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New Corporate Social Responsibility Requirements: Dodd-Frank Act Mandates Disclosure to SEC of Payments to Foreign Governments and Use of Minerals from the Democratic Republic of the Congo

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), signed into law on July 21, 2010,[1] contains two provisions intended to promote greater international transparency and sensitivity to human rights by oil, gas, and mining companies as well as companies that purchase minerals from the Democratic Republic of the Congo (DRC) and surrounding areas. Both provisions affect companies that file reports with the Securities and Exchange Commission (SEC). Under Section 1502 of the Act, companies must disclose annually a description of the measures taken by the company to exercise due diligence on the source and chain of custody of certain minerals that are associated with armed conflicts in and around the DRC, some of which are used in common electronic devices. Section 1504 requires oil, gas, and mineral companies that are required to file annual reports with the SEC to disclose annually all payments made to foreign governments in connection with commercial development of certain national resources in foreign countries. The level of transparency required under both sections has far-reaching implications for companies that produce electronic devices, such as cell phones, digital cameras, computers and DVD players, many of which may contain "conflict minerals," as well for the oil, gas, and mineral sectors. As a result of the new law, many companies should consider reviewing current business, finance, and compliance practices and where necessary must satisfy SEC disclosure requirements on an annual basis in SEC reports. Failure to do so could lead to investigation and enforcement actions by the SEC and/or the US Department of Justice (DOJ), costly litigation and possible public relations problems.

1 Pub. L. No. 111-203 (2010).

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Section 1502: Conflict Mineral Due Diligence

To help address the long-running international concern about the exploitation of certain minerals from the DRC and neighboring countries to help fund armed conflicts, Section 1502 of the Act amends the Securities Exchange Act of 1934 (Exchange Act) to require covered companies that use certain minerals in their products to disclose annually whether those minerals originate from the DRC or adjoining countries[2] if the use of the minerals is "necessary to the functionality of production of a product manufactured."[3] The "conflict minerals" that are covered under Section 1502 include columbite-tantalite (coltan), cassiterite (tin ore), gold, wolframite, or any of their derivatives, or any other mineral determined by the Secretary of State to be financing conflict in the DRC or adjoining countries.[4] Minerals described in the Act are commonly found in electronic devices such as cell phones, computers, digital cameras, and DVD players, although not all minerals used in these devices come from this region of the world.

The SEC is required to issue regulations implementing Section 1502 no later than April 17, 2011 (within 270 days of enactment of the Act). The Act provides limited guidance as to the specific information that a company must disclose, and the SEC will therefore need to clarify the disclosure requirements in its regulations. The Act obligates covered companies to describe "products manufactured or contracted to be manufactured" that are not "DRC conflict free,"[5] disclose the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and efforts to determine the mine or location of origin with "the greatest possible specificity."[6] Moreover, it provides that when a covered company discloses that its products contain conflict minerals that originate from the DRC or adjoining countries, it must disclose due diligence undertaken to discover the source and chain of custody of the mineral. Finally, the section mandates that the report submitted to the SEC must be reviewed by an independent private sector auditor.

Section 1504: Disclosure of Payments to Foreign Governments

Section 1504 amends the Exchange Act to require disclosure of payments to foreign governments by resource extraction issuers. The Act defines "resource extraction issuer" as an issuer required to file an annual report with the SEC that is engaged in commercial development of oil, natural gas, or minerals.[7] A key Senate sponsor of the provision stated that Section 1504 supports international transparency in the oil, gas, and mineral sectors, and seeks to hold foreign governments accountable for payments received from foreign companies seeking to exploit resources, in an effort to reverse what has been commonly called the "resource curse"[8] of corruption in countries that have significant natural resources. The provision is based on the Energy Security Through Transparency Act (ESTT)[9] introduced by Senators Lugar and Cardin.

Under Section 1504, the SEC must issue final rules no later than April 17, 2011 (within 270 days of enactment of the Act). Thus, companies in the oil, natural gas, or minerals industries will have to wait for specific guidance as to whether Section 1504 is applicable to them and as

2 Under Section 1502 of the Act, an adjoining country is any country that shares an internationally recognized border with the DRC. Therefore, a company must disclose to the SEC if the conflict mineral originated in the Central African Republic, Sudan, Uganda, Rwanda, Burundi, Zambia, or Angola.

