corresponding liquidity. The more liquid a market, the more likely investors are to participate in that market, resulting in a deeper and more diverse capital pool from which the State can draw for its financing needs that ultimately lowers borrowing costs for taxpayers.

- 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.**

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During the requested time period, our municipal area maintained groups dedicated to market-making (or "flow") and, to a lesser extent through January 2009, proprietary trading. Our review of trading records within the timeframe referenced in your letter indicates that the proprietary trading group entered into four California CDS transactions with other broker-dealers in 2008, in which the Firm purchased protection for a total gross and net notional amount of \$35 million as part of the management of its overall portfolio. Three of those four transactions are still open. This same desk also entered into some State CDS transactions with the market-making group to manage the overall municipal area's California-related and other credit risks or to facilitate customer activity in connection with our market-making function. The municipal area eliminated its proprietary trading function in January 2009.

Throughout the entire period of your requests, however, the overwhelming majority of our trading of California CDS has been as part of our market-making function. As we previously have discussed with you, in the course of our market-making activities, we generally attempt to run a balanced book between cash bond positions, various interest rate and credit hedges, and other risk exposures. We trade California CDS attendant to meeting the needs of our clients and our own firm in managing exposure to a broad range of California-related bonds and credit risks. These risks include those associated with trading in the nearly \$200 billion in bonds issued by several hundred California issuers since 2007. In addition to the State and its various obligations (general obligation bonds, economic recovery bonds, lease revenue bonds, appropriation-backed tobacco bonds, etc.), we may, for example, transact in bonds issued by the Los Angeles Unified School District, the City and County of San Francisco, and the California Department of Water Resources. Despite our efforts to run a balanced book, our overall risk profile at any point in time may be net long or short (either interest rate risks or credit risks), depending on the flow of trading we engage in with clients. To the extent that the Firm develops a net long credit protection position in State CDS, that position is a function of offsetting risks from our market-making activities, and not "proprietary trading" as set forth in your letter.

**2. If the answer to Question No. 1 indicates your firm, on a proprietary trading basis, took a net long credit 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.**

As noted above, in the course of our market-making activities, we generally attempt to run a balanced book between cash bond positions, various interest rate and credit hedges, and other risk exposures. At any moment in time, however, we might find that our overall risk profile is net long or short (either interest rate risks or credit risks), depending on the flow of trading in the cash bonds of the State of California or other issuers within the State, other credit instruments, and CDS. With respect to the 2008 California CDS contracts described above, the total gross notional amount of those four contracts was small compared to the Firm's typically much larger net long exposure to debt issued by the State of California and its municipalities and agencies.

**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?**

Goldman Sachs intends to continue to make markets in municipal CDS as part of its overall market-making activities in California bonds. To the extent necessary to offset positions arising from such

market-making activities, the Firm may at times find itself in a net “long credit protection” position (as your letter defines that phrase) against its typically longer exposure to California bonds. The Firm has no plans, however, to engage in “proprietary trading” of State CDS as set forth in your letter.

- 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.**

When institutional investors transact with Goldman Sachs, they typically do not disclose their motivation or investment objective, and we would not disclose one client’s confidential trading information to another client. Moreover, because clients purchase or sell bonds or CDS from multiple dealers and clients typically do not disclose their overall securities portfolio, Goldman Sachs does not have an accurate view of clients’ net positions. As a result, we cannot accurately determine whether our clients are taking a “speculative” position as set forth in your letter. In addition, client trading portfolios are dynamic and include many complex instruments and strategies. We thus do not believe that there is any practicable way for us to track or characterize specific instruments or positions either as speculative or as hedges.

- 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.**

Our Global Investment Research Division does not create or publish research on municipal issuers. From time to time, however, various groups within the Firm’s Securities Division have provided marketing materials to clients to educate them about the municipal asset class and the products available to gain or

limit exposure to that asset class, including tax-exempt bonds, interest rate derivatives, CDS and, most recently, BABs. (We previously have provided an example of such materials to your office.) Some of those materials have discussed broad macro themes across municipals and the means to express views accordingly, both long and short. In a few instances, they have offered as potential trading opportunities the purchase of protection on a basket of municipal credits that has included, among other entities, California.

- 6. For the period from January 1, 2007 to present, please provide the following information about income your firm received from 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.**

In the ordinary course of our market-making business, we do not isolate profit and loss information on California CDS because California CDS typically are held by the Firm as part of integrated strategies, including hedges against long positions in California general obligation bonds and other related credit risks. Any attempt to reconstruct hypothetical profit and loss information limited solely to market-making activities in California CDS may be unreliable in our view and present only part of a larger picture. In addition, as mentioned above, we cannot identify which specific CDS contracts our clients purchased or sold in order to take a speculative position. As a result, we cannot break out profit and loss information in the manner you have requested.

- 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.**

We view our market-making activity as essential to the entire municipal market and to the underwriting of all our clients' bond financings. In the ebb and flow of the market, buyers and sellers cannot always be immediately matched. As a market-maker, we step in with our own capital to execute a trade for a client. By consistently providing prices at which we are willing to both buy and sell, we promote confidence in a market's liquidity and make investing clients more willing to participate. As noted above, we do not and cannot know the reasons for a client's decision to sell a bond (thus taking a short view on the credit), buy a bond (thus taking a long view on the credit), or transact in CDS as either a short or a long investor (as both are required for the CDS market to function). Refusing to trade with any portion of the market would result in less secondary market liquidity and ultimately higher spreads for the State's bonds as investors who lose confidence in the market's liquidity withdraw and demand for bonds correspondingly decreases.

- 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?**

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Goldman Sachs remains committed to making markets across a broad range of products to investors who may have a broad range of motivations, thereby promoting broad and diverse investor participation in the municipal market. We believe that these efforts promote liquidity and transparency in the municipal market, conditions that benefit both our issuing and investing clients.

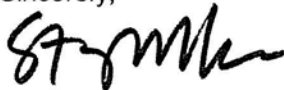
**9. Does your firm believe California taxpayers benefit from speculative trading of State CDS? Please explain your answer. If your answer is yes, please tell us how any perceived benefit could outweigh the potential financial harm speculative trading could inflict on taxpayers.**

We believe that broad trading in State CDS benefits California and its taxpayers. Such trading contributes to the development of a deep, liquid market for the State's bonds as well as bonds of other California entities, and thus to lower borrowing costs for taxpayers. We share your concern about abusive or manipulative trading activity and support efforts to regulate and prosecute such activity.

Goldman Sachs maintains a continuing commitment to California as a bond underwriter and to the municipal finance markets generally. We remain one of the largest and most active primary and secondary market-makers in all California bonds, and we frequently commit our capital in these and other efforts that lower the borrowing costs to taxpayers. California is a very important client of the Firm, and we have been privileged to work with the State to finance critical infrastructure and other needs.

Thank you for the opportunity to continue this important dialogue with you. We look forward to continuing to serve the State and the larger municipal market.

Sincerely,



Stephen M. Scherr