

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE
COMMISSION

Admin. Proc. File No. 3-11818 :

In the Matter of :

BANC OF AMERICA CAPITAL
MANAGEMENT, LLC, BACAP
DISTRIBUTORS, LLC, AND BANC
OF AMERICA SECURITIES, LLC, :

Respondents.

PROPOSED PLAN OF DISTRIBUTION

I. Background

1.1. On February 9, 2005 the Securities and Exchange Commission ("SEC" or "Commission") entered an order in this proceeding (the "Order"). Among other things, the Order recited that between July 2000 and July 2003: (i) Banc of America Capital Management, LLC ("BACAP") and BACAP Distributors, LLC ("BACAP Distributors") "allowed certain market timing clients to engage in short-term or excessive trading and never disclosed this fact to other investors"; (ii) BACAP and BACAP Distributors "entered into arrangements with two entities, allowing them to engage in frequent short-term trading in at least 13 Nations Funds mutual funds ... despite knowing that such trading could be detrimental to Nations Funds' shareholders"; and (iii) Banc of America Securities, LLC ("BAS") "facilitated market timing and late trading by some introducing broker dealers and a hedge fund at the expense of shareholders of Nations Funds and other mutual fund families." (Order ¶¶1-2, 7). As a result, the Commission found that the Respondents willfully violated the antifraud provisions of the securities laws. (Order ¶¶116-132). The Order established a Fair Fund consisting of \$250,000,000 in disgorgement and \$125,000,000 in civil money penalties, for a total fund of \$375,000,000. That Order required an Independent Distribution Consultant ("IDC") to develop a plan ("Distribution Plan" or "Plan") for the distribution of the Fair Fund, "according to a methodology developed by the IDC

in consultation with Respondents and the independent trustees of the Nations Funds mutual funds and acceptable to the staff of the Commission.” (Order ¶139(a)).¹ Shortly after the entry of the Order, Professor Lawrence A. Hamermesh, Ruby R. Vale Professor of Corporate and Business Law at Widener University School of Law in Wilmington, Delaware, was appointed as the IDC in this proceeding.² On February 25, 2005, Respondents deposited the amount of the Fair Fund (\$375,000,000) at the U.S. Treasury for investment in government obligations. Other than interest from these investments, it is not anticipated that the Fair Fund will receive additional funds. If such funds are received before distributions under this Plan have begun, such funds will be distributed by means of proportionally increasing distributions otherwise provided for in this Plan, or by such other means approved by the IDC in consultation with the Respondents, the trustees of the Nations Funds, and the Commission or its staff. After distributions under this Plan have begun, the Fund will not accept additional funds for distribution.

1.2. This Distribution Plan is the result of extensive consultation. Among other efforts, Professor Hamermesh:

- Met with Deloitte & Touche to review the analyses it prepared for the Independent Trustees of the Nations Funds to assist with their evaluation of the effects of market timing and late trading activity in the Nations Funds.
- Met and spoke with Respondents’ economic adviser Lexecon, which has, at Professor Hamermesh’s request and under his guidance, managed the trading data and developed and executed the numerical and financial analyses of that data.
- Retained Professor Erik R. Sirri, professor of finance at Babson College and former Chief Economist of the Commission, and consulted him, prior to April 30, 2006, on issues of financial and economic analysis associated with the development of the Distribution Plan with respect to distributions to Nations Funds shareholders.³

¹ The plan of distribution of the Fair Fund is to provide for the distribution of the entire \$375 million fund, including both the disgorgement and penalty portions of the Fund. Order ¶139(a).

² Professor Hamermesh also serves as IDC for the fair fund established under the February 9, 2005 order in *In the Matter of Columbia Management Advisors, Inc. and Columbia Funds Distributor, Inc.* (the “Columbia Funds Proceeding”). That proceeding involves a separate fair fund from the fund established with respect to the Nations Funds. As prescribed in the Order in this proceeding involving the Nations Funds (¶139), Respondents have agreed to pay all compensation of and expenses incurred by Professor Hamermesh as IDC for the Nations Funds Fair Fund.

³ Erik Sirri is now Director of the Division of Market Regulation at the Commission. His consultation with Professor Hamermesh occurred during the period from around March 2005 through March 2006.

1.3. The Fair Fund established by the Order differs from the fair funds established with respect to other mutual fund families that have settled with the Commission. Like the other settlement funds, the Fair Fund in this proceeding addresses trading in the funds for which the Respondents served as adviser and distributor (the "Nations Funds"); it also addresses, however, trading in many other fund families, where such trading was found to have been facilitated by respondent BAS, a registered broker-dealer.