3 *Id.*

4 *Id.*

5 "DRC conflict free" products are defined as those that do not contain minerals that "directly or indirectly finance or benefit armed groups" in the DRC or adjoining countries. *Id.*

6 *Id.*

7 Pub. L. No. 111-203, §1504. We anticipate that the SEC's rules will also apply to foreign private issuers that file annual reports on Form 20-F or Form 40-F.

8 *See* 155 Cong. Rec. S9746 (daily ed. Sept. 23, 2009) (statement of Senator Lugar).

9 The ESTT, as introduced in the Senate, urges the administration to undertake to become an "implementing" country of the Extractive Industry Transparency Initiative (EITI). The EITI sets out a global framework for companies to disclose payments to foreign governments and for governments to disclose what they receive. See 155 Cong. Rec. S9746 (daily ed. Sept. 23, 2009) (statement of Senator Lugar). Currently, 36 countries have implemented or committed to implementing the EITI. *See* http://eiti.org/implementingcountries. There are also 50 oil and gas companies that support the Initiative and conduct international level self-assessments. *See* http://eiti.org/supporters/companies; *see also* Mara V.J. Senn and Rachel Frankel, "Firms Can Avoid EITI, FCPA Pitfalls," Oil and Gas Journal, July 21, 2008.

to their detailed compliance obligations. Section 1504's requirement that companies that are required to file an annual report with the SEC make new disclosures about payments to foreign governments will at a minimum lead many companies to strengthen their record-keeping practices. The Act articulates some general guidance that should be taken into account immediately. The Act provides that a resource extraction issuer must include in an annual report (e.g., SEC Form 10-K) information relating to any payment made by it, any subsidiary, or any entity under its control to a "foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals...."[10] Such information shall include the type and total amount of payments made for each project as well as the type and total amount of payments made to each government.[11]

The Act defines "payments" as those made to further commercial development and that are not *de minimis*.[12] Payments that must be disclosed include, but are not limited to, taxes, royalties, fees, production entitlements, bonuses, and other material benefits as determined by the SEC to be part of the commonly recognized revenue stream.[13] The Act requires disclosure of "any payment" without excluding payments that could be illegal under that country's anti-corruption laws as well as those of the United States and other jurisdictions. The term "foreign government" is defined as a "a department, an agency, or instrumentality…or a company owned by a foreign government," and "commercial development" is the "exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the [SEC]."[14] A number of issues will need to resolved through the implementing regulations, including whether the SEC will require a company to disclose payments made to a foreign government if only a minor part of its business relates to commercial development of oil, gas, or minerals.

10 Dodd-Frank Act, Pub. L. No. 111-203, §1504. This advisory focuses on the disclosure requirement as it relates to payments made to foreign governments.

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.* The SEC's regulations will presumably address whether the definition of "foreign government" includes foreign officials, political parties and candidates, as such terms are used in the Foreign Corrupt Practices Act.

Implications

Sections 1502 and 1504 are important new statutory reporting requirements intended by Congress to address corporate social responsibility and could reflect a trend toward more such laws in the future. The new requirements will require many multinational companies to review their record-keeping and internal reporting procedures and make unprecedented disclosures to the SEC and the general public.

The SEC rules issued pursuant to Section 1502 will impose important new requirements on companies that may be using conflict minerals. The Act specifically targets disclosure of columbite-tantalite, cassiterite, and wolframite because these minerals are widely used in electronic devices such as cell phones, computers, and digital cameras. At a minimum, many covered companies will need to examine their due diligence processes and will have to devote resources to tracking the source and chain of custody of the minerals used in their products. Companies that use conflict minerals from the DRC or from surrounding countries in their products will have to bear the cost of hiring independent private sector auditors to ensure that the company exercised proper due diligence. Thus, if a company determines that its products contain conflict minerals, it may want to assess its business practices and may choose to avoid purchasing the covered minerals from the DRC and adjoining countries, or to ensure that it buys only from mines that do not finance or benefit armed groups in the region.

