

Morgan Stanley

May 26, 2010

The Honorable Bill Lockyer
Treasurer of the State of California
915 Capitol Mall, Room 110
Sacramento, California 95814

Dear Mr. Lockyer:

Thank you for your May 5, 2010 letter requesting additional information regarding the municipal credit default swap ("CDS") market. Our response to your first request, dated April 14, 2010, clarified Morgan Stanley's (the "Firm") role within the municipal CDS market and our views regarding its effect on primary and secondary market trading of the State of California's (the "State") debt. At Mr. Gorman's request, our team has prepared responses to your additional questions, which we provide below.

1. Please provide additional details about your firm's proprietary trading of State CDS from January 1, 2007 to present.

As we described in our April 14, 2010 letter, Morgan Stanley is an active market maker in all significant categories of the CDS market, including corporate, sovereign/municipal, and index products. Morgan Stanley does not have a dedicated proprietary trading business focused on State CDS. However, the Firm does carry long or short positions, which can be sizeable, in State or other municipal CDS in the context of the Firm's market making activity.

2. If the answer to Question No. 1 indicates that 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.

As noted in Question No. 1, Morgan Stanley does not have a dedicated proprietary trading desk for State or other municipal CDS; all net long and net short positions are taken in the context of our market making business.

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?

Morgan Stanley has no current plans to establish a proprietary trading business for State CDS.

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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 CDS in order to take a speculative position on State CDS spreads.

Morgan Stanley does not ascertain whether a counterparty is or is not hedging or taking a speculative position on State CDS spreads, nor are we typically aware of their other positions in either State CDS or State securities. We would not expect our counterparties to be willing to disclose this information to Morgan Stanley or any other counterparty.

In the course of the Firm's market making activities, we have executed trades with a variety of counterparties since January 1, 2007. These include: \$6.4 billion of gross notional traded with hedge funds and mutual funds; \$2.7 billion of gross notional traded with broker dealers; and \$0.6 billion of gross notional traded with financial institutions and insurance companies. As noted, we are not in a position to know if any of these trades were for speculative purposes.

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 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.

Morgan Stanley has not recommended that clients take speculative long or short positions on State CDS. As an addendum to our April 14, 2010 letter, Morgan Stanley provided all research information distributed to clients regarding municipal and State CDS.

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.

As a matter of company policy and in order to provide equal disclosure to all market participants consistent with best practices and Regulation FD, Morgan Stanley does not publicly disclose operating results other than those that are provided in its quarterly and year-end reports. Morgan Stanley's quarterly and yearly financial reports and SEC filings can be found at <http://www.morganstanley.com/about/ir/index.html>.

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.

As we note in our response to Question No. 4, Morgan Stanley does not attempt to discover the motivations of the investors with whom we trade nor would we expect our counterparties to provide this information. Moreover, as we noted in our April 14, 2010 response, Morgan Stanley's public finance underwriting business is separate and independent, both physically and functionally, from the traders who trade municipal and State CDS. Morgan Stanley runs the businesses with independent personnel, resources, and budgets. Public finance bankers' and underwriters' decisions are not influenced by Morgan Stanley's CDS market making activity nor are Morgan Stanley's CDS traders' decisions influenced by public finance bankers' and underwriters' activities. Additionally, Morgan

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Stanley has information barriers in place between traders on the public side and public finance bankers on the private side to avoid actual or apparent trading activity (in bonds, CDS, or other instruments) based upon the knowledge of the public finance bankers.

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.

Morgan Stanley expects to continue to make markets in municipal and State CDS.


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.

As we noted in our April 14, 2010 letter, we do not believe that the municipal CDS market has materially impacted the State's bond sales or the borrowing costs paid by taxpayers given the relatively small size of the municipal CDS market, types of market participants in the traditional bond market and the CDS market, and historical trading data. However, as the State expands its taxable borrowing program and the investor base resembles corporate, consumer, and international sovereign debt, there will be increasing investor demand for risk management tools like CDS.

In closing, thank you again for continuing a dialogue with Morgan Stanley on this important topic. We would welcome the opportunity to meet with you and your staff to further explore your questions.

Sincerely,


Jack DiMaio
Managing Director and
Global Head of IRCC


Stratford Shields
Managing Director and
Head of Public Finance

cc: James Gorman
John Sheldon