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MP&T Director-File Reference 1102-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Letter of Comment No: 71
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RE: Accounting for Stock-Based Compensation—File Reference 1102-001

Ladies and Gentlemen:

This letter is submitted on behalf of CIENA Corporation in response to the FASB's request for comments on its consideration of proposed changes in the accounting treatment for stock-based compensation programs. CIENA develops and markets intelligent optical networking systems. It has been public since 1997 and is traded on the Nasdaq Stock Market.

As is the case with most high tech companies, stock options are a significant part of the compensation CIENA offers its employees. Ours is a broad-based program. Every employee receives a stock option grant at the time he or she joins the company and additional grants every six months; and over 70% of our outstanding options are held by employees other than executive officers. Like many of our peers, we believe our option program is an indispensable tool for recruiting and retaining a talented and dedicated workforce. Consequently, the accepted manner of accounting for options under GAAP is of considerable interest to us.

We recognize that this question has been the topic of extensive discussion both at the FASB and the International Accounting Standards Board. We do not purport, in this letter, to raise any new issues or develop new arguments. We do believe, however, that it is important that the FASB have the benefit of the views of companies like CIENA, which will be required to implement any changes in GAAP that result from these deliberations.

Much of the public debate about this issue has been focused largely on *whether* stock options should be expensed at the time they are granted, rather than *how* they should be expensed. As a consequence, the serious practical issues raised by expensing options have too often been ignored in the face of theoretical arguments about whether options are or are not "compensation" and whether they do or do not involve a present "cost" to the issuer. We believe these are the wrong questions.

We recognize that when we grant options we give our employees something of value, something that may ultimately have a "cost," in the broad sense of the word, to our shareholders in the form of dilution. (Many options are, for one reason or another, never exercised, and would thus not ever "cost" shareholders anything.) It goes without saying that

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we have an obligation to investors to make full disclosure of our option grants, and to provide them with all the information they might find helpful in evaluating the effect of those grants on future returns to shareholders. We have no concern that disclosing our option grants in a manner that is clear, consistent, and understandable and that permits meaningful comparison with our peers will prevent us from continuing to use options as a compensation tool. We are perfectly willing to make that disclosure.

The Invitation for Comment specifically disavows requesting views on “whether the fair value of stock options can be reliably measured.” In our view, however, this is like asking someone to give his views on *Ilamlet* without mentioning the Prince of Denmark. We believe that most of the other issues regarding expensing stock options would diminish, if not vanish, if there existed a method of valuing stock options that would produce reliable, consistent, and comparable results. The absence of such a method is the central issue in this debate, and accordingly we have taken the liberty of expressing our view on it in this letter.

The most widely-used technique is the “Black-Scholes” option-pricing model. It was developed for exchange-traded options, which differ significantly from employee stock options. The former have relatively short terms and are highly liquid. Employee stock options, by contrast, are typically held for periods measured in years and are non-transferable. Moreover, employee options normally are subject to “vesting” and are forfeited if an employee leaves the company before they are vested. Finally, the Black-Scholes model was developed for “European-style” options, which can only be exercised at the end of their term, whereas most employee stock options are “American-style” in that they can be exercised at any time after they have vested.

Perhaps the most troublesome aspect of using Black-Scholes to value employee stock options is that it is highly sensitive to the necessary assumptions about the volatility of the price of the underlying stock. This is of particular concern for companies like CIENA, whose stock prices have historically experienced periods of extreme volatility, and which volatility has, itself, fluctuated significantly during different periods. In such cases – which are not uncommon – it is difficult to make meaningful estimates of volatility; and reasonable estimates can vary widely.

Results from the Black-Scholes model also are sensitive to the expected life of the options. Again, making these estimates is particularly difficult for younger companies like CIENA. We have been a public company for only five and a half years. We therefore have too little history to make any reliable estimates of what fraction of the ten-year nominal term of our options would accurately reflect their real term. Any such estimate would, in any event, be complicated by the sharp fluctuations in the size of our workforce that has resulted from our rapid early growth, several acquisitions, and recent substantial layoffs due to market conditions.

As a result of these and other problems, the use of the Black-Scholes formula to value employee stock options can only produce results that are unreliable, inconsistent, and unlikely

to permit useful comparison across different issuers. The alternatives to Black-Scholes, such as the binomial model, are no better. As the noted economists, Burton Malkiel and William Baumol, have observed, “[T]here is no way to measure . . . the value of [employee stock] options at the time they are issued -- with reasonable precision.” (Wall Street Journal, April 4, 2002.)

CIENA’s experience with the Black-Scholes model provides an example of how unrealistic the results it produces may be. As required by SFAS 123 we disclose in the notes to our financial statements the weighted average value of the options we granted for the last three fiscal years, as determined by the Black-Scholes model. For our fiscal years ended October 31, 2000, 2001 and 2002, the per share values were \$64.99, \$27.92 and \$4.88, respectively. The price of our stock has declined steadily since October 2000, and today, after hitting a low of \$2.41 in early October, 2002, it trades in the range of \$5.50 to \$6.50 per share. In hindsight, it defies common sense to say that the average option issued during fiscal 2001 had a fair value of \$27.92.

While recording an expense when an employee stock option is issued may be sound as a matter of theory, the practical problems of determining the amount of the expense are so severe that the outcome of clinging blindly to theory would be far worse than the situation that exists today. There are many instance in accounting in which theory gives way to practicality. In theory, for example investors would have a better picture of the financial health of a company if it marked its assets to market each quarter. However, with the exception of readily salable assets for which there is a liquid market, the accounting profession has long recognized that such a scheme would be not only impracticable, but an invitation to manipulation. The same analysis is applicable to stock options.

Therefore, unless and until there is developed a more reliable method of valuing employee stock options at the time they are issued, we believe it would be a mistake to require that they be expensed. We are confident that, provided adequate information about employee stock options, the market is perfectly capable of evaluating their effects on a company’s financial situation. If changes are to be made in the existing rules, the focus should be on identifying the objective information about options that would be useful to employees and developing formats of disclosure that will make that information easier to use.

Sincerely,

A handwritten signature in black ink, appearing to be "R. J. ...", written over a horizontal line.