

Discover Financial Services  
Form S-4  
November 27, 2007  
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As filed with the Securities and Exchange Commission on November 27, 2007.

Registration No. 333-

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, DC 20549

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**FORM S-4**  
**REGISTRATION STATEMENT**  
*UNDER*  
*THE SECURITIES ACT OF 1933*

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**Discover Financial Services**

(Exact name of registrant as specified in its charter)

<b>Delaware</b> (State or Other Jurisdiction of Incorporation or Organization)	<b>6141</b> (Primary Standard Industrial Classification Code Number) <b>2500 Lake Cook Road</b>  <b>Riverwoods, Illinois 60015</b>  <b>Telephone: (224) 405-0900</b>	<b>36-2517428</b> (I.R.S. Employer Identification No.)
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(Address, Including Zip Code, and Telephone Number, Including Area Code, of Registrant's Principal Executive Offices)

**Kathryn McNamara Corley**  
**Senior Vice President, General Counsel and Secretary**  
**2500 Lake Cook Road**  
**Riverwoods, Illinois 60015**

# Edgar Filing: Discover Financial Services - Form S-4

(Name, Address, Including Zip Code, and Telephone Number, Including Area Code, of Agent For service)

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*Copies to:*

**Joseph W. Armbrust**

**Michael T. Kohler**

**Sidley Austin LLP**

**787 Seventh Avenue**

**New York, New York 10019**

**Telephone: (212) 839-5300**

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**Approximate date of commencement of proposed sale to public:** As soon as practicable after the effective date of this registration statement.

If the securities being registered on this form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G, check the following box. "

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

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## CALCULATION OF REGISTRATION FEE

<b>Title of Each Class of Securities to be Registered</b>	<b>Amount to be Registered</b>	<b>Proposed Maximum Offering Price Per Unit<sup>(1)</sup></b>	<b>Proposed Maximum Aggregate Offering Price</b>	<b>Amount of Registration Fee</b>
6.450% Senior Notes due 2017	\$400,000,000	100%	\$400,000,000	\$12,280.00
Floating Rate Senior Notes due 2010	\$400,000,000	100%	\$400,000,000	\$12,280.00
Total	\$800,000,000	100%	\$800,000,000	\$24,560.00

(1) Estimated solely for purposes of computing the registration fee pursuant to Rule 457(o) under the Securities Act of 1933.

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**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.**



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**The information in this prospectus is not complete and may be changed. These securities may not be sold until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.**

**SUBJECT TO COMPLETION, DATED NOVEMBER 27, 2007**

**PROSPECTUS**

**Offer to Exchange**

**\$400,000,000 6.450% Senior Notes due 2017**

**and**

**\$400,000,000 Floating Rate Senior Notes due 2010**

**For**

**\$400,000,000 6.450% Senior Notes due 2017**

**and**

**\$400,000,000 Floating Rate Senior Notes due 2010**

**Which Have Been Registered Under the Securities Act of 1933**

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**Material Terms to the Exchange Offer and Exchange Notes**

We are offering to exchange the notes we sold previously in private offerings (referred to as the old notes) for new registered exchange notes (referred to as the exchange notes).

You may withdraw tenders of old notes at any time prior to the expiration of this exchange offer.

This exchange offer expires at \_\_\_\_\_, New York City time, on \_\_\_\_\_, \_\_\_\_\_, unless we extend the offer.

The terms of the exchange notes to be issued in this exchange offer are substantially identical to the old notes, except for the transfer restrictions, and registration rights and the obligation to pay additional interest under specified circumstances.



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**You should rely only on the information contained in this prospectus or to which we have referred you. We have not authorized any person to provide you with different information or to make any representation not contained in this prospectus.**

In this prospectus, the terms Discover, we, us and our refer to Discover Financial Services, a Delaware corporation, and its subsidiaries, taken as a whole and, for the period prior to June 30, 2007, to our predecessor, the Discover segment of Morgan Stanley. The term Morgan Stanley refers to Morgan Stanley, a Delaware corporation, and its subsidiaries, excluding Discover, unless the context indicates otherwise. References to years refer to fiscal years ending November 30 of each year, unless the context indicates otherwise.

We completed our spin-off from Morgan Stanley, our former parent company, on June 30, 2007.

*You should not assume that the information contained in this prospectus is accurate as of any date other than the date set forth on the cover. Changes to the information contained in this prospectus may occur after that date, and we undertake no obligation to update the information. You should be aware of certain risks relating to our business and ownership of the exchange notes, which are described under the heading Risk Factors.*

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### **Trademarks, Service Marks and Trade Names**

We own or have rights to use the trademarks, trade names and service marks that we use in conjunction with the operation of our business, including, but not limited to: Discover, PULSE, Cashback Bonus, ShopDiscover, Discover Motiva Card, Miles by Discover Card, Discover Open Road Card, Discover Network and Goldfish. All other trademarks, trade names and service marks included in this prospectus are the property of their respective owners.

### **Industry Data**

This prospectus includes industry and trade association data, forecasts and information that we have prepared based, in part, upon data, forecasts and information obtained from independent trade associations, industry publications and surveys and other independent sources available to us. Some data also are based on our good faith estimates, which are derived from management's knowledge of the industry and from independent sources. These third-party publications and surveys generally state that the information included therein is believed to have been obtained from sources believed to be reliable, but that the publications and surveys can give no assurance as to the accuracy or completeness of such information. We have not independently verified any of the data from third-party sources nor have we ascertained the underlying economic assumptions on which such data are based. Similarly, we believe our internal research is reliable, even though such research has not been verified by any independent sources.

### **NOTICE TO NEW HAMPSHIRE RESIDENTS**

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER RSA 421-B WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE OF NEW HAMPSHIRE THAT ANY DOCUMENT FILED UNDER RSA 421-B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXCEPTION OR EXEMPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THE SECRETARY OF STATE HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY OR TRANSACTION. IT IS UNLAWFUL TO MAKE OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER OR CLIENT, ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

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**SUMMARY**

*The following summary contains certain information from this prospectus relating to us and the securities offered in the exchange offer. It does not contain all the details concerning us or the exchange notes, including information that may be important to you. To understand our business and financial position and this exchange offer, you should carefully review this entire prospectus.*

**Our Company**

We are a leading credit card issuer and electronic payment services company with one of the most recognized brands in U.S. financial services. Since our inception in 1986, we have grown to become one of the largest card issuers in the United States, with more than 50 million cardmembers (41.6 million accounts and 18.4 million active accounts) and \$47.4 billion in managed receivables as of August 31, 2007. We are also a leader in payments processing, as we are one of only two credit card issuers with its own U.S. payments network and the only issuer whose wholly-owned network operations include both credit and debit functionality. In 2006, we processed more than 3 billion transactions through our signature card network (the Discover Network) and PULSE EFT Association (the PULSE Network or PULSE), one of the nation's leading ATM/debit networks.

We issue credit cards in the United States under the Discover Card brand to various segments within the consumer and small business sectors. Most of our cards offer a Cashback Bonus rewards program. In addition, we offer a range of banking products to our customers, including personal and home equity loans, certificates of deposit and money market accounts.

Discover Network cards are currently accepted at more than 4 million merchant and cash access locations primarily in the United States, Mexico, Canada and the Caribbean. In October 2004, the U.S. Department of Justice (DOJ) prevailed in its antitrust lawsuit (the DOJ litigation) against Visa U.S.A., Inc. (together with its predecessors, Visa) and MasterCard Worldwide (together with its predecessors, MasterCard) which challenged their exclusionary rules rules that effectively precluded us from offering network services to financial institutions. Since then, we have accelerated our network growth by entering the debit market with the acquisition of the PULSE Network, and by signing card issuing agreements with a number of financial institutions. We also have significantly expanded our relationships with companies that provide merchants with credit card processing services, which we believe will further increase the number of merchants accepting Discover Network cards.

In addition, we issue credit cards on the MasterCard and Visa networks in the United Kingdom, the world's second-largest credit card market. Our portfolio includes Goldfish, one of the United Kingdom's leading rewards credit cards, as well as several Morgan Stanley-branded credit cards and a number of affinity credit cards. As of August 31, 2007, we had more than 2 million cardmembers in the United Kingdom and \$4.4 billion of managed receivables in this market.

Our revenues (net interest income plus other income) have increased over the last three years, from \$4.5 billion in 2004 to \$5.1 billion in 2006, and net income has increased from \$776 million to \$1.1 billion over the same period. Our revenues and net income for the nine months ended August 31, 2007 were \$3.7 billion and \$645 million, respectively, and \$3.9 billion and \$890 million, respectively, for the nine months ended August 31, 2006.

We were incorporated in Delaware in 1960. Our principal executive offices are located at 2500 Lake Cook Road, Riverwoods, Illinois 60015. Our main telephone number is (224) 405-0900.

We completed our spin-off from Morgan Stanley, our former parent company, on June 30, 2007.



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**The Exchange Offer**

In connection with the issuance of \$400,000,000 aggregate principal amount of our 6.450% Senior Notes due 2017 and \$400,000,000 aggregate principal amount of our Floating Rate Senior Notes due 2010 (collectively, the old notes ), we entered into a registration rights agreement with the initial purchasers of the old notes. Under that agreement, we agreed to deliver to you this prospectus and to use our reasonable best efforts to complete this exchange offer within 360 days after the date of original issuance of the old notes. You are entitled to exchange in this exchange offer each applicable series of old notes for a like principal amount of our 6.450% Senior Notes due 2017 or Floating Rate Senior Notes due 2010, as applicable (collectively, the exchange notes ), which are substantially identical to the old notes except that:

the exchange notes have been registered under the Securities Act of 1933, as amended, referred to as the Securities Act, and will be freely tradable by persons who are not affiliated with us;

the exchange notes are not entitled to registration rights which are applicable to the old notes under the registration rights agreement; and

our obligation to pay additional interest on the old notes as described under The Exchange Offer Purpose and Effect of This Exchange Offer does not apply to the exchange notes.

**The Exchange Offer**

We are offering to exchange up to the entire aggregate principal amount of each series of the exchange notes in exchange for a like aggregate principal amount of the corresponding series of the old notes. We are commencing two separate exchange offers, one with respect to each series of old notes. We refer to these exchange offers, collectively, as the exchange offer in this prospectus. Old notes may be exchanged only in denominations of \$2,000 and integral multiples of \$1,000 in excess thereof. For a description of the procedures for tendering the old notes, see The Exchange Offer Procedures for Tendering Old Notes.

**Resales**

Based on existing interpretations of the Securities Act by the SEC staff set forth in several no-action letters to third parties, and subject to the immediately following sentence, we believe that exchange notes issued under this exchange offer in exchange for old notes may be offered for resale, resold and otherwise transferred by the holders thereof (other than holders who are broker-dealers) without further compliance with the registration and prospectus delivery provisions of the Securities Act. However, any purchaser of old notes who is an affiliate of ours or who intends to participate in the exchange offer for the purpose of distributing the exchange notes, or any broker-dealer who purchased the old notes from us for resale pursuant to Rule 144A or any other available exemption under the Securities Act, (i) will not be able to rely on the interpretations of the SEC staff set forth in the above-mentioned no-action letters, (ii) will not be entitled to tender its old notes in the exchange offer, and (iii) must comply with the registration and prospectus delivery requirements of the Securities Act in connection with any sale or transfer of the old notes unless such sale or transfer is made pursuant to an exemption from such requirements.

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**Expiration Date; Withdrawal of Tenders** This exchange offer will expire at \_\_\_\_\_, New York City time, \_\_\_\_\_, \_\_\_\_\_, or such later date and time to which we extend it. We do not currently intend to extend the expiration date. A tender of old notes pursuant to this exchange offer may be withdrawn at any time prior to the expiration date. Any old notes not accepted for exchange for any reason will be returned without expense to the tendering holder promptly after the expiration or termination of this exchange offer.

**Conditions to this Exchange Offer** This exchange offer is subject to customary conditions, some of which we may waive. See The Exchange Offer Certain Conditions to This Exchange Offer.

**Procedures for Tendering Old Notes** If you wish to accept this exchange offer, you must complete, sign and date the accompanying letter of transmittal, or a copy of it, according to the instructions contained in this prospectus and the letter of transmittal. You must mail or otherwise deliver the letter of transmittal, or the copy, together with the old notes and any other required documents, to the exchange agent at the address set forth on the cover of the letter of transmittal. If you hold old notes through The Depository Trust Company ( DTC ) and wish to participate in this exchange offer, you may use DTC's Automated Tender Offer Program to tender, by which you will agree to be bound by the letter of transmittal.

By signing or agreeing to be bound by the letter of transmittal, you will represent to us that, among other things:

you are not an affiliate of ours or if you are such an affiliate, you will comply with the registration and prospectus delivery requirements of the Securities Act to the extent applicable;

you are acquiring the exchange notes in the ordinary course of your business;

at the time of the exchange offer, you have no arrangement with any person to participate in the distribution (within the meaning of the Securities Act) of the old notes or the exchange notes; and

if you are a broker-dealer that will receive exchange notes for its own account in exchange for old notes that were acquired as a result of market making or other trading activities, you will deliver a prospectus (or to the extent permitted by law, make available a prospectus to purchasers) in connection with any resale of such exchange notes.

See The Exchange Offer Procedures for Tendering Old Notes.

**Guaranteed Delivery Procedures** If you wish to tender your old notes and your old notes are not immediately available or you cannot deliver your old notes, the letter



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of transmittal or any other documents required by the letter of transmittal or to comply with the applicable procedures under DTC's Automated Tender Offer Program prior to the expiration date, you may tender your old notes according to the guaranteed delivery procedures set forth in this prospectus under The Exchange Offer Guaranteed Delivery Procedures.

**Effect on Holders of Old Notes**

As a result of this exchange offer, and upon our acceptance for exchange of all old notes validly tendered pursuant to this exchange offer, we will have fulfilled a covenant contained in the registration rights agreement applicable to the old notes. Accordingly, we will not be obligated to pay damages as described in the registration rights agreement. If you are a holder of old notes and do not tender your old notes in this exchange offer, you will continue to hold such old notes and you will be entitled to all the rights and limitations applicable to the old notes in the indenture related to the applicable series of old notes, except for any rights under the registration rights agreement that by their terms terminate upon the consummation of this exchange offer.

**Consequences of Failure to Exchange**

All old notes that are not tendered or that are tendered but not accepted will continue to be subject to the restrictions on transfer provided for in the old notes and in the indenture related to that series of notes. In general, the old notes may not be offered or sold unless registered under the Securities Act, except pursuant to an exemption from, or in a transaction not subject to, the Securities Act and applicable state securities laws. Other than in connection with this exchange offer, or as otherwise required under certain limited circumstances pursuant to the terms of the registration rights agreement, we do not currently anticipate that we will register the old notes under the Securities Act. See The Exchange Offer Consequence of Failure to Exchange.

**Summary of Certain United States Federal Income Tax Considerations**

The exchange of old notes for exchange notes will not be a taxable event to you for U.S. federal income tax purposes. As a result, (1) you will not recognize taxable gain or loss as a result of exchanging your old notes for exchange notes, (2) the holding period of the exchange notes will include the holding period of the old notes exchanged therefor, and (3) the adjusted issue price and the adjusted tax basis of the exchange notes will be the same as the adjusted issue price and adjusted tax basis of the old notes exchanged therefor immediately before the exchange. See Material U.S. Federal Income Tax Considerations.

**Use of Proceeds**

We will not receive any cash proceeds from the issuance of the exchange notes in this exchange offer.

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<b>Exchange Agent</b>	U.S. Bank National Association is the exchange agent for this exchange offer. The address, telephone number and facsimile number of the exchange agent are set forth under The Exchange Offer Exchange Agent.
<b>Other</b>	Participation in this exchange offer is voluntary, and you should carefully consider whether to accept. You are urged to consult your financial and tax advisors in making your own decision on what action to take.
<b>The Exchange Notes</b>	
	The following summary of the terms of the exchange notes is not intended to be complete. For a more complete description of the terms of the exchange notes, see Description of the Exchange Notes.
<b>Issuer</b>	Discover Financial Services
<b>Notes Offered</b>	<p>\$400,000,000 aggregate principal amount of Floating Rate Senior Notes due 2010 (the Floating Rate Notes ). The Floating Rate Notes will mature on June 11, 2010 (the Floating Rate Note Stated Maturity ).</p> <p>\$400,000,000 aggregate principal amount of 6.450% Senior Notes due 2017 (the Fixed Rate Notes ). The Fixed Rate Notes will mature on June 12, 2017 (the Fixed Rate Note Stated Maturity ).</p>
<b>Interest</b>	<p>The Floating Rate Notes will bear interest at LIBOR plus 0.53% per annum.</p> <p>The Fixed Rate Notes will bear interest at 6.450% per annum.</p>
<b>Interest Payment Dates</b>	<p>Interest on the Floating Rate Notes will be payable in arrears on June 12, September 12, December 12 and March 12 of each year.</p> <p>Interest on the Fixed Rate Notes will be payable in arrears on June 12 and December 12 of each year.</p>
<b>Ranking</b>	<p>The Floating Rate Notes and the Fixed Rate Notes (together, the exchange notes ) will be unsecured and will rank equally with other unsecured senior indebtedness that we have or that we may incur. The exchange notes will be effectively junior to our secured indebtedness and all of our subsidiaries existing and future obligations. See Description of the Exchange Notes Ranking.</p> <p>As of August 31, 2007, at the parent holding company level, Discover Financial Services had \$799 million of long-term indebtedness and no secured indebtedness. As of August 31, 2007, excluding intercompany amounts, our subsidiaries had \$29.6 billion of total indebtedness and other liabilities, including deposits.</p>



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### **Optional Redemption**

We may redeem the Fixed Rate Notes, in whole or in part, at our option at any time at a make-whole redemption price, plus accrued and unpaid interest. The make-whole redemption price is described in [Description of the Exchange Notes](#) [Optional Redemption By Us](#).

### **Tax Redemption**

We may redeem the Floating Rate Notes and/or the Fixed Rate Notes as a whole, but not in part, at our option at any time prior to maturity, upon the giving of a notice of tax redemption to the holders, if any, upon the occurrence of specified events relating to applicable tax law. See [Description of the Exchange Notes](#) [Tax Redemption](#).

### **Additional Amounts**

We will, subject to certain exceptions and limitations, pay to a holder of any exchange note, as additional interest, such additional amounts as may be necessary in order that every net payment by us or a paying agent of the principal of and interest on the exchange note and any other amounts payable on the exchange note after withholding or deduction for or on account of any present or future tax, assessment or governmental charge imposed or levied by the United States or any political subdivision or taxing authority thereof or therein will not be less than the amount provided for in the exchange note to be then due and payable under the note. See [Description of the Exchange Notes](#) [Payment of Additional Amounts](#).

### **Covenants**

Subject to a number of important limitations and exceptions, the indenture governing the exchange notes will contain covenants that will limit our ability to, among other things (i) create, assume, incur or guarantee any indebtedness for borrowed money that is secured by a pledge, lien or other encumbrance on certain voting securities of certain subsidiaries or (ii) merge or consolidate with any other person or sell, lease or convey all or substantially all of our assets to any other person. Other than as described below under [Change of Control Offer](#), there are no covenants or other provisions in the indenture that would afford holders of exchange notes additional protection in the event of a recapitalization transaction, a change of control of our company or a highly leveraged transaction. See [Description of the Exchange Notes](#) [Covenants Restricting Pledges, Mergers and Other Significant Corporate Actions](#).

### **Change of Control Offer**

If a Change of Control Triggering Event (as defined in [Description of the Exchange Notes](#) [Repurchase at the Option of Holders](#) ) occurs, holders of the exchange notes may require us to make an offer to repurchase the exchange notes at a price equal to 101% of their principal amount, plus accrued and unpaid interest, if any, on the repurchase date, as described under the heading [Description of the Exchange Notes](#) [Repurchase at the Option of Holders](#).

### **Events of Default**

The exchange notes and the indenture will contain certain events of default, consisting of, among others, the following:

failure to pay the principal when due or failure to pay interest in respect of the exchange notes within 30 days of the due date for an interest payment;

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failure to comply with our covenants, with such failure continuing for 60 days after written notice has been delivered to us;

default under any mortgage, indenture or other instrument securing or evidencing any of our indebtedness or that of our principal subsidiaries in an aggregate principal amount of \$50 million or more and which default (i) constitutes a failure to make any scheduled principal or interest payment when due after giving effect to any applicable grace period or (ii) accelerates the payment of such debt and such acceleration is not rescinded or annulled, or such debt is not discharged, within 15 days after written notice to us of such default by (i) the trustee or (ii) the holders of at least 25% in principal amount of the outstanding exchange notes of such series; and

events of bankruptcy, insolvency or reorganization.

See Description of the Exchange Notes Events of Default .

**Further Issuances**

We may from time to time without notice to or consent of the holders of the exchange notes issue an unlimited amount of additional notes of the same series as the exchange notes. Holders of the notes should be aware that additional notes that are treated as the same series as the exchange notes may be treated as separate issues for U.S. federal income tax purposes. See Description of the Exchange Notes The Notes.

**Listing**

We do not intend to list the exchange notes on any exchange or to include the exchange notes in any automated quotation system.

**Governing Law**

The indenture and the exchange notes will be governed by the laws of the State of New York.

**Trustee, Transfer Agent and Registrar**

U.S. Bank National Association.

**Risk Factors**

Investing in the exchange notes involves substantial risks. See Risk Factors for a discussion of the factors that you should consider.



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**RISK FACTORS**

*You should carefully consider each of the following risks and all of the other information contained in this prospectus before participating in the exchange offer. Some of these risks relate principally to our business and the industry in which we operate, while others relate principally to our spin-off from Morgan Stanley, and other risks relate principally to the exchange offer and the exchange notes.*

*Our business, financial position, results of operations or liquidity could be adversely affected by any of these risks, and, as a result, our ability to comply with our obligations with respect to the exchange notes could be materially and adversely affected.*

**Risks Related to Our Business**

***We face competition from other credit card issuers, and we may not be able to compete effectively, which could result in fewer customers and lower account balances and could materially adversely affect our financial condition, cash flows and results of operations.***

The credit card issuing business is highly competitive, and we compete with other credit card issuers on the basis of a number of factors, including: merchant acceptance, products and services, incentives and reward programs, brand, network, reputation and pricing. This competition, among other things, affects our ability to obtain applicants for our credit cards, encourage cardmembers to use our credit cards, maximize the revenue generated by card usage and generate cardmember loyalty and satisfaction so as to minimize the number of cardmembers switching to other credit card brands. Competition is also increasingly based on the value provided to the cardholder by rewards programs. Many credit card issuers have instituted rewards programs that are similar to ours, and issuers may in the future institute rewards programs that are more attractive to cardmembers than our programs. In addition, because most domestically issued credit cards, other than those issued by American Express, are issued on the Visa and MasterCard networks, most other card issuers benefit from the dominant position and marketing and pricing power of Visa and MasterCard. If we are unable to compete successfully, or if competing successfully requires us to take aggressive actions in response to competitors' actions, our financial condition, cash flows and results of operations could be materially adversely affected.

***We incur considerable expenses in competing with other credit card issuers, and many of our competitors have greater scale, which may place us at a competitive disadvantage.***

We incur considerable expenses in competing with other credit card issuers to attract and retain cardmembers and increase card usage. A substantial portion of these expenses relates to marketing expenditures; however, traditional customer acquisition methods have become increasingly challenging. Telemarketing has been hampered by the Federal Trade Commission's National Do Not Call Registry, which had increased to over 145 million phone numbers as of October 2007. Direct mail response rates have fallen, with market researcher Synovate reporting that, in the industry, only three out of every 1,000 offers generated responses in 2005 compared to approximately 28 out of every 1,000 in 1992.

Because of the highly competitive nature of the credit card issuing business and increasing marketing challenges, a primary method of competition among credit card issuers, including us, is to offer low introductory interest rates and balance transfer programs that offer a favorable annual percentage rate or other financial incentives for a specified length of time on account balances transferred from another credit card. This type of competition has adversely affected credit card yields, and many cardholders now frequently switch credit cards or transfer their balances to another card. There can be no assurance that any of the expenses we incur or incentives we offer to attempt to acquire and maintain accounts and increase card usage will be effective.

Furthermore, many of our competitors are larger than we are, have greater financial resources than we do and/or have lower capital costs and operating costs than we have and expect to have, and have assets such as

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branch locations and co-brand relationships that may help them compete more effectively. In addition, there is an increasing trend toward consolidation among credit card issuers, resulting in even greater pooled resources. We may be at a competitive disadvantage as a result of the greater scale of many of our competitors.

***We face competition from other operators of payment networks, and we may not be able to compete effectively, which could result in reduced transaction volume, limited merchant acceptance of our cards, limited issuance of cards on our network by third parties and materially reduced earnings.***

We face substantial and increasingly intense competition in the payments industry. We compete with other payment networks to attract third-party issuers to issue credit and debit cards and other card products on the Discover and PULSE Networks. Competition with other operators of payment networks is generally based on issuer interchange fees, other economic terms, merchant acceptance and network functionality. Competition is also based on service quality, brand image, reputation and market share.

Many of our competitors are well established, larger than we are and/or have greater financial resources than we do. These competitors have provided financial incentives to card issuers, such as large cash signing bonuses for new programs, funding for and sponsorship of marketing programs and other bonuses. Visa and MasterCard have each been in existence for more than 40 years and enjoy greater merchant acceptance and broader global brand recognition than we do. In addition, Visa and MasterCard have entered into long-term arrangements with many financial institutions that may have the effect of preventing them from issuing credit cards on the Discover Network or issuing debit cards on the PULSE Network. MasterCard recently completed an initial public offering, which provided it with significant capital and may enhance its strategic flexibility. Visa also intends to undertake an initial public offering. American Express is also a strong competitor, with international acceptance, high transaction fees and an upscale brand image.

Furthermore, as a result of their dominant market position and considerable marketing and pricing power, in recent years Visa and MasterCard have been able to aggressively increase transaction fees charged to merchants in an effort to retain and grow their issuer volume. If we are unable to remain competitive on issuer interchange and other incentives, we may be unable to offer adequate pricing to third-party issuers while maintaining sufficient net revenues. At the same time, increasing the transaction fees charged to merchants in order to increase the interchange fees payable to credit card issuers could adversely affect our effort to increase merchant acceptance of credit cards issued on the Discover Network and may cause merchant acceptance to decrease. See Our transaction volume is concentrated among large merchants, and a reduction in the number of, or rates paid by, merchants that participate in the Discover Network could materially adversely affect our business, financial condition, results of operations and cash flows. This, in turn, could adversely affect our ability to attract third-party issuers and our ability to maintain or grow revenues from our proprietary network. Similarly, the PULSE Network operates in the highly competitive PIN debit business with well established and financially strong network competitors (particularly Visa) that have the ability to offer more attractive economics and bundled products to financial institutions.

In addition, if we are unable to maintain sufficient network functionality to be competitive with other networks, our ability to attract third-party issuers and maintain or increase the revenues generated by our proprietary card issuing business may be materially adversely affected. An inability to compete effectively with other payment networks for the reasons discussed above or any other reason could result in reduced transaction volume, limited merchant acceptance of our cards, limited issuance of cards on our network by third parties and materially reduced earnings.

***Our business depends on our ability to manage our credit risks, and failing to manage these risks successfully may result in high charge-off rates or impede our growth.***

We market our products to a wide range of consumers, and our success depends on our ability to continue to manage our credit risk while attracting new cardmembers with profitable usage patterns. We select our cardmembers, manage their accounts and establish terms and credit limits using proprietary scoring models and

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other analytical techniques designed to set terms and credit limits such that we are appropriately compensated for the credit risk we accept, while encouraging cardmembers to use their available credit. The models and approaches we use to select, manage and underwrite our cardmembers may not accurately predict future charge-offs due to, among other things, inaccurate assumptions or models. While we continually seek to improve our assumptions and models, we may make modifications that unintentionally cause them to be less predictive. We may also incorrectly interpret the data produced by these models in setting our credit policies. Our ability to manage credit risk may also be adversely affected by economic conditions, legal or regulatory changes (such as bankruptcy laws, minimum payment regulations and re-age guidance), competitors actions and consumer behavior, as well as inadequate collections staffing, techniques, models and vendor performance.

