



CORPORATE &  
INVESTMENT BANKING

Letter of Comment No: 7  
File Reference: FSPFAS140B  
Date Received: 9/7/04

September 1, 2004

Lawrence W. Smith  
Director-Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O.Box 5116  
Norwalk, CT 06856-5116

**Proposed FASB Staff Position (FSP FAS 140-b), "Application Of EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge." When Future Distribution Fees Are Sold to Unrelated Third Parties"**

**SG Constellation**

SG Constellation, LLC is pleased to submit the following comments:

**Executive Summary**

The GAAP sale treatment applied by over 30 of our clients over the last 10 years is, and has been, appropriate. Such treatment, wherein the seller recognizes revenue, rather than debt, accurately reflects the economic, legal and accounting substance and realities of our sale transactions.

Clarification of existing GAAP for these transactions would be helpful since there is no literature directly on point and there has been a significant change in facts and circumstances since the release of EITF 85-24. The most significant change has been the market we helped create for purchasing these future fee streams from distributors.

SG Constellation was a pioneer in the development of this market. We buy, hold, and risk manage these fees to their full term. Our level of due diligence on evaluating and understanding all of the risks inherent in these fees is recognized as the most thorough in the industry. Therefore, we believe we are uniquely qualified to provide back-ground on these transactions to assist the FASB in its deliberations on this matter. We would be happy to answer any follow up questions the FASB staff may have and remain available to the FASB as a resource during their deliberations.

We believe a thorough review of the facts will support sale accounting and immediate income recognition because these transaction fulfill all of the essential of revenue under both EITF 88-18 and Concepts Statement 5:

- the form of the transaction is a sale upon which legal true sale opinions have been received and subsequent securitization have been based;
- all of the risks and rewards of ownership have been transferred;
- the fees streams involved are easily tagged and tracked throughout their life;
- there is no recourse other than normal contractual protection;
- there is no continuing involvement as the distributor has fully performed the service for which the fee is paid. Therefore, the fees are earned, due and payable upon the initial sale of the fund shares to the investor;
- the transactions are not cancelable by either party;
- the purchaser's rate of return is not limited as evidenced by the significant losses incurred by many purchasers of these fees and subsequent investors in securitization bonds backed by these fees;
- variations in the distributor's and/or the fund's performance have a "trifling impact" on the performance of these fees;

The issue of symmetrical accounting between the fund and the distributor has been raised and is the cause of some concern. How can one entity believe it has a receivable that can be sold or recognize revenue on a sale of future fees when the entity from which the amounts are due does not have a payable or book an expense? We believe the existence of a second, related, set of cash flows from the fund's investors, who have an obligation to pay contingent fees upon redemption, creates a unique situation wherein the fund (and the investor if it were preparing GAAP financial statements) should not have a payable or book an expense, yet the distributor should be able to book income if not a receivable. This is because individually the fee streams have significant uncertainties that

render them as contingencies not payables. This is reinforced by the fact that there is no market for either of these fees on a separate basis due to the significant uncertainties involved with valuing each individually. However, in combination, the complimentary nature of the fees eliminates many of the uncertainties thus allowing them to be valued and sold in an active, competitive market.

We believe that the cash received from a sale transaction qualifies as deferred income under EITF 88-18, and that immediate recognition of that deferred income is appropriate given the facts and circumstances. We also believe a good argument can be made that the characteristics of this unique combination of fee streams are sufficient to allow the distributor to book a receivable upon the initial sale of the shares and then sell them if it so chooses. However, we acknowledge that the issue of asset definition is beyond the purview of this FSP.

We believe that, when the complex relationship of these two fee streams is better understood, a position supporting sale treatment can, and will, be reached. Whether through reinterpretation of EITF 85-24, extension of EITF 88-18 to allow for immediate income recognition for “deferred revenue” as defined therein, or clarification of FASB 140 through an FSP, we submit that the facts and circumstances which underlie these transactions support sale treatment under GAAP.

