



**BILL LOCKYER**  
TREASURER  
STATE OF CALIFORNIA

March 29, 2010

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

Dear Mr. Gorman:

I write to request information about your firm's market activities related to credit default swaps – on municipal bonds in general, and State of California general obligation (GO) bonds specifically.

The State never has defaulted on a debt service payment in its history. Small wonder.

The State's GO bonds are backed by the full faith and credit, and taxing power, of the eighth-largest economy on the planet. Under the state Constitution, debt service has second call on General Fund revenues, right behind schools. To provide a picture of this protection's strength, consider:

The Governor's revised 2009/10 budget projects General Fund revenues at \$88.1 billion and schools spending at \$41.8 billion. GO debt service has first call on the remaining \$46.3 billion. GO debt service for FY 2009/10 is projected at \$5.2 billion. In other words, we have debt service coverage of more than 8 times.

There's more. GO debt service payments are continuously appropriated. In plain English, that means debt service gets paid even if the State has no budget.

Your firm is fully aware of all this, because it sells California GO bonds. Frequently, your firm manages those bond sales.

Credit default swaps (CDS) amount to insurance against default. Yet, despite the security-plus backing of California GOs, and our spotless record of paying our debt on time and in full, market participants actively buy and sell credit default swaps (CDS) on our bonds. In fact, my office has information that indicates CDS on the State's GO bonds may rank No. 1 in dollar value among all



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municipal issuers. We also have information that indicates your firm, which sells California GO bonds, may participate in the municipal CDS market.

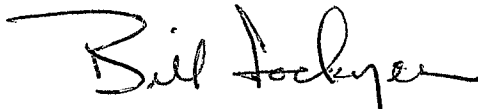
Data reported in the news media and other sources show that the prices, or spreads, on California CDS wrongly brand our bonds as a greater risk than those issued by such nations as Kazakhstan, Croatia, Bulgaria and Thailand. The perception of risk could adversely affect the price of our bonds when we go to market. That makes the CDS market important to our taxpayers. That is why I want to fully understand the municipal CDS market in general, the market for California CDS, and your firm's role in these markets.

I have no preconceived notions about the effect of CDS trading on California GO bond prices, or about your firm's activities in the California CDS market. I do, however, worry about firms selling our bonds, on one hand, and trading CDS on our bonds, or otherwise participating in that market, on the other. I also firmly believe taxpayers have a right to know this information.

Please provide responses to the enclosed questions by the close of business on April 12, 2010.

Thank you in advance for your cooperation.

Sincerely,



BILL LOCKYER  
California State Treasurer

Enclosure

### **State of California Credit Default Swap Questions**

- 1) Describe your firm's trading activity in municipal and State of California credit default swaps ("CDS"). In your answer, please provide detailed information about all of the following:
  - Your firm's activity in making markets (i.e., providing, on a regular basis, firm one-way or two-way quotes to clients) in municipal and State of California CDS.
  - Your firm's role as a broker, arranger or facilitator of State of California CDS trades.
  - The categories of clients for whom you provide market-making services, or for whom you broker, arrange or facilitate trades, in municipal and State of California CDS. Examples of such clients include, but are not limited to, hedge funds, insurance companies, monoline insurers, banks and dealers.
  - Your firm's volume of State of California CDS trades from Jan. 1, 2007 through the present. Please provide the total volume and the volume for each category of client.
  - Your firm's current outstanding gross and net notional amount of State of California CDS.
  
- 2) Describe any credit analysis/marketing information you distribute to clients that contains information regarding municipal CDS in general, and California CDS specifically, from Jan. 1, 2007 through the present.
  
- 3) Describe, in your view, how State of California CDS trading, in recent years, has affected the State, its bond sales and the borrowing costs paid by taxpayers.
  
- 4) Provide your outlook for the municipal CDS market and, more specifically, the State of California CDS market, over the next two years. In your response, please include a discussion of your firm's views on: whether (and how) continued growth of the taxable Build America Bond market could increase the use of municipal CDS; and the circumstances under which growth in CDS trading could adversely affect the State and its debt issuance?