Section 1502 will allow investors to review whether a company's actions are contributing to armed violence and instability in the DRC or adjoining countries. Making the results of the due diligence process publicly available

could in some cases also expose a company to litigation under statutes such as the Alien Tort Statute, for example, if plaintiffs choose to claim that a company has "aided and abetted" a violation of international law in connection with use of conflict minerals in its products. A company's disclosure that its products contain conflict minerals could also lead to a host of public relations problems both with investors and the general public.

Section 1504 could in some cases implicate the DOJ and SEC's oversight and regulation of companies pursuant to the Foreign Corrupt Practices Act (FCPA). Generally, the FCPA's anti-bribery provisions prohibit corruptly providing anything of value to government officials in order to obtain or retain business. The FCPA also contains a books and records provision that requires companies to maintain accurate books and records and devise and maintain a system of internal accounting records. A resource extraction issuer that discloses payments to foreign governments may become subject to enhanced scrutiny that could result in a time-consuming and costly FCPA investigation or enforcement action. For example, a discrepancy between the company's disclosure and the foreign government's disclosure could raise red flags, drawing attention from the DOJ and/or SEC. Affected companies are urged to participate in the SEC rulemaking process during the comment period, and to the extent necessary, should seek the advice of counsel.

The disclosure requirement could raise another FCPA issue. The DOJ and SEC both have consistently encouraged companies to voluntarily disclose illegal payments, often rewarding companies that voluntarily disclose potentially covered payments with deferred prosecution agreements or mitigation of civil and criminal penalties.[15] If a company fails to disclose information required by the Act, and the DOJ and/or SEC subsequently learn about a resource extraction issuer's FCPA violations through cooperation with foreign governmental authorities or a whistleblower, the SEC and/or DOJ may take a harder line toward prosecution and enforcement under the FCPA, in addition to the SEC opening an investigation and bringing suit for failure to make such disclosures pursuant to Section 1504.[16] In addition, any violations of Section 1504, when ultimately disclosed to investors, could provide a new basis for shareholder class action or derivative lawsuits, including actions for fraud brought pursuant to Section 10(b) of the Exchange Act.

In some cases, companies that are subject to Section 1504 because they are required to file annual reports with the SEC may be at a competitive disadvantage to companies that are not subject to this requirement. Some foreign governments may be more likely to award bids and contracts to companies not required to file annual reports with the SEC, and thus not obligated to disclose payments, as a way to circumvent public scrutiny of payments they receive. Another concern for companies affected by the new law will be the public disclosure of otherwise confidential bids, as well as public disclosure of otherwise confidential information, such as the terms of a particular arrangement for a company to purchase oil or gas from a foreign government.

As noted above, the SEC is required to issue implementing regulations for each of these two provisions no later than April 17, 2011. The disclosure requirements under the two sections are not immediately effective. Section 1502 disclosures will need to be made by a covered company in a report submitted annually to the SEC, and made publicly available on the company's website, beginning with the company's first full fiscal year that begins after SEC regulations are issued. Section 1504 disclosures will need to be included in a covered company's annual report, submitted to the SEC in an interactive data format with

15 *See, e.g., Securities & Exchange Commission Division of Enforcement, Enforcement Manual* § 6.1.2 (2010); Memorandum from Deputy Attorney General Mark R. Filip, Principles of Federal Prosecution of Business Organizations §§ 9-28.700, 9-28.750 *available at* http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf.

16 An issuer, as well as any officer, director, employee or agent of the issuer, may be subject to criminal and/or civil monetary penalties (and/or imprisonment for natural persons) for FCPA violations or violations of Section 13 of the Exchange Act.

electronic tags identifying certain information, commencing with the first fiscal year that ends not earlier than one year after the SEC issues final rules.

Because of the various implications discussed above, a company that believes it is or may become subject to one or both of these provisions should consider submitting comments on the rules that the SEC ultimately proposes and should consider evaluating relevant policies, practices, and record-keeping, to ensure compliance with the new requirements. In particular, companies subject to Section 1504 may want to begin investigating ways to easily track all payments to governments, including the type and amount of each payment, to avoid having to reconstruct information for each payment after the fact.

We hope that you have found this advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:

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