1.4. The preponderance of this trading through BAS was in mutual fund families that have reached their own settlements with the Commission with respect to market timing and/or late trading allegations and thus have established their own fair funds. Mutual funds in such families, which include, for example, the mutual funds advised by Alliance Capital Management, L.P. (the "Alliance Funds"), Invesco Funds Group, Inc. (the "Invesco Funds"), AIM Advisors, Inc. (the "AIM Funds"), Massachusetts Financial Services Co. (the "MFS Funds") and Janus Capital Management LLC (the "Janus Funds"), are referred to in this Distribution Plan as the "Settling Funds." Some of the trading through BAS was also in fund families that have not entered into settlements with the Commission and thus have not established their own fair funds. Mutual funds in such fund families are referred to in this Distribution Plan as "Nonsettling Funds." The Settling Funds and the Nonsettling Funds are referred to collectively as the "Unaffiliated Funds."

II. Distribution Methodology—In General

2.1. The methodology for the distribution of the money in the Fair Fund involves two bases for allocation. First, it is designed to provide compensation for dilution and related harm to contemporaneous long term shareholders arising from the trading identified in the Order in the various funds identified in Tables 2 through 4. The term "contemporaneous," as used in this Distribution Plan, refers to those persons or entities who were fund shareholders at the time of the trading identified in the Order, regardless of whether such persons continued to hold fund shares thereafter. Although the duration of such trading varied from fund to fund, in general the trading in question occurred during the period from 2000 through mid-2003.

2.2. The trading at issue is attributable to specified traders: Canary Capital Partners, LLC and related entities ("Canary"), TranSierra Capital, LLC ("TranSierra"), and certain introducing brokers with significant mutual fund market timing clients (the "Introducing Brokers") who traded through BAS. See Order ¶¶29-54; 82-92.

2.3. In determining dilution and related harm, the effects of all of the trading by these firms have been assessed; no such trading has been excluded.

2.4. The methodology for determining dilution and related harm from such trading attempts to estimate, on a daily basis over the course of that trading, the extent to which a fund's net asset value ("NAV") would have been greater or less than the actual NAV had that trading not occurred. That difference (where positive) is the estimate of the dilution and related harm to the contemporaneous holders of the fund on each of the days on which such trading occurred. The sum of those daily increments (both positive and negative) represents the aggregate harm to each fund's shareholders during the period in which timing trading occurred.⁴

2.5. The second basis for allocating the Fair Fund in this proceeding involves return, to contemporaneous long term holders of Nations Funds in which the trading identified in the Order occurred, of advisory and administrative fees paid to BACAP and BACAP Distributors by those funds during the periods in which that trading occurred. Order ¶¶62-63. BACAP has acted as a fiduciary for the Nations Funds. Order ¶5. Where an advisor grants timing capacity in the funds that it advises, such a return of fees can be an appropriate use of the settlement proceeds in the fair funds. See, e.g., *In the Matter of Janus Capital Management LLC.*, File No. 3-11590, *Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order*, Investment Advisers Act Release No. IA-2277 (Aug. 18, 2004), ¶33.

2.6. The aggregate results of the application of the foregoing principles to both the Nations Funds and the Unaffiliated Funds are summarized in Table 1. The methods of calculation of each eligible contemporaneous shareholder's share of the Fair Fund are intended to result in a payment from the Fair Fund to each such shareholder that restores the impaired value of such shareholder's investment in a particular fund. The methods of calculation are intended to fairly estimate the impaired value that each investor has suffered and make a payment in that amount. In the view of the IDC, these methods of calculation are fair and reasonable in the context of this case, and result in a fair and reasonable allocation of the Fair Fund.

III. Estimation of Dilution and Related Harm to Contemporaneous Shareholders

⁴ There may be instances of accounts for which the effect of timer trading was beneficial (and for which harm-based compensation would be inappropriate). Because of this possibility, it may also be the case that the other account holders' share of estimated harm would in the aggregate exceed the aggregate amount estimated for the fund as a whole. For the Nations Funds, at least, it appears that such instances are both unusual and small in scope, and are not likely to have a substantial effect on the ultimate distribution.

