Prudential Financial

Dennis Sullivan
Vice President, Corporate Controllers

The Prudential Insurance Company of America
Corporate Controllers Department
213 Washington Street, Newark, NJ 07102

October 20, 2003

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

Comments on Proposed FSP FIN 46-d, "Treatment of decision-maker fees in calculation of expected losses and expected residual returns"

This letter primarily comments on FSP FIN 46-d. However, it also incorporates comments we've recently identified as pertinent to FSP FIN 46-6, regarding the deferral for nonregistered investment companies, and some feedback commentary on the Board's discussion of October 15, 2003 concerning fixed decision-maker fees and kick-out rights.

In our comments below on FSP FIN 46-d, we recommend a new approach to the treatment of all fees, which we believe will simplify this issue, and at the same time solve a number of the items currently under discussion. That approach, more fully described and supported in the discussion on that FSP, can be summarized as follows:

- If a fee arrangement is 'above-market' (regardless of what the fee is for), treat the fee as described in the proposed FSP FIN 46-d (i.e., the variability is included in the expected loss analysis; both the variability and fair value of the fee are included in the expected residual return analysis);
- IF a decision-maker or guarantor fee is market-based (or below), include only the variability in the fee in the analysis of expected losses and of expected residual returns. An exemption for kick-out rights would apply only to decision-maker or guarantor fees.

Deferral for non-registered investment companies

Consideration of expanding scope for investment companies that have never applied US GAAP

In order to meet the 'deferability' requirement, a non-registered investment company must be, "... currently accounting for their investments in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide." Consider that some potential VIEs that may require consideration under FIN 46, may not have a requirement to prepare financial statements in accordance US GAAP. The obvious example would be foreign investment companies, in which a US-GAAP reporting enterprise may hold a variable interest (e.g., debt). As worded, the deferral would not be available, and if consolidation of the foreign entity becomes necessary as a result of the US enterprise's adoption of FIN 46, the US enterprise would need the foreign entity to apply FIN 46 to its investee companies. We believe that an expansion of this deferral to cover such a situation is merited, and recommend language similar to the following, be added to the end of the

first paragraph: "..., or would be expected to account for their investments using the guidance in the Audit Guide, on initial application of US GAAP."

Exemption for certain decision-maker fees

The Board appears to be concerned that some may structure most of the 'juice' in a VIE to be paid out in fees, that might otherwise be exempt. The recommendation we make in our discussion of FSP FIN 46-d would address that concern, more explicitly than currently expressed in FIN 46, and at the same time remove the requirement that any exemption to be provided -b extend only where the fee arrangement is the only potential variable interest held by the decision maker. We believe that the existence of one variable interest in a VIE should not trigger an additional weighting to another variable interest in the same VIE. Variable interests should either be deemed to exist and be considered, or be deemed not to exist and be excluded.

Clarify that the 'decision maker' includes paragraph 16 entities

If the Board determines to proceed with an exemption for decision maker fees, only where no or minimal other variable interests are held by the decision maker, we recommend the Board clarify whether such exemption would apply where it is the decision maker' related parties (as described in paragraph 16 of FIN 46) that hold more than minimal variable interests in the VIE, and whether there would be a difference at the common parent level of reporting versus the decision-maker stand-alone reporting.

We believe a clarification is necessary, as paragraph 16 requires a combining of variable interests, in making a determination of what party is the primary beneficiary. The exemption under discussion, however, provides guidance in determining whether a relationship represents a variable interest.

Kick-out rights

Fees to decision makers that can be removed without cause should be excluded

We strongly support the Board's decision to draw a distinction 'kick-out rights' that can be exercised without cause, and those that require a 'cause'. We believe that an enterprise that can be removed without cause should not be considered a 'decision maker' as that term is used within FIN 46.

