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From: frank.reda@prudential.com [mailto:frank.reda@prudential.com]
Sent: Wednesday, November 12, 2003 3:21 PM
To: Ann McIntosh
Cc: Ron Lott; john.mcphillips@prudential.com;
dennis.sullivan@prudential.com
Subject: FIN 46

RE: FASB discussion of November 11 and the redrafting of FSP FIN 46-b and 46-c on a combined basis

As I understood the Board discussions of yesterday regarding the combination of the FSPs on kick-out rights and exemption for certain decision maker fees, the direction selected by the Board was to embed the notion of kick-out rights that are exercisable without cause, as one criterion among many that must be met, before a decision maker would be permitted to leave their fees out of the analysis. This note expresses my concern about that direction, and proposes an alternative course of action, which also involves combining into the discussion FSP FIN 46-d. I am sending this note now, rather than awaiting a chance to reply by comment letter, as it did not appear from the discussion that re-exposure is part of the plan.

In order to ensure the FIN 46 changes are comprehensive, I feel it is important that when the FASB staff addresses fees from VIEs, they incorporate into their consideration all of the issues. The Board has made a step in the right direction by combining two FSPs; but they must go further. Prudential Financial submitted a comment letter (letter from Dennis Sullivan, dated October 20, 2003) addressing FSP FIN 46-d, among other things. Our comments in that letter proposed one comprehensive alternative to how fees should be dealt with in making determinations about which entity is the primary beneficiary of a VIE. Our proposal would guide the treatment for all fees, whether for decision-making or not, and would, I feel, resolve a number of the issues before the Board.

In summary, our proposal first requires a judgment about whether the total of fees generated by a related party grouping (as under para 16) are market based, regardless of the nature of the services provided. "Market based" could be replaced with "commensurate with the level of effort" discussed yesterday by the Board. Where the fees exceed that level, the fees would be given the treatment described in the draft FSP FIN 46-d - that is, both the variability and the fair value of the fee would be included in the analysis. If the fees do not exceed that level, then the fee is not a variable interest, unless the services provided include 'decision-maker' services. In that case, the variability (but not the fair value) of all fees would be included. Under our proposal, an entity that can be removed without cause (by substantive provisions of law or contract) would not be considered the 'decision maker' - on the basis that other interest holders are deciding whether that entity should continue, or not. Additionally, our proposal would render FSP FIN 46-b unnecessary, which removes the unacceptable notion that the ownership of other variable interests will drive the extent to which a variable interest that is in the form of a fee arrangement would be weighted in the determination.

The Board tied yesterday's proposal back to paragraphs C30 and C31 of FIN 46, describing the elements of a controlling financial interest. I believe our proposal also fits that principle. In addition, considering kick-out rights as a stand-alone indicator to exclude fees is supported by another characteristic of a controlling financial interest, which I describe as control over continued access to the controlling financial interest. Current accounting guidance applicable to voting interest entities already reflects the concept that if you are presumed to have control today, but others can obtain it - whether by voting to remove you or by exercising options or conversion features, you may not be considered to have control and thereby not consolidate the entity. At the very least, these concepts should be reconciled with the direction that ultimately is taken.

In yesterday's discussion, there also was a shift to the notion that an 'employee' should not have to consolidate a VIE, and therefore the Board has embedded the kick-out rights as a criteria for exempting fees, in an attempt to describe an employee relationship. While I agree that an employee should not be required to consolidate, an employee relationship is not the ONLY relationship that should not require consolidation, and therefore do not agree with the manner in which the kick-out rights has been combined into the other set of criteria.

As you re-draft the guidance in accordance with the Board's instructions of yesterday, I ask that you incorporate in your discussions and considerations the treatment of fees in the calculation of expected losses and residual returns; I submit that our proposal is a positive step in the right direction.

I have attached our previous letter to this e-mail for your convenience.

Please feel free to contact me to discuss any of the above issues or any of the comments in the attached letter.

Frank Reda
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