A. *Estimating Dilution*

3.1. The starting point in estimating the dilution arising from timer trading is a determination of the net gains realized through that trading. Each timer's purchases and sales are formed into buy-sell pairs using a last-in, first out ("LIFO") methodology.⁵

3.2. For any given mutual fund, if the funds a timer uses to purchase fund shares ("timer funds") were never invested in risky portfolio assets by the portfolio manager, timer net gains would accurately measure dilution to contemporaneous shareholders. To the extent, however, that timer funds were invested in risky assets, dilution may diverge from timer net gains. Accordingly, it is necessary to estimate the extent to which portfolio managers invested in (and sold) portfolio assets in response to timer investment (and sales).⁶

3.3. For each buy-sell pair, the mutual fund's incremental investment in risky assets (*i.e.*, assets with unpredictable future returns) is estimated by assuming that a constant fraction of the timer funds is invested in risky assets each day until either the timer funds are invested or the timer's shares are redeemed. When the timer's shares are redeemed, the portfolio manager is assumed to sell risky assets at the same rate to fund the redemption.⁷

⁵ Because of the focus on the actual dilutive impact on fund shareholders, aggregate timer gains and losses in each individual fund are netted through the period in which timer trading occurred.

⁶ See Greene, Jason T. and Ciccotello, Conrad S., "Mutual Fund Dilution from Market Timing Trades" (September 27, 2004).

⁷ To implement this approach it was necessary to estimate the constant fraction of timer funds that are invested each day by the portfolio manager (*i.e.* the investment rate). To do this estimation a regression analysis was used. Regression analysis is a statistical procedure commonly used by statisticians and economists to find the relationship between two variables. Here, regression analysis was used to find the relationship between the flow of timer money and the amount of risky assets purchased or sold by the portfolio manager. Since this relationship may vary by fund, whenever possible a separate regression was performed for each fund. In cases where it was not possible to perform a separate regression (due to lack of information specific to a particular fund), a weighted average of the estimates of funds with available data was used.

A regression analysis can be set up (or "specified") in many different ways. For example, one might look at the relationship between investment today and flow today. Alternatively, one might look at the relationship between investment today and flow today and yesterday (under the assumption that it takes time to invest money so yesterday's flow also influences today's investment). Many different specifications were tried and the specification that produced the highest investment rate was used.

The regression analysis used data on flows of money into the Nations Funds and the portfolio manager investments for the Nations Funds (this data was also used to calculate transaction costs). To ensure typical portfolio manager behavior was being estimated, extreme observations (also called outliers) were removed from this data prior to running the regression analysis. In

3.4. To illustrate, take the case where a timer buys 10 fund shares for \$100 on day 1, sells those 10 shares on day 4 for \$110, and the estimated daily average investment rate is 10 percent per day. The model assumes the portfolio manager invests \$10 per day in risky assets on days 2 through 4. Consequently, before the redemption on day 4, the fund holds \$30 of the timer funds in risky assets and \$70 in cash; and immediately after the redemption on day 4, the fund holds \$30 of the timer funds in risky assets and has a cash deficit of \$40 (= \$70 - \$110). On days 5 through 14, the portfolio manager is assumed to sell \$40 of risky assets at the rate of \$4 per day to offset the cash deficit and return the fund to its previous cash level.

3.5. To estimate the effect of the incremental investment in risky assets, the fund's profits and losses on the incremental investment are estimated for each day, and the total effect is the sum of the daily profits and losses. The effect of the incremental investment each day is estimated as the fund's return that day multiplied by the incremental investment in risky assets that day. For example, continuing the previous illustration, the fund's investment in risky assets is \$20 higher on day 3 than it would have been absent the timing activity. If the fund's return on day 3 was 1 percent, then the investment of the timer funds benefited the fund's shareholders that day by \$0.20 (= \$20 * .01); and if the fund's return on day 3 was -2 percent, then the timing activity harmed the fund's shareholders that day by \$0.40 (= \$20 * .02).

3.6. Last, the effects of all incremental investments are summed and added to the total net profits made by the timers (\$10 in this example) to arrive at an estimate of the total dilution harm to shareholders from the timing activity.⁸

B. Estimating Transaction Costs Related to Timer Trading

3.7. The Order states that timer trading may have adversely affected the funds' NAV's in an additional way, aside from dilution. (Order ¶19). To the extent that timer investment and disinvestment resulted in excess portfolio purchases and sales, the funds may have incurred transaction costs that reduced their NAV's. Such transaction costs can be estimated by comparing estimated transaction costs due to the funds' actual inflows and outflows to the estimated transaction costs that would have occurred had there been no timing activity. The difference between the two estimates of transaction costs is taken as the incremental transaction cost attributable to the timing activity.

addition, it was assumed that at least 1% of timer funds was invested each day even if the regression suggested a lower amount.