A cardmember's ability to repay us can be negatively impacted by changes in their payment obligations under nontraditional or non-conforming mortgage loans, including subprime mortgage loans. Such changes can result from changes in economic conditions including increases in base lending rates upon which payment obligations are based, which in turn could adversely impact the ability of our cardmembers to meet their payment obligations to other lenders and to us and could result in higher credit losses in our portfolio.

Rising delinquencies and rising rates of bankruptcy are often precursors of future charge-offs. For instance, bankruptcy rates in the United Kingdom have increased significantly in recent years as a result of the relaxation of the bankruptcy laws, which has contributed to increases in charge-off rates in our U.K. operations. There can be no assurance that our lending standards will protect us against high charge-off levels. In addition, because an important source of our funding is the securitization market, an increase in delinquencies and/or charge-offs could increase our cost of funds or unintentionally cause an early amortization event. See We may be unable to securitize our receivables at acceptable rates or at all, which could materially adversely affect our liquidity, cost of funds, reserves and capital requirements.

We plan to expand in several card and consumer lending sectors. Areas of particular focus include: a small business card, which we launched in 2006; relaunching the Miles by Discover Card product, which occurred in 2007; launching personal loan and student lending products, which occurred in 2007; and prepaid cards. We also continuously refine and test our credit criteria, which results in some instances in approving applications that did not previously meet our underwriting criteria. We have less experience in these areas as compared to our traditional products and segments, and there can be no assurance that we will be able to manage our credit risk or generate sufficient revenue to cover our expenses in these markets. Our failure to manage our credit risks may materially adversely affect our profitability and ability to grow.

***Economic downturns, financial market events and other conditions beyond our control could materially adversely affect our business.***

Economic downturns, financial market events and other conditions beyond our control may adversely affect consumer spending, asset values, investments, financial market liquidity, consumer indebtedness and unemployment rates, which in turn can negatively impact our business. If general economic conditions in the United States or United Kingdom deteriorate or interest rates increase, the number of transactions, average purchase amount of transactions, or average balances outstanding on our cards may be reduced, which would reduce transaction fees and interest income and thereby adversely affect profitability. In addition, high levels of unemployment, low levels of spending, recessions or other conditions, including terrorism, natural disasters or the outbreak of diseases such as avian flu, may adversely affect the ability of cardmembers to pay amounts owed to us, which would increase delinquencies and charge-offs and could materially adversely affect our business.

***Changes in the level of interest rates could materially adversely affect our earnings.***

Changes in interest rates cause our interest expense to increase or decrease, as certain of our debt instruments carry interest rates that fluctuate with market benchmarks. If we are unable to pass our higher cost of funds to our customers, the increase in interest expense could materially adversely affect earnings. Some of our

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managed receivables bear interest at a fixed rate or do not earn interest, and we may not be able to increase the rate on those loans to mitigate our higher cost of funds. At the same time, our variable rate managed receivables, which are based on a market benchmark, may not change at the same rate as our floating rate debt instruments or may be subject to a cap.

Interest rates may also adversely impact our delinquency and charge-off rates. Many consumer lending products bear interest rates that fluctuate with certain base lending rates published in the market, such as the prime rate and LIBOR (London Interbank Offered Rate). As a result, higher interest rates often lead to higher payment requirements by consumers under obligations to us or other lenders, which may reduce their ability to remain current on their obligations to us and thereby lead to loan delinquencies and additions to our loan loss provision, which could materially adversely affect our earnings.

***In connection with our recent spin-off from Morgan Stanley, we have incurred additional indebtedness that could restrict our operations.***

In recent years, Morgan Stanley provided a significant portion of our funding. Since our recent spin-off from Morgan Stanley, we finance our capital needs with third party funding. We have entered into a multi-year unsecured committed credit facility of \$2.5 billion, which contains customary restrictions, covenants and events of default. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources. The terms of this facility and any future indebtedness impose various restrictions and covenants on us (such as tangible net worth requirements) that could have adverse consequences, including,

limiting our ability to pay dividends to our stockholders;

increasing our vulnerability to changing economic, regulatory and industry conditions;

limiting our ability to compete and our flexibility in planning for, or reacting to, changes in our business and the industry;

limiting our ability to borrow additional funds; and

requiring us to dedicate a substantial portion of our cash flow from operations to payments on our debt, thereby reducing funds available for working capital, capital expenditures, acquisitions and other purposes.

Our total combined indebtedness as of August 31, 2007 was approximately \$28.5 billion, as compared to \$21.5 billion at August 31, 2006. The increase in indebtedness primarily represents incremental deposits obtained to establish a \$8.1 billion liquidity reserve. We may also incur additional substantial indebtedness in the future.

***We may be unable to securitize our receivables at acceptable rates or at all, which could materially adversely affect our liquidity, cost of funds, reserves and capital requirements.***

The securitization of credit card receivables, which involves the transfer of receivables to a trust and the issuance by the trust of beneficial interests to third-party investors, is our largest single source of funding. Factors affecting our ability to securitize our credit card receivables at acceptable pricing levels, or at all, include the overall credit quality of our receivables, negative credit ratings action affecting our asset-backed securities (or Discover Bank), the stability of the market for securitization transactions, investor demand, and the legal, regulatory, accounting and tax requirements governing securitization transactions. In addition, future changes to Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended, may make it more difficult for us to maintain sale accounting treatment for our securitizations under GAAP or may require us to recognize securitizations on our combined statements of financial condition, which could substantially increase Discover Bank's regulatory capital requirements.

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Our results of operations and financial condition could also be materially adversely affected by the occurrence of events that could result in the early amortization of our securitization transactions. Credit card securitizations are normally structured as revolving transactions that do not distribute to securitization investors their share of monthly principal payment on the receivables during the revolving period, and instead use those payments to fund the purchase of replacement receivables. The occurrence of early amortization events may result in termination of the revolving period of our securitization transactions. Early amortization events include, for example, insufficient cash flows in the securitized pool of receivables to meet contractual requirements, certain breaches of representations, warranties or covenants in the agreements relating to the securitization, and bankruptcy or insolvency.

If we are unable to continue to securitize our credit card receivables at acceptable pricing levels, or at all, including by reason of the early amortization of any of our securitization transactions, we would seek to liquidate investment securities, increase bank deposits and use alternative funding sources to fund increases in loan receivables and meet our other liquidity needs. In the event of an economic early amortization, receivables that otherwise would have been subsequently purchased by the trust from us would instead continue to be recognized on our combined statements of financial condition since the cash flows generated in the trust would instead be used to repay investors in the asset-backed securities. Recognizing these receivables would require us to obtain alternative funding. Our available investment securities and other alternative sources may be insufficient to meet our funding needs, which could materially adversely affect our liquidity, cost of funds, reserves and capital requirements.

***Declines in the value of, or income earned from, our retained interests in our securitization transactions could materially adversely affect our financial condition, results of operations and cash flows.***

We retain interests in the assets transferred to or created in our securitization transactions and earn income from these assets. The value of our retained interests and the amount of income that we earn depend on many factors, including, among others, the revenues, performance and credit risk of the securitized loans, which are subject to the same risks and uncertainties as loans that we have not securitized. The value of our interests may also change because of changes in the assumptions used to estimate their fair value, such as market interest rates and other conditions, increases in bankruptcy or charge-off rates, payment rates and changes in the interpretation and application of accounting rules relating to such valuation. If the income that we earn from our retained interests in securitization transactions were to decrease or the value of our retained interests were to decrease, our financial condition, results of operations and cash flows could be materially adversely affected.

***An inability to accept brokered deposits in the future could materially adversely affect our liquidity position and funding costs.***

The Federal Deposit Insurance Act ( FDIA ) prohibits a bank, including our subsidiaries Discover Bank and Bank of New Castle, from accepting brokered deposits or offering interest rates on any deposits significantly higher than the prevailing rate in its normal market area or nationally (depending upon where the deposits are solicited), unless (1) it is well-capitalized or (2) it is adequately capitalized and receives a waiver from the Federal Deposit Insurance Corporation ( FDIC ). A bank that is adequately capitalized and that accepts brokered deposits under a waiver from the FDIC may not pay an interest rate on any deposit in excess of 75 basis points over certain prevailing market rates. There are no such restrictions on a bank that is well-capitalized. While Discover Bank and Bank of New Castle each met the FDIC 's definition of well-capitalized as of August 31, 2007, there can be no assurance that they will continue to meet this definition. An inability to accept brokered deposits in the future could materially adversely affect our liquidity position and funding costs.

***We rely in part on unsecured and secured debt for our funding and the inability to access the U.S. or U.K. debt markets could materially adversely affect our business, financial condition and results of operations.***

While our primary sources of funding are securitizations and brokered deposits, we are also dependent on access to the U.S. and U.K. unsecured debt markets to fund our managed receivables as well as other assets. In

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general, the amount, type and cost of our funding directly affects the cost of operating our business and growing our assets and is dependent upon outside factors such as our credit rating from ratings agencies. Historically we have benefited from Morgan Stanley's credit ratings (Morgan Stanley is rated Aa3 by Moody's Investors Service (Moody's), AA- by Fitch Ratings (Fitch) and AA- by Standard & Poor's (S&P)). Discover Bank has maintained its BBB rating from S&P and has been assigned a Baa2 deposit and Baa2 senior unsecured rating from Moody's and a BBB rating from Fitch. We have been assigned a BBB- long-term rating from S&P, a Baa3 senior unsecured rating from Moody's and a BBB long-term rating from Fitch. The difference in ratings categories between Morgan Stanley and us reflects the relative risks associated with the different businesses. While business risks are complex and difficult to compare between businesses as different as Morgan Stanley's and ours, generally Morgan Stanley is more diversified and has greater overall scale than us. A rating is not a recommendation to purchase, sell or hold any particular security. In addition, there can be no assurance that a rating will be maintained for any given period of time or that a rating will not be lowered or withdrawn in its entirety. If our ratings are for any reason further reduced or we are unable to access the U.S. or U.K. unsecured debt markets for any reason, our business, financial condition and results of operations could be materially adversely affected.

In response to the exploration of the spin-off in 2005, Moody's placed the asset-backed securities issued domestically by the Discover Card Master Trust under review for a possible downgrade, which we believe contributed to a temporary disruption in our ability to access the securitization markets, increasing our reliance on intercompany funding and deposit markets. This disruption lasted approximately five months, at which time Moody's reaffirmed the ratings on the asset-backed securities.

***We may be unable to increase or sustain Discover Card usage, which could impair growth in, or lead to diminishing, average balances and total revenue.***

A key element of our strategy is to increase the usage of the Discover Card by our cardmembers, including making it their primary card, and thereby increase our revenue from transaction and service fees and our managed receivables. However, our cardmembers' use and payment patterns may change because of social, legal and economic factors, and cardmembers may decide not to increase card usage or may decide to pay the balances within the grace period to avoid finance charges. We face challenges from competing credit card products in our attempts to increase credit card usage by our existing cardmembers. Our ability to increase cardmember usage is also dependent on cardmember satisfaction, which may be adversely affected by factors outside of our control, including competitors' actions. As part of our strategy to increase usage, we are seeking to increase the number of merchants who accept cards issued on the Discover Network. If we are unable to increase merchant acceptance of our cards, our ability to grow usage of Discover Cards may be hampered. As a result of these factors, we may be unable to increase or sustain credit card usage, which could impair growth in, or lead to diminishing, average balances and total revenue.

***We may be unable to grow earnings if we do not attract new cardmembers, or if we attract cardmembers with unfavorable spending and payment habits.***

We are seeking to increase managed receivables by attracting new cardmembers who will use their Discover Cards, meet their monthly payment obligations and maintain balances that generate interest and fee income for us. We are subject to substantial competition from other credit card issuers for these new cardmembers. We plan to continue marketing the Discover Card, but we may not have adequate financial resources to permit us to incur all of the marketing costs that may be necessary to maintain or grow our managed receivables or to attract new accounts. The spending and payment habits of these new cardmembers may not be sufficient to make their accounts as profitable as we expect. In addition, our risk models may not accurately predict the credit risk for these new cardmembers, which could result in unanticipated losses in future periods. To the extent that the spending and payment habits of new cardmembers do not meet our expectations, our earnings and growth may be negatively affected.

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***Our transaction volume is concentrated among large merchants, and a reduction in the number of, or rates paid by, merchants that participate in the Discover Network could materially adversely affect our business, financial condition, results of operations and cash flows.***

Discover Card transaction volume was concentrated among our top 100 merchants in 2006. These merchants may pressure us to reduce our rates by continuing to participate in the Discover Network only on the condition that we change the terms of their economic participation. At the same time, we are subject to increasing pricing pressure from third-party issuers as a result of the continued consolidation in the banking industry, which results in fewer large issuers that, in turn, generally have a greater ability to negotiate pricing discounts. In addition, many of our merchants, primarily our small and mid-size merchants, are not contractually committed to us for any period of time and may cease to participate in the Discover Network at any time on short notice.

In addition, actual and perceived limitations on acceptance of credit cards issued on the Discover Network could adversely affect the use of the Discover Card by existing cardmembers and the attractiveness of the Discover Card to prospective new cardmembers. Furthermore, we may have difficulty attracting and retaining third-party issuers if we are unable to add and retain merchants who accept cards issued on the Discover or PULSE Networks. As a result of these factors, a reduction in the number of, or rates paid by, our merchants could materially adversely affect our business, financial condition, results of operations and cash flows.

***We may be unable to grow earnings if we are unable to increase the number of small and mid-size merchants that participate in the Discover Network.***

In seeking to expand our merchant acceptance among small and mid-size merchants, we have recently started to use third-party acquirers and processors to add merchants to the Discover Network and accept and process payments for these merchants on an integrated basis with Visa and MasterCard payments. This strategy could have results that we do not anticipate, such as decreased revenues, higher expenses, degraded service levels and retaliatory responses from competitors. There can be no assurance that the use of third-party acquirers and processors will increase merchant acceptance among small or mid-size merchants. If we are unable to increase small and mid-size merchant acceptance, our ability to grow earnings could be adversely affected.

***Our business, financial condition and results of operations may be adversely affected by the increasing focus of merchants on the fees charged by credit card networks.***

Merchant acceptance and fees are critical to the success of both our card issuing and payment processing businesses. Merchants have shown increasing concern with the levels of fees charged by credit card companies, and have in the past and may in the future seek to negotiate better pricing or other financial incentives as a condition to continued participation in the Discover Network. During the past few years, merchants and their trade groups have filed approximately 50 lawsuits against Visa, MasterCard, American Express and their card-issuing banks, claiming that their practices toward merchants, including interchange fees, violate federal antitrust laws. There can be no assurance that they will not in the future bring legal proceedings against other credit card issuers and networks, including us. Merchants also may promote forms of payment with lower fees, such as PIN debit, or seek to impose surcharges at the point of sale for use of credit cards. The heightened focus by merchants on the fees charged by credit card networks, including us, could lead to reduced merchant acceptance of Discover Network cards or reduced fees, either of which could adversely affect our business, financial condition and results of operations.

***Our U.K. operations are currently not profitable, and there can be no assurance when or if they will become profitable.***

Our U.K. operations are an important part of our business strategy, and strengthening these operations is one of our primary goals. However, the U.K. market is currently experiencing high delinquencies and bankruptcy levels, compounded by changing regulations, which have resulted in losses in our U.K. operations. Additionally,

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the United Kingdom has relatively low levels of interchange and fee income and lower net interest margin, which has resulted in and may continue to result in insufficient revenues to compensate for the current levels of loan losses. Our U.K. operations also have a relatively higher cost structure given their smaller scale.

In addition, we recorded significant goodwill on our combined statements of financial condition in connection with our acquisition of Goldfish in 2006. We may in the future be required to write down goodwill associated with this acquisition.

Our strategy to expand our operations in the United Kingdom may also be unsuccessful for several other reasons, including many of those that are applicable to our attempts to expand our business domestically. In addition to the challenging market conditions described above, U.K. and European regulators have recently increased their focus on the credit card industry. There can be no assurance when or if our U.K. operations will become profitable.

***We expect to continue to incur significant expenses in the litigation we are pursuing against Visa and MasterCard, and there can be no assurance that we will ultimately be successful in this action.***

In October 2004, the DOJ prevailed in its antitrust litigation against Visa and MasterCard which challenged their exclusionary practices. Following this ruling, we filed a complaint against Visa and MasterCard seeking substantial damages for the market foreclosure caused by their anticompetitive rules. The trial date is expected to be no later than Fall 2008. We expect to continue to incur substantial legal expenses in the litigation we are pursuing against Visa and MasterCard. Outside counsel and consultant legal expenses for this litigation were approximately \$51 million and \$8 million in 2006 and 2005, respectively, with the year-over-year increase primarily due to discovery-related expenses incurred in 2006. Fact discovery is scheduled to be completed in May 2007, and 2007 expenses associated with this litigation are expected to be slightly lower than 2006 expenses. Furthermore, there can be no assurance that we will be successful in recovering any damages in this action. Upon resolution of the litigation, after expenses, we will be required to pay Morgan Stanley the first \$700 million of value of cash or non-cash proceeds (increased at the rate of 6% per annum until paid in full) (the minimum proceeds), plus 50% of any proceeds in excess of \$1.5 billion, subject to certain limitations and a maximum potential payment to Morgan Stanley of \$1.5 billion. All payments by Discover to Morgan Stanley will be net of taxes payable by Discover with respect to such proceeds. If, in connection with or following a change of control of Discover, the litigation is settled for an amount less than the minimum proceeds, Discover will be required to pay Morgan Stanley an amount equal to the minimum proceeds. As a result of our agreement to pay the value of non-cash proceeds, we may be required to pay amounts to Morgan Stanley in excess of cash received in connection with the litigation. The value of non-cash proceeds will be determined by an independent third party.

***Visa and MasterCard may enact additional restrictions on issuing banks, merchants or merchant acquirers that materially adversely affect the Discover or PULSE Networks, or the Discover Card issuing business.***

Visa and MasterCard aggressively seek to protect their networks from competition and have used their rules and policies to do so. For example, in the past they enacted and enforced rules that prohibited their member banks from issuing cards on competing payment networks such as Discover. These rules were ultimately found to violate the antitrust laws. They have adversely affected our business in the past, and they may have lingering effects going forward. Visa and MasterCard also may enact new rules or enforce other rules in the future, including limiting the ability of issuing banks to use the PULSE Network, which may materially adversely affect our ability to compete.

***If fraudulent activity associated with our cards increases, our brands could suffer reputational damage, the use of our cards could decrease and our fraud losses could be materially adversely affected.***

We are subject to the risk of fraudulent activity associated with merchants, cardmembers and other third parties handling cardmember information. Credit and debit card fraud, identity theft and related crimes are



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prevalent and perpetrators are growing ever more sophisticated. Our financial condition, the level of our fraud charge-offs and other results of operations could be materially adversely affected if fraudulent activity were to significantly increase. In addition, significant increases in fraudulent activity could lead to regulatory intervention (such as mandatory card reissuance) and reputational and financial damage to our brands, which could negatively impact the use of our cards and thereby have a material adverse effect on our business.

***If our security systems, or those of merchants, merchant acquirers or other third parties containing information about cardholders, are compromised, we may be subject to liability and damage to our reputation.***

Our security protection measures, including the security of transaction information processed on our systems or the systems or processing technology of third parties participating in the Discover or PULSE Networks, may not be sufficient to protect the confidentiality of information relating to cardholders or transactions processed on the Discover or PULSE Networks. Cardholder data also is stored on systems of third-party service providers and merchants that may not have adequate security systems. Third-party carriers regularly transport cardholder data, and they may lose sensitive cardholder information. Unauthorized access to the Discover or PULSE Networks or any other Discover information systems potentially could jeopardize the security of confidential information stored in our computer systems or transmitted by our cardmembers or others. If our security systems or those of merchants, processors or other third-party service providers are compromised such that this confidential information is disclosed to unauthorized parties, we may be subject to liability. The preventive measures we take to address these factors are costly, and may become more costly in the future. Moreover, these measures may not protect us from liability, which may not be adequately covered by insurance, or from damage to our reputation.

***The financial services and payment services industries are rapidly evolving, and we may be unsuccessful in introducing new products or services in response to this evolution.***

The financial services and payment services industries experience constant and significant technological changes, such as continuing development of technologies in the areas of smart cards, radio frequency and proximity payment devices, electronic commerce and mobile commerce, among others. The effect of technological changes on our business is unpredictable.

We depend in part on third parties for the development of and access to new technologies. We expect that new services and technologies relating to the payments business will continue to appear in the market, and these new services and technologies may be superior to, or render obsolete, the technologies that we currently use in our card products and services. As a result, our future success is in part dependent on our ability to identify and adapt to technological changes and evolving industry standards and to provide payment solutions for our cardmembers and merchant and financial institution customers.

Difficulties or delays in the development, production, testing and marketing of new products or services may be caused by a number of factors including, among other things, operational, capital and regulatory constraints. The occurrence of such difficulties may affect the success of our products or services, and developing unsuccessful products and services could result in financial losses, as well as decreased capital availability. In addition, the new products and services offered may not be attractive to our cardmembers and merchant and financial institution customers.

***If key technology platforms such as our transaction authorization and settlement systems become obsolete, or if we encounter difficulties processing transactions efficiently or at all, our revenue or results of operations could be materially adversely affected.***

We have a large technology staff utilizing current technology. There is no assurance that we may be able to sustain our investment in new technology to avoid obsolescence of critical systems and applications. Further, our transaction authorization and settlement systems may encounter service interruptions due to system or software failure, fire, natural disasters, power loss, disruptions in long distance or local telecommunications access,

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terrorism or accident. Some of our transaction processing systems are operated at a single facility and could be subject to service interruptions in the event of failure. Our services could be disrupted by a natural disaster or other problem at any of our primary or back-up facilities or our other owned or leased facilities.

We also depend on third-party service providers for the timely transmission of information across our data transportation network and for other telecommunications and technology services, including ancillary transaction processing services for the PULSE Network. Regardless of whether as a result of natural disaster, operational disruption, terrorism, termination of its relationship with us, or any other reason, if a service provider fails to provide the communications capacity or deliver services that we require or expect, the failure could interrupt our services and operations and hamper our ability to process cardholders' transactions in a timely and accurate manner or to maintain thorough and accurate records of those transactions. Such a failure could adversely affect the perception of the reliability of the Discover and PULSE Networks and the quality of our brands, and could materially adversely affect our revenues or results of operations.

### ***Merchant defaults may adversely affect our business, financial condition, cash flows and results of operations.***

As an issuer and merchant acquirer in the United States on the Discover Network, and an issuer in the United Kingdom on the MasterCard and Visa networks, we may be contingently liable for certain disputed credit card sales transactions that arise between cardholders and merchants. If a dispute is resolved in the cardholder's favor, we will cause a credit or refund of the amount to be issued to the cardholder and charge back the transaction to the merchant. If we are unable to collect this amount from the merchant or a third-party acquirer, we will bear the loss for the amount credited or refunded to the cardholder. Where the purchased product or service is not provided until some later date following the purchase, such as an airline ticket, the likelihood of potential liability increases. See Note 20: Commitments, Contingencies and Guarantees to the audited combined financial statements and Note 7: Commitments, Contingencies and Guarantees to the unaudited financial statements.

### ***Our success is dependent, in part, upon our executive officers and other key personnel, and the loss of key personnel could materially adversely affect our business.***

Our success depends, in part, on our executive officers and other key personnel. Our senior management team has significant industry experience and would be difficult to replace. Moreover, our senior management team is relatively small and we believe we are in a critical period of competition in the financial services and payments industry. The market for qualified individuals is highly competitive, and we may not be able to attract and retain qualified personnel or candidates to replace or succeed members of our senior management team or other key personnel. The loss of key personnel could materially adversely affect our business.

### ***We may be unsuccessful in protecting our intellectual property, including our brands.***

The Discover, Goldfish and PULSE brands are very important assets, and our success is dependent on our ability to protect these and our other intellectual property. We may not be able to successfully protect our intellectual property. If others misappropriate, use or otherwise diminish the value of our intellectual property, our business could be adversely affected.

### ***Increased usage by consumers of credit sources such as home equity loans and mortgage refinancings instead of credit card borrowings could adversely affect our business.***

During the last few years, lower interest rates and other factors have led to increased availability to consumers of credit sources such as home equity loans and mortgage refinancings at comparatively attractive interest rates. These and other options for consumer credit compete with our card products as alternative sources for consumer borrowing, as consumers may finance expenditures or refinance account balances with these alternative sources of credit. Increased usage by consumers of such alternative sources of credit could adversely affect our businesses.

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### ***Acquisitions that we pursue could disrupt our business and harm our financial condition.***

We may consider or undertake strategic acquisitions of businesses, products or technologies. If we do so, we may not be able to successfully finance or integrate any such businesses, products or technologies. In addition, the integration of any acquisition may divert management's time and resources from our core business and disrupt our operations. We may allocate resources, such as time and money, on projects that do not increase our earnings. To the extent we pay the purchase price of any acquisition in cash, it would reduce our cash balances; similarly, if the purchase price is paid with our stock, it could be dilutive to our stockholders.

### ***We are subject to regulation by a number of different regulatory agencies, which have broad discretion to require us to alter our operations in ways that could adversely affect our business or subject us to penalties for noncompliance.***

We must comply with an array of banking and consumer lending laws and regulations at the state, federal, U.K. and European levels, and these laws and regulations apply to almost every aspect of our business. We are subject to regulation and regular examinations by the FDIC, the Office of the Delaware State Bank Commissioner and the Financial Services Authority of the United Kingdom ( FSA ). In addition, we are subject to regulation by the Federal Reserve Board, the Federal Trade Commission, state banking regulators, U.S. Department of Justice and European regulators, as well as the Securities and Exchange Commission and New York Stock Exchange in our capacity as a public company. From time to time, these regulations and regulatory agencies have required us to alter certain of our operating practices, and may require us to do the same in the future. Our ability to introduce new products may be impaired or delayed as a result of regulatory review or failure to obtain required regulatory approvals. We conduct our business primarily through our banks, and various federal, state and European regulators have broad discretion to impose restrictions on our operations. U.S. federal and state consumer protection laws and rules, and laws and rules of foreign jurisdictions where we conduct business limit the manner and terms on which we may offer and extend credit. Failure to comply with these laws and regulations could lead to adverse consequences such as financial, structural, reputational and operational penalties, including receivership and litigation exposure and fines. In addition, efforts to abide by these laws and regulations may increase our costs of operations or limit our ability to engage in certain business activities, including affecting our ability to generate or collect receivables from cardmembers.

### ***Changes in regulations, or the application thereof, may adversely affect our business, financial condition and results of operations.***

Periodically, regulatory authorities may enact new laws or amend existing laws to further regulate the industries in which we operate. Such new laws or rules could impose limits on the amount of interest or fees we can charge, curtail our ability to collect on account balances, increase compliance costs or materially affect us or the credit card industry in some other manner. For instance, in the past we have been obligated by industry-wide regulatory guidance to change our re-age policy to alter the terms under which delinquent accounts are returned to a current status, which negatively affected our charge-off and delinquency rates. Also, in response to industry-wide regulatory guidance, we increased minimum payment requirements on certain credit card loans and modified our overlimit fee policies and procedures to stop charging such fees for accounts meeting specific criteria, which have impacted, and we believe will continue to negatively impact, balances of credit card loans and related interest and fee revenue and charge-offs. We cannot predict whether any additional or similar regulatory changes will occur in the future.

Congress is considering legislation to restrict certain practices in the credit card industry, including those relating to grace periods, two-cycle billing method (which we utilize on most of our products), risk-based penalty pricing, interest rates, use of arbitration agreements and fees. It is not clear at this time whether new limitations on credit card practices will be adopted by Congress or at the state level and, if adopted, what impact such new limitations would have on us. In addition, the laws governing bankruptcy and debtor relief in the United States, the United Kingdom or other countries where we have cardmembers, could also change, making it more expensive or more difficult for us to collect from our cardmembers. Also, Congress may move to regulate

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holding companies that own depository institutions, such as us, which could result in additional complexity and expense. Congress is also considering granting the FDIC rulemaking authority under unfair and deceptive practices laws. Furthermore, various federal and state agencies and standard-setting bodies may, from time to time, enact new or amend existing accounting rules or standards that could impact our business practices or funding transactions.