### **Description of Fees**

Under rule 12b-1, and as regulated by the NASD, there are 2 functions of 12b-1 fees: a .25% service fee and .75% asset based sales charge (“ABSC” or “Distribution Fee.”) The ABSC is intended to reimburse the fund’s distributor for commissions it advances to brokers at the time they sell a Class B share (“B-share”). This is similar to the broker receiving an upfront sales charge (Class A shares) which is also earned at the point of sale. In the case of B-shares, while the broker’s compensation for new sales is earned, due and paid at the moment of sale, the ABSC fee reimbursement is collected over time. Thus the distributor’s act of placing the investment is severable from any future acts it may perform in the provision of shareholder servicing. The distributor’s right to the ABSC, when, as, and if received, is created upon the sale of new B-shares. The distributor has substantial risks of ownership (see below) that may result in the impairment of the fee flows to the point where full recoupment is not realized.

Please note again that the distributor's selling activities are identical, irrespective of share class, i.e., front, back-end, or levelized loads.

B share redemptions are subject to a CDSC, which diminishes as the holding period extends, because of the possibility that a shareholder may redeem shares prior to fully reimbursing the distributor for its related commission outlay. By construction, the CDSC amount is approximately equal to the future ABSC's that will not be collected. The CDSC is asset based; in addition, it has unique capital market risks. The basis of the CDSC is generally at the lower of the original cost of the mutual fund shares or the market value at redemption. Any dividends or capital gain distributions that have been reinvested in the fund further reduce this basis. Note that the ABSC is assessed to the fund, but the CDSC is assessed to the redeeming shareholder.

The focus of this discussion is on transactions that combine the sale of the "distribution fee" portion of the 12b-1 fee, (as opposed to the continuing "servicing fee"), along with the related CDSC's. In a typical transaction, the B-share distributor pays out, say, 4% to brokers for new sales. In return, the distributor expects to collect distribution fees of, say, 75 basis points annually on the net asset value of the shares it has sold along with the related CDSC's. This entails an extended period before inflow matches outflow. To replenish its capital, a distributor may sell its rights to receive these separate, but related, potential fee streams from the two sources.

### **Role of the Independent Fund Board**

12b-1 Plans ("Plans") are subject to annual consideration and renewal by the fund's board. To our knowledge, Plans that mandate that the distributor will continue to receive ABSC after Plan termination ("Enhanced Plans") no longer exist in the fund industry. The Plans require the vote of a super majority of the fund's independent directors plus a separate vote by a majority of all directors in favor of continuance of its provisions. At all times, the Plan is subject to termination, usually upon 30 - 60 days notice. The board's review is rigorous, and a key fiduciary role of the board. If they do not conclude that the Plan has been, and will be, in the best interests of the fund's shareholders, they are duty-bound to terminate or modify it.

In 1998, the independent board of directors of several of the funds managed by Putnam Investment Management chose to accelerate the conversion date (from the prospectus stated 8 years to 6 years) of certain B-share pools which had provided an unusually high degree of ABSC's. This action was taken independently without any recommendation or influence from the funds' distributor or advisor. In this case, Putnam Distributors owned the deferred

commission assets (“DCA”). If Putnam had sold these DCA’s to an independent third party Purchaser, the accelerated conversion of these pools to A shares would have resulted in a loss of expected gross revenues to be suffered by the Purchaser. Since the funds’ board of directors initiated the action, acting within the purview of its fiduciary responsibility to the funds’ shareholders, the Purchaser would have no recourse of any kind to recover damages.

### **Role of the distributor**

The distributor may be affiliated to the fund’s advisor, and/or to the fund’s administrator, or may be wholly independent of both. In all cases, the nature of the service provided is the same, but distinct: 1) bringing new assets to the fund, and 2) meeting the servicing needs of existing shareholders, thereby helping to retain assets.

The role and responsibilities of a distributor are numerous, and can be expensive to maintain internally. Thus, there is a demand for the services of independent distributors, whose cadre includes ALPS, BISYS, Forum, Integrated Fund Services, KBR, PFPC, Quasar (US Bancorp), SEI, Stephens, and UMB Distributors. Their market is wide enough to have established levels of clearing prices for the varying services rendered.

Sales of distributor rights are not motivated primarily by liquidity concerns, but rather to achieve full risk transference and predictability of cash revenues. The underlying agreements and documentation are specifically designed to satisfy each of these needs.