⁸ Timer trading involved in this proceeding largely involved very short holding periods, often just one day. Therefore, the effect of investment in and disinvestment of risky portfolio assets due to flows of timer funds is in this case quite small. In the aggregate, dilution using this cash investment model differs from timer net gains by about 2%.

3.8. For Nations Funds for which the pertinent data are available, incremental transactions in response to a given inflow or outflow are modeled by assuming that the portfolio manager invests (or disinvests) in risky assets at the estimated daily average investment rate until the flow is completely invested (or disinvested). For each inflow or outflow, this produces a series of daily portfolio manager investments or disinvestments. To get the net portfolio manager investment or disinvestment on any given day, all portfolio manager investments and disinvestments on that day due to all inflows and outflows are summed. In other words, where there is investment due to previous inflows and disinvestment due to previous outflows, the investments and disinvestments are netted against each other for that day. Investments and disinvestments are not netted against each other across days.

3.9. Transaction costs are estimated from the daily series of net investments by multiplying the net investment or disinvestment on each day by the transaction cost per dollar of investment or disinvestment. Total transaction costs are the sum of the daily transaction costs.

3.10. Transaction costs vary by fund type and time period. Funds are classified into five fund groups based on their Morningstar classification: U.S. Large-Cap, U.S. Small-Cap, International, Municipal Bond and Other Bond. (When a fund's category cannot be identified, the U.S. Small-Cap classification is used.) Transaction costs (expressed in basis points) for U.S. Large-Cap, U.S. Small-Cap and International funds are equity trading costs calculated by Plexus Group, Inc. using Plexus Asset Manager client data, and are the sum of "commissions" and "impact costs." Bond fund transaction costs (expressed in basis points) are average trading costs for institutional corporate bonds calculated in Schultz, Paul, 2001, "Corporate Bond Trading Costs: A Peek Behind the Curtain," *The Journal of Finance* 56, 677–698 at 677.

C. Interest

3.11. In order to make compensation on an equivalent basis for losses spread over time, and to provide appropriate compensation to long-term fund shareholders, this Distribution Plan contemplates an adjustment for the time value of the estimated harms. The methodology incorporated in this Distribution Plan therefore builds in a component of interest on estimates of harm, accruing from the time of dilution harm through the date of payment into the Fair Fund. The rate of interest was selected to approximate Bank of America's cost of unsecured borrowing,⁹ and is estimated by reference to the Merrill Lynch index of 1-3 year A-rated corporate debt over the course of the period in which timer trading occurred.

⁹ See Knoll, Michael S. and Colon, Jeffrey M. Colon Miguel, "The Calculation of Prejudgment Interest" (May 31, 2005).

IV. Allocation to Contemporaneous Nations Funds Shareholders

4.1. Applying the foregoing analysis to timer trading in the Nations Funds results in an estimated allocation to contemporaneous holders of those funds of approximately \$19.0 million in respect of dilution and \$0.5 million in respect of transaction costs (as more fully set forth in Table 2).¹⁰ In addition to those amounts, the distribution to such holders includes net advisory and administration fees earned by BACAP from the affected funds during the periods in which timer trading in those funds occurred. That additional amount is approximately \$63.4 million, which will be distributed among the Nations Funds contemporaneous shareholders in proportion to their holdings during the periods affected by timer trading. Finally, the inclusion of interest on these amounts results in a total distribution to Nations Funds shareholders of approximately \$89.7 million.¹¹

V. Allocation to Holders in Unaffiliated Fund Families

5.1. The same methodology described earlier for estimating dilution and related harm is used to arrive at an estimate of such harm to contemporaneous shareholders of the Unaffiliated Funds. To arrive at this estimate requires the adoption of assumptions about portfolio manager investment and disinvestment in response to timer fund flows, and the estimated response derived from Nations Funds portfolio management is used in the estimate of dilution for the Unaffiliated Funds.¹²

¹⁰ For Nations Funds where data on total flows are not available, transaction costs are estimated using the weighted average ratio of transaction costs to timer buys and sells for the Nations Funds for which data are available.

¹¹ Due to the relatively small amounts involved, and applying the criteria described in paragraph 6.8 of this Distribution Plan, distributions relating to the Nations Bond Fund, the Nations Government Securities Fund and the Nations Short-Term Income Fund will be paid directly to the funds themselves, rather than to contemporaneous shareholders. Application of the criteria described in paragraph 6.8 of this Distribution Plan may also result in payments to one or more other funds rather than contemporaneous shareholders.

¹² The aggregate dilution calculation is not particularly sensitive to the assumptions concerning daily average investment rates. Even if that rate were doubled, the aggregate dilution calculation remains essentially unchanged.