Regulation of the credit card industry, including regulation applicable to Discover Card and merchants that accept it, has expanded significantly in recent years. For instance, financial institutions, including us, were required to implement an enhanced anti-money laundering program in 2002 pursuant to the USA PATRIOT Act. Various U.S. federal and state regulatory agencies and state legislatures are considering new legislation or regulations relating to the use of credit cards to purchase online prescription drugs and to finance Internet gambling, patent reform, identity theft, account maintenance guidelines, privacy, disclosure rules, data security and marketing that could have a direct effect on us and our merchant and financial institution customers.

In the United Kingdom, during the last three years there have been increasing regulatory initiatives with respect to late and overlimit fees, interchange fees and the sale of retail insurance products, a relaxation of bankruptcy laws and an increase in industry-wide consumer protection measures. We expect that these initiatives and measures will continue to increase our compliance costs and the risk of consumer complaints, litigation and regulatory inquiries, as well as materially adversely affect the economics of our business.

***Current and proposed regulation addressing consumer privacy and data use and security could inhibit the number of payment cards issued and increase our costs.***

Regulatory pronouncements relating to consumer privacy, data use and security affect our business. In the United States, we are subject to the Federal Trade Commission's and the banking regulators' information safeguard rules under the Gramm-Leach-Bliley Act. The rules require that financial institutions (including us) develop, implement and maintain a written, comprehensive information security program containing safeguards that are appropriate to the financial institution's size and complexity, the nature and scope of the financial institution's activities, and the sensitivity of any customer information at issue. Both the United States and the United Kingdom have experienced a heightened legislative and regulatory focus on data security, including, in the United States, requiring consumer notification in the event of a data breach. In the United States, there are a number of bills pending in Congress and in individual states, and there have been numerous legislative hearings focusing on these issues. In addition, a number of states have enacted security breach legislation requiring varying levels of consumer notification in the event of certain types of security breaches, and several other states are considering similar legislation. In the United Kingdom, there are detailed regulations on data privacy under the European Commission Data Protection Directive (Directive 95/46/EC) and the U.K. Data Protection Act of 1998, which are enforced by the Information Commissioner, the United Kingdom's privacy regulator.

Regulation of privacy, data use and security may cause an increase in the costs to issue payment cards and/or may decrease the number of our cards that we or third parties issue. New regulations in these areas may also increase our costs to comply with such regulations, which could materially adversely affect our earnings. In addition, failure to comply with the privacy and data use and security laws and regulations to which we are subject, including by reason of inadvertent disclosure of confidential information, could result in fines, sanctions, penalties or other adverse consequences and loss of consumer confidence, which could materially adversely affect our results of operations, overall business and reputation.

***Legislation or regulation could be enacted requiring us to hold higher levels of capital, which we may not be able to obtain and which would reduce our return on capital.***

Discover Bank and Bank of New Castle are subject to capital, funding and liquidity requirements prescribed by statutes, regulation and orders. If new legislation or regulations are enacted that increase the levels of regulatory capital that are required, we may be required to obtain additional capital. In addition, regulators have broad discretion to impose additional capital and other requirements on us, including imposing restrictions on the

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ability of our regulated subsidiaries to pay dividends. Our ability to obtain additional capital would be dependent upon, among other things, general economic conditions, our financial performance and prospects, and our ability and willingness to make capital contributions to Discover Bank and Bank of New Castle. If we were required to increase capital for Discover Bank or Bank of New Castle, it would have the effect of reducing our return on capital. In addition, if Discover Bank and Bank of New Castle were to fail to meet these regulatory capital requirements, it would become subject to restrictions that could materially adversely affect our ability to conduct normal operations.

***Litigation and regulatory actions could subject us to significant fines, penalties and/or requirements resulting in increased expenses.***

Businesses in the credit card industry have historically been subject to various significant legal actions, including class action lawsuits and patent claims. Many of these actions have included claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. While we have historically relied on our arbitration clause in agreements with cardmembers, which has limited our exposure to consumer class action litigation, there can be no assurance that we will continue to be successful in enforcing our arbitration clause in the future or that we will not be subject to significant legal actions such as those to which some of our competitors have been subject. In addition, we may be involved in various actions or proceedings brought by governmental regulatory agencies in the event of noncompliance with laws or regulations, which could subject us to significant fines, penalties and/or requirements resulting in increased expenses.

### **Risks Related to the Spin-Off**

***Our cost of funding increased after our separation from Morgan Stanley, and our liquidity may decrease.***

While Morgan Stanley provided a significant portion of our funding in recent years, it no longer provides any funding following our spin-off. We have lower credit ratings and more constrained liquidity than our former parent company, Morgan Stanley. Although our debt is currently rated investment grade, a credit ratings downgrade to below investment grade would reduce our investor base and increase our cost of funding. Our liquidity may also decrease, and we may be less able to withstand a liquidity stress event. We may also face additional challenges in the future, including more limited capital resources to invest in or expand our businesses.

***Our historical financial results are as a business segment of Morgan Stanley and therefore may not be representative of our results as a separate, stand-alone company.***

The historical financial information we have included in this prospectus has been derived from Morgan Stanley's consolidated financial statements and does not necessarily reflect what our financial condition, results of operations or cash flows would have been had we operated as a separate, stand-alone company during the periods presented. The historical costs and expenses reflected in our audited combined financial statements include an allocation for certain corporate functions historically provided by Morgan Stanley, including general corporate expenses, employee benefits and incentives. These allocations were based on what we and Morgan Stanley considered to be reasonable reflections of the historical utilization levels of these services required in support of our business. The historical information does not necessarily indicate what our results of operations, financial condition, cash flows or costs and expenses will be in the future. Our pro forma adjustments reflect changes that may occur in our funding and operations as a result of the separation. However, we cannot assure you that these adjustments will reflect our costs as a publicly traded, stand-alone company. For additional information, see Management's Discussion and Analysis of Financial Condition and Results of Operations, Selected Historical Combined and Condensed Consolidated Financial Data, Unaudited Pro Forma Condensed Combined Statements of Income and the notes to those statements included elsewhere in this prospectus.

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*The obligations associated with being a public company require significant resources and management attention.*

In connection with our recent separation from Morgan Stanley, we have become subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), and the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act). The Exchange Act requires that we file annual, quarterly and current reports with respect to our business and financial condition. The Sarbanes-Oxley Act requires, among other things, that we establish and maintain effective internal controls and procedures for financial reporting. All of the procedures and practices required of us as a subsidiary of Morgan Stanley were established prior to the spin-off, but we have additional procedures and practices required of us as a separate, stand-alone public company. As a result, we have incurred and will continue to incur significant legal, accounting and other expenses that we did not previously incur. Furthermore, the corporate infrastructure and other resources required to operate as a public company may divert management's attention from implementing our growth strategy, which could prevent us from improving our business, results of operations and financial condition. We have made, and will continue to make, changes to our internal controls and procedures for financial reporting and accounting systems to meet our reporting obligations. We cannot predict or estimate the amount of additional costs we may incur in order to comply with these requirements.

Section 404 of the Sarbanes-Oxley Act requires annual management assessments of the effectiveness of our internal control over financial reporting, starting with the second annual report that we file with the SEC. In connection with the implementation of the necessary procedures and practices related to internal controls over financial reporting, we may identify deficiencies that we may not be able to remediate in time to meet the deadline imposed by the Sarbanes-Oxley Act for compliance with the requirements of Section 404. We will be unable to issue securities in the public markets through the use of a shelf registration statement if we are not in compliance with Section 404. In addition, failure to achieve and maintain an effective internal control environment could have a material adverse effect on our business and stock price.

*As a result of our separation from Morgan Stanley we may experience increased costs resulting from a decrease in the purchasing power and other operational efficiencies we previously had due to our association with Morgan Stanley.*

Prior to our separation from Morgan Stanley, we were able to take advantage of Morgan Stanley's purchasing power in procuring goods, technology and services, including insurance, employee benefit support and audit services. As a smaller separate, stand-alone company, we may be unable to obtain goods, technology and services at prices and on terms as favorable as those available to us prior to the separation, which could have a material adverse effect on our business, financial condition, cash flows and results of operations. Our tax liability may also increase due to increased state income taxes in the jurisdictions where combined filings were previously made with Morgan Stanley.

*In connection with our separation from Morgan Stanley, we have assumed past, present and future liabilities related to our business, and have entered into agreements relating to the ongoing provision of services and other matters which may be on terms less favorable to us than if they had been negotiated with another party.*

Pursuant to certain agreements we entered into with Morgan Stanley in connection with the spin-off, we have agreed to indemnify Morgan Stanley for, among other matters, past, present and future liabilities related to our business. Such liabilities include unknown liabilities, which could be significant.

We entered into these agreements and other agreements relating to the ongoing provision of services and other matters with Morgan Stanley while still a wholly-owned subsidiary of Morgan Stanley. Accordingly, the terms of those agreements may not reflect those that would have been reached with another party. If these agreements were to have been entered into with another party, we may have obtained more favorable terms than under these agreements.

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***We must abide by certain restrictions to preserve the tax treatment of the distribution of our common stock by Morgan Stanley and we must indemnify Morgan Stanley for taxes resulting from certain actions we take that cause the distribution to fail to qualify as a tax-free transaction.***

Morgan Stanley has received a ruling from the Internal Revenue Service that, based on customary representations and qualifications, the distribution of our common stock by Morgan Stanley was tax-free to Morgan Stanley stockholders for U.S. federal income tax purposes. These representations include representations as to the satisfaction of certain requirements that must be met in order for the distribution to qualify for tax-free treatment under the Internal Revenue Code of 1986, as amended (the Code), and state law. If any of the representations and assumptions upon which the ruling is based is untrue or incomplete in any material respect, Morgan Stanley may not be able to rely upon the ruling.

If the distribution were not to qualify for tax-free treatment under sections 355, 368 and related provisions of the Code, Morgan Stanley would recognize taxable gain equal to the excess of the fair market value of our stock over Morgan Stanley's tax basis in our stock. Under certain circumstances, we would be required under the U.S. tax sharing agreement entered into between Morgan Stanley and us to indemnify Morgan Stanley for all or a portion of this liability. In addition, each holder who received our common stock in the distribution would be treated as receiving a taxable distribution in an amount equal to the fair market value of our common stock received.

Even if the distribution otherwise qualifies as a tax-free distribution under the Code, current tax law generally creates a presumption that the distribution would be taxable to Morgan Stanley (but not to its stockholders) if we engage in, or enter into an agreement to engage in, a transaction that would result in a 50% or greater change, by vote or by value, in our stock ownership during the four-year period beginning on the date that begins two years before the distribution date, unless it is established that the transaction is not pursuant to a plan or series of transactions related to the distribution. Treasury regulations currently in effect generally provide that whether an acquisition transaction and a distribution are part of a plan is determined based on all of the facts and circumstances including, but not limited to, specific factors listed in the regulations. In addition, the regulations provide several safe harbors for acquisition transactions that are not considered to be part of a plan.

Under the U.S. tax sharing agreement entered into between Morgan Stanley and us, for a period of two years following the distribution, generally we may not take certain actions unless Morgan Stanley provides us with prior written consent for such action, or we provide Morgan Stanley with a tax ruling or rulings, or an unqualified opinion of counsel, in each case acceptable to Morgan Stanley, to the effect that the action will not affect the tax-free nature of the separation and distribution, but we will remain liable for any taxes and other liabilities imposed as a result of the separation and distribution failing to qualify as a tax-free transaction, as a result of such action. These restrictions may prevent us from entering into strategic or other transactions which might be advantageous to us or to our stockholders, such as issuing equity securities to satisfy our financing needs, acquiring businesses or assets by issuing equity securities, or mergers or other business combinations. For additional information, see Arrangements Between Us and Morgan Stanley Tax Sharing Agreements.

***Our ability to operate our business effectively may suffer if we do not, quickly and cost effectively, establish our own financial, administrative and other support functions to operate as a stand-alone company.***

Historically, we have relied on certain financial, administrative and other resources of Morgan Stanley to operate our business. In conjunction with our separation from Morgan Stanley, we have enhanced and will need to continue to enhance our own financial, administrative and other support systems or contract with third parties to replace Morgan Stanley's systems. We will also need to continue to establish our own accounting and auditing policies and systems on a stand-alone basis.

Prior to our spin-off, Morgan Stanley performed many important corporate functions for our operations, including portions of human resources, information technology, accounting, office space leasing, corporate

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services and treasury. We estimate the annual costs associated with replacing these functions and establishing our own infrastructure related thereto, to be approximately \$60 million. See Unaudited Pro Forma Condensed Combined Statements of Income. Prior to the spin-off, we entered into agreements with Morgan Stanley under which Morgan Stanley will provide some of these services to us on a transitional basis, for which we will pay Morgan Stanley. See Arrangements Between Us and Morgan Stanley for a description of these arrangements. Upon the occurrence of certain events, including a change of control, Morgan Stanley may terminate these services. These services may not be sufficient to meet our needs and, after these agreements with Morgan Stanley expire or are terminated, we may not be able to replace these services at all or obtain these services at acceptable prices and terms. Any failure or significant downturn in our own financial or administrative policies and systems or in Morgan Stanley's financial or administrative policies and systems during the transitional period could impact our results and could materially harm our business, financial condition and results of operations.

In the United Kingdom, prior to our separation from Morgan Stanley, we shared a brand and bank charter with Morgan Stanley, and our primary card brand was Morgan Stanley. From the date of the spin-off, we have a limited right to use the Morgan Stanley brand for three years, following which we will not be able to use this brand. We expect our primary brand in the United Kingdom will be Goldfish, and we will also utilize other brands. Transitioning to a new brand will result in increased marketing and transitional costs and may result in customer attrition.

### **Risks Related to the Exchange Offer**

#### ***Failure to exchange your old notes will leave them subject to transfer restrictions.***

Any old notes that remain outstanding after this exchange offer will continue to be subject to restrictions on their transfer. After this exchange offer, holders of old notes will not have any further rights under the registration rights agreement that applies to their notes, with limited exceptions. In general, old notes may not be offered or sold unless registered under the Securities Act, except pursuant to an exemption from, or in a transaction not subject to, the Securities Act and applicable state securities laws. We currently do not anticipate registering the old notes under the Securities Act. As old notes are tendered and accepted in the exchange offer, the aggregate principal amount of old notes will decrease, which will decrease their liquidity. Any market for old notes that are not exchanged could be adversely affected by the conclusion of this exchange offer.

#### ***Late deliveries of the old notes and other required documents could prevent a holder from exchanging its notes.***

Holders are responsible for complying with all exchange offer procedures. Issuance of exchange notes in exchange for old notes will only occur upon completion of the procedures described in this prospectus under the heading The Exchange Offer Procedures for Tendering Old Notes. Therefore, holders of old notes who wish to exchange them for exchange notes should allow sufficient time for completion of the exchange procedures. We are not obligated to notify you of any failure to follow the proper procedures.

#### ***If you are a broker-dealer, your ability to transfer the exchange notes may be restricted.***

A broker-dealer that purchased old notes for its own account as part of market making or trading activities must deliver a prospectus when it sells the exchange notes. Our obligation to make this prospectus available to broker-dealers is limited. Consequently, we cannot guarantee that a proper prospectus will be available to broker-dealers wishing to resell their exchange notes.



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### **Risks Related to the Exchange Notes**

***We are a holding company that conducts all of our business through subsidiaries. The debt and other liabilities of our subsidiaries will be effectively senior to the exchange notes.***

We conduct all of our business through our subsidiaries. Our cash flow and, consequently, our ability to pay interest in cash and to service our debt, including the exchange notes, are dependent to a certain extent upon the cash flow of our subsidiaries and the payment of funds to us by those subsidiaries in the form of loans, dividends or otherwise. Our subsidiaries are separate and distinct legal entities and have no obligation, contingent or otherwise, to pay any amounts due on the exchange notes or to make cash available for that purpose. In addition, many of our operating subsidiaries are highly regulated and may be subject to restrictions on their ability to pay dividends to us. These subsidiaries may use the earnings they generate, as well as their existing assets, to fulfill their own direct debt service requirements.

The exchange notes will be our senior unsecured obligations and will rank equally with all of our existing and future senior unsecured indebtedness. To the extent that any of our subsidiaries have outstanding indebtedness, the exchange notes will effectively rank junior to such indebtedness and other liabilities, including deposits. See [Description of the Exchange Notes](#) [Ranking](#).

***There are no covenants in the indentures governing the exchange notes relating to our ability to incur future indebtedness or pay dividends and limited restrictions on our ability to engage in other activities, which could adversely affect our ability to pay our obligations under the exchange notes.***

The indenture governing the exchange notes does not contain any financial covenants. The indenture permits us and our subsidiaries to incur additional debt, including secured debt. Because the exchange notes will be unsecured, in the event of any liquidation, dissolution, reorganization, bankruptcy or other similar proceeding regarding us, whether voluntary or involuntary, the holders of our secured debt will be entitled to receive payment to the extent of the assets securing that debt before we can make any payment with respect to the exchange notes. If any of the foregoing events occurs, we cannot assure you that we will have sufficient assets to pay amounts due on our debt and the exchange notes. As a result, you may receive less than you are entitled to receive or recover nothing if any liquidation, dissolution, reorganization, bankruptcy or other similar proceeding occurs.

The indenture will not limit our subsidiaries' ability to issue or repurchase securities, pay dividends or engage in transactions with affiliates. Our ability to use our funds for numerous purposes may limit the funds available to pay our obligations under the exchange notes.

***There may not be a public market for the exchange notes.***

The exchange notes constitute a new issue of securities with no established trading market. We do not intend to list the exchange notes on any securities exchange or to include the exchange notes in any automated quotation system. Accordingly, no market for the exchange notes may develop, and any market that develops may not last. If the exchange notes are traded, they may trade at a discount from their initial offering price, depending on prevailing interest rates, the market for similar securities, our performance and other factors. To the extent that an active trading market does not develop, you may not be able to resell your exchange notes at their fair market value or at all.

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**FORWARD-LOOKING STATEMENTS**

This prospectus and materials we have filed or will file with the Securities and Exchange Commission (the "SEC") (as well as information included in our other written or oral statements) contain or will contain certain statements that are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Actual outcomes and results may differ materially from those expressed in, or implied by, our forward-looking statements. Words such as "expects," "anticipates," "believes," "estimates" and other similar expressions or future or conditional verbs such as "will," "should," "would" and "could" are intended to identify such forward-looking statements. You should not rely solely on the forward-looking statements and should consider all uncertainties and risks throughout this prospectus, including those described under "Risk Factors." The statements are only as of the date they are made, and we undertake no obligation to update any forward-looking statement.

Possible events or factors that could cause results or performance to differ materially from those expressed in our forward-looking statements include the following:

the actions and initiatives of current and potential competitors;

our ability to manage credit risks and securitize our receivables at acceptable rates;

changes in economic variables, such as the number and size of personal bankruptcy filings, the rate of unemployment and the levels of consumer confidence and consumer debt;

the level and volatility of equity prices, commodity prices and interest rates, currency values, investments and other market indices;

the availability and cost of funding and capital;

access to U.S. or U.K. debt markets;

the ability to increase or sustain Discover Card usage or attract new cardmembers and introduce new products or services;

our ability to attract new merchants and maintain relationships with current merchants;

material security breaches of key systems;

unforeseen and catastrophic events;

our reputation;

the potential effects of technological changes;

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the effect of political, economic and market conditions and geopolitical events;

unanticipated developments relating to lawsuits, investigations or similar matters;

the impact of current, pending and future legislation, regulation and regulatory and legal actions;

our ability to attract and retain employees;

the ability to protect our intellectual property;

the impact of our separation from Morgan Stanley;

the impact of any potential future acquisitions;

investor sentiment; and

the restrictions on our operations resulting from indebtedness incurred during our separation from Morgan Stanley.

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The foregoing review of important factors should not be construed as exclusive and should be read in conjunction with the other cautionary statements that are included in this prospectus. These factors expressly qualify all subsequent oral and written forward-looking statements attributable to us or persons acting on our behalf. Except for any ongoing obligations to disclose material information as required under U.S. federal securities laws, we do not have any intention or obligation to update forward-looking statements after we distribute this prospectus, whether as a result of new information, future developments or otherwise.

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**THE EXCHANGE OFFER**

*We are commencing two separate exchange offers with respect to each series of old notes. We refer to these exchange offers, collectively, as the exchange offer in this prospectus. When we refer to exchanging old notes for exchange notes, we mean exchanging old notes of an applicable series for exchange notes of a corresponding series. The following is a summary of the exchange offer relating to the old notes. As a summary, this section does not contain all of the information you might find useful. For further information, you should read the registration rights agreement with the initial purchasers of the old notes and the form of letter of transmittal, copies of which have been filed as exhibits to the registration statement of which this prospectus forms a part.*

**Purpose and Effect of This Exchange Offer**

In connection with the sale of the old notes, we entered into a registration rights agreement with the initial purchasers of the old notes in which we agreed to file a registration statement relating to an offer to exchange the old notes for the exchange notes. The registration statement of which this prospectus forms a part was filed in compliance with this obligation. We also agreed to use our reasonable best efforts to cause such offer to be consummated within 360 calendar days following the issuance of the applicable series of old notes. The exchange notes will have terms substantially identical to the old notes except that the exchange notes will not contain terms with respect to transfer restrictions, registration rights and additional interest payable for the failure to have the registration statement of which this prospectus forms a part declared effective within 330 calendar days after the issuance of the applicable series of old notes or this exchange offer consummated within 360 calendar days after the issuance of the applicable series of old notes.

Each holder of old notes that wishes to exchange old notes in this exchange offer will be required to make the representations discussed below under Procedures for Tendering Old Notes.

If: (i) because of any change in law or in currently prevailing interpretations of the SEC staff, we are not permitted to effect the exchange offer with respect to a series of notes, (ii) the exchange offer with respect to a series of notes is not consummated within 360 calendar days of the date of issuance of the old notes, (iii) in the case of any holder of any series of notes that participates in the exchange offer, such holder does not receive exchange notes of such series on the date of the exchange that may be sold without restriction under state and federal securities laws (other than due solely to the status of such holder as an affiliate of ours within the meaning of the Securities Act or as a broker-dealer), or (iv) we so elect, then in each case we will (1) promptly deliver to the holders written notice thereof and (2) at our sole expense, (a) file, as promptly as practicable (but in no event more than 45 days after so required pursuant to the registration rights agreement), a shelf registration statement covering resales of such notes, (b) use our reasonable best efforts to cause the shelf registration statement to be declared effective under the Securities Act and (c) use our reasonable best efforts to keep effective the shelf registration statement until the earlier of two years (or, if Rule 144(k) is amended to provide a shorter restrictive period, such shorter period) after the date of the issuance of the old notes or such time as all of the applicable notes have been sold thereunder. We will, if a shelf registration statement is filed with respect to one or more series of notes, provide to each holder of such notes copies of the prospectus that is a part of the shelf registration statement, notify each such holder of such notes when the shelf registration statement for such notes has become effective and take certain other actions as are required to permit unrestricted resales of such notes. A holder that sells notes pursuant to the shelf registration statement will be required to be named as a selling security holder in the related prospectus, to provide information related thereto and to deliver such prospectus to purchasers, will be subject to certain of the civil liability provisions under the Securities Act in connection with such sales and will be bound by the provisions of the registration rights agreement that are applicable to such a holder (including certain indemnification rights and obligations). We will not have any obligation to include in the shelf registration statement holders who do not deliver such information to us.

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### **Resale of Exchange Notes**

Based on existing interpretations of the Securities Act by the SEC staff set forth in several no-action letters to third parties, and subject to the immediately following sentence, we believe that exchange notes issued under this exchange offer in exchange for old notes may be offered for resale, resold and otherwise transferred by the holders thereof (other than holders who are broker-dealers) without further compliance with the registration and prospectus delivery provisions of the Securities Act provided that such exchange notes are acquired in the ordinary course of such holder's business and such holder has no arrangement with any person to participate in a distribution of such exchange notes. However, any purchaser of old notes who is an affiliate of ours or who has an arrangement or understanding with any person to participate in a distribution of the exchange notes, or any broker-dealer who purchased the old notes from us for resale pursuant to Rule 144A or any other available exemption under the Securities Act, (i) will not be able to rely on the interpretations of the SEC staff set forth in the above-mentioned no-action letters, (ii) will not be entitled to tender its old notes in the exchange offer, and (iii) must comply with the registration and prospectus delivery requirements of the Securities Act in connection with any sale or transfer of the old notes unless such sale or transfer is made pursuant to an exemption from such requirements. We do not intend to seek our own no-action letter, and there can be no assurance that the SEC staff would make a similar determination with respect to the exchange notes as it has in such no-action letters to third parties.

This prospectus may be used for an offer to resell, for the resale or for other retransfer of exchange notes only as specifically set forth in this prospectus. With regard to broker-dealers, in connection with any resale of the exchange notes, any broker-dealer who acquired the exchange notes for its own account as a result of market-making or other trading activities (a Participating Broker-Dealer) must deliver a prospectus meeting the requirements of the Securities Act. The SEC has taken the position that Participating Broker-Dealers may fulfill their prospectus delivery requirements with respect to the exchange notes, other than a resale of an unsold allotment from the original sale thereof, with the prospectus contained in the exchange offer registration statement. Under the registration rights agreement, to the extent required by the applicable rules of the SEC, we will make this prospectus and any amendment or supplement thereto available to any broker-dealer for use in connection with any resale of any exchange notes for a period of not less than 90 calendar days after the consummation of the exchange offer. Please see Plan of Distribution for more details regarding these procedures for the transfer of exchange notes.

### **Terms of this Exchange Offer**

Upon the terms and subject to the conditions set forth in this prospectus and in the letter of transmittal, we will accept for exchange any old notes properly tendered and not properly withdrawn prior to the expiration date, as defined below. We will issue a like principal amount of exchange notes in exchange for the principal amount of old notes surrendered under this exchange offer. The exchange notes will bear interest from the most recent date to which interest has been paid on the old notes, or if no interest has been paid, from the issue date of the applicable series of old notes. Accordingly, registered holders of exchange notes on the relevant record date for the first interest payment date following the completion of the exchange offer will receive interest accruing from the most recent date to which interest has been paid or, if no interest has been paid, from the issue date of the old notes. Old notes accepted for exchange will cease to accrue interest from and after the date of completion of the exchange offer. Accordingly, holders whose old notes are accepted for exchange will not receive any payment in respect of accrued interest on such old notes otherwise payable on any interest payment date the record date for which occurs on or after completion of the exchange offer. Old notes may be exchanged only in denominations of principal amount of \$2,000 and integral multiples of \$1,000 in excess thereof.

The form and terms of the exchange notes will be substantially identical to the form and terms of the old notes except the exchange notes will be registered under the Securities Act, will not bear legends restricting their transfer, will not be subject to the registration rights relating to the old notes and will not provide for any additional interest upon our failure to fulfill our obligations under the registration rights agreement to file, and

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cause to be effective, a registration statement. The exchange notes will evidence the same debt as the old notes. The exchange notes will be issued under and entitled to the benefits of the same indenture that authorized the issuance of the old notes. Consequently, both series will be treated as a single class of debt securities under the applicable indenture.

This exchange offer is not conditioned upon any minimum aggregate principal amount of old notes being tendered for exchange.

This prospectus and the letter of transmittal are being sent to all registered holders of old notes. There will be no fixed record date for determining registered holders of old notes entitled to participate in this exchange offer.

We intend to conduct this exchange offer in accordance with the provisions of the registration rights agreement, the applicable requirements of the Securities Act and the Securities Exchange Act of 1934, as amended, referred to as the Exchange Act, and the rules and regulations of the SEC. Old notes that are not tendered for exchange in this exchange offer will remain outstanding and continue to accrue interest and will be entitled to the rights and benefits such holders have under the indenture relating to the old notes but will not retain any rights under the registration rights agreement except as specified therein.

