

THE CHARLES SCHWAB CORPORATION
101 Montgomery Street, San Francisco, California 94104

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Letter of Comment No: 5539
File Reference: 1102-100

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
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director@fasb.org

**Re: Exposure Draft of a Proposed Statement of Financial Accounting Standards,
Share-Based Payment (File Reference No. 1102-100)**

Dear Ms. Bielstein:

We are pleased to respond to the Financial Accounting Standards Board ("FASB") with our comments on its Exposure Draft of a Proposed Statement of Financial Accounting Standards, *Share-Based Payment*. We strongly support the FASB's objectives of improving U.S. financial accounting and reporting standards and promoting international convergence around high quality accounting.

Individual investors need reliable financial information in order to make informed investment choices. We believe the measurement of any expense for employee stock options should be comparable between publicly traded companies. The FASB has made significant progress in evaluating option-pricing models that attempt to take into account the unique characteristics of employee stock options. However, we believe that more research and debate over the valuation methodology is needed to allow for further development of a valuation standard that will result in public companies calculating and reporting the option value in the same way. Therefore, we encourage the FASB to delay the issuance of the proposed accounting standard.

In addition, we ask that the FASB consider the proposals presented by our Chief Executive Officer, David S. Pottruck, published in the Wall Street Journal on March 10, 2004, and reproduced in the appendix to this letter.

We also ask that the FASB reconsider certain provisions of the proposed standard, as follows:

Attribution of Compensation Cost

We do not agree with the proposed accounting for awards with a graded vesting schedule, which effectively would require companies to front-load the recognition of compensation expense, for the following reasons:

1. Graded vesting is designed to provide an incremental and equal benefit to employees for each successive service period. For an award that vests on a straight-line basis over 4 years, the proposed standard would require recognition of 52% of the expense in year 1 and 6% in year 4. This is inconsistent with the timing of employee services and, in our view, is not rational.
2. The proposed standard diverges from existing accounting standards for other normal employee compensation arrangements such as cash incentive plans and employment contracts. Since the Board has concluded that equity instruments granted to employees represent a compensation cost, the timing of the expense recognition should be consistent with such conclusion.
3. The proposed standard increases the complexity and cost of applying the accounting standard exponentially since each single grant would be divided into multiple grants, each required to be tracked and accounted for separately.

We believe that employee compensation costs should be recognized as an expense over the period that the employee provides service by using a systematic and rational method, which may include the straight-line method.

Transition

We believe that companies replacing the Black-Scholes-Merton formula with a lattice binomial option-pricing model for measuring stock option values should be allowed to re-measure the fair value of prior awards and recast the historical pro forma compensation cost accordingly for awards granted prior to the effective date of the proposed standard, for the following reasons:

1. The different models generate significantly different valuations for the same stock option grant. If pro forma amounts are not recast, compensation costs reflected in earnings related to stock options will not be comparable to prior pro forma amounts.
2. The FASB has indicated that a lattice binomial option-pricing model is preferable to the Black-Scholes-Merton formula for measuring the fair value of stock options granted to employees. Recasting historical pro forma amounts to be consistent with a current preferable lattice methodology would provide a more meaningful presentation of compensation cost.

Income Taxes

The proposed standard removes the “portfolio approach” currently used to recognize the differences between the actual tax benefits realized for stock option grants and a company’s effective tax rate. The result of removing the portfolio approach is that all excess tax deductions are recorded as capital transactions, but any shortfall in the tax deduction for an individual option is expensed. We recommend the FASB reconsider this proposed change for the following reasons:

1. We believe it is not appropriate to create one-sided earnings volatility and therefore the accounting for an excess deduction and a shortfall should be consistent (at a minimum, shortfalls should be offset by any remaining paid-in capital related to excess tax deductions).
2. The change would require companies to calculate and track the deferred tax attributes of each individual stock option, significantly increasing the cost of complying with the standard.

We believe that the portfolio view currently required by Statement 123 should not be changed.

We appreciate the opportunity to express our views. If you have any questions regarding our comments, please contact Geoffrey Huggins, Senior Vice President - Accounting Policy at (415) 636-3191.

Yours truly,

/s/ Christopher V. Dodds

Christopher V. Dodds
Executive Vice President
Chief Financial Officer

APPENDIX

THE COMPETITIVE OPTION

by David S. Pottruck, CEO, The Charles Schwab Corporation

American business must step up and do the right thing as it relates to stock options, and Congress needs to broaden its scope in considering what change is needed. I strongly believe that stock options must be preserved as a powerful tool for growth and innovation while we also address the issues of fairness and greed that have soiled the public trust.

America's economic system, with its genius of broad equity ownership, is the envy of the world. In fact, even today, the Chinese are considering how to introduce stock options into their economy to help reward and motivate the kind of entrepreneurial spirit that exists from Silicon Valley to Boston's Route 128. Yet our debate and uncertainty here have already seriously decreased option awards for employees across America. We are in danger of using the equivalent of an accounting bludgeon to beat our own competitiveness into submission. The "blunt instrument" solution of expensing options as they are granted will do little to stop abuse, and will only limit management's interest in applying options broadly within the company. In the end, I believe simply expensing options will lead to only the very top executives receiving them.