Such sales of distributor rights have the following key elements:

- Seller relinquishes all right, title, and interest to the Purchaser in exchange for cash, and the nature and intent of the transaction is supported by a legal true sale opinion;
- Seller, Fund, and Purchaser execute an Irrevocable Payment Instruction whereby the ABSC and CDSC are remitted directly from the fund and transfer agent to the purchaser;
- Purchaser has no recourse to Seller based on the agreed-upon economic arrangement of the transfer; Purchaser has limited recourse for breach of contract;
- Purchaser has the immediate right to transfer, assign or dispose of its purchased rights;
- Purchaser steps into the Seller’s position with the fund, and accepts all risks of ownership, including:
  - Capital markets exposure on asset-based fees;
  - Shareholder behavioral risks;

- Fund portfolio behavioral risks;
  - Risk that the fund board may terminate or reduce the Distribution Plan (12b-1 fee);
- Adverse effects brought about by regulatory action;
- NASD cap on sales charges.

Note that termination of the distributor's contract by the fund has no effect on either the Seller or Purchaser in respect the fee rights it has purchased. Distributors that have completed the economic activity of selling new shares of the fund to investors continue to receive ABSC's unless the Plan itself is terminated, thereby stopping the ABSC fee flow. In any case, the Purchaser remains entitled to its CDSC fees from redeeming shareholders.

The capital market risks are quite real. Comerica, through its ownership of Munder Capital, reported a series of significant write-downs during the 2001-2003 period related to the diminished value of its DCA. It had booked over \$100 million of DCA between 1998 and 2000. Many of the underlying fund portfolios had substantial exposure to NASDAQ securities. The 75% decline in that market, from its peak in 2000 to March 2003, resulted in tens of millions of dollars in losses to Comerica. Similarly, institutional investors in the DCA-securitized bonds purchased from third party Purchasers between 1997 and 2001 have suffered losses measured in the hundreds of millions of dollars. Furthermore, it is believed that losses suffered from capital market impacts have been a major reason why some Purchasers of DCA have exited the business.

### **Transactional Overview**

In an arm's-length purchase of the distributor's rights to the ABSC and CDSC, the price is equivalent to the economic present value of the projected future fee flows, adjusted for risk exposure, cost of capital, administrative overhead, and profit margin. The distributor receives cash consideration, essentially at the same time as the sales transactions settle at the transfer agent.

The seller distributor has no future involvement in respect of the rights it has sold because the ABSC is calculated and remitted by the fund's administrator, and the CDSC is withheld from redeeming investors by the fund's transfer agent. These fees are remitted directly to the purchaser, and not to the distributor. In short, the presence or absence of the distributor subsequent to the sale of its fee rights would not affect execution of the Purchase and Sale Agreement.

The transfer agent flags each share lot in a manner that allows tracking to support calculation of CDSC, conversion to A shares after a set period, and identification of the party which owns the related fees. The servicing involved here is far

simpler than that involved for other assets that have qualified for sale treatment (e.g. mortgages, credit cards, etc.) in that the administration of the cash flows is performed by the fund's transfer agent and/or fund administrator, and not the distributor.

### **Accounting for the Transaction**

Third-party sales of the bundled rights to ABSC and CDSC flows had not yet transacted when either EITF 85-24 or EITF 88-18 was promulgated. Non-proprietary mutual fund managers first introduced B-shares to the market in 1988. It was years later that third parties could value these rights and accept the various risks associated with the prospective cash flows. What are being purchased and sold here are two distinct, yet linked, rights to potential cash flows. The first is a right to receive ABSC's from the funds themselves when, as, and if they are paid. The second is the right to receive CDSC's from redeeming shareholders. The timing, magnitude and duration of each flow are all subject to many variables.

Where the cash comes from (e.g. ABSC's from the fund or CDSC's from the investor) should not matter to the accounting answer. While accounting symmetry would be neater, the facts do not support it. In this case, the cash flows are coming from different payors. Funds are not required to book their obligation to pay ABSC's as a liability due to the uncertainty surrounding their ultimate payment. In addition to the uncertainty surrounding the level of the NAV upon which the ASBC fee is based, the other significant uncertainty is whether or not the fund shares upon which the fees are based will remain outstanding. As noted above, should an investor redeem his shares, that investor must pay a CDSC but the fund itself is relieved of its obligation to pay the ABSC. Likewise, if the investors in B shares were preparing GAAP financial statements, their obligations to pay a CDSC would most likely be considered a contingency disclosed in the footnotes, and not a liability, since, by its nature, the fee is contingent. The CDSC payment is due only if the investor redeems shares prior to their conversion to A-shares.