We will be deemed to have accepted for exchange properly tendered old notes when we have given oral or written notice of the acceptance to the exchange agent. The exchange agent will act as agent for the tendering holders for the purposes of receiving the exchange notes from us and delivering exchange notes to such holders.

Subject to the terms of the registration rights agreement, we expressly reserve the right to amend or terminate this exchange offer because of any change in law or in currently prevailing interpretations of the SEC staff, which prevents us from effecting the exchange offer with respect to a series of notes. See Certain Conditions to This Exchange Offer.

### **Expiration Date; Extensions; Amendments**

This exchange offer will expire at \_\_\_\_\_, New York City time on \_\_\_\_\_, \_\_\_\_\_, which we refer to as the expiration date, unless, in our sole discretion, we extend it. As soon as practicable after the close of the exchange offer, we will accept for exchange all outstanding old notes properly tendered and not validly withdrawn prior to \_\_\_\_\_, New York City time, on the expiration date in accordance with the terms of this prospectus and the letter of transmittal.

In order to extend this exchange offer, we will notify the exchange agent in writing of any extension of the expiration date. We will notify each registered holder of old notes by making a public announcement or by press release of any extension no later than \_\_\_\_\_, New York City time, on the business day after the previously scheduled expiration date.

We reserve the right, in our sole discretion:

to delay accepting for exchange any old notes;

to extend this exchange offer;

to terminate this exchange offer because of any change in law or in currently prevailing interpretations of the SEC staff which prevents us from effecting the exchange offer with respect to a series of notes; or

subject to the terms of the registration rights agreement, to amend the terms of this exchange offer in any manner.

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We will promptly notify the exchange agent and the registered holders of the old notes of any delay in acceptance, extension, termination or amendment by written notice or by public announcement. During any extension, all old notes previously tendered will remain subject to this exchange offer, and we may accept them for exchange unless they have been previously withdrawn. We will return any old notes that we do not accept for exchange for any reason without expense to their tendering holder promptly after the expiration or termination of this exchange offer.

If we amend this exchange offer in a manner that we determine to constitute a material change, including the waiver of a material condition, we will promptly disclose such amendment in a manner reasonably calculated to inform the holders of old notes of such amendment and will extend this exchange offer to the extent required by law, if necessary. Generally we must keep this exchange offer open for at least five business days after a material change.

Without limiting the manner in which we may choose to make public announcements of any delay in acceptance, extension, termination or amendment of this exchange offer, we shall have no obligation to publish, advertise, or otherwise communicate any such public announcement, other than by issuing a timely press release to a financial news service.

### **Certain Conditions to This Exchange Offer**

Despite any other term of this exchange offer, we will not be required to accept for exchange, or exchange any exchange notes for, any old notes, and we may terminate or amend this exchange offer as provided in this prospectus before accepting any old notes for exchange if this exchange offer, or the making of any exchange by a holder of old notes, would violate applicable law or any applicable interpretation of the SEC staff. This condition is for our sole benefit and may be asserted by us regardless of the circumstances giving rise to it. Our failure at any time to exercise the foregoing right shall not be deemed a waiver of such right, and such right shall be deemed an ongoing right that may be asserted at any time and from time to time.

In addition, we will not accept for exchange any old notes tendered, and will not issue exchange notes in exchange for any such old notes, if at such time any stop order will be threatened or in effect with respect to the registration statement of which this prospectus is a part or the qualification of the applicable indenture under the Trust Indenture Act of 1939, as amended.

### **Procedures for Tendering Old Notes**

Only a holder of old notes may tender such old notes in this exchange offer. To tender in this exchange offer, a holder must:

complete, sign and date the letter of transmittal, or a copy of the letter of transmittal; have the signature on the letter of transmittal guaranteed if the letter of transmittal so requires; and mail or deliver such letter of transmittal or copy to the exchange agent prior to the expiration date; or

comply with DTC's Automated Tender Offer Program procedures described below.

In addition, either:

the exchange agent must receive the tendering holder's old notes along with the letter of transmittal;

the exchange agent must receive, prior to the expiration date, a timely confirmation of book-entry transfer of such old notes into the exchange agent's account at DTC according to the procedures for book-entry transfer described below or a properly transmitted agent's message (as defined below); or

the holder must comply with the guaranteed delivery procedures described below.





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To be tendered effectively, the exchange agent must receive any physical delivery of the letter of transmittal and other required documents at the appropriate address set forth below under "Exchange Agent" prior to the expiration date.

The tender by a holder that is not withdrawn prior to the expiration date will constitute an agreement between such holder and us in accordance with the terms and subject to the conditions set forth in this prospectus and in the letter of transmittal.

The method of delivery of old notes, the letter of transmittal and all other required documents to the exchange agent is at the holder's election and risk. Rather than mail these items, we recommend that holders use an overnight or hand delivery service. In all cases, holders should allow sufficient time to assure delivery to the exchange agent before the expiration date. Holders should not send us the letter of transmittal or old notes. Holders may request their respective brokers, dealers, commercial banks, trust companies or other nominees to effect the above transactions for them.

Any beneficial owner whose old notes are registered in the name of a broker, dealer, commercial bank, trust company or other nominee and who wishes to tender should contact the registered holder promptly and instruct it to tender on such beneficial owner's behalf. If such beneficial owner wishes to tender on its own behalf, it must, prior to completing and executing the letter of transmittal and delivering its old notes, either:

make appropriate arrangements to register ownership of the old notes in such beneficial owner's name; or

obtain a properly completed bond power from the registered holder of the old notes.

The transfer of registered ownership may take considerable time and may not be completed prior to the expiration date.

Signatures on a letter of transmittal or a notice of withdrawal described below must be guaranteed by a member firm of a registered national securities exchange or of the National Association of Securities Dealers, Inc., a commercial bank or trust company having an office or correspondent in the United States or another eligible institution within the meaning of Rule 17Ad-15 under the Exchange Act (each referred to as an eligible institution), unless the old notes tendered pursuant thereto are tendered:

by a registered holder who has not completed the box entitled "Special Issuance Instructions" or "Special Delivery Instructions" on the letter of transmittal; or

for the account of an eligible institution.

If the letter of transmittal with respect to any old notes is signed by a person other than the registered holder of such old notes, such old notes must be endorsed or accompanied by a properly completed bond power. The bond power must be properly signed by the registered holder and an eligible institution must guarantee the signature on the bond power.

If the letter of transmittal or any old notes or bond powers are signed by trustees, executors, administrators, guardians, attorneys-in-fact, officers of corporations or others acting in a fiduciary or representative capacity, such persons should so indicate when signing. Unless waived by us, they should also submit evidence satisfactory to us of their authority to deliver the letter of transmittal.

The exchange agent and DTC have confirmed that any financial institution that is a participant in DTC's system may use DTC's Automated Tender Offer Program to tender. Participants in the program may, instead of physically completing and signing the letter of transmittal and delivering it to the exchange agent, transmit their acceptance of this exchange offer electronically. They may do so by causing DTC to transfer the old notes to the exchange agent in accordance with its procedures for transfer. DTC will then send an agent's message to the

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exchange agent. The term "agent's message" means a message transmitted by DTC, received by the exchange agent and forming part of the book-entry confirmation, to the effect that:

DTC has received an express acknowledgment from a participant in its Automated Tender Offer Program that is tendering old notes that are the subject of such book-entry confirmation;

such participant has received and agrees to be bound by the terms of the letter of transmittal (or, in the case of an agent's message relating to guaranteed delivery, that such participant has received and agrees to be bound by the applicable notice of guaranteed delivery); and

the agreement may be enforced against such participant.

By signing or agreeing to be bound by the letter of transmittal, each tendering holder of old notes will represent, among other things:

that it is not an affiliate of ours or if it is such an affiliate, such holder will comply with the registration and prospectus delivery requirements of the Securities Act to the extent applicable;

the exchange notes will be acquired in the ordinary course of its business;

at the time of the exchange offer, it has no arrangement with any person to participate in the distribution (within the meaning of the Securities Act) of the old notes or the exchange notes; and

if such holder is a broker-dealer that will receive exchange notes for its own account in exchange for old notes that were acquired as a result of market making or other trading activities, that it will deliver a prospectus (or to the extent permitted by law, make available a prospectus to purchasers) in connection with any resale of such exchange notes.

We will determine in our sole discretion all questions as to the validity, form, eligibility (including time of receipt), acceptance of tendered old notes and withdrawal of tendered old notes. Our determination will be final and binding. We reserve the absolute right to reject any old notes not properly tendered or any old notes the acceptance of which would, in our opinion or the opinion of our counsel, be unlawful. We also reserve the right to waive any defects, irregularities or conditions of tender as to any old notes. Our interpretation of the terms and conditions of this exchange offer (including the instructions in the letter of transmittal) will be final and binding on all parties. Unless waived, any defects or irregularities in connection with tenders of old notes must be cured within such time as we shall determine. Although we intend to notify holders of defects or irregularities with respect to tenders of old notes, neither we, the exchange agent nor any other person will incur any liability for failure to give such notification. Tenders of old notes will not be deemed made until such defects or irregularities have been cured or waived. Any old notes received by the exchange agent that are not properly tendered and as to which the defects or irregularities have not been cured or waived will be returned to the exchange agent without cost to the tendering holder, unless otherwise provided in the letter of transmittal, promptly following the expiration date.

### **Book-entry Transfer**

The exchange agent will make a request to establish an account with respect to the old notes at DTC for purposes of this exchange offer promptly after the date of this prospectus, and any financial institution participating in DTC's system may make book-entry delivery of old notes by causing DTC to transfer such old notes into the exchange agent's account at DTC in accordance with DTC's procedures for transfer. Holders of old notes who are unable to deliver confirmation of the book-entry tender of their old notes into the exchange agent's account at DTC or all other documents of transmittal to the exchange agent on or prior to the expiration date must tender their old notes according to the guaranteed delivery procedures described below.



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### **Guaranteed Delivery Procedures**

Holders wishing to tender their old notes but whose old notes are not immediately available or who cannot deliver their old notes, the letter of transmittal or any other required documents to the exchange agent or comply with the applicable procedures under DTC's Automated Tender Offer Program prior to the expiration date may tender if:

the tender is made through an eligible institution;

on or prior to the expiration date, the exchange agent receives from such eligible institution either a properly completed and duly executed notice of guaranteed delivery by facsimile transmission, mail, overnight courier or hand delivery or a properly transmitted agent's message and notice of guaranteed delivery:

setting forth the name and address of the holder, the registered number(s) of such old notes and the principal amount of old notes tendered;

stating that the tender is being made thereby; and

guaranteeing that, within three New York Stock Exchange trading days after the expiration date, the letter of transmittal or facsimile thereof together with the old notes or a book-entry confirmation, and any other documents required by the letter of transmittal will be deposited by the eligible institution with the exchange agent; and

the exchange agent receives such properly completed and executed letter of transmittal or facsimile thereof, as well as all tendered old notes in proper form for transfer or a book-entry confirmation, and all other documents required by the letter of transmittal, within three New York Stock Exchange trading days after the expiration date.

Upon request to the exchange agent, a notice of guaranteed delivery will be sent to holders who wish to tender their old notes according to the guaranteed delivery procedures set forth above.

### **Withdrawal of Tenders**

Except as otherwise provided in this prospectus, holders of old notes may withdraw their tenders at any time prior to the expiration date.

For a withdrawal to be effective:

the exchange agent must receive a written notice, which notice may be by telegram, telex, facsimile transmission or letter of withdrawal at the appropriate address set forth below under Exchange Agent, or

holders must comply with the appropriate procedures of DTC's Automated Tender Offer Program. Any such notice of withdrawal must:

specify the name of the person who tendered the old notes to be withdrawn;

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identify the old notes to be withdrawn, including the principal amount of such old notes; and

where certificates for old notes have been transmitted, specify the name in which such old notes were registered, if different from that of the withdrawing holder.

If certificates for old notes have been delivered or otherwise identified to the exchange agent, then, prior to the release of such certificates, the withdrawing holder must submit:

the serial numbers of the specific certificates to be withdrawn; and

a signed notice of withdrawal as set forth above with signatures guaranteed by an eligible institution unless such holder is an eligible institution.

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If old notes have been tendered pursuant to the procedure for book-entry transfer described above, any notice of withdrawal must specify the name and number of the account at DTC to be credited with the withdrawn old notes and otherwise comply with the procedures of such facility. We will determine all questions as to the validity, form and eligibility, including time of receipt, of such notices, and our determination shall be final and binding on all parties. We will deem any old notes so withdrawn not to have been validly tendered for exchange for purposes of this exchange offer. Any old notes that have been tendered for exchange but that are not exchanged for any reason will be returned to their holder without cost to the holder (or, in the case of old notes tendered by book-entry transfer into the exchange agent's account at DTC according to the procedures described above, such old notes will be credited to an account maintained with DTC for old notes) as soon as practicable after withdrawal, rejection of tender or termination of this exchange offer. Properly withdrawn old notes may be retendered by following one of the procedures described under "Procedures for Tendering Old Notes" above at any time on or prior to the expiration date.

**Exchange Agent**

U.S. Bank National Association has been appointed as exchange agent for this exchange offer. You should direct questions and requests for assistance, requests for additional copies of this prospectus or of the letter of transmittal and requests for the notice of guaranteed delivery to the exchange agent, addressed as follows:

**By Overnight Delivery, Registered**

**or Certified Mail:**

U.S. Bank National Association  
West Side Flats Operations Center

Attn: Specialized Finance Offer

60 Livingston Avenue

Mail Station EP-MN WS2N

St. Paul, MN 55107-2292

**By Facsimile Transmission:**

(651) 495 8158

**By Hand:**

U.S. Bank National Association

West Side Flats	02/02/2009	70,000(2)	\$ 6.75	216,062
Ron Ricks	02/02/2009	90,000(2)	\$ 6.75	277,794
Michael G. Van de Ven	02/02/2009	90,000(2)	\$ 6.75	277,794
Robert E. Jordan	02/02/2009	80,000(2)	\$ 6.75	246,928

- (1) In accordance with the terms of the plan under which all stock options were granted, options must be granted with an exercise price per share at least equal to the fair market value of the Company's common

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stock on the date of grant. Fair market value is determined based on the closing price of the Company's common stock on the date of grant of the options, as reported by the NYSE.

- (2) The options have a ten year term and vest with respect to one-third of the shares covered thereby annually, beginning on the first anniversary of the date of grant.

**Outstanding Equity Awards at Fiscal 2009 Year-End**

The following table provides information with respect to stock options held by the named executive officers as of December 31, 2009. Stock options are the only type of equity award that has been granted to the named executive officers.

Name	Option Awards			Option Expiration Date
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Option Exercise Price (\$)	
Gary C. Kelly	5,313		\$ 22.80	12/31/2010
	15,000		\$ 21.30	02/15/2011
	5,400	1,100(1)	\$ 17.11	06/19/2011
	4,348		\$ 18.73	01/01/2012
	17,250		\$ 17.78	01/18/2012
	4,151		\$ 14.03	01/02/2013
	21,000		\$ 13.19	01/23/2013
	4,352		\$ 15.91	01/05/2014
	30,000		\$ 15.51	01/23/2014
	180,000		\$ 14.95	07/15/2014
	4,322		\$ 14.25	01/20/2015
	6,295		\$ 16.43	12/31/2015
	150,000		\$ 16.40	09/18/2017
	50,000	100,000(2)	\$ 12.18	01/31/2018
	150,000(3)	\$ 6.75	02/01/2019	
Laura H. Wright	650		\$ 10.88	01/01/2010
	969		\$ 22.80	12/31/2010
	4,400		\$ 21.30	02/15/2011
	5,400	1,100(1)	\$ 17.11	06/19/2011
	719		\$ 18.73	01/01/2012
	5,060		\$ 17.78	01/18/2012
	553		\$ 14.03	01/02/2013
	7,500		\$ 13.19	01/23/2013
	1,114		\$ 15.91	01/05/2014
	12,000		\$ 15.51	01/23/2014
	1,296	1,824(4)	\$ 14.75	09/01/2014
	14,780		\$ 14.25	01/20/2015
	41,416		\$ 16.43	12/31/2015
	40,000		\$ 17.53	03/17/2016
21,667	43,333(5)	\$ 12.18	01/31/2018	
	70,000(6)	\$ 6.75	02/01/2019	
Ron Ricks	3,915		\$ 22.80	12/31/2010
	14,500		\$ 21.30	02/15/2011
	3,916		\$ 18.73	01/01/2012





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Name	Option Awards		Option Exercise Price (\$)	Option Expiration Date
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable		
	15,950		\$ 17.78	01/18/2012
	3,916		\$ 14.33	01/07/2013
	17,545		\$ 13.19	01/23/2013
	3,084		\$ 15.91	01/05/2014
	20,000		\$ 15.51	01/23/2014
	1,246	1,754(7)	\$ 14.75	09/01/2014
	25,065		\$ 14.25	01/20/2015
	42,719		\$ 16.43	12/31/2015
	40,000		\$ 17.53	03/17/2016
	26,667	53,333(8)	\$ 12.18	01/31/2018
		90,000(9)	\$ 6.75	02/01/2019
Michael G. Van de Ven	75		\$ 22.80	12/31/2010
	4,000		\$ 21.30	02/15/2011
	5,400	1,100(1)	\$ 17.11	06/19/2011
	1,942		\$ 18.73	01/01/2012
	4,400		\$ 17.78	01/18/2012
	75		\$ 14.03	01/02/2013
	5,200		\$ 13.19	01/23/2013
	750		\$ 15.91	01/05/2014
	6,600		\$ 15.51	01/23/2014
	1,262	1,778(10)	\$ 14.75	09/01/2014
	8,340		\$ 14.25	01/20/2015
	1,076	2,424(11)	\$ 16.18	11/17/2015
	50,750		\$ 16.43	12/31/2015
	50,000		\$ 17.53	03/17/2016
	25,000	50,000(12)	\$ 12.18	01/31/2018
		90,000(9)	\$ 6.75	02/01/2019
Robert E. Jordan	734		\$ 22.80	12/31/2010
	6,000		\$ 21.30	02/15/2011
	5,400	1,100(1)	\$ 17.11	06/19/2011
	734		\$ 18.73	01/01/2012
	6,600		\$ 17.78	01/18/2012
	7,260		\$ 13.19	01/23/2013
	8,800		\$ 15.51	01/23/2014
	9,420		\$ 14.25	01/20/2015
	20,000		\$ 16.43	12/31/2015
	20,000		\$ 17.53	03/17/2016
	21,667	43,333(5)	\$ 12.18	01/31/2018
		80,000(13)	\$ 6.75	02/01/2019

(1) All of these options will become exercisable on June 19, 2010.

(2) Of these options, (i) options to purchase 50,000 shares became exercisable on February 1, 2010; and (ii) options to purchase 50,000 shares will become exercisable on February 1, 2011.



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- (3) Of these options, (i) options to purchase 50,000 shares became exercisable on February 2, 2010; (ii) options to purchase 50,000 shares will become exercisable on February 2, 2011; and (iii) options to purchase 50,000 shares will become exercisable on February 2, 2012.
- (4) Of these options, (i) options to purchase 384 shares will become exercisable on September 1, 2010; (ii) options to purchase 432 shares will become exercisable on September 1, 2011; (iii) options to purchase 480 shares will become exercisable on September 1, 2012; and (iv) options to purchase 528 shares will become exercisable on September 1, 2013.
- (5) Of these options, (i) options to purchase 21,666 shares became exercisable on February 1, 2010; and (ii) options to purchase 21,667 shares will become exercisable on February 1, 2011.
- (6) Of these options, (i) options to purchase 23,334 shares became exercisable on February 2, 2010; (ii) options to purchase 23,333 shares will become exercisable on February 2, 2011; and (iii) options to purchase 23,333 shares will become exercisable on February 2, 2012.
- (7) Of these options, (i) options to purchase 369 shares will become exercisable on September 1, 2010; (ii) options to purchase 415 shares will become exercisable on September 1, 2011; (iii) options to purchase 462 shares will become exercisable on September 1, 2012; and (iv) options to purchase 508 shares will become exercisable on September 1, 2013.
- (8) Of these options, (i) options to purchase 26,666 shares became exercisable on February 1, 2010; and (ii) options to purchase 26,667 shares will become exercisable on February 1, 2011.
- (9) Of these options, (i) options to purchase 30,000 shares became exercisable on February 2, 2010; and (ii) options to purchase 30,000 shares will become exercisable on each of February 2, 2011, and February 2, 2012.
- (10) Of these options, (i) options to purchase 374 shares will become exercisable on September 1, 2010; (ii) options to purchase 421 shares will become exercisable on September 1, 2011; (iii) options to purchase 468 shares will become exercisable on September 1, 2012; and (iv) options to purchase 515 shares will become exercisable on September 1, 2013.
- (11) Of these options, (i) options to purchase 377 shares will become exercisable on November 17, 2010; (ii) options to purchase 431 shares will become exercisable on November 17, 2011; (iii) options to purchase 485 shares will become exercisable on November 17, 2012; (iv) options to purchase 538 shares will become exercisable on November 17, 2013; and (v) options to purchase 593 shares will become exercisable on November 17, 2014.
- (12) Of these options, (i) options to purchase 25,000 shares became exercisable on February 1, 2010; and (ii) options to purchase 25,000 shares will become exercisable on February 1, 2011.
- (13) Of these options, (i) options to purchase 26,667 shares became exercisable on February 2, 2010; (ii) options to purchase 26,666 shares will become exercisable on February 2, 2011; and (iii) options to purchase 26,667 shares will become exercisable on February 2, 2012.

**Table of Contents****Option Exercises During Fiscal 2009**

The following table provides information with respect to stock options exercised, and the value realized upon exercise, by the named executive officers during 2009.

Name	Option Awards	
	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise \$(1)
Gary C. Kelly		
Laura H. Wright	6,000	\$ 2,718
Ron Ricks	15,926	\$ 7,678
Michael G. Van de Ven	33,770	\$ 15,722
Robert E. Jordan		

- (1) Amounts reflect the difference in the market price of the underlying common stock at the time of exercise and the exercise price of the stock option.

**Equity Compensation Plan Information(1)**

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights(2) (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity Compensation Plans Approved by Security Holders	21,730,107	\$ 14.88	10,312,687
Equity Compensation Plans not Approved by Security Holders	56,953,771	\$ 13.91	9,684,414
Total	78,683,878	\$ 14.18	19,997,101(3)

- (1) As of December 31, 2009.

- (2) As adjusted for stock splits.

- (3) Of these shares, (i) 2,293,180 shares remained available for issuance under the Company's 2007 Equity Incentive Plan as a result of option exercises, as well as in settlement of awards of restricted stock and restricted stock units; (ii) 8,019,507 shares remained available for issuance under the Company's tax-qualified employee stock purchase plan; and (iii) 9,684,414 shares remained available for issuance pursuant to stock option plans that provide for option grants with exercise prices at no less than fair market value of the Company's common stock on the date of grant and terms of no longer than ten years.

The Company has previously awarded stock options under plans covering Employees subject to collective bargaining agreements (collective bargaining plans) and plans governing Employees not subject to collective bargaining agreements. None of the collective bargaining plans were required to be approved by Shareholders. Options granted to Employees under collective bargaining plans are non-qualified, and are granted at or above the fair market value of the Company's common stock on the date of grant. Neither executive officers nor members of the Company's Board of Directors are eligible to participate in any of these collective bargaining plans. Each of the collective bargaining plans provides that the

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number of shares with respect to which options may be granted, and the number of shares of common stock subject to an outstanding option, shall be proportionately adjusted in the event of a subdivision or consolidation of shares or the payment of a stock dividend on common stock, and the purchase price per share of outstanding options shall be proportionately revised.

**Table of Contents****Nonqualified Deferred Compensation in Fiscal 2009**

As discussed above under Compensation Discussion and Analysis, the Company maintains tax-qualified 401(k) and profit sharing plans for its eligible Employees. The 401(k) plans provide for a Company match on Employee contributions, and the profit sharing plan provides for an annual Company contribution equal to a percentage of Company profits that is allocated among participant accounts as a uniform percentage of compensation. In conjunction with these tax-qualified plans, the Company offers a non-qualified excess benefit plan, which is designed to provide benefits with respect to amounts ( excess amounts ) that cannot be contributed to the 401(k) and profit sharing plans due to qualified plan contribution limits established by the Internal Revenue Code. Pursuant to the excess benefit plan, Employees, including the named executive officers, with excess amounts of at least \$1,000 who have previously properly elected to participate in the plan, may defer payment of their excess amounts by making a timely deferral election under the excess benefit plan. Employees are immediately 100 percent vested in their benefits under the excess benefit plan; however, the benefits are unsecured obligations of the Company in the event of its bankruptcy or insolvency. Prior to the beginning of each plan year, participants are allowed to select a rate of return to apply to the contributions to be made with respect to the upcoming plan year. The excess benefit plan currently allows participants to select a rate of return equal to either or both of two investment options: (i) the Citibank 90 Day Treasury Bill Index plus two percentage points, and (ii) the Vanguard Institutional Index Fund. Once an excess amount is credited to a participant's account, the participant may not change that investment election for that amount or transfer amounts between funds. Participants are entitled to a distribution of their accounts upon separation from service with the Company and must elect the time and form of distribution of their accounts prior to their first year of participation in the excess benefit plan. Distribution may be in a lump sum payout or in annual installments over a period of up to five years and may be received or commenced (i) in the calendar year of separation from service, or (ii) the calendar year following the year in which separation from service occurs.

The Company has also established an individual nonqualified deferred compensation arrangement for Mr. Kelly as part of the Company's employment contract with Mr. Kelly, as discussed above under Compensation Discussion and Analysis. Pursuant to this arrangement, the Company makes contributions to Mr. Kelly's account to the extent such amounts cannot be contributed to the qualified plans due to contribution limits and compensation limits established by the Internal Revenue Code. The individual deferred compensation arrangement with Mr. Kelly provides for accrual and crediting to Mr. Kelly's account, each January, of simple interest at a rate of ten percent annually, compounded annually, on the accrued and unpaid balance of the deferred compensation credited to his account as of the preceding December 31. The deferred compensation credited to Mr. Kelly's account will be paid to him at the rate of \$200,000 per calendar year, commencing with the calendar year following the year in which (i) he attains age 65 or (ii) his employment terminates, whichever occurs later. The following table provides information with respect to nonqualified deferred compensation earned by the named executive officers for 2009.

		Nonqualified Deferred Compensation for Fiscal 2009			
		Executive Contributions	Southwest Contributions	Aggregate Earnings	Aggregate Withdrawals/ Distributions
Name	Plan	in Last Fiscal Year	in Last Fiscal Year	In Last Fiscal Year	in Last Fiscal Year
		(\$)	(\$)(1)	(\$)	(\$)
Gary C. Kelly	Employment Contract		\$ 8,457(1)	\$ 16,701(2)	\$ 216,413(3)(4)
	Excess Benefit Plan			\$ 1,171(5)	\$ 54,455(6)
Laura H. Wright					
Ron Ricks	Excess Benefit Plan			\$ 7,633(5)	\$ 36,309(7)
Michael G. Van de Ven					
Robert E. Jordan	Excess Benefit Plan			\$ 6,470(5)	\$ 30,779(6)

- (1) All of this amount is also reported for this officer in the All Other Compensation column of the Summary Compensation Table for 2009. This amount was earned with respect to fiscal 2009, but will not be contributed to his account until 2010.

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- (2) Includes the \$6,347 disclosed in the Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table for 2009.
- (3) This includes the \$8,457 reported as nonqualified deferred compensation contributions earned for 2009, but that will not be contributed to Mr. Kelly's account until 2010. Mr. Kelly's actual cash balance at December 31, 2009, was \$207,956.
- (4) Of this amount, \$121,973 has been reported as compensation to the named executive officer in the Company's Summary Compensation Table for previous years.
- (5) None of these earnings were above-market or preferential. Therefore, no portion of this amount has been reported as compensation to the named executive officer for the last completed year in the Summary Compensation Table.
- (6) None of this amount has been required to be reported as compensation to the named executive officer in the Summary Compensation Table for previous years.
- (7) Of this amount, \$3,387 has been reported as compensation to the named executive officer in the Company's Summary Compensation Table for previous years.

