PROPOSED FASB STAFF POSITION

No. FAS 140-b

Title: 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

Comment Deadline: September 2, 2004

1. Questions have arisen as to the appropriate accounting for transactions in which a distributor's right to future cash flows relating to distribution fees (12b-1 fees, as described below) is exchanged for cash. This FASB Staff Position (FSP) clarifies whether receipt of cash in exchange for the rights to future cash flows from distribution fees can be treated as revenue or gain for accounting purposes.

Background

2. Mutual fund shares sold without a sales load payable at the time of purchase (front-end sales load) are commonly referred to as "B shares." Instead of a front-end load, B shares often have an asset-based fee (12b-1 fee) that is charged over a period of years (12b-1 plan period). B shares typically also charge a contingent deferred sales charge (CDSC). The CDSC, sometimes referred to as a back-end load or sales charge, is an asset-based fee charged to investors redeeming B shares during a stated period.

3. At the time of sale of a B share, the distributor pays a sales commission to a sales representative (usually a broker-dealer). The sales representative may also participate in a portion of the annual 12b-1 fee for providing ongoing assistance and service to the holder of B shares. The distributor also incurs other expenses relating to the distribution effort including advertising, marketing, and financing costs for the up-front payment of the sales commission. To compensate the distributor for expenses incurred, the mutual fund is charged a 12b-1 fee in accordance with the fund's distribution plan (12b-1 plan). To ensure the distributor is compensated in the event of investor redemption, the CDSC is charged to investors who redeem their B shares before the expiration of the 12b-1 plan. The CDSC declines over time until it reaches zero (typically four to six years) to correspond to the shortfall in 12b-1 fee due to the redemption.

4. Annual 12b-1 fees are calculated as a percentage of the net assets during the 12b-1 plan period. The CDSC is calculated as a percentage of the lesser of current net assets or the original cost of shares being redeemed. Thus, 12b-1 fees and CDSC vary directly with the net asset value of the fund. Additionally, under the directives of Rule 12b-1, the fund's board is obligated to regularly reevaluate the benefits of the 12b-1 plan to the fund shareholders. Should the board conclude that the 12b-1 plan is no longer appropriate for its shareholders, the board should rescind the plan. Because the dollar amount of the 12b-1 fees and the CDSC is uncertain due to market movements and shareholder redemptions, and because the 12b-1 plan could be rescinded by the fund's board, funds that have sold B

shares generally do not have a recognizable payable under generally accepted accounting principles (GAAP). Likewise, the distributor does not have a recognizable receivable under GAAP (EITF Issue 85-24).

5. Other types of 12b-1 plans (generally referred to as enhanced or board-contingent plans) have features that continue payments or provide that payments may continue to the distributor for previously sold B shares in the event of plan termination.

6. The distributor is generally a subsidiary of the fund sponsor and primarily exists to separate the distribution function from the management (investment advisory) and other administrative (record keeping and transaction services) functions.

7. Some distributors have entered into transactions in which the right to receive future 12b-1 fees and the CDSC is exchanged for a lump sum payment from a third party. These exchanges may include some level of recourse and various indemnities that protect the third party in the event that the 12b-1 plan is rescinded by the fund's board. Some distributors entering into such exchanges have accounted for the exchange as a sale of an unrecognized financial asset or as the receipt of fees resulting in full revenue recognition of the future 12b-1 fees and the corresponding recognition of previously deferred expenses.

FASB Staff Position

8. The FASB staff does not believe revenue or gain recognition is appropriate at the time the cash is received from the third party for a right to future fees. The FASB staff believes that cash received from a third party should not be considered "fees" as discussed in EITF Issue 85-24. The staff believes that transfers of the rights to future fees that are not recognized as a receivable by the distributor are not within the scope of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The FASB staff believes the classification of the cash received from a third party should be based on the provisions of EITF Issue No. 88-18, "Sales of Future Revenues," that is, as debt or deferred income.

Effective Date and Transition

9. The guidance in this FSP is effective for transactions entered into after the final FSP is posted to the FASB website. The impacts of applying the FSP's requirements to previously recognized transactions shall be recognized as a cumulative effect of a change in accounting principle pursuant to the guidance in FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and APB Opinion No. 20, *Accounting Changes*, in the period in which the FSP is posted to the FASB website.