In order to make a viable sale transaction; these two fee streams need to be combined into one transaction. This creates a conflict with existing accounting because it does not fall squarely within the purview of either EITF 85-24 or FAS 140. Therefore, the draft FSP suggests looking to EITF 88-18 in order to determine the nature of the liability. We believe, based on the substance of this transaction, that any liability would be deferred income under 88-18. As noted in the executive summary of this letter, these transactions satisfy the six criteria in 88-18 of deferred income. 88-18 notes that "[the task force did not address the circumstances, if any, in which immediate income recognition might be

appropriate.” We respectively submit that, having satisfied the deferred income criteria under 88-18, immediate income recognition is appropriate due to the transfer of risks and rewards inherent in these transactions. We suggest that the FSP be revised to consider this point.

We believe other arguments could be made to support our contention, including a revision to 85-24 acknowledging that the unique combination of these two fees should allow the distributor to book a receivable or that the receipt of a fixed, third party, payment results in receipt of the “fees” and therefore should result in immediate income recognition. In addition, we believe there is scope to consider analogies to FASB 140 as well. But, we suggest that the most direct route to clarification of this issue is for the final FSP to state that, if the cash flow qualifies as deferred income under 88-18, immediate recognition is appropriate given the facts and circumstances of these transactions.

#### **Related theoretical issues**

FSP-140b would mandate that distributors record a prepaid expense and an offsetting loan. It does not give guidance as to how the unpredictable magnitude, timing and duration of the cash flows should be matched to the fixed obligation.

During the 8-year life of a B-share (presuming it is not redeemed), the ABSC will necessarily vary with the NAV. The prepaid expense would presumably be amortized over some estimate of its productive life, but the “loan” would necessarily be reduced as ABSC and CDSC is received. The asymmetrical matching of the linear expense amortization to the variable loan reduction will create confusing, and possibly misleading, variations in the distributor’s financial statements, when in fact the fees were earned at inception, and realized in cash via the sale of the distributor’s rights.

Further, it does not discuss how a distributor should clear its books once the underlying shares are either converted to Class A or redeemed prior to conversion. In no event will the aggregate cash flows exactly match the cash paid by the third party to the distributor; FSP-140b’s implementation will result in the reporting of profit or loss over each monthly DCA pool’s life to conversion when that is not the economic reality.

After the sale, the distributor is no longer a party to the transaction. The cash flows are no longer in its control and no obligation for future services or repayment exists. The recordation of these fee transactions as flowing through the distributor over time serves no informative purpose, and would indicate that the Seller, rather than the Purchaser, owns the underlying fees. Accounting

symmetry would dictate that only one entity could own a given asset. If the Seller retains it on its books, what should the Purchaser reflect?

### **Distributor Net Capital**

While we acknowledge that FSP-140b's implications on the regulatory net capital of distributors is not within the purview of the FASB, we also feel that it should be peripherally discussed.

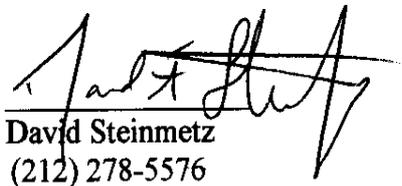
There were about \$342 billion of B-share assets on US fund platforms at June 30, 2004. At one point, the back-end load class assets exceeded \$600 billion. We estimate that the current amount of related DCA is in the range of \$7 to \$10 billion. If the proposed FSP is implemented as written, it will require distributors to immediately allocate a like amount of assets to maintain required levels of regulatory capital. This because the deferred commission asset is non-allowable in the calculation of regulatory capital, but the "loan" is a charge against distributor capital.

Based on our analysis, and that of many reputable law firms, rating agencies, and Qualified Institutional Buyers, the transaction is a True Sale, and the rights to future fees that have been sold could not be considered a part of the distributor's bankruptcy estate.

Accordingly, we urge the FASB to consider our forgoing discussion and amend the proposed FSP 140-b to consider the circumstances when immediate revenue recognition would be appropriate.

Respectfully submitted,

**SG Constellation LLC**

By:   
David Steinmetz  
(212) 278-5576