SEC Adopts Controversial Disclosure Rules Regarding the Use of Conflict Minerals and Government Payments by Resource Extraction Issuers

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On August 22, 2012, the Securities and Exchange Commission (SEC) approved two new controversial and, potentially, highly burdensome and expensive sets of disclosure rules for public companies that were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Both sets of rules were approved by a split vote. These rules cover disclosure regarding use and sources of "conflict minerals" and regarding a broad list of payments made by resource extraction companies to U.S. or foreign governments. By the SEC's own estimates, the initial aggregate cost of compliance with the conflict minerals rules will range from $3 billion to $4 billion, with the annual cost of ongoing compliance ranging between $207 million and $609 million.

The SEC's final rule releases are available here (conflict minerals) and here (resource extraction payments).

Conflict Minerals

In response to the extreme levels of violence in the Democratic Republic of the Congo (DRC), which Congress felt was financed in part by the trade of "conflict minerals," Congress required the SEC to adopt regulations in 2010 requiring additional disclosure by SEC reporting companies that use conflict minerals in product manufacturing. Conflict minerals include tantalum, tin, tungsten and gold.[1] All categories of SEC reporting companies are covered by the new rules, including foreign private issuers and smaller reporting companies.

The SEC retained the three-step analytical process from the proposing release, with some modifications to the steps in response to comments. A useful flow chart of these steps is set forth on page 33 of the SEC's final rule release on conflict minerals.

Step One

The first step is for an issuer to determine if conflict minerals are necessary *to the functionality or production of a product manufactured or contracted to be manufactured* by the issuer. If not, no further inquiry or disclosure is required.

Necessary to the Functionality or Production of a Product

The final rules do not define when conflict minerals are "necessary to the functionality or production of a product". This determination is ultimately one of facts and circumstances.

With respect to the question of functionality, the SEC noted that issuers should consider the following factors in their analysis, any of which, individually or in the aggregate, could be determinative:

- whether a conflict mineral is contained in and intentionally added to the product or any component of the product and is not a naturally-occurring by-product;
- whether a conflict mineral is necessary to the product's generally expected function, use or purpose; or
- if a conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration.

With respect to the question of production, the SEC modified its guidance contained in the proposing release to specify that an issuer should consider the following factors:

- whether the conflict mineral is intentionally included in the product's production process, other than if it is included in a tool, machine or other equipment used to produce the product (such as computers or power lines);
- whether the conflict mineral is included in the product; and
- whether the conflict mineral is necessary to produce the product.

Under the revised guidance, if conflict minerals are used, for example, as a catalyst in the production of a product, but are not contained in the product itself, the conflict minerals are not considered necessary to the production of a product.

Manufactured or Contracted To Be Manufactured

The SEC did not consider it necessary to define the term "manufacturing" in the final rules. However, the SEC clarified that it did not consider an issuer that only services, maintains or repairs a product containing conflict minerals to be "manufacturing" a product. In addition, the SEC stated that mining activities were not considered to be manufacturing or contracting to manufacture *unless* the issuer also engaged in manufacturing.

The phrase "contracted to manufacture" drew a significant number of comments following the proposing release. A company is considered to have "contracted to manufacture" if it has some actual influence over the manufacturing of its products. According to the final release, "an issuer is considered to be contracting to manufacture a product depending on the degree of influence it exercises over the materials, parts, ingredients, or components to be included in any product that contains conflict minerals or their derivatives." The following activities are not considered to be contracting to manufacture a product, if the company's actions consist of no more than:

- specifying or negotiating contractual terms with a manufacturer that do not directly relate to the manufacturing of the product;
- affixing its brand, marks, logo or label to a generic product manufactured by a third party; or
- servicing, maintaining or repairing a product manufactured by a third party.

Step Two

The second step in the process is for the issuer to conduct a reasonable country of origin inquiry in good faith to determine if the minerals originated from the DRC or adjoining countries[2] or are from scrap or recycled sources. In order to provide guidance in this regard, the final release sets out general standards for the inquiry. The SEC noted that an issuer would satisfy the reasonable country of origin inquiry standard "if it seeks and obtains reasonably reliable representations indicating the facility at which its conflict minerals were processed and demonstrating that those conflict minerals did not originate in the [DRC or adjoining countries] or came from recycled or scrap sources." The representations can be received directly from suppliers or indirectly through more immediate suppliers. An issuer need not receive representations from all of its suppliers, but it must believe the representations that it receives to be true. Further, the SEC states that an issuer may not ignore warning signs. These procedures may require facilities or suppliers to obtain an independent private sector audit.