That will be a travesty, because when used appropriately, stock options harness the engine of sweat equity, putting the power of ownership and entrepreneurial spirit to work both within start-ups and the world's largest corporations. As Blasi, Kruse and Bernstein conclude in their groundbreaking book "In the Company of Owners," "using broad-based options...will, over the long run, help to make most companies more competitive and create more wealth for shareholders." Here at Schwab, thousands of employees from all levels of the company have seen the rewards of their long-term commitment in the form of stock option returns over our 30 years. In turn, our clients and shareholders have benefited from the energy, innovation and commitment of those employees.

Any worthwhile solution must maintain this competitive edge, and also address the true problems: executive greed, the concentrated distribution of stock options to the very few executives at the top of corporations, abuse and gaming of corporate financial performance to benefit those executives at the top, and the lack of a consistent and accurate accounting approach applied to all public corporations. I believe stock options can be preserved as a viable tool for growth and innovation while also addressing these issues.

Here are my proposals:

First, a CEO should be required to hold at least 50% of his or her options for a minimum of 10 years (and perhaps this percentage should be even higher). This will reduce the CEO's motivation to manage earnings for short-term results simply to garner immediate personal financial gain from a quick exercise of the options. It also ensures CEO commitment to the company for the long-term.

Second, stock options for a company's five most senior executives should not be exercisable for a minimum of three years. Upon receipt of stock options, each of these executives must select one of three sell strategies:

- (a) wait the three years and then sell in equal annual installments over the subsequent five years;
- (b) agree to sell the entire grant in a predesignated program after a minimum hold of five years; or
- (c) hold exercised or unexercised options until retirement or for a minimum of 10 years and then sell the underlying stock as they see fit. These approaches, similar to deferred compensation, require an upfront election, again reducing the motivation to manipulate the company's financial performance for personal benefit.

Third, any company with 1,000 or more employees may award no more than 10% of stock options to the top five executives. Ninety percent of the stock options granted by a company must go to the remaining employees. This would ensure that stock options remain a widely distributed incentive tool and would address the perception of an imbalance between executives and other employees.

Even if we implement these changes, I fear the existing proposals for expensing options will result in very few options being issued, thereby limiting the kinds of risk-taking and reward-sharing that has made companies like Schwab, Intel, Pepsi, Cisco, and Wells Fargo (to name only a few) such great places to build careers.

A consistent accounting approach to expensing must also be applied in order to make accurate comparisons for investors. The current FASB effort is expected to require such a "consistent" accounting approach but combines it with valuation guidelines only. It requires companies to find the best inputs to value options and apply them. Like many other fair-value models, the FASB will give general guidance on valuation, but leave the actual calculation up to management, valuation firms, and auditors.

Current proposals suggest expensing options at the time they are granted, but that requires estimates of "fair value" and the "true cost" of those options. They use economic models that often bear no resemblance to what the stock underlying the options will be actually worth to employees or what the true cost is to the company and shareholders. Differing applications of the option pricing models will cause inconsistency among different companies.

To be accurate and reflect changing outcomes, the proposed expensing approach would require subsequent recalculations and either charges or restatements in subsequent financial reporting. This would be an accounting nightmare and would impair the ability to make comparisons across companies or periods of time. This complicated and inconsistent method of expensing options isn't needed to get the desired result, primarily because the current argument that "options don't show up as an expense" is specious. Options that are in the money are in fact reflected in the company's "shares outstanding" calculation and therefore affect "earnings per share," a key valuation statistic.

This natural and accurate measurement of the cost of options only breaks down when companies buy back their own stock in an attempt to offset stock option-caused dilution. In this situation, millions or even billions of dollars of cash virtually “disappear” from the balance sheet never having run through the income statement. That shouldn't be. Cash used to buy back stock that is simply offsetting option-driven dilution should be expensed through the income statement. The use of this cash should have to “show up” somewhere. And my final recommendation is to do exactly that.

Management should have the choice of letting in-the-money options be reflected in the shares outstanding number, thereby affecting EPS. Alternately, the company could use cash, which would run through the income statement, to offset dilution. There would be no debate about an option grant's market value and its cost to the company and shareholders; it would be the dilution of EPS or the cost of the buy back. There would be no issues with options that are deeply out of the money; they wouldn't figure into EPS and there would be no need to offset dilution and use cash for buy backs. Under this approach there would be no subsequent restatements. Management would control the choice, but the expense of options would always appear somewhere: either in the income statement or the EPS calculation, and investors would have total comparability.

These proposals of mine will not only allow America's competitiveness to thrive, but also curb potential abuse. They will also set the right example for our worldwide competitors to follow.
