Frederic W. Cook & Co., Inc.

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Current Recapture Policies and the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") requires companies to adopt a policy that will recapture any excess incentive compensation that was paid based on erroneous financial statements. In light of the new requirement, this report researches the "recapture" or "clawback" policies currently in place at 100 large companies and examines how they differ from what will be required under the Act. Our research concludes that current policies fall short of the new requirement and will need to be amended; however, it also identifies opportunities for companies to enhance their policies beyond what is required, such as when there is employee fraud or misconduct absent a financial restatement.

The Act, which was signed into law by President Obama on July 21, 2010, requires the Securities and Exchange Commission ("SEC") to issue rules directing the national securities exchanges and associations to prohibit the listing of any company that fails to comply with the new recapture or clawback policy contained in the Act. The policy applies to incentive-based compensation in the event of an accounting restatement due to material noncompliance with financial reporting requirements. It affects current or former executive officers that received incentive-based pay during the three-year period prior to the date the issuer was required to prepare a restatement, and requires the recovery of compensation paid in excess of what would have been paid under the restatement. It also states that all incentive compensation based on erroneous financial statements will be subject to recapture, including stock options if applicable. Numerous questions exist with respect to the application of the new requirement and the Act does not set a date by which the SEC must issue its rules.

Even before the Act, recapture policies had become increasingly prevalent in recent years as a means of protecting companies and their shareholders in cases of fraud or misconduct. The initial impetus was the Sarbanes-Oxley Act of 2002 ("SOX"), which applied to the CEO and the CFO of a public company when there was a restated financial statement "due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws." If these circumstances exist, the CEO or CFO must repay the issuer any amounts received during the 12 months following the filing of the inaccurate financial statements that fall into one of two categories: (1) "any bonus or other incentive-based or equity-based compensation" or (2) "any profits received from the sale of securities."

The American Recovery and Reinvestment Act of 2009 added additional repayment rules for financial institutions receiving federal funds. The restrictions generally applied to the five highest-paid senior executive officers plus up to the next 20 highest-paid employees and required repayment of "any bonus, retention award or incentive compensation" that was based on "statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate."

In light of the growing prevalence of recapture policies and the new requirement, we researched policies at large U.S. public companies to better understand current practices and examined how they differ from what will be required under the new law. We have also identified the features of current clawback policies that go beyond what is required under the Act, which may assist companies wishing to have additional protections, such as a clawback in the event of fraud absent a restatement or if a restrictive covenant (e.g., non-compete) is violated.

For our research, we selected the 100 largest U.S. companies in the Standard & Poor's 500 Index, using market capitalization as of February 28, 2010. All information on clawback policies was obtained from the most recent public documents filed with the SEC, including proxy statements and Form 10-Q, 10-K, and 8-K filings, as well as from company websites. A list of the companies researched is included in the Appendix.

We collected data on the following topics:

1. Type of recapture policy
2. Recapture triggers
3. Who is covered by the policy
4. What type of compensation may be recaptured
5. Who is in charge of enforcement and interpretation

Type of Recapture Policy

In addition to what is minimally required under SOX, we found a total of 90 recapture policies in place at 77 of the 100 companies, as some companies have multiple recapture policies. Recapture provisions can either be stand-alone policies or included in an individual award agreement or incentive plan document. Of the 90 recapture policies, 64 (71%) were stand-alone policies and 26 (29%) were included in an agreement or plan. A stand-alone policy is more often implemented because it allows for broader application of the clawback provisions to all plans. In some instances, companies have a broad policy that applies to all incentive pay, but then also reference the policy in individual grant agreements, which require an employee's signature and acknowledgement of the policy. We believe this to be a best practice because it both reminds the employee annually of the policy and can help improve the enforceability of the policy.

Recapture Triggers

The following are various situations in which a clawback provision applies. Our research indicates that a minority of the policies surveyed cover the situations required under the new law.

Restatement with or without Misconduct (95% of companies with a policy) — The most prevalent recapture provisions deal with a financial restatement. Sixty percent of those with a policy require misconduct in connection with a restatement, and 35% cover any restatement (i.e., no misconduct is required), which is the standard under the Act. An example of a provision that applies to any restatement is shown below for Cisco:

> *"In the event of a restatement of incorrect financial results, the Compensation and Management Development Committee (the "Compensation Committee") will review all cash incentive awards under the Executive Incentive Plan ("bonuses") that were paid to executive officers (within the meaning of Rule 3b-7 of the Securities Exchange Act of 1934, as amended) for performance periods beginning after July 28, 2007 which occur during the restatement period. If any such bonus would have been lower had the level of achievement of applicable financial performance goals been calculated based on such restated financial results, the Compensation Committee will, if it determines appropriate in its sole discretion, to the extent permitted by governing law, require the reimbursement of the incremental portion of the bonus in excess of the bonus that would have been paid based on the restated financial results."*

Breach of Restrictive Covenants (26%) — The next most-common provision applies if there is the violation of a restrictive covenant, such as a non-competition or confidentiality arrangement. For example, Medtronic requires payback if a

> *"current or former employee engages in any of the following activities: (a) performing services for or on behalf of any competitor of, or competing with, the Company or any affiliate; (b) unauthorized disclosure of material proprietary information of the Company or any affiliate; (c) a violation of applicable business ethics policies or business policies of the Company or any affiliate; or (d) any other occurrence determined by the Compensation Committee of the Board of Directors."*

DuPont requires payback in the event of

> *"the breach of a noncompete or confidentiality covenant set out in the employment agreement between the Grantee and the Company or an Affiliate."*

Fraud or Misconduct by an Individual (no restatement necessary) (19%) — An example of a clawback policy that does not require a financial restatement, but is related to fraud or misconduct is found at CVS Caremark, where

