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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"

We appreciate the opportunity to comment on the referenced document. We do not believe the Proposed FSP should be finalized as drafted. Not only do we believe its conclusion is inappropriate, we also believe the Proposed FSP would not provide meaningful, broadly applicable guidance for preparers to determine how to treat the sale of distribution fees to third parties, particularly subsequent to the sale transaction.

We believe that the Staff would be better served to articulate an underlying model as to how to apply existing literature to these transactions. A more principles based approach would not only respond to the current practice issue but would also be able to be applied in the future as transactions, or even the parties to the transactions, change.

In developing a principles-based approach, the Staff should consider the existing guidance of EITF Issue 85-24 and more current guidance concerning revenue recognition concepts. The consensus of EITF Issue 85-24 will likely be reconsidered as the Board completes its revenue recognition project. However, until that project is completed, we believe that the general guidance of Concepts Statement 5 and Staff Accounting Bulletin 104 should be considered in determining how to treat the proceeds of the sale of the rights to future distribution fees by distributors of certain mutual funds.

Concepts Statement 5 contains general guidance that revenue is only recognized when it is realized or realizable and earned (paragraph 83). It is our understanding that in debating EITF Issue 85-24, the focus was on whether the distribution fees to be received in the future were realized or realizable, not on whether they were earned. Because of the uncertainty of the timing and amount of fees to be received, the Task Force concluded that the accounting should focus on the deferral of the costs rather than the accrual of the fees. If the Task Force had been concerned about whether the fees had actually been earned, the discussion would have focused on the treatment of the up-front distribution fees received at the time of the sale of "A" shares (e.g., "front-end sales charges"), rather than the fees to be received in the future related to past sales of "B" shares. As these fees are compensation for the same activity (the sale of a share), we do not believe the Task Force would have considered one to be earned and the other not. Therefore, the conclusion of Issue 85-24 must have resulted from concern about the realization or realizability of the fee.

As a result, the consensus of EITF Issue 85-24 indicates that the fees should be recognized when received. Additionally, the consensus provides that certain costs that are expected to be recovered from the future receipt of the fees are capitalized. Because of the consensus in Issue 85-24, we believe the relevant question that arises from the transfer of the right to the fees is whether a liability has been incurred. If a liability has been incurred, we would agree that the proceeds should be recorded as a liability and presumably the guidance of EITF Issue 86-28, "Accounting Implications of Indexed Debt Instruments", would be adapted to the liability over its life to determine the amount of interest expense on the liability. However, if the receipt does not represent the proceeds from incurring a liability, we believe the revenues from the distribution of the shares have been realized, and in accordance with Concepts Statement 5 and EITF Issue 85-24, should be recognized in income.

Accordingly, the FSP would be more helpful if it addressed the narrower question of how to determine whether the proceeds of a sale represent a liability. There is no literature that is directly on point. Therefore, some in practice have applied the guidance of Statement 140 by analogy, while others refer to the considerations in EITF Issue 88-18. The reference to Statement 140 focuses on the terms of the transfer and the legal isolation from the distributor, while the reference to Issue 88-18 tends to focus on the distributors continuing involvement with the generation of the fees in the future. Neither of these groups believes the guidance they use is directly applicable to the instant question. They merely refer to it by analogy to determine whether the proceeds of the transfer represent a liability. When the proceeds do not represent a liability, based on the guidance of Issue 85-24, a conclusion was reached that the earnings process was complete and income should be recognized.

Our preference has been to refer to the factors in Issue 88-18, by analogy, to determine whether a liability has been incurred. These factors seem to be more germane in that they focus on the continuing involvement of the enterprise (distributor) in generating the revenues (fees) that have been transferred. Our analysis has also considered the fact that the fees would belong to the third party even in the event of the bankruptcy of the distributor (i.e., that the requirements of Statement 140 have also been met). We believe it would be appropriate for the Staff to indicate that analogies to the concepts of each of these pronouncements are required.

It also would be helpful, particularly in light of recent suggestions of the SEC Staff, if the FSP provided some guidance about how to evaluate the continuing involvement of the distributor in the generation of the fees that are due to the investor after the sale transaction (the second criteria of Issue 88-18). For example, we have generally considered the fact that the distribution activities have been completed together with the existence of separate contractual arrangements that provide for compensation at market rates for ongoing advisory services for the underlying fund as indicating that there is not continuing involvement by the distributor in the generation of the distribution fees. This view is further supported by the fact that the distribution and advisory activities are sometime carried out by separate organizations, either from inception or by subsequent changes in advisory relationships, without affecting the rights of the distributor to its distribution fees.

In addition, although we acknowledge that the distributor does not have a recognized receivable due to the application of EITF 85-24, we observe that the guidance of Statement 140 is not limited in its applicability just to transfers of receivables. Rather, Statement 140 applies to transfers of all types of recognized financial assets (see paragraph 9). Statement 140 defines financial assets to include contracts that convey a right to receive cash (paragraph 364). In fact the responses to Questions 14 through 16 in the Staff Implementation Guide for Statement 140 reconfirms the breadth of its scope (and in fact expands it) by clarifying that the transfer of all derivatives, even those that are not financial assets, should be evaluated under Statement 140. Clearly Statement 140 is applicable to transfers of all recognized financial assets, not just receivables.