**Potential Payments Upon Termination or Change-in-Control**

Pursuant to the terms of his employment contract, Mr. Kelly has the right to terminate his employment contract within 60 days after the occurrence of a change-in-control of the Company. In such event, his employment contract provides for a lump sum severance payment equal to his unpaid base salary for the remaining term of the contract plus \$750,000. Mr. Kelly is not entitled to any special compensation or benefits in the event of his termination of employment for any reason other than a change-in-control, with the exception of his termination by the Company on account of a disabling illness resulting from a job-related cause. A disabling illness is defined to include any emotional or mental disorder, physical disease, or injury as a result of which Mr. Kelly is, for a continuous period of 90 days, unable to perform his duties under the employment contract. If Mr. Kelly's employment is terminated by the Company due to disability resulting from a job-related cause (after an additional 90-day notice period during which he has not recovered), he is entitled to receive regular installments of his base salary in effect at the time of termination of employment for the remainder of the term of the employment contract. The structure of these provisions is the same basic structure as has been used by the Company since 1982, and the \$750,000 lump sum amount has been in place since 1988. The change-in-control provision for Mr. Kelly is intended to assure that, should the Company receive proposals from third parties with respect to its future, Mr. Kelly can, without being influenced by the uncertainties of his own situation, (i) assess such proposals, (ii) formulate an objective opinion as to whether or not such proposals would be in the best interests of the Company and its Shareholders, and (iii) take any other action regarding such proposals as the Board might determine to be appropriate. For purposes of Mr. Kelly's agreement, as well as the Executive Service Recognition Plan Executive Employment Agreements discussed below, a change-in-control is generally deemed to occur in the event a third party acquires 20 percent or more of the Company's voting securities or a majority of the Directors of the Company are replaced as a result of a tender offer or merger, sale of assets, or contested election.

In 1987, the Board of Directors of the Company established Executive Service Recognition Plan Executive Employment Agreements (the executive change-in-control agreements) to permit the Company to continue to attract and retain well-qualified executive and key personnel and to assure both the Company of continuity of management and its executives of continued employment in the event of any actual or threatened change-in-control of the Company. The Company has entered into executive change-in-control agreements with Ms. Wright, Mr. Ricks, Mr. Van de Ven, and Mr. Jordan. Mr. Kelly has not entered into an executive change-in-control agreement because of the provisions contained in his employment contract. The terms of the agreements with Ms. Wright, Mr. Ricks, Mr. Van de Ven, and Mr. Jordan would be invoked only in the event of a change-in-control, and these executives are not entitled to any special compensation or benefits in the event of termination of employment for any reason other than a termination of employment subsequent to a change-in-control. Under the terms of these agreements, Ms. Wright, Mr. Ricks, Mr. Van de Ven, and Mr. Jordan must remain in the employment of the Company for one year after the occurrence of a change-in-control (the Employment Year). In such event, they would be entitled to a base salary in an amount at least equal to the



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highest salary received by them during the preceding 12-month period. In addition, for any fiscal year that ends during the Employment Year, they would be entitled to an annual bonus in an amount at least equal to the highest bonus (the Change-in-Control Bonus Amount) paid or payable to them in respect of either of the two fiscal years immediately prior to the fiscal year in which the change-in-control occurs. If, during the Employment Year, the executive's employment is terminated other than for cause or disability, or the executive resigns for good reason, then the executive is entitled to a lump sum payment equal to:

- (a) a prorated bonus, which would be based on the annual bonus paid to the executive for the last full fiscal year of the Company prior to the fiscal year of the date of termination;
- (b) the executive's annual base salary in effect at the time of notice of termination; and
- (c) the Change-in-Control Bonus Amount paid to the executive for the last full fiscal year of the Company (being the year in which the change-in-control has occurred, but not the date of termination of employment) or, if no such bonus has been paid, the Change-in-Control Bonus Amount that would have been payable to the executive for the then current fiscal year (being the year in which the date of termination of employment has occurred).

Good reason is generally defined as the assignment to the executive of duties inconsistent with the executive's duties prior to the change-in-control or a failure of the Company to abide by the provisions of the executive's agreement.

Incremental amounts receivable by the named executive officers pursuant to the arrangements discussed above are set forth in the table below.

Name	Termination by the Company at any time due to disability occurring for any reason other than as a result of a job-related cause (\$)	Termination by the Company due to disability occurring as a result of a job-related cause (\$)	Termination by the Company at any time for cause (\$)	Change of control (\$)	Voluntary termination by the executive within 60 days after a change-in-control (\$)	Termination after a change in control (i) by the executive for good reason or (ii) by the Company for reasons other than for cause or disability (\$)
Gary C. Kelly		\$ 503,750			\$ 1,253,750	
Laura H. Wright						\$ 709,000
Ron Ricks						\$ 1,050,000
Michael G. Van de Ven						\$ 965,000
Robert E. Jordan						\$ 880,000

Pursuant to the terms of the Company's option plans, if the Company is not the surviving entity in any merger or consolidation (or survives only as a subsidiary of an entity other than a previously wholly-owned subsidiary of the Company) or if the Company is to be dissolved or liquidated and if the surviving corporation refuses to assume or substitute new options for currently outstanding Company options, all outstanding options will fully vest and will be exercisable until a date fixed by the Company, which date must be prior to the effective date of the merger, consolidation, dissolution, or liquidation. Therefore, to the extent these amounts are payable, they will be payable prior to the effective date of a change-in-control and therefore will not be payable at the same time as the amounts above. The following table sets forth the estimated benefits to the named executive officers in the event the surviving corporation refuses to assume or substitute new options for the named executive officer's outstanding options.

Name	Estimated Benefits(\$)(1)
Gary C. Kelly	\$ 702,000
Laura H. Wright	\$ 327,600
Ron Ricks	\$ 421,200

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Michael G. Van de Ven	\$	421,200
Robert E. Jordan	\$	374,400

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- (1) Assumes the triggering event took place on December 31, 2009, and reflects the aggregate market value of unvested options that would become vested under the circumstances. Aggregate market value is computed by multiplying (i) the difference between \$11.43 (the closing price of the Company's common stock on December 31, 2009) and the exercise price of the options by (ii) the number of shares underlying unvested options at December 31, 2009.

In addition to the amounts discussed above, in the event of termination of their employment for any reason other than for cause, each of the named executive officers would be eligible to participate in any non-contract retiree medical benefit plan or program that the Company may then make available to its retirees generally on the same terms as other retirees. In addition, these individuals would be entitled to the amounts credited to their accounts pursuant to the Company's qualified retirement plans, as well as nonqualified deferred compensation amounts credited to their accounts pursuant to the Company's excess benefit plan and/or their employment contracts (as applicable), each as disclosed in more detail above under the heading "Nonqualified Deferred Compensation in Fiscal 2009." In the event of the death of any of the named executive officers, they would receive \$100,000 of life insurance payments pursuant to additional life insurance premiums paid by the Company for officers of the Company.

**Table of Contents****COMPENSATION OF DIRECTORS****Fiscal 2009 Director Compensation**

The following table provides information with respect to compensation earned by the Directors for the year ended December 31, 2009.

Name	Fees Earned or Paid in Cash (\$)	Stock Awards (\$)(1)	Option Awards (\$)(2)	All Other Compensation (\$)	Total (\$)
David W. Biegler	\$ 111,760	\$ 6,930		\$ 4,353(3)	\$ 123,043
Douglas H. Brooks(4)					
Louis E. Caldera	\$ 5,661(5)			\$ 71,039(6)	\$ 76,700
C. Webb Crockett	\$ 66,225	\$ 6,930		\$ 3,562(3)	\$ 76,717
William H. Cunningham	\$ 118,875	\$ 6,930		\$ 3,958(3)	\$ 129,763
John G. Denison	\$ 68,914			\$ 226(3)	\$ 69,140
Travis C. Johnson	\$ 77,060	\$ 6,930		\$ 3,166(3)	\$ 87,156
Nancy B. Loeffler	\$ 48,115	\$ 6,930		\$ 792(3)	\$ 55,837
John T. Montford	\$ 126,100	\$ 6,930		\$ 6,502(3)	\$ 139,532
Daniel D. Villanueva	\$ 60,920			\$ 2,375(3)	\$ 63,295

- (1) Stock awards were granted pursuant to the Company's Outside Director Incentive Plan. In accordance with the terms of such plan, Messrs. Brooks, Caldera, Denison, and Villanueva were not eligible to receive grants during 2009. Each of the Directors who were eligible to receive grants received 1,000 performance shares in May 2009. The values included in this column represent the grant date fair value of these awards computed in accordance with FASB ASC Topic 718. Each amount is equal to the number of shares of common stock with respect to which the performance shares were issued multiplied by \$6.93, which was the closing price on the date of grant. The aggregate number of performance shares outstanding at December 31, 2009, for each of the Directors listed in the table was as follows: Mr. Biegler 5,000; Mr. Brooks 0; Mr. Caldera 0; Mr. Crockett 6,750; Dr. Cunningham 6,750; Mr. Denison 0; Mr. Johnson 6,750; Ms. Loeffler 5,250; Mr. Montford 6,000; Mr. Villanueva 0. Performance shares were the only type of stock award held by these Directors at fiscal year-end.
- (2) None of the Directors received option awards during 2009. The aggregate number of shares underlying stock options outstanding at fiscal year-end for each of the Directors listed in the table was as follows: Mr. Biegler 8,000; Mr. Brooks 0; Mr. Caldera 0; Mr. Crockett 0; Dr. Cunningham 15,000; Mr. Denison 10,000; Mr. Johnson 0; Ms. Loeffler 10,000; Mr. Montford 10,000; Mr. Villanueva 10,000.
- (3) Consists of reimbursement for taxes on flight benefits.
- (4) Mr. Brooks was appointed to the Board of Directors, effective February 15, 2010, and therefore did not receive any compensation for 2009.
- (5) Mr. Caldera resigned from the Board effective January 15, 2009. His cash fees represent a prorated portion of his retainer payment that was paid in May 2008 for the period from May 2008 to May 2009.
- (6) Consists of (i) a retirement payment of \$35,000 pursuant to the Company's Severance Plan for Directors discussed below, (ii) a payout of \$35,474 under the Company's Outside Director Incentive Plan discussed below; and (iii) reimbursement for taxes on flight benefits of \$565.

Directors' retainer fees are paid on an annual basis in May of each year. The Board retainer fees paid for each of the 12-month periods ending May 2009 and May 2010 were \$14,760. In addition, Board members received \$3,780 for attendance at each meeting of the Board of Directors

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during 2009 and \$1,890 for meetings attended telephonically. Committee members, other than Executive and Special Committee members, received \$1,970 for attendance at each Committee meeting during 2009 and \$985 for Committee meetings attended

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telephonically. Non-Employee members of the Executive Committee received a \$7,200 retainer for their services on such Committee for each of the 12-month periods ending May 2009 and May 2010. Members of the Special Committee received a fee of \$3,780 for each in-person meeting, deposition, or trial preparation during 2009 and a fee of \$1,970 for meetings attended telephonically. The Chair of the Audit Committee received an annual retainer fee of \$9,650 for his service as Chair of such Committee for each of the 12-month periods ending May 2009 and May 2010. The Chairs of the Compensation, Nominating and Corporate Governance, and Executive Committees received an annual retainer fee of \$5,000 for their service as Chairs of such Committees for each of the 12-month periods ending May 2009 and May 2010. In addition, the Chair of the Safety and Compliance Oversight Committee received a pro rated portion of a \$5,000 annual retainer fee for his service as Chair of such Committee for the period ending May 2010. The Presiding Director received an annual retainer fee of \$10,000 for his services for each of the 12-month periods ending May 2009 and May 2010. The Company also provides free travel on Southwest Airlines for Board members and their spouses, children, and spouses of their children. In addition, Board members are provided up to 20 passes annually that may be used for free travel on Southwest Airlines on an unrestricted basis (*e.g.*, for charitable purposes). Board members receive reimbursements for taxes on their flight benefits.

*Southwest Airlines Co. Outside Director Incentive Plan.* The Board adopted the Southwest Airlines Co. Outside Director Incentive Plan in 2001 for the purpose of aligning more closely the interests of the non-Employee Directors with those of the Company's Shareholders and to provide the non-Employee Directors with retirement income. Pursuant to the plan, on the date of each Annual Meeting of Shareholders, each non-Employee Director who has served as a Director since the prior year's Annual Meeting of Shareholders receives an automatic grant of 1,000 performance shares. On the 30<sup>th</sup> calendar day following the date on which a non-Employee Director ceases to serve as a Director of the Company for any reason, the non-Employee Director is entitled to an amount in cash equal to the average fair market value of the Company's common stock during the 30 days preceding the Director's last date of service multiplied by the number of performance shares then held by such Director. In March 2010, the Board approved the termination of this plan for purposes of future grants. All outstanding grants will remain in effect in accordance with the terms of the plan.

*Southwest Airlines Co. Severance Plan for Directors.* The Board of Directors adopted the Southwest Airlines Co. Severance Plan for Directors in 2000. Pursuant to this plan, upon retirement from the Board of Directors, a non-Employee Director who has served at least five years as of the date of retirement is entitled to a cash payment of \$35,000, and a non-Employee Director who has served at least ten years is entitled to a cash payment of \$75,000.

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**AUDIT COMMITTEE REPORT**

The Audit Committee has reviewed and discussed with management the audited financial statements of the Company for the year ended December 31, 2009. In addition, we have discussed with Ernst & Young LLP, the Company's independent auditors, the matters required to be discussed by the statement on Auditing Standards No. 61, as amended (AICPA, *Professional Standards*, vol. 1, AU section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T.

The Audit Committee has also received the written disclosures and the letter from Ernst & Young required by applicable requirements of the Public Company Accounting Oversight Board regarding Ernst & Young's communications with the Audit Committee concerning independence, and has discussed with Ernst & Young its independence.

Based on the foregoing review and discussions and relying thereon, we have recommended to the Company's Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

AUDIT COMMITTEE

John T. Montford, Chair

David W. Biegler

William H. Cunningham

John G. Denison

Travis C. Johnson

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**PROPOSAL 2**

**APPROVAL OF THE SOUTHWEST AIRLINES CO. AMENDED AND RESTATED**

**2007 EQUITY INCENTIVE PLAN**

The Southwest Airlines Co. 2007 Equity Incentive Plan was originally approved by the Board of Directors on March 15, 2007 and by the Company's Shareholders on May 16, 2007. The Board of Directors approved the Amended and Restated 2007 Equity Incentive Plan (the Plan) on March 18, 2010, subject to approval by the Company's Shareholders. If approved by the Shareholders at the Annual Meeting, the Plan will become effective immediately. The following summary of the Plan should be read in conjunction with, and is qualified in its entirety by reference to, the complete text of the Plan, which is attached to this Proxy Statement as Appendix B.

**Summary of the Plan**

*Types of Awards*

The Plan provides for grants of stock options, restricted stock, restricted stock units, unrestricted shares of common stock, stock appreciation rights, and phantom shares (each, an award), the terms and conditions of which are described in more detail below. The Plan has been designed to allow for awards to satisfy the performance-based compensation exception provided for under Section 162(m) of the Internal Revenue Code (the Section 162(m) Exception).

*Eligibility*

Any Employee, non-Employee Director, or advisor of the Company or its affiliates is eligible to participate in the Plan; however, only Employees are eligible to receive incentive stock options. As of March 31, 2010, approximately 246 Employees and four non-Employee Directors were participating in the existing plan.

*Shares Available for Issuance*

The maximum number of shares of common stock that may be issued under the Plan with respect to all types of awards in the aggregate may not exceed 18 million (the Plan Limit), which is an increase of 12 million over the 6 million shares previously reserved for issuance under the Plan. No award may be granted under the Plan if the number of shares of common stock to be delivered in connection with such award exceeds the number of shares of common stock remaining available under the Plan minus the number of shares of common stock issuable in settlement of, or relating to, then-outstanding awards. To the extent all or a portion of an award under the Plan (a) expires or is canceled, forfeited, exchanged, settled in cash, or otherwise terminated without an issuance of shares of common stock; or (b) in the case of restricted stock, is forfeited, the shares of common stock subject to the award will again be available for awards under the Plan, except that if any such shares of common stock could not again be available for awards to a particular participant under any applicable law or regulation, the shares will be available exclusively for awards to participants who are not subject to such limitation. In addition, (i) subject to the Plan's prohibition of repricing of stock options and stock appreciation rights, awards granted on the condition precedent of surrender of outstanding awards will not count against the Plan limits until such time as the previous awards are surrendered and cancelled; and (ii) to the extent awards are granted under the Plan in substitution for awards held by individuals providing services to corporations or other entities who become Employees or Directors as a result of a merger or consolidation or other business transaction with the Company or any affiliate, any shares of common stock underlying such substitute awards will not be counted against the Plan limits, so long as the grant of the substitute awards would not otherwise require shareholder approval pursuant to the rules of any stock exchange or applicable law. The maximum number of shares of common stock with respect to which stock options, stock appreciation rights, and any other types of awards designed to satisfy the Section 162(m) Exception may be granted in the aggregate to any participant during any calendar year may not exceed 1 million (regardless of whether settled in cash or shares of common stock). In addition, the maximum number of shares of common stock with respect to which unrestricted shares of



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common stock, stock-settled phantom shares, and awards to non-Employee Directors may be granted during the term of the Plan may not exceed 5 percent of the Plan Limit. The share limits set forth in this paragraph are subject to adjustment, as discussed below under Adjustments. As of the date of this Proxy Statement, only stock options have been granted under the existing plan. As of March 31, 2010, options to purchase 3,489,015 shares of common stock were outstanding, and 2,297,012 shares remained available for issuance under the existing plan. Unless earlier terminated by action of the Board, awards may be granted through March 17, 2020.

### ***Administration***

The Plan must be administered by the Board or by a committee appointed by the Board consisting of at least two members of the Board. The Board or committee, as applicable, will be referred to as the committee. With respect to any award that is intended to satisfy the requirements of Rule 16b-3 under the Securities Exchange Act of 1934, as amended, the committee must consist of at least such number of Directors as is required from time to time by such rule, and each committee member must satisfy the qualification requirements of such rule. With respect to any award that is intended to satisfy the Section 162(m) Exception, the committee must consist of at least such number of Directors as is required from time to time to satisfy such exception, and each committee member must satisfy the qualification requirements of the exception. To the extent required under the rules of any stock exchange or automated quotation system on which the Company's common stock is listed for trading or is quoted, each member of the committee must satisfy any independence requirements of such exchange or quotation system. The failure of any committee member to meet the qualification requirements of Rule 16b-3 or the Section 162(m) Exception will not invalidate any actions taken or awards granted by the committee. Subject to certain limitations, including any limitations set forth in the Texas Business Organizations Code, the committee may delegate some or all of its authority under the Plan to one or more members of the committee or to one or more officers of the Company.

The committee will have the power to interpret the Plan, to establish rules and regulations relating to the Plan, and to make all other determinations necessary or advisable for administering the Plan. The Plan does not permit the repricing of options or stock appreciation rights or the granting of discounted awards, and no awards may be granted under the Plan after March 17, 2020.

### ***Stock Options***

A stock option is a right to purchase shares of common stock at a time and price established by the committee. Stock options granted under the Plan may be either incentive stock options, within the meaning of Section 422 of the Internal Revenue Code, or non-qualified stock options, as determined by the committee. Subject to the express terms of the Plan, the committee has the power to determine the number and kind of stock options granted, the exercise price for the stock options, the vesting schedule applicable to the stock options (including any performance goals, if applicable), the term of the stock options, and any other terms that are not inconsistent with the purposes and provisions of the Plan that the committee may deem appropriate; provided that (i) no stock option may have a term of longer than ten years (five years in the case of an incentive stock option granted to a 10 percent Shareholder), and (ii) the per share exercise price of any stock option cannot be less than 100% of the fair market value of a share of common stock on the date of grant (110% of the fair market value in the case of an incentive stock option granted to a 10 percent Shareholder, as calculated pursuant to the rules of the Internal Revenue Code). The closing price of a share of the Company's common stock on March 31, 2010, was \$13.22.

Unless limited by the committee, the exercise price for an option may be paid, to the extent permitted by applicable law, as follows: (i) in cash, check, bank draft, or money order payable to the Company; (ii) by delivery to the Company (either by actual delivery or attestation) of shares of common stock; (iii) through a cashless exercise; or (iv) in any other manner permitted by the committee.

In the event of the termination of a Plan participant's service with the Company, any of the participant's stock options that have not vested as of the date of termination will automatically become null and void on the

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date of termination. The vested portion of the participant's outstanding stock options will become null and void on the date that is earliest to occur of the following: (i) the date of the participant's termination of service for cause; (ii) the expiration of two years following the date of termination of the participant's service other than for cause; (iii) the expiration of such period of time or the occurrence of such event as the committee in its discretion may provide in the participant's stock option agreement; and (iv) the expiration of ten years from the date of grant of the participant's stock option.

### ***Restricted Stock, Restricted Stock Units, and Unrestricted Shares***

Restricted stock is an award of shares of common stock that is granted subject to forfeiture based on terms and conditions that are established by the committee. A restricted stock unit is a right to receive in the future, in the discretion of the committee, (i) shares of common stock, (ii) cash equal to the fair market value of shares of common stock, or (iii) a combination of shares of common stock and cash. Restricted stock and restricted stock units granted under the Plan will be subject to a vesting schedule, which may include specified performance goals or other criteria that the committee determines must be satisfied in order to remove any restrictions with respect to such award; provided that (i) in no event may restricted stock or restricted stock units with a vesting schedule based on the passing of time have (or be accelerated to have) a vesting schedule of less than three years from the date of grant and no more than 33 1/3 percent of any such award may vest (or be accelerated such that it vests) on each anniversary of the date of grant; and (ii) in no event may restricted stock or restricted stock units with a vesting schedule based on the achievement of a performance measure vest (or be accelerated to vest) in under one year from the date of grant. Unless otherwise determined by the committee, in the event of the termination of a Plan participant's service with the Company, any of the participant's restricted stock or restricted stock units that have not vested as of the date of termination will be forfeited. Shares of restricted stock will be registered in the participant's name or otherwise credited to the participant as of the date of grant, but will remain held by the Company for the account of the participant (and will not be transferable) until they have vested; however, a holder of restricted stock will have the right (to the extent applicable) to vote and to receive dividends or other distributions made or paid with respect to shares of common stock generally. A holder of restricted stock units will not have these rights until the units have vested and only if the units are settled in stock.

The committee may also grant awards of unrestricted shares of common stock in recognition of outstanding achievements and performance or for any other reason it deems appropriate.

### ***Stock Appreciation Rights***

A stock appreciation right is a right to receive, in the discretion of the committee, a payment in cash or shares of common stock equal to the excess of the fair market value of a specified number of shares of common stock on the date the right is exercised over a specified exercise price. Stock appreciation rights may be granted in tandem with stock options (a tandem stock appreciation right) or not in tandem with stock options (a stand-alone stock appreciation right). The committee has the power to determine the number and kind of stock appreciation rights granted, the exercise price of the stock appreciation rights, the period during which they can be exercised, any vesting schedule applicable to such stock appreciation rights (including any applicable performance goals), and any other terms that are not inconsistent with the purposes and provisions of the Plan that the committee may deem appropriate; provided that (i) no stock appreciation right may have a term of longer than ten years, and (ii) the per share exercise price of any stock appreciation right cannot be less than 100% of the fair market value of a share of common stock on the date of grant. Payment for stock appreciation rights may be made in shares of common stock, cash equal to the fair market value of the shares of common stock subject to the stock appreciation rights, or a combination of cash and shares.

A tandem stock appreciation right will be subject to the same terms and conditions as the related stock option and will be exercisable only at such times and to such extent as the related stock option is exercisable. Each tandem stock appreciation right entitles the holder to exercise the related stock option with respect to all or a portion of the vested shares underlying the stock option, or to exercise the stock appreciation right by

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surrendering to the Company all or a portion of the related stock option (to the extent vested), in which case the holder will be entitled to receive an amount equal to the excess of the fair market value of the shares of common stock underlying the surrendered portion of the stock option over the aggregate stock option exercise price for such shares. The exercise of a tandem stock appreciation right will cause the immediate and automatic cancellation of its related stock option with respect to the number of shares underlying the surrendered portion of the stock option. Likewise, the exercise of the related stock option will cause the immediate and automatic cancellation of the tandem stock appreciation right with respect to the number of shares underlying the surrendered portion of the stock appreciation right.

In the event of the termination of a Plan participant's service with the Company, any of the participant's stock appreciation rights that have not vested as of the date of termination will automatically become null and void on the date of termination. The vested portion of the participant's outstanding stock appreciation rights will become null and void on the date that is earliest to occur of the following: (i) the date of the participant's termination of service for cause; (ii) the expiration of two years following the date of termination of the participant's service other than for cause; (iii) the expiration of such period of time or the occurrence of such event as the committee in its discretion may provide in the participant's stock appreciation rights agreement; and (iv) the expiration of ten years from the date of grant of the participant's stock appreciation rights.

### ***Phantom Shares***

A phantom share is a right granted to a participant to receive cash or shares of common stock equal to the fair market value or the appreciation in the fair market value of a share of common stock. The Plan empowers the committee to determine (i) the valuation date(s) on which (or over which) the value of a phantom share award will be measured and fixed; (ii) the number of phantom shares with respect to which the value is to be calculated; (iii) any vesting schedule applicable to the phantom shares, including any applicable performance goals; (iv) the effect of termination of service on a participant's rights with respect to the phantom shares; (v) the payment date(s) applicable to the phantom shares; and (vi) any other terms the committee deems appropriate.

### ***Performance Goals***

The committee may condition the grant, vesting, and/or exercisability of any award upon the attainment of one or more performance targets related to one or more performance measures over a performance period. Awards that are not intended to satisfy the performance-based compensation exception to the Section 162(m) Exception may be based on the achievement of such goals and be subject to such terms, conditions, and restrictions as the committee shall determine. Awards that are intended to satisfy the Section 162(m) Exception based on the satisfaction of one or more performance measures must be conditioned on specified levels of one or more of the following: (1) the earnings or earnings per share of the Company or of any business unit of the Company designated by the committee; (2) the net operating margin of the Company or of any business unit of the Company designated by the committee; (3) the cash flow return on investment of the Company or any business unit of the Company designated by the committee; (4) the earnings before interest, taxes, depreciation, and/or amortization of the Company or any business unit of the Company designated by the committee; (5) the return on shareholders' equity achieved by the Company; (6) the total shareholders' return achieved by the Company; (7) any of the foregoing calculated on a non-GAAP basis; (8) the price of a share of the Company's common stock; (9) the Company's market share; (10) the market share of a business unit of the Company designated by the committee; (11) the Company's sales; (12) the sales of a business unit of the Company designated by the committee; (13) the economic value added; or (14) any combination of the foregoing. A measure that is calculated on a non-GAAP basis is a measure that is adjusted (to the extent consistent with the Section 162(m) Exception) to reflect the impact of special items, which items are reflected from time to time in the Company's published financials. Special items are material nonrecurring adjustments deemed appropriate to exclude by the committee and may include, without limitation, (a) unrealized gains or losses and other items that are recorded by the Company as a result of Accounting Standards Codification Topic 815 (previously issued as Statement of Financial Accounting Standards No. 133, *Accounting for*

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*Derivative Instruments and Hedging Activities*, as amended); (b) impairment and other non-cash charges including the impact of changes in accounting principles or estimates or other unusual, infrequent non-cash items; and (c) other items not considered to be representative of the Company's ongoing operations.

A performance target must be established no later than ninety days after the beginning of the applicable performance period, and (i) the performance target must be substantially uncertain at such time and (ii) no more than 25% of the overall performance period can have elapsed by such time. The committee may adjust performance measures for specified significant extraordinary items or events, to the extent consistent with the Section 162(m) Exception.