We note that an ability to remove an enterprise from a position of power is used in practice today, in making judgments about whether a presumption of control may be overcome. That notion would be contradicted by a requirement to include 'decision-maker fees' in the analysis determining who is the primary beneficiary, where the decision-maker can be removed without cause, as such a requirement could lead to a conclusion (with no rebuttal available) that an enterprise must consolidate an entity even where the enterprise does not have an ability to control its continued access to the very same item that may have led to the conclusion to consolidate – in this case, the fees.

We believe the objective of a determination of whether kick-out rights exempt a service provider's fees from being considered 'decision-maker fees' should be, that if an investor wants to remove the service provider, there should be both nothing preventing them from trying to succeed, and a reasonable chance they will succeed in garnering the required level of support. Once that support is achieved, the removal of the service provider must occur on a timely basis. We believe this determination should consider:

- The number of investors voting on the matter;
- The level of vote required;

- Whether similar arrangements in VIEs conducting similar activities exist, and if so whether there is a history of successful removals;
- The existence in the market of potential acceptable replacements for the service provider;
- The absence of penalty charges or high costs to find or hire a replacement provider.

FSP FIN 46-d, Treatment of decision maker fees

Reconsider treatment of all fees

Rather than providing computational guidance related only to decision maker fees, we urge the Board to reconsider how all fees are treated, and to develop a simpler approach to the treatment of all fees under FIN 46. We recommend below an alternative to the current approach, which we believe would address potential abuses left in the current approach, and at the same time cure perceived 'false-positives'.

As previously mentioned, our proposal can be summarized as follows:

- IF a fee arrangement is 'above-market' (regardless of what the fee is for), treat the fee as described in the proposed FSP FIN 46-d (i.e., the variability is included in the expected loss analysis; both the variability and fair value of the fee are included in the expected residual return analysis);
- IF a decision-maker or guarantor fee is market-based (or below), include the variability in the fee in the analysis of expected losses and of expected residual returns.

The exemption for 'kick-out' rights discussed previously would apply only to market-based decision-maker or guarantor fees. An exemption for certain ('fixed') decision-maker fees would not be necessary.

The excess fair value of all above-market fees would be included in the analysis of residual returns, as described in FSP FIN 46-d. In this manner, all fees that are in excess of what would be considered market-basis, would be treated similarly, which we do not believe to be the case currently. Under the current version of FIN 46, it is our understanding that the fair value of decision maker fees are included (regardless of whether they are market-based), whereas only the variability of non-decision maker, non-market-based fees are included in the analysis. Thus, fixed non-decision maker fees that are off-market, but which do not vary, would not otherwise be included in the analysis. Abuses could be contrived, then, involving fixed-fee arrangements, that are patently off-market, that would not be included in the fee earners' share of expected residual returns.

We considered an alternative to the approach, whereby only the excess of the fair value of the fee, above a market-based fee, would be included in the analysis based on expected residual returns. However, we concluded that the existence of above-market terms may be a strong indicator that the fee earner should consolidate. We additionally believe that there would be insurmountable difficulties in determining a fair value of a market-based fee, as 'market-based' will likely be described as a range of terms, not one set of terms that could lead to a specific value.

We have also considered whether the fair value of fees set below-market should be included in the fee earners' share of expected losses, following much the same computation as suggested in FSP FIN 46-d. We do not believe that the same concepts apply where fees are set at worse than 'market terms', as apply where a benefit versus the market exists. Therefore, our recommendation distinguishes between fees that are 'above market' (which should be included at fair value) and those that are 'below market' (for which only the variability should be included if they represent decision-maker or guarantor fees).

Make technical correction directly to FIN 46
The first paragraph of the Answer section makes an implicit amendment to the wording of FIN 46 paragraph 8. While we support that amendment, we think it is important that the amendment be stated explicitly as a technical correction to the wording of FIN 46. That is, the phrase, "available to, or absorbed by, the variable interest holders" should be inserted at the end of paragraph 8(a). Similar words should be incorporated within paragraph 8(b).

Sincerley,

Dennis Sullivan