Consistent with the definition of a financial asset, the contractual right to receive 12b-1 and CDSC fees is a contractual right, albeit a conditional one, to cash in the future. However, because of the consensus of EITF Issue 85-24, it is unrecognized and, therefore, outside the scope of Statement 140 (see paragraph 4). Nonetheless, even if the staff is not inclined to expand the scope of Statement 140, as it did in the case of derivatives, the guidance of the Statement could be applied by analogy, as previously discussed, to assess whether the proceeds of the sale of distribution fees represent a liability.

If the Staff decides to proceed along the course of the Exposure Draft, it should more clearly articulate the basis for its conclusion. Preparers and auditors need to understand the reasons for the staff's conclusion so that specific transactions and transactions between members of a consolidated group with separate reporting responsibilities can be evaluated. There are differences in the terms of transactions currently in the marketplace and new transactions will evolve over time. In addition, distributors that are affiliates of advisors often sell their rights to future distribution fees to their parent company or sister advisor firm to raise the cash to pay the distribution expenses. These distributors are generally registered broker dealers who have separate company reporting obligations.

The broad reaching statement of the Staff's position in the proposed FSP is not helpful in differentiating among existing transaction structures, nor will it be helpful in evaluating future transactions or transactions between members of a consolidated group. For example, it is unclear if the Staff's conclusion is based on the source of the receipt or its timing. It would be unprecedented, in our view, to determine whether a receipt is income based either on the identity of the payer or the timing of its receipt. If one of these alternatives is not being suggested, we are unclear as to the reason for the Staff's conclusion as no basis is provided.

In addition, the Staff indicates that the classification of the receipt should be based on the provisions of EITF Issue 88-18 as either debt or deferred income. An unusual aspect of these types of transactions is the fact that the distributor needs to do nothing further to be entitled to these fees. We believe this fact should be directly addressed in the final FSP, particularly if the Staff believes this fact is not relevant.

Because of this fact, in many of the transactions with which we are familiar, the analysis suggested in the Exposure Draft will conclude that deferred income treatment is appropriate. However, unlike other items of deferred income, for 12b-1 fees the activities precedent to the completion of the earnings process (the sale of the B share) have already been completed. If the Staff finalizes its position, as exposed, additional guidance should be provided about how the deferred income is to be recognized in income. If the Staff believes that the amounts of deferred income should be recognized as if the transferred fees were received by the distributor, rather than the third party, the Staff should address how that process is to be implemented if the amount of fees actually paid by the fund is not able to be determined by the distributor or the amounts differ from those anticipated in the receipt from the third party.

In addition, we have the following suggestions to improve the clarity of the Background section of the Proposed FSP. Our suggestions are:

- Mentioning that, in addition to an agreement to receive 12b-1 and CDSC fees, the arrangement with the fund also provides for the payment of a shareholder-servicing fee could further enhance the description in paragraph 2 of the Proposed FSP. This fact is important because the shareholder-servicing fee represents fair compensation to the distributor for various administrative services (e.g., record keeping) that must be provided to the shareholder over the term of its investment and is typically not transferred in the sale transactions. This fee and the related services are comparable to loan servicing activities, which typically exist in loan securitizations, involving collecting and remitting loan payments on behalf of the investors in loans.

- Paragraph 7 of the Proposal describes the transfer of the right to receive future distribution fees to a third party. We have two suggestions regarding that paragraph.

  - The mention of one type of indemnity gives the impression that it is the key consideration that the staff considered in reaching its conclusion. However, this indemnity typically does not exist in sales of distribution fees with which we are familiar. Therefore, we suggest either that the sentence be deleted or preferably, expanded to indicate that these agreements often contain several indemnities, which include the one mentioned. Similarly, we would suggest that the examples of indemnities include one or two more so as not to give the impression that any of them are determinative. For example, the sentence could be rephrased something like "These exchanges often include various forms of recourse through indemnities. Examples of such indemnities include those to reimburse the third party in the event the 12b-1 plan is rescinded by the Fund's board, transferred 12b-1 fees are commingled with those owned by the distributor, or the fund is liquidated." As previously mentioned, we believe the concept of continuing involvement through indemnities should be more specifically addressed in a final FSP.

  - Another key characteristic of the transfer transactions is that they are conducted in such a way as to transfer the legal right to the future fees to the Third Party, even in the event of the bankruptcy of the distributor that is the transferor, and that the right received by the Third Party is often rated by credit rating agencies. These facts are significant legal and economic characteristics of these transactions and should be mentioned. Failure to mention them would open the staff to criticism that the conclusion of the FSP was reached without a thorough understanding of the underlying transactions.

We would be pleased to discuss our views further with the staff at your convenience.

Sincerely,

Ernst + Young LLP