Prior to the payment of any award that has been conditioned upon achievement of a performance measure that is intended to qualify for the Section 162(m) Exception, the committee must certify whether the performance target(s) have been achieved. The committee will have the discretion to reduce any award.

### ***Adjustments***

In the event of a subdivision or consolidation of shares of the Company's common stock or the payment of a stock dividend on the common stock without receipt of consideration by the Company, (i) the number of shares of common stock with respect to which an outstanding award may thereafter be exercised or satisfied, as applicable, will, in the event of an increase in the number of outstanding shares, be proportionately increased, and the exercise price per share (if applicable) will be proportionately reduced; and (ii) the number of shares of common stock with respect to which an outstanding award may thereafter be exercised or satisfied, as applicable, will, in the event of a reduction in the number of outstanding shares, be proportionately reduced, and the exercise price per share (if applicable) will be proportionately increased. In the event of any such change in the outstanding common stock, the aggregate number of shares available under the Plan may be appropriately adjusted by the committee.

In the event the Company recapitalizes or otherwise changes its capital structure, the number and class of shares of common stock covered by an outstanding award will be adjusted so that such award will thereafter cover the number and class of shares of stock and securities to which a participant would have been entitled pursuant to the terms of the recapitalization if, immediately prior to such recapitalization, the participant had been the holder of record of the number of shares of common stock then covered by such award. If the Company is not to be the surviving entity in any merger or consolidation (or survives only as a subsidiary of an entity other than a previously wholly-owned subsidiary of the Company), or if the Company is to be dissolved or liquidated, then, unless a surviving corporation assumes or substitutes new awards for awards then outstanding under the Plan, (i) all unvested options then outstanding will be accelerated and will become exercisable in full, and all restrictions and/or performance measures with respect to any award will be deemed to be satisfied, on or before a date fixed by the Company prior to the effective date of such merger or consolidation or such dissolution or liquidation, and (ii) upon such effective date, awards will expire.

### ***Transfer Restrictions***

The rights of a participant with respect to any award will not be transferable by the participant other than by will or the laws of descent or distribution.

### ***Amendment and Termination***

The Board in its discretion may amend or terminate the Plan at any time; provided that no change in the Plan may generally be made that would impair the rights of a participant with respect to an award theretofore granted without the consent of the Participant; and provided, further, that no amendment may be made without approval of the Shareholders of the Company if such approval is required under applicable law or by the requirements of any exchange or automated quotation system upon which the common stock is listed for trading or quoted.

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### **Summary of Certain Federal Income Tax Consequences**

The following discussion is intended as a general summary of the federal income tax consequences associated with the grant and exercise of stock options. Section 409A of the Internal Revenue Code imposes additional taxes on deferred compensation that does not comply with the requirements of such section; however, awards granted under the Plan are intended to either be exempt from or to comply with the limitations and restrictions of section 409A of the Internal Revenue Code. This summary does not purport to be complete and does not address any applicable state or local tax law.

#### ***Non-Qualified Stock Options***

In general, no taxable income is realized by a participant upon the grant of a non-qualified stock option, and no deduction is then available to the Company. Upon exercise of a non-qualified stock option, the excess of the fair market value of the shares on the date of exercise over the exercise price will be includable in the gross income of the participant as ordinary income. The amount includable in the gross income of the participant will also be deductible by the Company. The tax basis of shares acquired by a participant will be equal to the exercise price plus the amount includable in the gross income of the participant as ordinary income. When a participant disposes of shares acquired upon exercise of a non-qualified stock option, any amount realized in excess of the tax basis of the shares generally will be treated as a capital gain; if the amount realized is less than such tax basis, the difference will be treated as a capital loss. Any capital gain or capital loss will be long-term or short-term, depending on whether the shares have been held for more than one year; the holding period commences upon exercise of the non-qualified stock option. Certain additional rules may apply if the exercise price of a non-qualified stock option is paid in shares or other securities previously owned by the participant.

#### ***Incentive Stock Options***

In general, no taxable income is realized by a participant and no deduction is available to the Company upon either the grant or exercise of an incentive stock option. If a participant holds the shares acquired upon the exercise of an incentive stock option for more than one year after the transfer of the shares upon exercise of the incentive stock option and at least two years from the date of the grant of the incentive stock option (the ISO Holding Period), the difference between the exercise price and the amount realized upon a subsequent sale of the shares will be treated as a long-term capital gain or loss and no deduction will be available to the Company. If the shares acquired upon exercise of an incentive stock option are disposed of before the expiration of the ISO Holding Period, the participant will realize ordinary income and the Company will be entitled to a deduction on the portion of the gain, if any, equal to the excess of the fair market value of the shares on the date of exercise over the incentive stock option exercise price (or, if less, the excess of the amount realized on the disposition over the tax basis of the shares); any further gain, or any loss, from such disposition will be taxable as a long-term or short-term capital gain or loss, depending upon whether the shares have been held for more than one year. Certain additional rules may apply if the exercise price of an incentive stock option is paid in shares or other securities previously owned by the participant.

The excess of the fair market value (at the time of exercise) of the shares acquired upon the exercise of an incentive stock option over the exercise price of such stock option may constitute an adjustment to taxable income for purposes of the alternative minimum tax. Special rules for computing alternative minimum taxable income also may apply in certain cases where there are subsequent sales of shares in disqualifying dispositions and to determine the basis of the shares for purposes of computing alternative minimum taxable income on a subsequent sale of the shares.

**Table of Contents*****Tax Code Limitations on Deductibility***

In order for the amounts described above to be deductible by the Company, such amounts must constitute reasonable compensation for services rendered or to be rendered and must be ordinary and necessary business expenses.

The ability of the Company to obtain a deduction for future payments under the Plan could also be limited by the golden parachute payment rules of section 280G of the Internal Revenue Code, which prevents the deductibility of certain excess parachute payments made in connection with a change in control of an employer-corporation.

Finally, the ability of the Company to obtain a deduction for amounts paid under the Plan could be limited by Section 162(m) of the Internal Revenue Code, which limits the deductibility, for federal income tax purposes, of compensation paid to certain executive officers of a publicly-traded corporation to \$1,000,000 with respect to any such officer during any taxable year of the corporation. However, an exception applies to this limitation in the case of certain performance-based compensation. In order to exempt performance-based compensation from the \$1,000,000 deductibility limitation, the grant or vesting of the award relating to the compensation must be based on the satisfaction of one or more performance goals as selected by the committee and described in greater detail above. Although the Plan has been drafted to satisfy the requirements for the Section 162(m) Exception, the Company may determine that it is in its best interests not to satisfy the requirements for the Section 162(m) Exception with respect to particular awards.

**Prior Issuances of Options under the Plan**

Stock options are the only type of award that has been granted under the existing plan. The following table sets forth certain information regarding the number of shares subject to options received under the existing plan since inception by (i) each of the named executive officers, (ii) all current executive officers as a group, (iii) all current Directors who are not executive officers as a group, (iv) each nominee for election as a Director, (v) each associate of any of the executive officers, Directors, and Director nominees; (vi) each other person who has received five percent or more of such options; and (vii) all Employees, including current officers who are not executive officers, as a group.

Name	Number of Shares
Gary C. Kelly Chairman of the Board, President, Chief Executive Officer, and Director Nominee*	450,000
Laura H. Wright Senior Vice President Finance & Chief Financial Officer	135,000
Ron Ricks Executive Vice President Corporate Services & Corporate Secretary	170,000
Michael G. Van de Ven Executive Vice President & Chief Operating Officer	165,000
Robert E. Jordan Executive Vice President Strategy & Planning	145,000
David W. Biegler Director Nominee	8,000
Douglas H. Brooks Director Nominee	10,000
William H. Cunningham Director Nominee	
John G. Denison Director Nominee	10,000
Travis C. Johnson Director Nominee	

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Name	Number of Shares
Nancy B. Loeffler Director Nominee	
John T. Montford Director Nominee	
Daniel D. Villanueva Director Nominee	10,000
All current executive officers as a group	1,170,000
All current Directors who are not executive officers as a group	38,000
Each associate of the above individuals	
All Employees, including all current officers who are not executive officers or Directors as a group	3,731,100

\* Represents more than five percent of the options granted under the existing plan.

The benefits or amounts that will be received by or allocated to individuals in the future under the Plan are not determinable at this time.

**Purposes of the Amendments**

The material differences between the Amended and Restated 2007 Equity Incentive Plan and the existing plan are summarized below. Appendix B reflects certain other amendments to the existing plan that have been unanimously approved by the Board of Directors, none of which require the approval of the Company's Shareholders. Shareholders should, however, carefully review Appendix B in its entirety.

*Duration of the Plan.* Awards may be granted under the Plan through March 17, 2020, while the existing plan would permit awards to be granted through March 14, 2017.

*Shares Reserved for Issuance under the Plan.* The Plan provides for a maximum of 18 million shares to be issued pursuant to awards under the Plan, while the existing plan limit is 6 million shares.

*Limit on Individual Grants.* The Plan provides that the maximum number of shares of common stock with respect to which stock options, stock appreciation rights, and any other types of awards designed to satisfy the Section 162(m) Exception may be granted in the aggregate to any participant during any calendar year may not exceed 1 million (regardless of whether settled in cash or shares of common stock). The existing plan provides for a limit of 450,000 shares that may be subject to awards to any individual over the term of the plan.

*Types of Awards.* The Plan provides for the grant of stock options, restricted stock, restricted stock units, unrestricted shares of common stock, stock appreciation rights, and phantom shares. The existing plan does not provide for grants of unrestricted shares of common stock, stock appreciation rights, or phantom shares.

*Eligibility.* The Plan provides for grants to Employees, non-Employee Directors, and advisors. The existing plan does not allow for grants to advisors.

*Director Grants.* The Plan provides for discretionary grants to non-Employee Directors, while the existing plan provides for a one-time formula grant to new Directors, in addition to discretionary grants.

*Settlement of Restricted Stock Units.* The Plan allows for restricted stock units to be settled in cash or shares of common stock, while the existing plan only allows for settlement in shares of common stock.





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*Grants Outside of the United States.* The Plan provides the Compensation Committee with discretion to grant awards to participants outside of the United States on such terms and conditions different from those specified in the Plan as may, in the judgment of the Compensation Committee, be necessary or desirable to further the purposes of the Plan. The existing plan does not address grants to international participants.

The Board of Directors believes these amendments are advisable and in the best interests of the Company and its Shareholders, as the increase in shares reserved for issuance under the Plan is necessary to enable the Compensation Committee's use of equity to (i) directly align a portion of senior management's compensation with the interests of Shareholders and (ii) implement a long-term, phased approach for improving the competitiveness and retention value of the Company's compensation program. In addition, the inclusion in the Plan of new types of equity vehicles will provide the Compensation Committee with additional flexibility to determine appropriate compensation designs.

If the Plan as proposed is not approved by Shareholders no awards will be granted to any persons with respect to the additional Plan shares submitted for approval, and the requested shares will not be added to the Plan. If not approved, eligible persons will continue to be eligible to receive awards with respect to the Plan in effect prior to its amendment and restatement. Because the proposed amendment will increase the number of shares of common stock that may be issued to non-Employee Directors and executive officers of the Company, each of the non-Employee Directors and executive officers of the Company has an interest in, and may benefit from, the approval of the Plan.

### **Vote Required**

Provided a quorum is present at the meeting, the affirmative vote of the holders of a majority of the shares entitled to vote on, and voted for or against, this proposal is required to approve this proposal.

### **Recommendation of the Board of Directors**

**The Board of Directors unanimously recommends a vote FOR this proposal. Proxies solicited by the Board of Directors will be so voted unless Shareholders specify a different choice.**

**Table of Contents****PROPOSAL 3****RATIFICATION OF THE SELECTION OF INDEPENDENT AUDITORS**

The firm of Ernst & Young LLP, independent auditors, has been selected by the Board of Directors to serve as the Company's independent auditors for the fiscal year ending December 31, 2010. Shareholder ratification of the selection of Ernst & Young LLP as the Company's independent auditors is not required by the Company's Bylaws or otherwise. However, the Board of Directors is submitting the selection of Ernst & Young to the Shareholders for ratification as a matter of good corporate practice. If the Shareholders fail to ratify the selection, the Audit Committee and Board of Directors will reconsider whether or not to retain Ernst & Young. Even if the selection is ratified, the Board of Directors and its Audit Committee, in their discretion, may direct the selection of a different independent accounting firm at any time during the year if the Board of Directors believes this change would be in the best interests of the Company and its Shareholders.

**Vote Required**

Provided a quorum is present at the meeting, the affirmative vote of the holders of a majority of the shares entitled to vote on, and voted for or against, this proposal is required to approve this proposal.

**Recommendation of the Board of Directors**

**The Board of Directors unanimously recommends a vote FOR the ratification of the selection of Ernst & Young LLP as the Company's independent auditors for the fiscal year ending December 31, 2010. Proxies solicited by the Board of Directors will be so voted unless Shareholders specify a different choice.**

**RELATIONSHIP WITH INDEPENDENT AUDITORS**

Ernst & Young LLP has served as the Company's auditors since the inception of the Company. A representative of Ernst & Young is expected to be present at the Annual Meeting and will have the opportunity to make a statement if he so desires and to respond to appropriate questions.

The following table sets forth the various fees for services provided to the Company by Ernst & Young in 2009 and 2008:

<b>Year</b>	<b>Audit Fees(1)</b>	<b>Audit-Related Fees(2)</b>	<b>Tax Fees(3)</b>	<b>All Other Fees(4)</b>	<b>Total Fees</b>
2009	\$ 1,733,167	\$ 214,850	\$ 49,440	\$ 2,143	\$ 1,999,600
2008	\$ 1,400,300	\$ 195,000	\$ 48,391	\$ 6,000	\$ 1,649,691

(1) Includes fees for the annual audit and quarterly reviews, SEC registration statements, accounting and financial reporting consultations, and research work regarding Generally Accepted Accounting Principles, passenger facility charge audits, the attestation of management's Reports on Internal Controls, and the audit of the Company's wholly-owned captive insurance company.

(2) Includes fees for audits of benefit plans.

(3) Includes services for tax compliance, tax advice, and tax planning.

(4) Consists of fees for other products and services.

A copy of the Audit Committee's Audit and Non-Audit Services Preapproval Policy is attached to this proxy statement as Appendix A. All of the services rendered by the independent auditors during 2009 were pre-approved by the Audit Committee or by its Chairman pursuant to his delegated authority.



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**SHAREHOLDER PROPOSAL**

**SHAREHOLDER ACTION BY WRITTEN CONSENT**

**(PROPOSAL 4)**

The Company has been notified by Mr. John Chevedden that he intends to present the following proposal for consideration at the Annual Meeting. This proposal will be voted on if it is properly presented at the Annual Meeting. The Company will provide to any Shareholder, promptly upon receipt of the Shareholder's written or oral request, the name and address of the proponent of this proposal and the number of shares of the Company's common stock held by the proponent of this proposal.

**4 Shareholder Action by Written Consent**

RESOLVED, Shareholders hereby request that our board of directors undertake such steps as may be necessary to permit shareholders to act by the written consent of a majority of our shares outstanding to the fullest extent permitted by law.

Taking action by written consent in lieu of a meeting is a mechanism shareholders can use to raise important matters outside the normal annual meeting cycle.

Limitations on a shareholder right to act by written consent are considered takeover defenses because they may impede the ability of a bidder to complete a profitable transaction for us or to obtain control of the board which could result in a higher price for our stock. Although it is not necessarily anticipated that a bidder will materialize, that very possibility presents a powerful incentive for improved management of our company.

A study by Harvard professor Paul Gompers supports the concept that shareholder disempowering governance features, including restrictions on shareholder ability to act by written consent, are significantly correlated to reduced shareholder value.

The merit of this Shareholder Action by Written Consent proposal should also be considered in the context of the need for improvement in our company's 2009 reported corporate governance status:

Our board was the only significant directorship for seven of our nine directors. This could indicate a significant lack of current transferable director experience for the vast majority of our directors. Contrast this with William Cunningham, who was burdened with five directorships, and was then assigned the additional tasks of being our Lead Director and a member of our audit committee. Plus Mr. Cunningham served on these boards rated D or F by the Corporate Library, an independent investment research firm: Hayes Lemmerz (HAYZ.PK), Introgen Therapeutics (INGNQ.PK) and LIN TV (TVL).

Travis Johnson had 31-years of long tenure (independence concern) and yet served on two key board committees including our nomination committee where he and Webb Crockett (15-years long-tenure) were 50% of the membership. Plus Mr. Crockett received a dismal 53% in withheld votes. In fact seven of our directors each received from 38% to 53% in our withheld votes in 2009.

Webb Crockett had a business relationship with Fennemore Craig, a law firm that performs services for Southwest Airlines. Directors Daniel Villanueva and John Denison owned zero shares commitment concern.

We had no shareholder right to vote on executive pay, cumulative voting or an independent board chairman. Shareholder proposals to address all or some of these topics have received majority votes at other companies and would be excellent topics for our next annual meeting.

The above concerns shows there is need for improvement. Please encourage our board to respond positively to this proposal to enable shareholder action by written consent Yes on 4.



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**BOARD OF DIRECTORS STATEMENT IN OPPOSITION TO PROPOSAL 4**

**The Board of Directors unanimously recommends a vote AGAINST the adoption of this Shareholder proposal for the following reasons:**

**Under Texas law, the Company's Shareholders may act by unanimous written consent.** Applicable Texas law also provides that shareholders of a Texas corporation may act by less than unanimous written consent if authorized in the corporation's certificate of formation. The Company's charter does not authorize action by less than unanimous written consent. Therefore, Shareholders are currently permitted to act only by unanimous written consent or by the required vote at a Shareholder meeting. The Proponent is advocating in this proposal that Shareholders be given the right to act by the written consent of a majority of the Company's outstanding shares, though the Board is unclear what other actions the Proponent might be advocating by use of the phrase "to the fullest extent permitted by law." In any event, the Board of Directors believes that adoption of such proposal is not in the best interests of the Company or its Shareholders.

**The Board believes that permitting Shareholders to act by the written consent of a majority of the Company's outstanding shares would undermine Shareholder democracy and could disenfranchise many Shareholders by enabling one or more substantial Shareholders to take a corporate action without action by, or even notice to, other Shareholders.** The current requirement that Shareholder action by written consent be made on a unanimous basis helps prevent one or more substantial Shareholders from taking corporate action without the participation of other Shareholders. There are currently more than 10,000 holders of record of the Company's common stock. The Board believes that each of these Shareholders should have the opportunity to consider and vote on proposed Shareholder actions. As discussed above, any Shareholder wishing to take action may do so through the written consent of all Shareholders or by the required vote at a duly convened meeting of Shareholders. In this way, the Board and all other Shareholders have sufficient notice, time, and information to determine whether the proposed action is in the best interests of the Company.

**The Board believes that in addition to ensuring that all shareholders have an opportunity to consider in advance any action to be taken by shareholders, the Texas legislature adopted a default standard requiring that shareholder written consent be unanimous in an effort to alleviate the burdens on company resources that shareholder action by less than unanimous written consent may impose.** Allowing the Company's Shareholders to act by less than unanimous written consent could leave the Company exposed to numerous attempts at Shareholder action by written consent that may be of little or no benefit to the Company and that are a significant encumbrance on the Company's resources as well as on the time and attention of its Employees, which resources would be better spent developing and growing the Company's business.

**The Board also believes that adoption of the proposal could have the effect of making a hostile takeover of the Company and similar disruptive transactions more likely.** In the takeover context, if Shareholders are permitted to act by the written consent of a majority of the Company's outstanding shares, substantial Shareholders could act on takeover bids without consulting minority Shareholders. As part of a hostile takeover attempt, bidders often attempt to force a response by the target company through threats or attempts to secure shareholder action without a meeting, which may not provide the board of directors of the target company with a reasonable opportunity to consider whether the hostile bid or shareholder proposal is in the best interests of the shareholders of the target company. Requiring any Shareholder action to be taken only at a duly called annual or special meeting of Shareholders or by unanimous written consent reduces the Company's vulnerability to such tactics and increases the likelihood that appropriate takeover bids for the Company can be considered in a deliberate, proper, and fully informed manner. The Board believes that this deliberative process is more likely to result in a fully-priced offer for the Company in which all Shareholders receive equal treatment.

**Furthermore, requiring Shareholder action by written consent to continue to be unanimous will not prevent the Company from implementing governance provisions that are particularly significant to Shareholders, and the Board has historically responded to Shareholder initiatives in these areas.** For

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example, (i) in 2004, the Board terminated the Company's Shareholder rights plan; (ii) in 2005, the Board amended the Company's bylaws to eliminate a classified Board structure; (iii) in 2007, the Board approved the removal of certain supermajority voting provisions in the Company's charter and bylaws; and (iv) in 2009, the Board amended the Company's bylaws to change the vote standard for the election of Directors in uncontested elections from a plurality of the votes cast to a majority of the votes cast.

In the exercise of their fiduciary duties under Texas law, the Directors will continue to evaluate evolving governance standards and practices and will consider whether additional changes should be made to the Company's current policies and practices. The Board believes, however, that permitting Shareholders to act by the written consent of a majority of the Company's outstanding shares is not in the Company's or its Shareholders' best interests.

### **Vote Required**

Provided a quorum is present at the meeting, the affirmative vote of the holders of a majority of the shares entitled to vote on, and voted for or against, this proposal is required to approve this proposal. It should be noted, however, that adoption of this proposal would not by itself give Shareholders the right to action by less than unanimous written consent. Under Texas law, the Board has to recommend further action by the Shareholders to amend the Company's charter to give Shareholders the right to take action by less than unanimous written consent.

### **Recommendation of the Board of Directors**

**The Board of Directors unanimously recommends a vote AGAINST this Shareholder proposal. Proxies solicited by the Board of Directors will be so voted unless Shareholders specify a different choice.**

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**OTHER MATTERS**

**Submission of Shareholder Proposals**

To permit the Company and its Shareholders to deal with Shareholder proposals in an informed and orderly manner, the Company's Bylaws establish an advance notice procedure with regard to the nomination (other than by or at the direction of the Board of Directors) of candidates for election to the Board of Directors and with regard to certain other matters to be brought before an Annual Meeting of Shareholders. The Company's Bylaws provide that, in order for a proposal that is not intended to be included in the Company's proxy statement to be properly and timely submitted as business to come before the Company's 2011 Annual Meeting of Shareholders, the proposal must be received by the Secretary of the Company not less than 60 days nor more than 90 days prior to the meeting. If less than 30 days' notice or prior public disclosure of the date of the meeting is given or made to Shareholders, written notice must be received not later than the close of business on the tenth day following the day on which such notice of the date of the Annual Meeting is mailed or such public disclosure is made. Any Shareholder proposal or nomination must contain the information specified in the Company's Bylaws concerning the matter to be brought before the meeting or the person to be nominated and the Shareholder submitting the proposal. Any notice relating to a Shareholder nomination of a person or persons for election to the Board must contain (i) as to each nominee, all information required to be disclosed in solicitations of proxies for election of Directors pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended; (ii) the name and address of the Shareholder giving the notice; and (iii) the number of shares of the Company beneficially owned by the Shareholder giving the notice. Based on a 2011 Annual Meeting date corresponding to this year's Annual Meeting date (and assuming a 30-day notice or public disclosure of such Annual Meeting date), if the Company does not receive notice of a proposal before March 20, 2011, it will be considered untimely and the proxy committee may properly use its discretionary authority to vote for or against the proposal. A copy of the applicable Bylaw provisions may be obtained, without charge, upon written request to the Secretary of the Company at the address set forth on page 1 of this proxy statement.

Notwithstanding the above provisions, any Shareholder who wishes to submit a proposal for inclusion in the Company's proxy statement and proxy relating to the 2011 Annual Meeting of Shareholders must forward such proposal to the Secretary of the Company, at the address indicated on the first page of this proxy statement, so that the Secretary receives it no later than December 17, 2010.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's executive officers, Directors, and persons who beneficially own more than ten percent of the Company's common stock to file reports of ownership and changes in ownership of Company common stock with the SEC and the NYSE. These persons are also required by SEC regulation to furnish the Company with copies of all such reports they file. To the Company's knowledge, based solely on its review of its copies of such reports, or written representations from such persons, the Company believes that all filing requirements applicable to its Directors, executive officers, and beneficial owners of more than ten percent of the Company's common stock have been satisfied.

**Discretionary Authority**

In the event a quorum is present at the meeting but sufficient votes to approve any of the items proposed by the Board of Directors have not been received, the persons named as proxies may propose one or more adjournments of the meeting to permit further solicitation of proxies. A Shareholder vote may be taken on one or more of the proposals in this proxy statement prior to such adjournment if sufficient proxies have been received and it is otherwise appropriate. Any adjournment will require the affirmative vote of the holders of a majority of those shares of common stock represented at the meeting in person or by proxy. If a quorum is present, the persons named as proxies will vote the proxies they have been authorized to vote on any other business properly before the meeting in favor of such an adjournment.



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The Board of Directors does not know of any other matters that are to be presented for action at the meeting. However, if other matters properly come before the meeting, it is intended that the enclosed proxy will be voted in accordance with the judgment of the persons voting the proxy.

### **Householding**

In some cases, only one copy of the Company's proxy statement and annual report to Shareholders is being delivered to multiple Shareholders sharing an address unless the Company has received contrary instructions from one or more of the Shareholders. Upon written or oral request at the address or phone number indicated on the first page of this proxy statement, the Company will promptly deliver a separate copy of these documents to a Shareholder at a shared address to which a single copy has been delivered. A Shareholder can notify the Company at the address or phone number indicated on the first page of this proxy statement if the Shareholder wishes to receive separate copies in the future. In addition, Shareholders sharing an address who are currently receiving multiple copies may also notify the Company at such address or phone number if they wish to receive only a single copy.

### **Costs of Solicitation**

The Company will pay the costs of solicitation of proxies by the Board. In addition to solicitation through distribution of these proxy materials, solicitation of proxies may be made personally or by telephone by the Company's regular Employees, and arrangements will be made with brokerage houses or other custodians, nominees and fiduciaries to send proxies and proxy material to their principals. In addition, the Company has hired Georgeson Inc. to distribute and solicit proxies for a fee of \$16,000 plus expenses.

**A copy of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, including the financial statements and the financial statement schedules, if any, but not including exhibits, will be provided at no charge to each person to whom this proxy statement is delivered upon the written request of such person addressed to Southwest Airlines Co., Attn: Investor Relations, HDQ-6FC, P.O. Box 36611, Dallas, Texas 75235.**

By Order of the Board of Directors,

Gary C. Kelly

Chairman of the Board

April 16, 2010

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**TO: Participants in the Southwest Airlines Co. ProfitSharing Plan (the Plan )**

The Accompanying Notice of Annual Meeting of Shareholders and proxy statement are related to shares of common stock of Southwest Airlines Co. held by the Trustee for your ProfitSharing account, as well as any shares you may own in your own name.

Under the Plan, each participant has the right to direct the Trustee to vote stock credited to his or her account. If you do not direct the Trustee to vote stock credited to your account, the Plan provides that the Trustee will vote your shares in the same proportion as the shares for which the Trustee receives voting instruction from other participants.

The Trustee is required to vote the shares held for your account in accordance with your instructions or, if you do not provide instructions, in accordance with the Plan. If you wish to instruct the Trustee on the vote of shares held for your account, you should vote via telephone or the Internet or complete and sign the form enclosed and return it in the addressed, postage-free envelope. Your vote must be received by May 17, 2010.

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**APPENDIX A**

**Southwest Airlines Co.**

**Audit and Non-Audit Services Preapproval Policy**

**Adopted March 20, 2003**

**I. Purpose**

Under the Sarbanes-Oxley Act of 2002 (the Act) and the rules of the Securities and Exchange Commission (the SEC), the Audit Committee of the Board of Directors is responsible for the appointment, compensation, and oversight of the work of the independent auditor. The Audit Committee is required to pre-approve the audit and non-audit services performed by the independent auditor in order to assure that they do not impair the auditor's independence from the Company. Accordingly, the Audit Committee has adopted, and the Board of Directors of Southwest Airlines Co. (the Company or Southwest) has ratified, this Audit and Non-Audit Services Preapproval Policy (the Policy), which sets forth the procedures and the conditions pursuant to which services proposed to be performed by the independent auditor may be preapproved.

