Proposed changes in bond index rules

Proposed index rule changes under consideration

A number of rule changes that will impact selection criteria and calculation methodologies for the BofA Merrill Lynch Global Bond Indices are currently under consideration. Full details of all proposed changes are outlined in this report.

Public commentary period

In order to ensure a transparent and unbiased rule-making process, we will accept comments on these proposed changes from all members of the investment community prior to reaching any final decisions. Comments should be emailed to the BofA Merrill Lynch Global Index group (mlindex@ml.com). All comments should be submitted no later than September 30, 2010. **Note: It is important that you register your vote even if you are in full agreement with the proposed rule changes.**

Final decisions will be announced in October

The rule changes outlined in this document are preliminary. After carefully considering all comments received, BofA Merrill Lynch, at its sole discretion, will make a final decision on those changes that are to be implemented. The official list of approved rule changes will be published in October. Any one or more of the preliminary changes included in this report may be modified or eliminated completely from the final list of rule changes. Similarly, new changes, not included in this report, may be introduced in the final list of rule changes.

All final changes will take effect on Dec. 31, 2010

Those changes that are officially adopted and announced in October will take effect on December 31, 2010, and new selection criteria will be incorporated in the Indices beginning with the January 2011 constituent lists.

BofA Merrill Lynch, at its sole discretion, reserves the right to issue rule changes apart from this standard cycle in the event that such a change is deemed necessary in order to deal with extraordinary circumstances including, but not limited to, changes in data availability.

Bond Indices

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Proposed Changes

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Refer to important disclosures on page 4 to 5. Link to Definitions on page 3.

Exclude toggle notes and flat-trading bonds from the US Cash Pay High Yield Index

Proposed rule change: Effective December 31, 2010, toggle notes that are still within their toggle period and all bonds trading without accrued interest (i.e., trading flat) will no longer qualify for inclusion in the US Cash Pay High Yield Index (J0A0) and all of its sub-indices.

Comments: Since toggle notes began to be issued the bonds have been included in the Cash Pay indices while accruing a regular cash coupon. However, as these bonds may "toggle" repeatedly between cash and payments-in-kind, these securities could move in and out of the index repeatedly over their lives. Under the new rule these bonds will remain out of the cash pay indices for the entire duration of the toggle period, regardless of whether they are paying cash or in-kind. Once the toggle period ends the bonds would qualify for inclusion in the cash pay indices.

Impact: As of June 30, 2010, the US Cash Pay High Yield Index holds only six toggle notes, having a combined weight of just 0.27%. Currently, there are nine flat-trading bonds, with a combined weight of 0.25%, included in the US Cash Pay High Yield Index.

Remove tranches with one remaining cash flow from the U.S. CMBS index

Proposed rule change: Effective December 31, 2010, CMBS tranches that have only one remaining cash flow will no longer qualify for inclusion in the US Commercial Mortgage Backed Securities Index (CMBS) and all associated parent and sub-indices.

Comments: In order to be consistent with the rule already in place for the U.S. ABS indices, as well as to avoid tranches paying off while still in the index, these securities will be removed from the U.S. CMBS indices at the beginning of the month in which they are expected to pay off.

Impact: The impact on the indices will be minor, as typically there are no more than a handful of tranches in the indices that are within a month of paying off. As of June 30, 2010 17 tranches would have been excluded as a result of this rule change.

Exclude 144a bonds from taxable and tax-exempt U.S. municipal securities indices

Proposed rule change: Effective December 31, 2010, taxable and tax-exempt U.S. municipal securities issued under rule 144a will no longer qualify for inclusion in any indices.

Comments: Securities issued under rule 144a are practically non-existent in the U.S. municipal bond market. In addition, the muni market is characterized by large-scale involvement by non-institutional investors, which further reduces the likelihood of significant 144a issuance and limits the potential liquidity of this segment. This suggests that excluding 144a securities will better align the index with the investment universe of most portfolio managers.

Impact: As of June 30, 2010 the impact on the indices will be minor, as there are only three 144a bonds with a total face value of $141mn in the US Municipal Securities Index (U0A0) that would be removed as a result of the proposed rule change. There are currently no 144a securities in either the Build America Bond Index (BABS) or the US Taxable Municipal Securities Index (DQTM), which is a sub-index of the US Broad Market Index (US00).

Designate U.S. taxable munis as a new category in the sector classification schema

Proposed rule change: Effective December 31, 2010, a revised sector classification schema will take affect that will segregate U.S. taxable municipal securities from the Local Authority category. In addition, the new U.S. Taxable Municipal category will have 20 sub-categories corresponding to the same sub-categories that currently exist for the tax-exempt U.S. municipal asset class.

Comments: The rapid growth of the new Build America Bond segment of the U.S. investment grade market has put U.S. taxable municipal securities in the spotlight. The new schema will allow for side by side performance comparisons across corresponding sectors of the taxable and tax-exempt U.S. municipal securities market.

Impact: This change will require updates to any process utilizing the BofA Merrill Lynch sector schema for individual security classification and/or sector analysis. Custom indices having sector dependencies may also be affected by the adoption of the new classification schema. Clients will have the option to request a rule modification for any custom index created on their behalf in order to minimize the impact of the changes on their index composition. Requests for custom index rule modifications should be submitted as soon as possible in order to ensure that they can be implemented concurrent with the adoption of the new schema.

Table 1: BofA Merrill Lynch Index sector classification schema – Quasi & Foreign Governments

Level 1 – Asset class	Level 2 – Group	Level 3 – Category	Level 4 – Sub-category
Quasi & Foreign Government (QGVT)	Quasi & Foreign Government (QGVT)	Agency (Agcy)	Agency (Agcy)
		Foreign Sovereign (FSov)	Foreign Sovereign (FSov)
		Government Guaranteed (Guar)	Government Guaranteed (Guar)
		Local-Authority (LGvt)	Local-Authority (LGvt)
		U.S. Taxable Municipal (TaxM)	Pre-Refunded (TPre)
			ETM (TEtm)
			Insured (TIns)
			GO - State (TGos)
			GO - Local (TGol)
			Revenue - Airport (TAir)
			Revenue - Education (TEdu)
			Revenue - Health (THlt)
			Revenue - Hospitals (Thos)
			Revenue - Pollution Control (TPcr)
			Revenue - Industrial Development Revenue (TIdr)
			Revenue - Leasing COPS & Appropriations (TLea)
			Revenue - Single Family Housing (TShn)
			Revenue - Multi-Family Housing (TMhn)
			Revenue - Tax (TTax)
			Revenue - Tobacco (TTob)
			Revenue - Toll & Turnpike (TTol)
			Revenue - Transportation (TTrn)
			Revenue - Power (TPow)
			Revenue – Utilities - Other (TUtl)
		Supranational (Supr)	Supranational (Supr)

Source: BofA Merrill Lynch bond indices

Link to Definitions

Credit

Click here for definitions of commonly used terms.

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