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Via Electronic Mail and FEDEX

Letter of Comment No: 44
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November 4, 2002

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
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File Reference No. 1101-001: Proposed Statement of Financial Accounting Standards, Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FAS 123

Dear Ms. Bielstein:

Credit Suisse Group ("CSG") appreciates the opportunity to comment on the Exposure Draft on Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FASB Statement No. 123 (the "Exposure Draft"). CSG is responding to the Exposure Draft both as a preparer of U.S. GAAP financial statements and as an intermediary, through our subsidiary Credit Suisse First Boston, in the financial markets.

Our letter is divided into two sections. The first section is devoted to our comments on the Exposure Draft – including the comparability of the transition alternatives provided as well as the additional disclosure requirements. The second section illustrates our concerns surrounding valuation of employee stock options.

Comments on the Exposure Draft

Multiple transition methods

We appreciate the Financial Accounting Standards Board ("FASB", or "the Board") expanding the transition provisions under FASB Statement No. 123 ("FAS 123") in an effort to ease transition. However, we believe that constituents would be better served by allowing only one transition method in order to ensure consistent expense recognition, and thus comparability, in the income statement among companies who adopt FAS 123 this year. CSG feels that FASB should maintain the prospective transition approach as prescribed under the existing provisions of FAS 123 and cease going forth with the alternative approaches in paragraph 2(a) of the Exposure Draft.

In the Basis of Conclusions in the Exposure Draft, the Board argues that multiple transition methods will not impair the comparability between financial statements. The

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Board also hypothesizes that the disclosure provisions in the Exposure Draft will mitigate any disadvantages generated by multiple transition methods. We feel that comparability must be strived for in the primary financial statements, and that the use of additional note disclosures to mitigate the disadvantages of multiple transition methods is flawed in concept.

Option pricing models
Many companies, including CSG, feel that option pricing models do not adequately reflect the true economic cost for employee stock options. Consequently, we believe it would be prudent for FASB to address those issues in conjunction with the Exposure Draft.

Finally, we urge FASB to consider our comments on valuation below when working with the IASB on harmonizing the accounting for employee stock options.

Quarterly pro forma reporting
We believe that including pro forma information on a quarterly basis is excessive and does not provide useful information to financial statement readers as most stock-based compensation awards are granted on a yearly cycle.

If the Board wishes to proceed with quarterly pro forma disclosure reporting requirements, we suggest requiring quarterly disclosure of this information only when significant new awards are granted. We believe that meaningful information for readers would be to disclose on an interim basis information consistent with the current requirements under FAS 123 but only to the extent new awards are granted during the period.

Comments on the valuation methodology under FAS 123

In our view, the valuation methodology prescribed under FAS 123 does not adequately reflect the true economic cost of employee stock options. By requiring option pricing models, the FASB does not allow for evolving valuation methodologies. We encourage the Board to explore alternate valuation methods.

We strongly believe that the option pricing models that exist today provide imprecise valuations for employee stock options. Models such as Black-Scholes can produce widely varying and misleading results for such options. In addition, there is a growing consensus among leading financial and academic experts that this formula should not be used to value employee and executive stock options.

There is a large body of academic literature that discusses why Black-Scholes option pricing may be unsuitable for valuing employee stock options. Various experts in valuing stock options note the following[1]:

[1] Source: Semiconductor Industry Association research article "Valuing Employee Stock Options"

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- Employees are usually not permitted to sell or transfer their options, whereas traded options are freely transferable.
- Employee stock options have a much longer life (typically 10 years) than traded options, which are relatively short-term in nature. The longer the term of the option, the more difficult it becomes to accurately value that option.
- Employees typically must forfeit any unvested options when they leave their jobs. As a result, forfeiture rates are not constant.
- Employees may also be forced to exercise vested options prematurely under certain circumstances – greatly diminishing the overall value of the option.
- The Black-Scholes theory does not consider the behavior of employees exercising options. In contrast to standard option theory, employee exercise behavior is very responsive to recent stock price movements. In addition, employees typically exercise their options early. This would significantly reduce the Black-Scholes value of the option. For your convenience, we attach in the appendix an excerpt of an independent study examining employee exercise behavior.

Conclusion

We suggest the Board abandon the approach to allow three different transition methods and instead, maintain the current transition provisions currently prescribed in FAS 123. We also recommend that the Board require the disclosures described in paragraph 3 be presented on an annual basis or more frequently as new stock-based compensation awards are granted.

Given our concerns regarding the valuation methods prescribed in FAS 123, CSG respectfully requests FASB to seek to improve methodologies for valuing employee stock options. To that end, CSG would be pleased to provide assistance to the FASB and the IASB in developing an approach that more accurately reflects the true economic cost to the issuer of employee stock options.

Finally, we urge both the FASB and the IASB to work together in developing a common accounting standard that would allow a more accurate reflection of the value associated with employee compensation contracts. Our concern is that until the issues related to option valuation in FAS 123 have been resolved, there will continue to be difficulties related to comparability of reported financial information.

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We appreciate the FASB's consideration of our comments and recommendations and support the goal of improving accounting standards to improve financial reporting. Please do not hesitate to contact Ken Evola at (212) 325-7382 or Todd Runyan in Zurich at 41-1-334-8063 with any questions or comments.

Sincerely,

Rudolf A. Bless
Managing Director, Chief Accounting Officer

Louis Fanzini
Vice President, Group Accounting Policies

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APPENDIX

Following are results of an independent study that examined employee exercise behavior. The study indicates that the exercise behavior of employees does not reflect Black-Scholes theory.

A study[2] of 50,000 employees holding employee options found that:

- In contrast to standard option theory, exercise behavior is very responsive to recent stock price movements. There is more exercise when market-to-strike price ratios are high. Exercise occurs in periods in which the stock price is rebounding from a previous fall.
- Employees typically exercise early (median fraction of option life elapsed at exercise is 0.82), commonly sacrificing a significant part of the Black-Scholes value (median Black-Scholes value lost is 24%).
- Employees typically exercise in blocks (median block is 50% of the grant). By far the most common block sizes are 25%, 50%, 75%, and 100% of options granted.
- Exercise of 25% of the grant is clustered at the first anniversary of the grant date. Similarly, exercises of 50%, 75%, and 100% of the grant are clustered at the second, third, and fourth anniversaries of the grant. Because the most common vesting schedule is 25% per year over four years, this pattern suggests many employees exercise options soon after they vest.
- Greater exercise is associated with higher stock volatility, as increases in volatility increase risk to employees.
- High-level employees behave differently than lower-level employees. Recent vesting, stock volatility and recent stock returns appear to have little effect on the exercise behavior of the high-level employees. High-level employees appear to be more sensitive to stock price compared to lower-level employees.
- Sixty-four percent of exercise events for the lowest-level employees (bottom 25% of stock grants) occur in the six months following the vesting date. This is twice the rate of the high-level employees.
- Changes in tax code influence the exercise decision. For example, widespread expectations of an increase in personal income tax rates for high-income levels resulted in increased option exercises in 1992, as reported by the press.

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[2] Source: Huddart, S., Lang M. Employee Stock Option Exercises. An empirical analysis. Journal of Accounting and Economics 21 (1996) pp. 5-43

Huddart, S. Patterns of Stock Option Exercises in the United States. Chapter 8 in Executive Compensation and Shareholder Value, Jennifer Carpenter and David Yermack, editors, (Norwell, MA.: Kluwer Academic Publishers, 1998) pp. 115-142