Prudential Financial

Dennis G. Sullivan
Vice President, Financial
Management

The Prudential Insurance Company of
America
751 Broad Street, Newark NJ 07102-
3777
Tel 973 802-5670 Fax 973 802-5896

September 1, 2004

Letter of Comment No: 8
File Reference: FSPFAS140B
Date Received: 9/7/04

Director, TA&I—FSP
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: 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"

Dear Director:

We appreciate the opportunity to respond the proposed staff position described in FSP FAS 140-b. The proposed FSP presents some important issues for us, as Prudential Financial, Inc. (PFI) distributes mutual fund products through two registered broker-dealer subsidiaries, including one recently-acquired subsidiary that, prior to the acquisition, was involved in the type of transaction squarely in the scope of the proposed FSP. Since that time, the new broker-dealer adopted its affiliate's practice of transferring the rights to receive future 12b-1 and CDSC fees to another affiliate company, under arrangements that may be within the scope of the FSP.

In considering how the proposed FSP might impact the public-company consolidated financial statements of PFI, and the subsidiary stand-alone financial statements of the two broker/dealer companies, we have identified a few items you should consider as you finalize the FSP.

<u>Transfer of the risks resolves the uncertainties that underpin cost deferral accounting</u>
Prior to initiating a transfer of 12b-1 and CDSC fees to a third party, the amount which the distributor may receive in future periods to recover its up-front costs will vary based upon the NAV of the fund and the timing of withdrawals triggering CDSC fees, and could disappear entirely based upon an annual review of the 12b-1 plan by the mutual fund's board of directors. We believe those contingencies were an important factor in the EITF's consensus in Issue 85-24 to retain the industry practice at the time, the cost deferral method, rather than the alternative considered, the income accrual method.

Under the cost deferral method, distributors create a 'DAC asset' that is amortized over the periods during which the 12b-1 and CDSC fees may be collected. Thus, distributors achieve matching by deferring the costs, and recognize revenue when it is collected. Distributors test the DAC asset for recoverability each period, by comparing the recorded amount against updated estimates of future receipts of 12b-1 and CDSC fees. The distributor would record an impairment loss against its DAC asset if it estimates that its future collections will be less than the recorded amount.

However, broker/dealers are not permitted to include the DAC asset in their calculation of its net capital calculation pursuant to SEC Rule 15c3-1. As a result, facing the alternative of requiring additional capital contributions, distributors may choose to enter into the type of transactions described by the FSP, which monetize the future revenue collections. In current practice, the off-balance sheet future revenue amount is exchanged for cash, an asset that is allowable.

While we believe it continues to be true, that a company should not record revenue when significant uncertainty about amount or ultimate collectibility exists, this type of transaction, when effected on a non-recourse basis, resolves those uncertainties for the distributor, by shifting them to the buyer. With the contingencies associated with that revenue removed, recognition becomes appropriate, and the commission expense would no longer be deferred.

Counter-intuitive financial statement reporting

In accordance with the provisions of the proposed FSP, a distributor entering into such a transaction would recognize the cash proceeds and a payable to the creditor. The distributor would continue to record the DAC asset in accordance with EITF Issue 85-24, and test it for impairment from time to time. However, any impairment taken by the distributor, would not likely be offset by a corresponding reduction in the liability, as there would be no extinguishment under FAS 140.

We are also concerned with the possibility that some may conclude there is a derivative embedded within that financing liability (e.g., payments on the hybrid contract vary based upon changes in mutual fund values). If that is the case, then by entering into a transaction that has the effect of eliminating the distributor's exposure to future movements in the funds' NAV, the distributor would have a mark-to-market derivative contract that tracks the transferred exposure. Instead of being exposed to losses on the DAC asset (because such losses would be offset to some extent by gains from the derivative), the distributor would now be exposed to increases in estimates of future collections (when the value of the derivative liability increases with no offsetting increase in the DAC asset).

Either way, the distributor's reported earnings would be impacted by a risk it has successfully transferred to another party. This would not serve to represent faithfully the distributor's financial results, and would at the same time render as moot the regulatory net capital management objective of the transaction (because the DAC is still recognized and still not allowable). We have estimated that implementing this guidance as proposed would require the injection of capital into the broker/dealer subsidiaries of approximately $100 million, to approximately $130 million, almost a 300% increase from those subsidiaries' current capital.

Earned versus collected revenue
Consider the following comparison of the results to a distributor of the sale of a class B share to those from a class A share. In a class A share sale, the distributor's expenses are incurred up front, as they are in a class B share sale. However, the distributor's revenue in a class A share is collected concurrent with the sale. Distributors record that revenue, up front, at the time of the sale. The services provided by a distributor are the same for the two classes of shares.

It is important to note that the distributor has performed all of the required services to earn the fee; it must simply wait until the NAVs can be measured so the amounts can be collected. This differentiates the transactions within the scope of the proposed FSP from transactions in which the revenues have yet to be earned, which based upon the types of examples given in EITF Issue 88-18 appears to have been the focus of EITF Issue 88-18. In fact, that issue specifically indicates, "The Task Force did not address the circumstances, if any, in which immediate income recognition might be appropriate." In our view, the resolution of uncertainties precluding income recognition is such a circumstance.

Related versus third-party transactions
The title of the proposed FSP suggests that only transactions involving unrelated third parties would be in its scope. Noting that the registered broker/dealers that would be 'sellers' in such transactions are required to prepare stand-alone audited financial statements filed with the SEC, obvious questions arise as to the accounting for similar transactions with the registered broker/dealer's parent company or other related party. While the title of the proposed FSP appears to limit the scope, we and our auditors have agreed there is nothing actually in the text of the proposed FSP indicating that limitation was intended.

The final FSP should clarify this point, by either describing the intended scope exclusion, or by removing the inference of an exclusion from the title.

Sincerely,

Dennis G. Sullivan