An issuer's disclosure obligations are limited to a description of the country of origin inquiry, the results of the inquiry as well as the issuer's determination on the basis of the inquiry, if either:

- The issuer knows that the minerals did not originate in the DRC or adjoining countries or are from scrap or recycled sources; or
- The issuer has no reason to believe that the minerals may have originated in the DRC or adjoining countries or may not be from scrap or recycled sources.

An issuer is required to conduct a further due diligence review of its conflict minerals and may be required to file a "Conflict Minerals Report" if the country of origin inquiry indicates:

- The issuer knows or has reason to believe that the minerals may have originated in the DRC or adjoining countries; and
- The issuer knows or has reason to believe that the minerals may not be from scrap or recycled sources.

No Conflicts Mineral Report will be required if, after the due diligence review, the issuer determines the minerals did not originate in the DRC or adjoining countries, or it determines that minerals came from recycled or scrap sources.

Step Three

If an issuer is required to conduct due diligence as a result of the determination from the second step, an issuer must exercise due diligence on the source and chain of custody of their conflict minerals in accordance with a nationally or internationally recognized due diligence framework, if one is available for the specific mineral. At the time of the final release, the SEC noted that the only such framework currently available is one prepared by the Organisation for Economic Co-operation and Development.

Except as discussed below under "DRC Conflict Undeterminable" and "Scrap and Recycled Sources," the issuer's due diligence procedures are subject to audit to determine "whether the design of the issuer's due diligence measures as set forth in the Conflict Minerals Report, with respect to the period covered by the report, is in conformity with, in all material respects, the criteria set forth in the nationally or internationally recognized due diligence framework used by the issuer, and whether the issuer's description of the due diligence measures it performed as

set forth in the Conflict Minerals Report, with respect to the period covered by the report, is consistent with the due diligence process that the issuer undertook." The audit standards required are based on existing Government Auditing Standards.

As a result of the due diligence review, an issuer must determine whether its products are DRC Conflict Free, Not Been Found to Be DRC Conflict Free or, DRC Conflict Undeterminable. The last category is only available on a temporary basis for two years (four years for smaller reporting issuers).

DRC Conflict Free

Under this standard, the issuer has determined that the minerals may originate from the DRC or adjoining countries but did not finance or benefit armed groups. As a result of this determination, the issuer must obtain an independent private sector audit of its Conflict Minerals Report and certify to that fact. The audit report, including the name of the auditor, must be included as part of the Conflicts Minerals Report.

Not Been Found to Be DRC Conflict Free

If the products are not "DRC Conflict Free," then the issuer, in addition to the auditing and certification requirements, must include the following information in its Conflict Minerals Report:

- a description of the products;
- the facilities used to process the conflict minerals necessary to those products;
- the country of origin of the conflict minerals necessary to those products; and
- the efforts to determine the mine or location of origin with the greatest possible specificity.

DRC Conflict Undeterminable

For a temporary period of time, an issuer may make the determination that its products are DRC Conflict Undeterminable for one of two reasons. Either, after conducting Step Three due diligence, the issuer was unable to determine whether the minerals financed or benefited armed groups in the DRC or adjoining countries or, after conducting Step Three due diligence, the information obtained by the issuer failed to clarify the conflict minerals' country of origin, whether the conflict minerals financed or benefited armed groups in those countries, or whether the conflict minerals came from recycled or scrap sources. This temporary transition period will end after the first two reporting years for all issuers other than smaller reporting companies, which have a four-year transition period. Therefore, if, after performing its Step Three due diligence, an issuer is still unable to determine that its product is DRC Conflict Free beginning with the reporting period from January 1, 2015 to December 31, 2015 (January 1, 2017 to December 31, 2017 for smaller reporting companies), the issuer would be required to describe the product as Not Been Found To Be Conflict Free.

An issuer reaching the DRC Conflict Undeterminable conclusion must include the following information in its Conflict Minerals Report:

- the issuer's products that are DRC Conflict Undeterminable;

- the facilities used to process the conflict minerals, if known;
- the country of origin of the conflict minerals, if known;
- the efforts to determine the mine or location of origin with the greatest possible specificity; and
- the steps the issuer has taken or will take, if any, since the end of the period covered in its most recent Conflict Minerals Report to mitigate the risk that its necessary conflict minerals benefit armed groups, including any steps to improve due diligence.

No independent private sector audit of the Conflict Minerals Report is required for products that are DRC Conflict Undeterminable.

Scrap and Recycled Sources

If an issuer is required to undertake due diligence to determine if its conflict minerals were from recycled or scrap sources, then it must follow a nationally or internationally recognized due diligence framework, if available, and obtain an audit report. Currently, only gold has an established due diligence framework for determining whether it is recycled or scrap. Until a due diligence framework is developed for the remaining conflict minerals, an issuer must describe its due diligence efforts and procedures but no independent private sector audit is required.