> *"the policy allows for the recoupment of the entire award, rather than only excess amounts generated by the Misconduct, subject to the determination of the Board, and the recoupment provisions may apply even where there is no financial restatement."*

Chevron's policy will recoup pay if an executive

> *"commits acts of embezzlement, fraud or theft or other acts that harm our business, reputation or other employees."*

Performance Clawback (9% of companies with a policy, or 70% of financial services companies) ─ Performance clawbacks were found at seven of 10 financial services companies, and allow for the recapture of compensation if performance declines in the future. These policies are intended to discourage behavior that could have a material adverse risk on the company. For example, Bank of America grants equity award that are

> *"subject to a "performance-based clawback" to encourage sustainable profitability over the vesting period. If during the vesting period Bank of America or the executive officer's line of business (if applicable) experiences a loss, the Compensation and Benefits Committee will assess the executive officer's accountability for the loss……Based on this assessment, the Compensation and Benefits Committee may determine to cancel all or part of the award."*

Another example is JPMorgan Chase, who reserves the right to clawback awards if an individual

> *"failed to properly identify, raise or assess, in a timely manner and as reasonably expected, risks and/or concerns with respect to risks material to the Firm or its business activities."*

Error in Incentive Calculation (3%) ─ Two companies specify that the recoupment can apply if there were an error in the incentive plan calculation, and do not require a restatement. Eli Lilly's policy allows for recapture of compensation awarded based on *"material errors in the performance calculation"* (in addition to a financial restatement). Microsoft's policy allows the Compensation Committee to

> *"recover payments of incentive compensation if the performance results leading to the payment are later subject to a downward adjustment or restatement of financial or nonfinancial performance.*"

Who is Covered?

Among companies with policies, 54% limit coverage to Section 16 executive officers, 25% apply to all incentive plan participants, 18% cover all senior executives, and 3% affect proxy officers only.

Sixty-eight percent of the companies with a policy only apply the repayment provision to the executive or employee who committed the fraud or misconduct. For coverage below the executive level, this is often the case because of communication difficulties, the administrative burden of trying to recapture the compensation for all plan participants, and the relatively small amounts that might be involved. The remaining policies provide that repayment may be extended to all executives or employees that benefited.

The new law will apply to only executive officers, whether or not they were involved in the misconduct, so most policies will have to be amended in this regard.

Forms of Compensation Subject to Recapture

Current policies do not specify in any detail how they apply to cash and equity compensation. Most leave the application of the policy to the discretion of the Board or Compensation Committee. Eighty-seven percent of the companies with policies covered both cash and equity compensation, 12% covered cash incentives only, and 1% covered only equity.

Enforcement and Interpretation

Recapture policies are typically enforced and interpreted by the Board of Directors (47% of companies with a policy) or the Compensation Committee (42%). The remaining are less specific, and indicate the responsibility falls on the company or are silent. The Compensation Committee has, of course, the most experience with the benefit programs that are potentially subject to a repayment. However, a significant potential for controversy may exist for some repayment decisions, particularly if enforcing the repayment policy requires litigation. Given these circumstances, our preference is that the repayment policy be administered by the Compensation Committee, with final approval by the Board of Directors.

Compliance with the New Law

As mentioned above, a minority of policies cover a restatement for any reason, which is required under the new law. It should be noted, however, that these policies still fail to comply with the new law in that they leave discretion on whether to apply the clawback to the Board or Compensation Committee. The new requirement does not allow for such discretion, and further, does not currently provide a *de minimis* rule on the overpayment amount. Our hope is that the SEC will address these areas when it issues rules.

We expect that most companies will not do more than what is required by the Act, especially those that do not currently have policies. However, we believe that it would be prudent for companies to consider additional protections, such as a policy related to fraud or misconduct absent a restatement, or applying the policy below the executive officer level if there is fraud or misconduct. We view both of these provisions as important safeguards and characteristics of a best-practice policy.

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Questions and/or comments about this report should be directed to Michael Chavira in our Los Angeles office at (310) 734-0108 or mpchavira@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.

Appendix

List of Companies:

3M
Abbott Laboratories
Altria Group
Amazon.com
American Express
Amgen
Anadarko Petroleum
Apache
Apple
AT&T
Bank of America
Bank of New York Mellon
Baxter International
Berkshire Hathaway
Boeing
Bristol-Myers Squibb
Carnival
Caterpillar
Celgene
Chevron
Cisco Systems
Citigroup
Coca-Cola
Colgate-Palmolive
Comcast
ConocoPhillips
Corning
Costco Wholesale
CVS Caremark
Dell
Devon Energy
DIRECTV
Dow Chemical
Du Pont
eBay
Eli Lilly
EMC
Emerson Electric
Exelon
Express Scripts
Exxon Mobil
FedEx
Ford Motor
Freeport-McMoRan
General Dynamics
General Electric
Gilead Sciences
Goldman Sachs
Google
Halliburton
Hewlett-Packard
Home Depot
Honeywell
IBM
Intel
Johnson & Johnson
JPMorgan Chase
Kimberly-Clark
Kraft Foods
Lockheed Martin
Lowe's
MasterCard
McDonald’s
Medco Health Solutions
Medtronic
Merck
MetLife
Microsoft
Monsanto
Morgan Stanley
News Corp.
Nike
Occidental Petroleum
Oracle
PepsiCo
Pfizer
Philip Morris International
PNC Financial
Procter & Gamble
Prudential Financial
QUALCOMM
Schlumberger
Southern Co.
Target
Texas Instruments
Time Warner
Travelers
U. S. Bancorp
Union Pacific
United Technologies
UnitedHealth
UPS
Verizon Communications
Visa
Walgreen
Wal-Mart Stores
Walt Disney
WellPoint
Wells Fargo
XTO Energy