

June 2010

SEC Alters the Playing Field for Managers of Money Market Funds

Changing Money Fund Regulations Likely to Reduce Yields and Narrow the Range of Manager Returns

More stringent regulations governing the management of money market funds should achieve their primary purpose – protecting investors’ assets during highly volatile markets – but in doing so, they likely will exert downward pressure on yields and reduce the variability of fund companies’ investment results.

The new regulatory framework, presented by the Securities and Exchange Commission (SEC) in February, is being implemented through changes to Rule 2a-7 of the Investment Company Act of 1940, which governs domestic money market funds. The changes include tougher requirements regarding credit quality, minimum liquidity levels, concentration limits and disclosure of holdings and NAVs (net asset values). The changes are intended to reduce the risk profile of money market funds and better insulate them from market disruptions.

BofA Global Capital Management already has adopted many of the SEC reforms because the firm practices a conservative approach to cash investing that emphasizes the preservation of investor capital. As the new rules force all managers to adopt similarly conservative investment practices, performance differentials among managers are likely to diminish. Fund companies who sought to differentiate themselves largely on the basis of yield, likely will need to compete on other factors investors consider when evaluating a fund company. These include:

- The reputation and stability of the fund sponsor
- The resources and investment expertise focused on money market funds
- The sophistication of the fund company’s technological infrastructure
- The quality of the service platform supporting the managers’ investors

The changes to the SEC’s regulations touch on almost every aspect of a money market fund’s operations, from portfolio construction to risk management to performance reporting (see page 3 for the effective dates of the key reforms). The more far-reaching reforms – and their impact on the money markets – are described below.

Portfolio Maturity Limits

The SEC has reduced the maximum weighted average maturity of money market funds’ portfolios from 90 days to 60 days, a move intended to limit funds’ exposure to certain risks, such as sudden interest rate movements. From a practical standpoint, the change very well may result in a “step up” in the money market curve at seven months and a steepening of the yield curve thereafter.

In addition, the SEC is further restricting the maximum weighted average life of funds’ portfolios to 120 days (previously there was no limit). The effect of that restriction is to limit investments in long-term floating-rate securities. This change is likely to increase the spread on these “floaters,” albeit only slightly, with corporate debt underperforming government-sponsored entity (GSE) issues.

Liquidity Requirements

Under the new regulatory framework, “illiquid securities” – defined as instruments that cannot be sold or disposed of at their carrying value within seven days – cannot exceed 5% of a fund’s portfolio. The limit was 10% previously. This likely will force fund managers to reduce their allocations to term repurchase agreements (repos), especially in government funds.

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More important is the creation of daily and weekly liquidity requirements that define the minimum percentages of money fund assets that must be in highly liquid securities. The daily requirement stipulates that taxable money market funds must hold at least 10% of their assets in cash, U.S. Treasury securities or securities that can be converted into cash within one day. The rule governing weekly liquidity states that all money market funds must hold at least 30% of assets in cash, U.S. Treasury securities, federal government Agency discount notes with remaining maturities of 60 days or less or securities that can convert to cash within one week.

The addition of minimum daily and weekly liquidity requirements should continue to limit any upward pressure on U.S. Treasuries with maturities of less than six months and GSE maturities shorter than two months. It also is possible that the U.S. Treasury curve could “step up” at seven months, but the premium likely would be less than that for the London Interbank Offered Rate (LIBOR) at the seven-month point on the yield curve.

“Know-Your-Investor” Procedures

Money market funds now are required to implement procedures to identify investors whose redemption requests potentially could present a risk to a fund. The new rule requires fund managers to gauge the likelihood of large redemptions and plan accordingly. Fund managers would need to increase their allocation to highly liquid securities if a given investor increases the risk of significant redemption activity.

Money market funds with significant concentrations of this “hot money” – large sums that flow in and out of the funds frequently – now will need to increase their allocations to highly liquid securities to levels higher than those described above. This will create additional downward pressure on the yields of these funds. The additional emphasis on transparency also could prompt fund companies to reduce investments from money market portals. These provisions, along with new requirements that mandate stress testing of portfolios, create additional fixed costs for the money funds industry. The additional costs, combined with fee waivers, could force smaller fund companies to exit the industry. A smaller pool of fund companies could generate concentration concerns among issuers because there could be fewer investors to absorb their issuance.

Enhanced Disclosure Requirements

Another challenge for fund companies is the requirement that money market funds must post their portfolio holdings on their websites (updating them monthly). They also must report their portfolio holdings to the SEC each month in a format the SEC can use to create a database that will enable the agency to better oversee the funds’ activities. In short, these requirements will give the SEC a clearer view to the practices and health of the money market industry, which, in turn, could contribute to the consolidation of the industry.

A particularly important component of the new disclosure rules is the requirement that information on a fund’s “shadow” NAV (“mark-to-market”) be made available to the public on a 60-day delay. Previously, funds reported their shadow NAVs twice a year with a 60-day lag. Increasing the frequency of shadow NAV reporting could prompt fund managers to further reduce their risk levels for fear that a drop below \$1 could lead to a run on their funds.

Repurchase Agreements

The changes to Rule 2a-7 tighten provisions that enable funds to “look through” to the collateral backing repurchase agreements for diversification purposes. To take advantage of this new provision, the collateral must be cash instruments or government securities. With the added transparency, however, comes a requirement that fund managers must evaluate the creditworthiness of the repurchase agreements’ counterparties.

The SEC’s efforts to protect money market investors during periods of extreme volatility likely will have an impact on the short-term debt markets, the money fund industry and, most importantly, investors. BofA Global Capital Management will continue to update our investors and partners on the impact of the new requirements as they are implemented. If you have any questions about the information presented above, please contact your BofA Global Capital Management representative.

Money Market Fund Reforms – Effective Dates

The implementation date for the Securities and Exchange Commission's amendments to Rule 2a-7 under the Investment Company Act of 1940 was May 5, 2010. However, some provisions have later effective dates to allow fund companies additional time to comply with the new rules. Those rules are as follows:

Effective Date	New Rules
May 5, 2010	Funds must adhere to requirements relating to stress testing and know-your-investor procedures and new rules regarding expanded authority for affiliate purchases and ability to suspend redemptions and payment of proceeds to facilitate orderly liquidity of a fund. Funds must also eliminate fixed-rate Treasury securities with maturities longer than 397 days.
May 28, 2010	Funds must adhere to tougher requirements governing credit quality, maturity limits, liquidity levels and repurchase agreements.
June 30, 2010	Funds must reduce weighted average maturity (WAM) from 90 days to 60 days and limit "spread" weighted average life (WAL) to 120 days. BofA Global Capital Management already is in compliance with this rule change.
October 7, 2010	Funds must report CUSIP-level information on end-of-month holdings, including WAM and WAL, on funds' public websites by the fifth day of the month.
December 7, 2010	Funds must begin filing portfolio information and shadow price NAV with the commission on Form NMFP.
December 31, 2010	Funds must disclose Nationally Recognized Statistical Rating Organization(s) designated by funds' boards of directors in statements of additional information.
October 31, 2011	Funds must be able to process transactions at prices other than at stable net asset value.

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Please read and consider the investment objectives, risks, charges and expenses for any fund carefully before investing. For a prospectus, which contains this and other important information about the fund, contact your BofA Global Capital Management representative or financial advisor or go to www.bofacapital.com.

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More details on the SEC money market reform announcement are available at: <http://www.sec.gov/news/press/2010/2010-14.htm>

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