Form and Timing of the Conflict Minerals Disclosure

The SEC modified its original proposal for the disclosure to be filed with the issuer's annual report on Form 10-K, Form 20-F or Form 40-F. The disclosure will now be contained in a new Form SD, with the Conflict Minerals Report filed as an exhibit.

All issuers will report on their use of conflict minerals on a calendar-year basis, regardless of the issuers' fiscal year-end. Conflict minerals are considered to be used in the calendar year in which the manufacture of a product that contains any conflict minerals is completed. The new SEC Form SD is required to be filed by May 31 of each year, beginning May 31, 2014. The Conflict Minerals Report must also be posted on the issuer's website for a period of one year.

The rules provide for a grace period for an issuer that acquires or obtains control over a company that manufactures or contracts to manufacture products with conflict minerals, if the acquired company had not been required to provide public disclosure with respect to its use of conflict minerals prior to its acquisition.

In a change from the proposing release, Form SD is considered filed, not furnished, which will subject the issuer to liability under Section 18 of the Securities Exchange Act of 1934. Section 18 subjects a person to liability for false and misleading statements unless the person can show that it acted in good faith and had no knowledge that such statement was false or misleading. The issuer's CEO and CFO are not required to certify the disclosure.

Exemption for Conflict Minerals Outside the Supply Chain

In a modification from the proposing release, the final rule exempts conflict minerals which are "outside the supply chain," but only for the period ending on January 31, 2013. A conflict mineral is considered to be "outside the supply chain"

after any columbite-tantalite, cassiterite and wolframite minerals have been smelted; after gold has been fully refined; or after any conflict mineral, or its derivatives, that have not been smelted or fully refined are located outside of the DRC and adjoining countries.

Government Payments by Resource Extraction Issuers

For purposes of the new disclosure rules, a resource extraction issuer is one engaged in the commercial development of oil, natural gas or minerals and which is required to file annual reports with the SEC. Resource extraction issuers will be required to disclose certain payments made by it, its subsidiaries or entities controlled by it, to the U.S. government and foreign governments, including sub-national governments. All categories of SEC reporting companies are covered by the new rules, including foreign private issuers and smaller reporting companies.

Disclosure is required for payments made to further the commercial development of oil, natural gas or minerals in amounts equal to or exceeding $100,000 during the fiscal year. Commercial development includes exploration, extraction, processing and export, or the acquisition of a license for any of the foregoing. The term payments includes taxes, royalties, fees, production entitlements, bonuses, dividends and infrastructure improvements. There are no exemptions from disclosure as a result of confidentiality provisions in contracts, prohibitions on disclosure contained in foreign law or commercially or competitively sensitive information.

A resource extraction issuer will be required to file the annual disclosures on new SEC Form SD, which will be due no later than 150 days after the end of its fiscal year, beginning with fiscal years ending after September 30, 2013. The initial report is only required to disclose payments made after September 30, 2013. For example, for an issuer with a December 31 year-end, the first report on Form SD will be due by May 30, 2014 and will be required to cover the period from October 1 to December 31, 2013. Future filings will cover the full fiscal year. The information must be filed as an exhibit in XBRL format, and the SEC expects to publish the taxonomy shortly. The requirement to file the exhibit in XBRL applies to all issuers, including those not yet using XBRL in SEC reporting, such as foreign private issuers reporting pursuant to International Financial Reporting Standards.

The Form SD is considered filed, not furnished, which will subject the issuer to liability under Section 18 of the Securities Exchange Act of 1934. The issuer’s CEO and CFO are not required to certify the disclosure.

Required government payment disclosure includes:

- Type and total amount of payments made for each project;
- Type and total amount of payments made to each government;
- Total amounts of the payments, by category;
- Currency used to make the payments;
- Financial period in which the payments were made;
- Business segment of the resource extraction issuer that made the payments;
- The government that received the payments, and the country in which the government is located; and

- The project of the resource extraction issuer to which the payments relate.

Conclusion

The long delay in the finalization of the conflict minerals rules and resource extraction payment rules reflects the SEC's attempt to balance significant concerns about cost and difficulty of compliance against the Congressional mandate in the Dodd-Frank Act. While a number of corporations have been working to put processes in place to track and, in some cases, improve their supply chains prior to the adoption of the conflict minerals rules, the recently enacted rules may well become subject to legal challenge.

[1] Conflict minerals are defined as columbite-tantalite (coltan), cassiterite, gold, wolframite or their derivatives, which are limited to tantalum, tin and tungsten. The Secretary of State has the authority to expand the list of derivatives if the Secretary determines that additional derivatives are financing conflict in the DRC or an adjoining country.

[2] The term "adjoining country" means any country that shares an internationally recognized border with the DRC, which presently includes Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia.

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