The SEC's rules provide that proposed services may be preapproved without consideration of specific case-by-case services by the Audit Committee (general preapproval) or may require the specific preapproval of the Audit Committee (specific preapproval). The Audit Committee believes that the combination of these two approaches in this Policy will result in an effective and efficient procedure to pre-approve services performed by the independent auditor. Accordingly, unless a type of service has received general preapproval, it will require specific preapproval by the Audit Committee if it is to be provided by the independent auditor. Any proposed services exceeding preapproved cost levels or budgeted amounts will also require specific preapproval by the Audit Committee.

For each preapproval, the Audit Committee will consider whether the services are consistent with the SEC's rules on auditor independence. The Audit Committee will also consider whether the independent auditor is best positioned to provide the most effective and efficient service, for reasons such as its familiarity with the Company's business, people, culture, accounting systems, risk profile and other factors, and whether the service might enhance the Company's ability to manage or control risk or improve audit quality. All such factors will be considered as a whole, and no one factor will necessarily be determinative.

The independent auditor has reviewed this Policy and believes that implementation of the policy will not adversely affect the auditor's independence.

**II. Delegation**

The Act and the SEC's rules permit the Audit Committee to delegate preapproval authority to one or more of its members. The member to whom such authority is delegated must report, for informational purposes only, any preapproval decisions to the Audit Committee at its next scheduled meeting.

**III. Audit Services**

The annual Audit Services Engagement Terms and Fees will be subject to the specific preapproval of the Audit Committee. The Audit Committee will monitor the Audit services engagement as necessary, but no less than on a quarterly basis, and will also approve, if necessary, any changes in terms, conditions and fees.

In addition to the annual Audit services engagement approved by the Audit Committee, the Audit Committee may grant preapproval to other Audit services, which are those services that only the independent auditor reasonably can provide. Other Audit services may include services associated with SEC registration statements or other documents issued in connection with securities offerings.

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**IV. Audit-related Services**

Audit-related services are assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements or that are traditionally performed by the independent auditor. Because the Audit Committee believes that the provision of Audit-related services does not impair the independence of the auditor and is consistent with the SEC's rules on auditor independence, the Audit Committee may grant general preapproval to Audit-related services. Audit-related services include, among others, due diligence services pertaining to potential business acquisitions/dispositions; accounting consultations related to accounting, financial reporting or disclosure matters not classified as Audit services; assistance with understanding and implementing new accounting and financial reporting guidance from rulemaking authorities; financial audits of Employee benefit plans; agreed-upon or expanded audit procedures related to accounting and/or billing records required to respond to or comply with financial, accounting or regulatory reporting matters; and assistance with internal control reporting requirements.

**V. Tax Services**

The Audit Committee believes that the independent auditor can provide Tax services to the Company such as tax compliance, tax planning and tax advice without impairing the auditor's independence and the SEC has stated that the independent auditor may provide such services. The Audit Committee believes it may grant general preapproval to those Tax services that have historically been provided by the auditor, that the Audit Committee has reviewed and believes would not impair the independence of the auditor, and that are consistent with the SEC's rules on auditor independence. The Audit Committee will not permit the retention of the independent auditor in connection with a transaction initially recommended by the independent auditor, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations. The Audit Committee will consult with the Chief Financial Officer or Vice President - Finance to determine that the tax planning and reporting positions are consistent with this policy.

The Audit Committee must preapprove tax services to be provided by the independent auditor to any Executive Officer or Director of the Company, in his or her individual capacity, where such services are paid for by the Company.

**VI. All Other Services**

The Audit Committee believes, based on the SEC's rules prohibiting the independent auditor from providing specific non-audit services, that other types of non-audit services are permitted. Accordingly, the Audit Committee believes it may grant general preapproval to those permissible non-audit services classified as All Other services that it believes are routine and recurring services, would not impair the independence of the auditor, and are consistent with the SEC's rules on auditor independence.

A list of the SEC's prohibited non-audit services is attached in this policy as Exhibit 1. The SEC's rules and relevant guidance should be consulted to determine the precise definitions of these services and the applicability of exceptions to certain of the prohibitions.

**VII. Preapproval Fee Levels or Budgeted Amounts**

Preapproval fee levels for all services to be provided by the independent auditor will be established by the Audit Committee. Any proposed services exceeding these levels or amounts will require specific preapproval by the Audit Committee. The Audit Committee is mindful of the overall relationship of fees for audit and non-audit services in determining whether to pre-approve any such services.

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**VIII. Procedures**

All requests or applications for services to be provided by the independent auditor that do not require specific approval by the Audit Committee will be submitted to the Chief Financial Officer and must include a detailed description of the services to be rendered. The Chief Financial Officer will determine whether such services are included within the list of services that have received the general preapproval of the Audit Committee. The Audit Committee will be informed on a timely basis of any such services rendered by the independent auditor.

Requests or applications to provide services that require specific approval by the Audit Committee will be submitted to the Audit Committee by both the independent auditor and the Chief Financial Officer and must include a joint statement as to whether, in their view, the request or application is consistent with the SEC's rules on auditor independence.

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**Exhibit 1**

**Prohibited Non-Audit Services**

Bookkeeping or other services related to the accounting records or financial statements of the audit client

Financial information systems design and implementation

Appraisal or valuation services, fairness opinions or contribution-in-kind reports

Actuarial services

Internal audit outsourcing services

Management functions

Human resources

Broker-dealer, investment adviser or investment banking services

Legal services

Expert services unrelated to the audit

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**APPENDIX B**

**SOUTHWEST AIRLINES CO.**

**AMENDED AND RESTATED 2007 EQUITY INCENTIVE PLAN**

**I. PURPOSE**

The purpose of the **SOUTHWEST AIRLINES CO. AMENDED AND RESTATED 2007 EQUITY INCENTIVE PLAN** is to benefit and advance the interests of the Company and its shareholders by (i) attracting and retaining highly-qualified key Employees, Directors, and Advisors for the Company and its Affiliates; (ii) providing additional incentives to such individuals to contribute to the long-term success of the Company; and (iii) further aligning the interests of such individuals with those of the Company's shareholders.

This plan amends and restates the Southwest Airlines Co. 2007 Equity Incentive Plan, which first became effective on May 16, 2007. To the extent permitted by applicable laws, rules, or regulations, including the rules of any stock exchange or automated quotation system upon which the Company's Common Stock is listed or quoted, the Committee shall have the power, in its sole discretion, to apply any or all of the amendments effected hereby to outstanding Awards previously granted hereunder.

**II. DEFINITIONS**

The following definitions shall be applicable throughout the Plan, unless specifically modified by any provision of the Plan:

(a) *Advisor* means any natural person performing advisory or consulting services for the Company or any Subsidiary, with or without compensation, to whom the Company chooses to grant an Award under the Plan; *provided that* (i) *bona fide* services must be rendered by such person; and (ii) such services are not rendered in connection with the offer or sale of securities in a capital-raising transaction and do not directly or indirectly promote or maintain a market for the Company's securities.

(b) *Affiliate* means any corporation, partnership, limited liability company or partnership, association, trust, or other organization that directly or indirectly controls, is controlled by, or is under common control with, the Company. For purposes of the preceding sentence, control (including, with correlative meanings, the terms controlled by and under common control with), as used with respect to any entity or organization, shall mean the possession, directly or indirectly, of the power (i) to vote more than 50 percent of the securities having ordinary voting power for the election of directors of the controlled entity or organization; or (ii) to direct or cause the direction of the management and policies of the controlled entity or organization, whether through the ownership of voting securities or by contract or otherwise.

(c) *Agreement* means an agreement, certificate, or other documentation (in each case, whether in written, electronic, or other format) governing the grant of an Award under the Plan, which shall contain terms and conditions not inconsistent with the Plan and which shall incorporate the Plan by reference.

(d) *Award* means any grant of Options, Restricted Stock Awards, Restricted Stock Units, unrestricted shares of Common Stock, Stock Appreciation Rights, Phantom Shares, or any combination of any of the above granted under the Plan, whether or not granted as a Performance Award.

(e) *Board* means the Board of Directors of the Company.

(f) *Code* means the Internal Revenue Code of 1986, as amended. References in the Plan to any section of the Code shall be deemed to include any amendments or successor provisions to such section and any rules and regulations promulgated thereunder.

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- (g) *Committee* means the committee(s) appointed by the Board to administer the Plan, in accordance with Section IV(a) of the Plan.
- (h) *Common Stock* means the common stock, par value \$1.00 per share, of the Company, or any security into which such common stock may be changed by reason of any transaction or event of the type described in Section XIII of the Plan.
- (i) *Company* means Southwest Airlines Co., a Texas corporation.
- (j) *Deductible Stock Awards* means (i) Options, (ii) Stock Appreciation Rights, and (iii) any other types of Awards designed to satisfy the Section 162(m) Exception.
- (k) *Director* means an individual who is a member of the Board.
- (l) *Employee* means any person (including a Director) in an employment relationship with the Company or any Affiliate.
- (m) *Exchange Act* means the Securities Exchange Act of 1934, as amended.
- (n) *Fair Market Value* of a share of Common Stock on a given date means, unless otherwise determined by the Committee, the closing price of a share of Common Stock as reported by the primary national securities exchange on which such stock is listed. If no sale shall have been made on that day, unless otherwise determined by the Committee, fair market value will be determined by reference to the last preceding date on which the price of the Common Stock is reported by such exchange. In the event the Common Stock is no longer listed for trading on a national securities exchange, the Committee may designate such other market or source of data as it deems appropriate for determining such value for purposes of the Plan. Notwithstanding anything to the contrary in the foregoing, the fair market value for purposes of grants under the Plan shall be determined in a manner consistent with avoiding adverse tax consequences under Section 409A.
- (o) *Incentive Stock Option* means an incentive stock option within the meaning of Section 422 of the Code.
- (p) *Plan Limit* has the meaning set forth in Section V of the Plan.
- (q) *Non-Employee Director* means a member of the Board who is not an Employee of the Company or any of its Affiliates.
- (r) *Non-Qualified Stock Option* means any Option that does not qualify as an Incentive Stock Option.
- (s) *Option* means a right granted to a Participant under Section VII of the Plan to purchase shares of Common Stock at such time and price, and subject to such other terms, conditions, restrictions, and contingencies as are set forth in the Plan and in the applicable Agreement. Options may be Incentive Stock Options or Non-Qualified Stock Options.
- (t) *Participant* means an Employee, Director, or Advisor to whom an Award has been granted under the Plan.
- (u) *Performance Award* means an Award granted to a Participant that is conditioned in some manner upon the achievement of one or more of the performance measures described in Section XII of the Plan.
- (v) *Phantom Share* means a right granted to a Participant pursuant to Section XI of the Plan to receive, in the discretion of the Committee, cash or shares of Common Stock equal to the Fair Market Value or the appreciation in the Fair Market Value of a share of Common Stock, which grant is subject to such terms, conditions, restrictions, and contingencies as are set forth in the Plan and in the applicable Agreement.
- (w) *Plan* means the Southwest Airlines Co. Amended and Restated 2007 Equity Incentive Plan.
- (x) *Plan Term* has the meaning set forth in Section III of the Plan.



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(y) *Restricted Stock Award* means an Award of Common Stock granted under Section VIII of the Plan that is subject to the restrictions set forth in such Section and to such other terms, conditions, restrictions, and contingencies as are set forth in the Plan and in the applicable Agreement.

(z) *Restricted Stock Unit* means a right granted pursuant to Section IX of the Plan to receive in the future, in the discretion of the Committee, (a) a share of Common Stock; (b) a cash payment equal to the Fair Market Value of a share of Common Stock; or (c) a combination of Common Stock and cash, which Award is subject to such terms, conditions, restrictions, and contingencies as are set forth in the Plan and in the applicable Agreement.

(aa) *Rule 16b-3* means Rule 16b-3 promulgated under the Exchange Act, as such may be amended from time to time, and any successor rule, regulation, or statute fulfilling the same or a similar function.

(bb) *Section 162(m)* means Section 162(m) of the Code.

(cc) *Section 162(m) Exception* means the exception under Section 162(m) for qualified performance-based compensation.

(dd) *Section 409A* means Section 409A of the Code and Department of Treasury regulations and other interpretive guidance issued thereunder.

(ee) *Service* means a Participant's employment or service with the Company or any Affiliate of the Company, whether in the capacity of an Employee, a Director, or an Advisor. A Participant's Service shall not be deemed to have terminated merely because of a change in the capacity in which the Participant renders Service to the Company or any Affiliate or because of a change in entity for which services are performed; *provided, however*, to the extent necessary to comply with the provisions of Section 409A, a termination of Service shall mean a separation from service within the meaning of Section 409A.

(ff) *Stand-Alone Stock Appreciation Right* has the meaning set forth in Section X of the Plan.

(gg) *Stock Appreciation Right* means a right granted pursuant to Section X of the Plan to receive, in the discretion of the Committee, a payment in cash or shares of Common Stock equal to the excess of the Fair Market Value of a specified number of shares of Common Stock on the date the right is exercised over a specified exercise price, as determined in accordance with Section X of the Plan and subject to such other terms, conditions, restrictions, and contingencies as are set forth in the Plan and in the applicable Agreement. Stock Appreciation Rights may be Tandem Stock Appreciation Rights or Stand-Alone Stock Appreciation Rights.

(hh) *Subsidiary* means a subsidiary corporation of the Company within the meaning of Section 424(f) of the Code; *provided that*, with respect to Awards other than Incentive Stock Options, the term *Subsidiary* shall also be deemed to include a partnership, limited liability company, or other entity in which the Company controls, directly or indirectly, a majority of the voting power or equity interests.

(ii) *Substitute Award* means an Award granted pursuant to Section XIII(d) of the Plan.

(jj) *Tandem Stock Appreciation Right* has the meaning set forth in Section X of the Plan.

**III. EFFECTIVE DATE AND DURATION OF THE PLAN**

The Plan originally became effective on May 16, 2007. As amended and restated, the Plan shall become effective upon the date of its approval by the shareholders of the Company. No Awards may be granted under the Plan after March 17, 2020 (the *Plan Term*). Subject to other applicable provisions of the Plan, all Awards made under the Plan prior to termination of the Plan shall remain in effect until such Awards have been satisfied or terminated in accordance with the Plan and the terms of the Awards.

**Table of Contents****IV. ADMINISTRATION**

(a) *Composition of the Committee.* The Plan shall be administered by the Board or by a committee of, and appointed by, the Board that shall be comprised of at least two members of the Board; *provided that*, (i) with respect to any Award that is intended to satisfy the requirements of Rule 16b-3, such committee shall consist of at least such number of Directors as is required from time to time by Rule 16b-3, and each such committee member shall satisfy the qualification requirements of such rule; (ii) with respect to any Award that is intended to satisfy the requirements of the Section 162(m) Exception, such committee shall consist of at least such number of Directors as is required from time to time to satisfy the Section 162(m) Exception, and each such committee member shall satisfy the qualification requirements of such exception; and (iii) to the extent required under the rules of any stock exchange or automated quotation system on which the Common Stock is listed for trading or quoted, each member of such committee shall satisfy any independence or other requirements of such exchange or quotation system; *provided, however*, that if any such committee member is found not to have met the qualification requirements set forth in clauses (i) and/or (ii) above, any actions taken or Awards granted by such committee shall not be invalidated by such failure to so qualify. Subject to (i) the limitations set forth in this Section IV and (ii) any limitations set forth in the Texas Business Organizations Code, as well as any other laws, rules, or regulations that may apply from time to time, the Committee shall have the authority to delegate some or all of its authority under the Plan to one or more members of the Committee or to one or more officers of the Company.

(b) *Powers of the Committee.* Subject to the express provisions of the Plan, the Committee shall have authority, in its discretion, to determine (i) the recipients of Awards; (ii) the timing of Awards; (iii) the types of Awards to be granted; (iv) the number of shares or cash amounts payable in connection with Awards; and (v) the terms, conditions, restrictions, and/or limitations applicable to each Award in accordance with the terms of the Plan. To the extent the Committee determines that restrictions imposed by the Plan preclude the achievement of the material purposes of the Awards in jurisdictions outside of the United States, the Committee will have the authority and discretion to grant Awards to Employees, Directors, and Advisors outside the United States on such terms and conditions different from those specified in the Plan as may, in the judgment of the Committee, be necessary or desirable to further the purposes of the Plan.

Subject to the express provisions of the Plan, and to the maximum extent permitted by law, the Committee shall also have the power (i) to interpret the Plan and the Agreements issued pursuant to the Plan; (ii) to establish, amend, and rescind any rules and regulations relating to the Plan; and (iii) to make all other determinations necessary or advisable for administering the Plan. The Committee may correct any defect, supply any omission, or reconcile any inconsistency in the Plan or in any Agreement relating to an Award in the manner and to the extent it shall deem expedient to carry it into effect. Subject to the express provisions of the Plan (*e.g.*, relating to repricing and minimum vesting requirements), the Committee shall have the authority to amend the terms of any outstanding Award or to waive any condition or restriction applicable to any Award in any manner that is not inconsistent with the terms of the Plan; *provided, however*, that no amendment may materially impair the rights of the holder thereof without the holder's consent. Notwithstanding the foregoing, subject to the limitations of applicable law, the Committee may amend the terms of any Award without the affected Participant's consent if necessary to comply with any law, regulation, judicial decision, accounting standards, regulatory guidance, or other legal requirement, or to comply with Section 409A. All decisions, determinations, and interpretations of the Committee regarding the Plan and its administration shall be final and binding.

With respect to any restriction in the Plan, or to which any Award is subject, that is based on the requirements of Rule 16b-3, Section 422 of the Code, the Section 162(m) Exception, Section 409A, the rules of any exchange upon which the Company's securities are listed or automated quotation system upon which the Company's securities are quoted, or any other applicable law, rule, or restriction, to the extent that any such restriction is no longer required, the Committee shall have the sole discretion and authority to grant Awards that are not subject to such restriction and/or to waive any such restriction with respect to outstanding Awards.

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(c) *Non-Uniform Determinations.* The Committee's determinations under the Plan need not be uniform and may be made by it selectively among persons who receive, or are eligible to receive, Awards under the Plan (whether or not such persons are similarly situated). Without limiting the generality of the foregoing, the Committee shall be entitled, among other things, to make non-uniform and selective determinations and to enter into non-uniform and selective Agreements as to the persons receiving Awards under the Plan and the terms and provisions of Awards under the Plan.

**V. SHARES SUBJECT TO THE PLAN**

Subject to adjustment in accordance with Section XIII of the Plan (Recapitalization or Reorganization), the maximum number of shares of Common Stock that may be issued under the Plan (the Plan Limit) with respect to all types of Awards in the aggregate shall not exceed 18 million (including the 6 million shares originally authorized for issuance under the Plan). Subject to the remaining provisions of this Section V, no Award may be granted if the number of shares of Common Stock to be delivered in connection with such Award exceeds the number of shares of Common Stock remaining available under the Plan minus the number of shares of Common Stock issuable in settlement of or relating to then-outstanding Awards. The Committee may adopt reasonable counting procedures to ensure appropriate counting, avoid double counting (as, for example, in the case of tandem or substitute awards), and make adjustments if the number of shares of Common Stock actually delivered differs from the number of shares previously counted in connection with an Award. To the extent all or a portion of an Award under the Plan (a) expires or is canceled, forfeited, exchanged, settled in cash, or otherwise terminated without an issuance of shares of common stock; or (b) in the case of Restricted Stock, is forfeited, the shares of Common Stock subject to the Award will again be available for Awards under the Plan, except that if any such shares of Common Stock could not again be available for Awards to a particular Participant under any applicable law or regulation, the shares will be available exclusively for Awards to Participants who are not subject to such limitation. Notwithstanding any provision in the Plan to the contrary, subject to adjustment in accordance with Section XIII of the Plan, (i) the maximum number of shares of Common Stock with respect to which Deductible Stock Awards may be granted in the aggregate to any Participant during any calendar year may not exceed 1 million (regardless of whether settled in cash or shares of Common Stock); and (ii) the maximum number of shares of Common Stock with respect to which unrestricted shares of Common Stock, stock-settled Phantom Shares, and Awards to Non-Employee Directors may be granted during the Plan Term may not exceed 5 percent of the Plan Limit. Any shares of Common Stock underlying Substitute Awards shall not be counted against the limits set forth in this paragraph to the extent the grant of such Substitute Awards would not otherwise require shareholder approval pursuant to the rules of any stock exchange or applicable law. Subject to the limitations set forth in Sections VII(g) and X(f) of the Plan, Awards granted on the condition precedent of surrender of outstanding Awards shall not count against the limits set forth in this Section V until such time as such previous Awards are surrendered and cancelled.

The shares of Common Stock to be offered pursuant to Awards under the Plan may be authorized but unissued shares of Common Stock, shares of Common Stock previously issued and outstanding and reacquired by the Company, or both. Any of such shares that remain unissued and that are not subject to outstanding Awards at the termination of the Plan shall cease to be subject to the Plan but, until termination of the Plan, the Company shall at all times make available a sufficient number of shares to meet the requirements of the Plan.

**VI. ELIGIBILITY**

Awards may be granted to any Employee, Director, or Advisor; *provided that* Awards of Incentive Stock Options may only be granted to Employees of the Company or any parent or Subsidiary in accordance with Section VII(d) below.

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**VII. OPTIONS**

(a) *Grants of Options.* The Committee may from time to time grant Options on the terms and conditions set forth in the Plan (including achievement of performance measures) and on such other terms and conditions as are not inconsistent with the purposes and provisions of the Plan as the Committee, in its discretion, may from time to time determine.

(b) *Option Term.* The term of each Option shall be as specified by the Committee, but in no event shall an Option be exercisable after the expiration of ten years from the date of its grant.

(c) *Exercisability of Options.* Options shall be exercisable in whole or in such installments and at such times as are determined by the Committee.

(d) *Special Limitations on Incentive Stock Options.* The maximum number of shares of Common Stock that may be issued under the Plan with respect to Incentive Stock Options shall be 18 million (including the 6 million shares originally authorized for issuance under the Plan), subject to the following limitations. An Incentive Stock Option may be granted only to an individual who is employed by the Company or any parent or Subsidiary at the time the Option is granted. To the extent that the aggregate Fair Market Value (determined at the time an Incentive Stock Option is granted) of the Common Stock with respect to which Incentive Stock Options are exercisable for the first time by an individual during any calendar year under all incentive stock option plans of the Company and its parent and Subsidiary exceeds \$100,000, such Incentive Stock Options shall be treated as Non-Qualified Stock Options. No Incentive Stock Option shall be granted to an individual if, at the time the Option is granted, such individual owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the Company or of its parent or Subsidiaries, within the meaning of Section 422(b)(6) of the Code, unless (i) at the time such Option is granted the option price is at least 110 percent of the Fair Market Value of the Common Stock subject to the Option and (ii) such Option by its terms is not exercisable after the expiration of five years from the date of grant.

(e) *Option Exercise Price and Payment of Exercise Price.* The exercise price of an Option shall be determined by the Committee but, subject to adjustment as provided in Section XIII, such exercise price shall not be less than the Fair Market Value of a share of Common Stock on the date such Option is granted. Unless limited by the Committee, the Option exercise price may be paid, to the extent permitted by applicable law, as follows: (i) in cash, check, bank draft, or money order payable to the Company; (ii) by delivery to the Company (either by actual delivery or attestation) of shares of Common Stock; (iii) by delivery (including by fax, telephonic, electronic, or other means in accordance with procedures determined by the Company) to the Company or its designated agent of an irrevocable Option exercise notice together with irrevocable instructions from the Participant to a broker or dealer, reasonably acceptable to the Company, to sell certain shares of Common Stock purchased upon exercise of an Option or to pledge such shares as collateral for a loan and promptly deliver to the Company the amount of sale or loan proceeds necessary to pay the exercise price for the Option (*provided that*, with respect to such a cashless exercise, the Option shall be deemed exercised on the date of sale of the shares of Common Stock received upon exercise); (iv) by a net exercise arrangement pursuant to which the Company will reduce the number of shares of Common Stock issued upon exercise by the largest whole number of shares with a Fair Market Value that does not exceed the aggregate exercise price; provided, however, that the Company shall accept a cash or other payment from the Participant to the extent of any remaining balance of the aggregate exercise price not satisfied by such reduction in the number of whole shares to be issued; and/or (v) in any other form of valid consideration that is acceptable to the Committee in its sole discretion.

(f) *Rights Upon Termination of Service.* Subject to Section VII(d) above (regarding Incentive Stock Options), in the event of the termination of a Participant's Service, such Participant's Options that have not vested as of the date of termination shall automatically and without notice terminate and become null and void at 4:00 p.m., Eastern Time, on the date of termination. The vested portion of the Participant's outstanding Options

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shall thereafter automatically and without notice terminate and become null and void at 4:00 p.m., Eastern Time, on the date that is the earliest to occur of the following (the "Option Termination Date"):

(i) The date of the Participant's termination of Service for cause, including breach by the Participant of an employment agreement with the Company or an Affiliate or the Participant's commission of a felony or misdemeanor (whether or not prosecuted) against the Company or an Affiliate;

(ii) The expiration of two years following the date of termination of a Participant's Service other than for cause;

(iii) The expiration of such period of time or the occurrence of such event as the Committee in its discretion may provide in the Participant's Option Agreement; and

(iv) The expiration of ten years from the date of grant of such Option.

Upon the occurrence of any event described in this Section VII(f), any Participant who desires to exercise an Option prior to the Option Termination Date shall be required to provide notice of exercise prior to the close of trading on the New York Stock Exchange on the Option Termination Date.

(g) *Restrictions on Repricing of Options.* Subject to Section XIII of the Plan ("Recapitalization or Reorganization"), unless approved by the Company's shareholders, no Option may be repriced, replaced, re-granted through cancellation, or modified if the effect would be to reduce the exercise price for the shares underlying the Option.

(h) *Shareholder Rights and Privileges.* A Participant shall have no right to receive dividends, vote, or otherwise exercise the privileges and rights of a shareholder with respect to an unexercised Option. The Participant shall be entitled to all the privileges and rights of a shareholder only with respect to such shares of Common Stock as have been purchased under the Option and for which shares of Common Stock have been registered in the Participant's name or otherwise credited to the Participant.

(i) *Option Agreements.* Options granted under the Plan shall be evidenced by an Option Agreement in such form and containing such provisions not inconsistent with the provisions of the Plan as the Committee from time to time shall approve, including, without limitation, (i) the number of Options granted; (ii) the date of grant; (iii) the exercise price for the Options; (iv) whether such Options are Incentive Stock Options or Non-Qualified Stock Options; (v) the period during which such Options may be exercised and any vesting schedule applicable to such Options, including any applicable performance measures (as set forth in Section XII); (vi) the effect of termination of Service on the exercisability of the Options; and (vii) any other terms that the Committee deems appropriate.

**VIII. RESTRICTED STOCK AWARDS AND UNRESTRICTED STOCK GRANTS**

(a) *Grants of Restricted Stock.* The Committee may from time to time grant shares of Restricted Stock on the terms and conditions set forth in the Plan (including achievement of performance measures) and on such other terms and conditions as are not inconsistent with the purposes and provisions of the Plan as the Committee, in its discretion, may from time to time determine.

(b) *Vesting of Restricted Stock.* Shares of Common Stock that are the subject of a Restricted Stock Award shall be subject to restrictions on disposition by the Participant and an obligation of the Participant to forfeit and surrender the shares to the Company under certain circumstances, as determined by the Committee. The Committee shall establish the vesting schedule applicable to each Restricted Stock Award, *provided that* (i) in no event shall any Restricted Stock Award that has a vesting schedule based on the passing of time have (or be accelerated such that it has) a vesting schedule of less than three years from the date of grant, and no more than 33 1/3 percent of any such Award shall vest (or be accelerated such that it vests) on each anniversary of the date

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of grant; and (ii) in no event shall any Restricted Stock Award that is a Performance Award vest (or be accelerated such that it vests) in under one year from the date of grant. The Committee may provide that the shares will vest upon (i) the Participant's continued employment with the Company for a specified period of time; (ii) the attainment of one or more performance measures established by the Committee, as set forth in Section XII; (iii) the occurrence of any event or the satisfaction of any other condition specified by the Committee in its sole discretion; or (iv) a combination of any of the foregoing.

(c) *Rights and Restrictions Governing Restricted Stock.* Common Stock awarded pursuant to a Restricted Stock Award shall be registered in the Participant's name or otherwise credited to the Participant. Unless provided otherwise in a Restricted Stock Agreement, the Participant shall have the right to receive dividends or other distributions with respect to shares of Common Stock subject to a Restricted Stock Award, to vote Common Stock subject thereto, and to enjoy all other shareholder rights, except that (i) the Participant shall not be entitled to delivery of unrestricted shares until all conditions to vesting have been satisfied; (ii) the Participant may not sell, transfer, pledge, assign, exchange, hypothecate, or otherwise encumber or dispose of the shares until all conditions to vesting have been satisfied; and (iii) a breach of the terms and conditions established by the Committee pursuant to the Restricted Stock Agreement shall cause a forfeiture of the Restricted Stock.

(d) *Payment for Restricted Stock.* The Committee shall determine the amount and form of any payment for Common Stock received pursuant to a Restricted Stock Award, *provided that*, in the absence of such a determination, a Participant shall not be required to make any payment for Common Stock received pursuant to a Restricted Stock Award, except to the extent otherwise required by law.

(e) *Rights Upon Termination of Service.* Unless otherwise determined by the Committee, in the event of the termination of a Participant's Service, any of such Participant's shares of Restricted Stock that have not vested as of the date of termination shall automatically and without notice be forfeited at 4:00 p.m., Eastern Time, on the date of termination.

(f) *Restricted Stock Agreements.* Restricted Stock Awards granted under the Plan shall be evidenced by a Restricted Stock Agreement in such form and containing such provisions not inconsistent with the provisions of the Plan as the Committee from time to time shall approve, including, without limitation, (i) the number of shares of Restricted Stock granted; (ii) the date of grant; (iii) the price, if any, to be paid by the Participant for such Restricted Stock; (iv) the vesting schedule applicable to such Restricted Stock, including any applicable performance measures (as set forth in Section XII) or other restrictions or contingencies; (v) the effect of termination of Service on the vesting of the Restricted Stock; and (vi) any other terms that the Committee deems appropriate.

(g) *Unrestricted Stock Grants.* The Committee, in its sole discretion, may grant Awards of unrestricted Common Stock in recognition of outstanding achievements and performance or for any other reason it deems appropriate.

## **IX. RESTRICTED STOCK UNITS**

(a) *Grants of Restricted Stock Units.* The Committee may from time to time grant Restricted Stock Units on the terms and conditions set forth in the Plan (including achievement of performance measures) and on such other terms and conditions as are not inconsistent with the purposes and provisions of the Plan as the Committee, in its discretion, may from time to time determine.

(b) *Vesting of Restricted Stock Units.* The Committee shall establish the vesting schedule applicable to each Restricted Stock Unit Award; *provided that* (i) in no event shall any Restricted Stock Unit Award that has a vesting schedule based on the passing of time have (or be accelerated such that it has) a vesting schedule of less than three years from the date of grant, and no more than 33 1/3 percent of any such Award shall vest (or be

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accelerated such that it vests) on each anniversary of the date of grant; and (ii) in no event shall any Restricted Stock Unit Award that is a Performance Award vest (or be accelerated such that it vests) in under one year from the date of grant. The Committee may provide that Restricted Stock Units will vest upon (i) the Participant's continued employment with the Company for a specified period of time; (ii) the attainment of one or more performance measures established by the Committee, as set forth in Section XII; (iii) the occurrence of any event or the satisfaction of any other condition specified by the Committee in its sole discretion; or (iv) a combination of any of the foregoing.

(c) *Settlement of Restricted Stock Units.* On the date on which Restricted Stock Units vest (or at such other time or times as the Committee may provide), the holder of such Restricted Stock Units shall be entitled to receive, as determined by the Committee, one share of Common Stock for each Restricted Stock Unit that has vested, cash equal to the Fair Market Value of the shares subject to the Restricted Stock Units, or a combination of cash and shares. If Restricted Stock Units are settled in shares, the applicable number of shares of Common Stock shall be registered in the Participant's name or otherwise credited to the Participant.

(d) *Shareholder Rights and Privileges.* A Participant shall have no right to receive dividends, vote, or otherwise exercise the privileges and rights of a shareholder with respect to outstanding Restricted Stock Units granted pursuant to this Section. The Participant shall be entitled to all of the privileges and rights of a shareholder only with respect to such shares of Common Stock as have been issued pursuant to a Restricted Stock Unit Award and that have been registered in the Participant's name or otherwise credited to the Participant.

(e) *Rights Upon Termination of Service.* Unless otherwise determined by the Committee, in the event of the termination of a Participant's Service, any of such Participant's Restricted Stock Units that have not vested as of the date of termination shall automatically and without notice be forfeited at 4:00 p.m., Eastern Time, on the date of termination.

(f) *Restricted Stock Unit Agreements.* Restricted Stock Units granted under the Plan shall be evidenced by a Restricted Stock Unit Agreement in such form and containing such provisions not inconsistent with the provisions of the Plan as the Committee from time to time shall approve, including, without limitation, (i) the number of Restricted Stock Units granted; (ii) the date of grant; (iii) the price, if any, to be paid by the Participant in connection with such Restricted Stock Units; (iv) the vesting schedule applicable to such Restricted Stock Units, including any applicable performance measures (as set forth in Section XII) or other restrictions or contingencies; (v) the effect of termination of Service on the vesting of the Restricted Stock Units; and (vi) any other terms that the Committee deems appropriate.

## **X. STOCK APPRECIATION RIGHTS**

(a) *Grants of Stock Appreciation Rights.* The Committee may from time to time grant Stock Appreciation Rights on the terms and conditions set forth in the Plan (including achievement of performance measures) and on such other terms and conditions as are not inconsistent with the purposes and provisions of the Plan as the Committee, in its discretion, may from time to time determine. The Committee may grant Stock Appreciation Rights in tandem with Stock Options (a Tandem Stock Appreciation Right) or not in tandem with Stock Options (a Stand-Alone Stock Appreciation Right).

(b) *Term of Stock Appreciation Rights.* The term of each Stock Appreciation Right shall be as specified by the Committee, but in no event shall a Stock Appreciation Right be exercisable after the expiration of ten years from the date of its grant.

(c) *Exercisability of Stock Appreciation Rights.* Stock Appreciation Rights shall be exercisable in whole or in such installments and at such times as are determined by the Committee.

(d) *Payment.* A Stock Appreciation Right shall entitle the holder thereof to receive from the Company an amount equal to the excess of the Fair Market Value of a share of Common Stock on the exercise date over the

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exercise price for the Stock Appreciation Right multiplied by the number of rights exercised. The exercise price of a Stock Appreciation Right shall be determined by the Committee but, subject to adjustment as provided in Section XIII, such exercise price shall not be less than the Fair Market Value of a share of Common Stock on the date the Stock Appreciation Right is granted. Payment for Stock Appreciation Rights may be made in shares of Common Stock, cash equal to the Fair Market Value of the shares subject to the Stock Appreciation Right, or a combination of cash and shares. If Stock Appreciation Rights are settled in shares, the applicable number of shares of Common Stock shall be registered in the Participant's name or otherwise credited to the Participant.

(e) *Stock Appreciation Rights Granted in Tandem with Options.* If a Stock Appreciation Right is granted in tandem with an Option, such Stock Appreciation Right may be granted at the same time as, or, in the case of a Non-Qualified Stock Option, subsequent to, the time the related Option is granted. The Stock Appreciation Right shall be subject to the same terms and conditions as the related Option and shall be exercisable only at such times and to such extent as the related Option is exercisable. A Stock Appreciation Right granted in tandem with an Option shall entitle the holder either

(i) to exercise the related Option with respect to all or a portion of the vested shares underlying such Option; or

(ii) to exercise the Stock Appreciation Right by surrendering to the Company all or a portion of the related Option (to the extent vested), in which case the holder shall be entitled to receive from the Company in exchange therefore an amount equal to the excess of the Fair Market Value of the shares of Common Stock underlying the surrendered portion of such Option (determined as of the day preceding the surrender of such Option) over the aggregate Option exercise price for such shares.

The exercise of a Tandem Stock Appreciation Right shall cause the immediate and automatic cancellation of its related Option with respect to the number of shares underlying the surrendered portion of the Option. Likewise, the exercise of the related Option shall cause the immediate and automatic cancellation of the tandem Stock Appreciation Right with respect to the number of shares underlying the surrendered portion of the Tandem Stock Appreciation Right.

(f) *Rights Upon Termination of Service and Restrictions on Repricing.* The provisions of Section 7(f) (relating to Termination of Service) and Section 7(g) (relating to restrictions on repricing) shall apply equally to grants of Stock Appreciation Rights.

(g) *Shareholder Rights and Privileges.* A Participant shall have no right to receive dividends, vote, or otherwise exercise the privileges and rights of a shareholder with respect to unexercised Stock Appreciation Rights. The Participant shall be entitled to all of the privileges and rights of a shareholder only to the extent that shares of Common Stock have been issued pursuant to a Stock Appreciation Right Award and have been registered in the Participant's name or otherwise credited to the Participant.

(h) *Stock Appreciation Rights Agreements.* Stock Appreciation Rights granted under the Plan shall be evidenced by a Stock Appreciation Rights Agreement in such form and containing such provisions not inconsistent with the provisions of the Plan as the Committee from time to time shall approve, including, without limitation, (i) the number of Stock Appreciation Rights granted; (ii) the date of grant; (iii) the exercise price for the Stock Appreciation Rights; (iv) the period during which such Stock Appreciation Rights may be exercised and any vesting schedule applicable to such Stock Appreciation Rights, including any applicable performance measures (as set forth in Section XII); (v) the effect of termination of Service on the exercisability of the Stock Appreciations Rights; and (vi) any other terms that the Committee deems appropriate.

## **XI. PHANTOM SHARES**

(a) *Grants of Phantom Shares.* The Committee may from time to time grant Phantom Shares on the terms and conditions set forth in the Plan and on such other terms and conditions as are not inconsistent with the purposes and provisions of the Plan as the Committee, in its discretion, may from time to time determine.



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(b) *Value of Phantom Shares.* The value of a Phantom Share shall be determined by reference to the Fair Market Value of a share of Common Stock on a given date or over a period of time specified by the Committee. The Committee shall provide in the Agreement for one or more valuation dates on which (or over which) the value of the Phantom Shares granted pursuant to the Agreement shall be measured and fixed, and shall designate in the Agreement the number of such Phantom Shares with respect to which the value is to be calculated.

(c) *Phantom Share Agreements.* Phantom Shares granted under the Plan shall be evidenced by a Phantom Share Agreement in such form and containing such provisions not inconsistent with the provisions of the Plan as the Committee from time to time shall approve, including, without limitation, (i) the number of Phantom Shares granted; (ii) the date of grant; (iii) the valuation date(s); (iv) any vesting schedule applicable to the Phantom Shares, including any applicable performance measures (as set forth in Section XII) or other restrictions or contingencies; (v) the effect of termination of Service on the Participant's rights with respect to the Phantom Shares; (vi) the payment date(s) applicable to the Phantom Shares; and (vii) any other terms that the Committee deems appropriate.

**XII. PERFORMANCE AWARDS**

The grant, vesting, and/or exercisability of any Award may, in the Committee's sole discretion, be conditioned, in whole or in part, on the attainment of performance targets related to one or more performance measures over a performance period, in which case, such Award shall constitute a Performance Award under the Plan.

(a) *Performance Measures.*

(i) Performance Awards that are not intended to qualify for the Section 162(m) Exception may be based on the achievement of such goals and be subject to such terms, conditions, and restrictions as the Committee shall determine.

(ii) Performance Awards that are intended to qualify for the Section 162(m) Exception based on the satisfaction of one or more performance measures shall be conditioned upon the achievement during a specified performance period of specified levels of one or more of the measures listed below. The Committee shall establish the performance measures applicable to such performance either (i) prior to the beginning of the performance period or (ii) within 90 days after the beginning of the performance period if the outcome of the performance targets is substantially uncertain at the time such targets are established, but not later than the date on which 25 percent of the performance period has elapsed; provided such measures may be made subject to adjustment for specified significant extraordinary items or events to the extent consistent with Section 162(m) of the Code. The performance measures established by the Committee may be based upon (1) the earnings or earnings per share of the Company or of any business unit of the Company designated by the Committee; (2) the net operating margin of the Company or of any business unit of the Company designated by the Committee; (3) the cash flow return on investment of the Company or any business unit of the Company designated by the Committee; (4) the earnings before interest, taxes, depreciation, and/or amortization of the Company or any business unit of the Company designated by the Committee; (5) the return on shareholders' equity achieved by the Company; (6) the total shareholders return achieved by the Company; (7) any of the foregoing calculated on a non-GAAP basis; (8) the price of a share of Common Stock; (9) the Company's market share; (10) the market share of a business unit of the Company designated by the Committee; (11) the Company's sales; (12) the sales of a business unit of the Company designated by the Committee; (13) the economic value added; or (14) any combination of the foregoing. A measure that is calculated on a non-GAAP basis is a measure that is adjusted (to the extent consistent with the Section 162(m) Exception) to reflect the impact of special items, which items are reflected from time to time in the Company's published financials. Special items are material nonrecurring adjustments deemed appropriate to exclude by the Committee and may include, without limitation, (a) unrealized gains or losses and other items that are recorded by the Company as a result of Accounting

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Standards Codification Topic 815 (previously issued as Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended); (b) impairment and other non-cash charges including the impact of changes in accounting principles or estimates or other unusual, infrequent non-cash items; and (c) other items not considered to be representative of the Company's ongoing operations.

(b) *Determination of Awards.* To the extent the Committee intends for Awards to qualify for the Section 162(m) Exception, prior to the Participants' receipt of shares of Common Stock (or cash, as applicable) pursuant to such Awards (or prior to receipt of the Awards themselves, if applicable), the Committee shall certify whether the performance targets and measure(s) related to such Awards have been achieved. The Committee, in its sole discretion, may provide for a reduction in a Participant's Performance Award during the performance period.

**XIII. RECAPITALIZATION OR REORGANIZATION**

(a) *No Effect on Right or Power.* The existence of the Plan and the Awards granted hereunder shall not affect in any way the right or power of the Board or the shareholders of the Company to make or authorize (i) any adjustment, recapitalization, reorganization, or other change in the Company's or any Affiliate's capital structure or its business; (ii) any merger or consolidation of the Company or any Affiliate; (iii) any issue of debt or equity securities ahead of or affecting Common Stock or the rights thereof; (iv) the dissolution or liquidation of the Company or any Affiliate; (v) any sale, lease, exchange, or other disposition of all or any part of the Company's or any Affiliate's assets or business; or (vi) any other corporate act or proceeding.

(b) *Subdivision or Consolidation of Shares; Stock Dividends.* The shares with respect to which Awards may be granted are shares of Common Stock as presently constituted, but if, and whenever, prior to the expiration of an Award theretofore granted, the Company shall effect a subdivision or consolidation of shares of Common Stock or the payment of a stock dividend on Common Stock without receipt of consideration by the Company, the number of shares of Common Stock with respect to which such Award may thereafter be exercised or satisfied, as applicable, (i) in the event of an increase in the number of outstanding shares, shall be proportionately increased, and the exercise price per share (if applicable) shall be proportionately reduced; and (ii) in the event of a reduction in the number of outstanding shares, shall be proportionately reduced, and the exercise price per share (if applicable) shall be proportionately increased. In the event of any such change in the outstanding Common Stock, the aggregate number of shares available under the Plan may be appropriately adjusted by the Committee, whose determination shall be conclusive.

(c) *Recapitalizations and Corporate Changes.* If the Company recapitalizes or otherwise changes its capital structure (a recapitalization), the number and class of shares of Common Stock covered by an Award theretofore granted shall be adjusted so that such Award shall thereafter cover the number and class of shares of stock and securities to which the Participant would have been entitled pursuant to the terms of the recapitalization if, immediately prior to such recapitalization, the Participant had been the holder of record of the number of shares of Common Stock then covered by such Award. If the Company shall not be the surviving entity in any merger or consolidation (or survives only as a Subsidiary of an entity other than a previously wholly-owned Subsidiary of the Company), or if the Company is to be dissolved or liquidated, then, unless a surviving corporation assumes or substitutes new Awards for Awards then outstanding hereunder, (i) all unvested Options then outstanding shall be accelerated and shall become exercisable in full, and all restrictions and/or performance measures with respect to any Award shall be deemed to be satisfied, on or before a date fixed by the Company prior to the effective date of such merger or consolidation or such dissolution or liquidation; and (ii) upon such effective date, Awards shall expire.

(d) *Awards and Rights in Substitution for Awards Granted by Other Employers.* Awards may be granted under the Plan from time to time in substitution for Awards held by individuals providing services to corporations or other entities who become Employees or Directors as a result of a merger or consolidation or other business transaction with the Company or any Affiliate.

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(e) *Shareholder Action.* Any adjustment provided for in the above Subsections shall be subject to any required shareholder action.

(f) *No Adjustments Unless Otherwise Provided.* Except as hereinbefore expressly provided, the issuance by the Company of shares of stock of any class or securities convertible into shares of stock of any class for property, labor, or services, upon direct sale, upon the exercise of rights or warrants to subscribe therefor, or upon conversion of shares or obligations of the Company convertible into such shares or other securities, and in any case whether or not for fair value, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number of shares of Common Stock subject to Awards theretofore granted or the exercise price per share, if applicable.

(g) *Other.* Notwithstanding anything to the contrary in this Section XIII, any adjustments made pursuant to this section shall be made in conformity with Section 409A to the extent necessary to avoid its application or adverse tax consequences thereunder.

### **XIV. AMENDMENT AND TERMINATION OF THE PLAN**

The Board in its discretion may terminate the Plan at any time with respect to any shares of Common Stock for which Awards have not theretofore been granted. In addition, the Board shall have the right to alter or amend the Plan or any part thereof from time to time; *provided that*, except as provided in Section XIII(c), no change in the Plan may be made that would impair the rights of a Participant with respect to an Award theretofore granted without the consent of the Participant; and *provided, further, that* no amendment shall be made without approval of the shareholders of the Company if such approval is required under applicable law or by the requirements of any exchange or automated quotation system upon which the Common Stock is listed for trading or quoted.

### **XV. MISCELLANEOUS**

(a) *No Right to An Award.* Neither the adoption of the Plan nor any action of the Board or of the Committee shall be deemed to give any individual any right to be granted an Award nor any other rights hereunder except as may be evidenced by an Award Agreement, and then only to the extent and on the terms and conditions expressly set forth therein. The Plan shall be unfunded. The Company shall not be required to establish any special or separate fund or to make any other segregation of funds or assets to assure the performance of its obligations with respect to any Award.

(b) *No Employment/Board Membership Rights Conferred.* Nothing contained in the Plan shall (i) confer upon any Employee any right with respect to continuation of an employment relationship with the Company or any Affiliate or (ii) interfere in any way with the right of the Company or any Affiliate to terminate his or her employment relationship at any time. Nothing contained in the Plan shall confer upon any Director any right with respect to continuation of membership on the Board or upon any Advisor any right to continue to provide services to the Company or any Affiliate.

(c) *Other Laws; Withholding.* By accepting any shares of Common Stock issued pursuant to an Award granted under the Plan, the Participant thereby represents and warrants to the Company that the purchase or receipt of such shares shall be for investment and not with a view to distribution; *provided that* such representation and warranty shall be inoperative if, in the opinion of counsel to the Company, a proposed sale or distribution of such shares is pursuant to an applicable effective registration statement under the Securities Act of 1933, as amended, or is, without such representation and warranty, exempt from registration under such Act. The Company shall not be obligated to issue any Common Stock pursuant to any Award granted under the Plan at any time when the requirements of any securities exchange upon which the Company's securities shall then be listed have not been met or when the shares covered by such Award have not been registered under the Securities Act

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of 1933, as amended, and such other state and federal laws, rules, and regulations as the Company or the Committee deem applicable and, in the opinion of legal counsel for the Company, there is no exemption from the registration requirements of such laws, rules, and regulations available for the issuance and sale of such shares. The Company may (i) endorse an appropriate legend referring to the foregoing restrictions upon the certificate or certificates representing any shares of Common Stock issued or transferred pursuant to any Award granted under this Plan; or (ii) otherwise note such restrictions with respect to Common Stock that is not certificated. No fractional shares of Common Stock shall be delivered, nor shall any cash in lieu of fractional shares be paid. The Company shall have the right to deduct in connection with all Awards any taxes required by law to be withheld and to require any payments required to enable it to satisfy its withholding obligations. This authority shall include the authority to withhold or receive Common Stock or other property and to make cash payments in respect thereof in satisfaction of a Participant's tax obligations, either on a mandatory or elective basis in the discretion of the Committee. The Committee, in its sole discretion, may require, as a condition to the exercise of any Option or delivery of any shares of Common Stock, that an additional amount be paid in cash equal to the amount of any taxes owed as a result of such exercise or delivery.

(d) *No Restriction on Corporate Action.* Nothing contained in the Plan shall be construed to prevent the Company or any Affiliate from taking any action that is deemed by the Company or such Affiliate to be appropriate or in its best interest, whether or not such action would have an adverse effect on the Plan or any Award made under the Plan. No Participant, beneficiary, or other person shall have any claim against the Company or any Affiliate as a result of any such action.

(e) *Restrictions on Transfer.* No Award granted under this Plan or any right evidenced thereby shall be transferable by the Participant other than by will or the laws of descent and distribution, and any Options shall be exercisable during the Participant's lifetime only by such Participant or the Participant's guardian or legal representative.

(f) *Section 409A.* The Plan is intended to provide compensation that is exempt from or that complies with Section 409A, and ambiguous provisions, if any, shall be construed in a manner that is compliant with or exempt from the application of Section 409A, as appropriate. The Plan shall not be amended in a manner that would cause the Plan or any amounts payable under the Plan to fail to comply with the requirements of Section 409A, to the extent applicable, and, further, the provisions of any purported amendment that may reasonably be expected to result in such non-compliance shall be of no force or effect with respect to the Plan. To the extent the Committee determines that any Award granted under the Plan is subject to Section 409A, the Award Agreement evidencing such Award shall incorporate the terms and conditions necessary to avoid adverse tax consequences under Section 409A. Notwithstanding any provision of the Plan to the contrary, in the event that following the effective date of the Plan the Committee determines that any Award may be subject to Section 409A, the Board may adopt such amendments to the Plan and the Award or adopt other policies and procedures (including amendments, policies, and procedures with retroactive effect), or take any other actions that the Board or the Committee determines are necessary or appropriate to (i) exempt the Award from Section 409A and/or preserve the intended tax treatment of the benefits provided with respect to the Award; or (ii) comply with the requirements of Section 409A.

Notwithstanding any provision of this Plan to the contrary, if a Participant is a specified employee within the meaning of Section 409A as of the date of the Participant's termination of Service and the Company determines, in good faith, that immediate payment of any amounts or benefits under this Plan would cause a violation of Section 409A, then any amounts or benefits that are payable under the Plan upon the Participant's separation from service within the meaning of Section 409A that (i) are subject to the provisions of Section 409A; (ii) are not otherwise excluded under Section 409A; and (iii) would otherwise be payable during the first six-month period following such separation from service, shall be paid on the first business day next following the earlier of (1) the date that is six months and one day following the date of termination or (2) the date of the Participant's death.

(g) *Governing Law.* **The Plan shall be governed by, and construed in accordance with, the laws of the State of Texas, without regard to conflicts of laws principles thereof.**



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1a.	David W. Biegler	..	..	..
1b.	Douglas H. Brooks	..	..	..
1c.	William H. Cunningham	..	..	..
1d.	John G. Denison	..	..	..
1e.	Travis C. Johnson	..	..	..
1f.	Gary C. Kelly	..	..	..
1g.	Nancy B. Loeffler	..	..	..
1h.	John T. Montford	..	..	..
1i.	Daniel D. Villanueva	..	..	..

For address change or comments, please check this box and write them on the reverse side where indicated.

Please sign exactly as your name(s) appear(s) hereon. When signing as attorney, executor, administrator, or other fiduciary, please give full title as such. Joint owners should each sign personally. All holders must sign. If a corporation or partnership, please sign in full corporate or partnership name, by authorized officer.

		<b>For</b>	<b>Against</b>	<b>Abstain</b>
2.	Approval of the Southwest Airlines Co. Amended and Restated 2007 Equity Incentive Plan.	..	..	..
3.	Ratification of the selection of Ernst & Young LLP as the Company's independent auditors for the fiscal year ending December 31, 2010.	..	..	..

**B. Shareholder Proposal**

**The Board of Directors recommends a vote AGAINST Proposal 4.**

		<b>For</b>	<b>Against</b>	<b>Abstain</b>
4.	Shareholder Action by Written Consent.	..	..	..

**NOTE:** Such other business as may properly come before the meeting or any adjournment thereof.

Signature [PLEASE SIGN WITHIN BOX]

Date

Signature (Joint Owners)

Date

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**SOUTHWEST AIRLINES CO.**

**ANNUAL MEETING OF SHAREHOLDERS**

**Wednesday, May 19, 2010**

**10:00 a.m. Central Daylight Time**

**Corporate Headquarters**

**2702 Love Field Drive**

**Dallas, Texas 75235**

**DIRECTIONS TO THE ANNUAL MEETING**

Southwest Airlines Co. corporate headquarters is located at 2702 Love Field Drive, Dallas, Texas. From Dallas Love Field Airport, take Cedar Springs Road south to the airport exit. Turn right onto West Mockingbird Lane. Turn right onto Denton Drive and travel approximately two miles to Seelcco Street. Turn right at Seelcco Street. Go past the security booth, and the headquarters building will be at your left. Please park near the main entrance to the building.

Our Annual Meeting will be broadcast live on the Internet. To listen to the broadcast, log on to [http://www.southwest.com/investor\\_relations/](http://www.southwest.com/investor_relations/).

M23293-P92011

**PROXY**

**SOUTHWEST AIRLINES CO.**

**2702 LOVE FIELD DRIVE**

**DALLAS, TEXAS 75235**

**This proxy is solicited on behalf of the Board of Directors.**

The undersigned hereby appoints Gary C. Kelly, Laura H. Wright, and Ron Ricks, and each of them, as proxies, each with full power of substitution, and hereby authorizes each of them to represent and to vote, as designated on the reverse side of this form, all shares of Common Stock of Southwest Airlines Co. that the undersigned is entitled to vote at the Annual Meeting of Shareholders of Southwest Airlines Co. to be held at the Company's headquarters, 2702 Love Field Drive, Dallas, Texas, on May 19, 2010, at 10:00 a.m., Central Daylight Time, or at any adjournment or postponement thereof.

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**THIS PROXY, WHEN PROPERLY EXECUTED, WILL BE VOTED IN THE MANNER DIRECTED BY THE UNDERSIGNED SHAREHOLDER. IF NO DIRECTION IS MADE, THIS PROXY WILL BE VOTED FOR PROPOSALS 1, 2, AND 3; AGAINST PROPOSAL 4; AND AT THE DISCRETION OF THE PROXY HOLDERS WITH REGARD TO ANY OTHER MATTER THAT MAY PROPERLY COME BEFORE THE MEETING OR ANY ADJOURNMENT OR POSTPONEMENT THEREOF.**

**YOUR VOTE IS IMPORTANT. PLEASE SIGN, DATE, AND RETURN THE ENCLOSED PROXY IN THE ENCLOSED ENVELOPE TO ENSURE THAT THE SHARES ARE REPRESENTED AT THE MEETING.**

**YOU MAY ALSO VOTE VIA THE TELEPHONE OR THE INTERNET.**

**Address Changes/Comments:**

(If you noted any Address Changes/Comments above, please mark the corresponding box on the reverse side.)

**Continued and to be signed on reverse side**