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SEC Proposes Burdensome Rules for Conflict Minerals and Payments by Resource Extraction Issuers

On December 15, 2010, the Securities and Exchange Commission (SEC) issued proposed rules[1] to implement corporate social responsibility requirements under two provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) relating to extraterritorial activities of companies that file reports with the SEC.[2] The statutory provisions are intended to promote greater international transparency and sensitivity to human rights by certain companies that (i) purchase "conflict minerals" from the Democratic Republic of the Congo (DRC) and surrounding countries, or (ii) engage in the commercial development of oil, natural gas, or minerals, and have made payments to governments in connection with such extraction activities.

The SEC's proposed rules largely track the relevant Dodd-Frank statutory provisions, which place new, unprecedented, and burdensome disclosure obligations on covered issuers related to their business operations. The proposed rules more clearly define which issuers are covered, as well as the scope of new disclosures, while posing a number of important questions about the kind of information that the SEC should require affected companies to disclose.

The proposed SEC disclosure rules for "conflict minerals" are expected to apply to more than 5,000 public companies across a broad range of industries, including both domestic and foreign companies that report to the SEC and smaller reporting companies. "Conflict minerals" are used in the manufacture of many electronic products, including mobile telephones, computers, videogame consoles, and digital cameras; as an alloy for making carbide tools and jet engine components; in metal wires, electrodes, and contacts in lighting, electronic, electrical, heating, and welding applications; in electronic, communications, and aerospace equipment, and in gold jewelry. Affected companies include those that manufacture or "contract to manufacture" products for which conflict minerals are necessary

1 Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948 (Dec. 23, 2010); Disclosure of Payments by Resource Extraction Issuers, Release No. 34-63549 (Dec. 15, 2010), 75 F.R. 80978 (Dec. 23, 2010).

2 Pub. L. No. 111-203, §§ 1502, 1504

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to the functionality or production of the product. Thus, the proposed rules would apply, for example, to a retailer that has any influence over the product's manufacturing, or that contracts with another party to have a product specifically manufactured for it for sale under its own brand name or a separate brand name that the retailer has established (regardless of whether the retailer has any influence over the product's manufacturing).

The proposed reporting requirements for resource extraction issuers that have made payments to governments in connection with extraction activities are expected to affect over 1,000 companies that file annual reports with the SEC and that engage in the commercial development of oil, natural gas, or minerals. Both domestic and foreign companies would be affected, as well as smaller reporting companies.

For each set of proposed rules, the SEC has sought input from the public on a very long list of specific questions. Comments on the SEC's proposed rules for both sets of requirements are due **Monday, January 31, 2011.** Affected companies should review the proposed rules and questions carefully and consider submitting comments. These companies also may want to consider commencing a review and evaluation of relevant policies, practices, and record-keeping to ensure that they will be able to comply with the new requirements.

The final rules, which under the Dodd-Frank Act must be issued no later than April 15, 2011, will apply beginning with the first full fiscal year of the issuer after the enactment of the final rules. For companies with a calendar year end, the new disclosures would first be required in the annual report for the year ended December 31, 2012, which would be filed in early 2013.

This Advisory highlights some of the pending issues in the proposed rules.

Background on Section 1502 of Dodd-Frank —Conflict Minerals

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 Dodd-Frank Act amended 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[3] if the use of the minerals is "necessary to the functionality or production of a product manufactured."[4] 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 minerals determined by the Secretary of State to be financing conflict in the DRC or adjoining countries.[5]

Columbite-tantalite is used to produce tantalum, which is used in electronic components, including mobile telephones, computers, videogame consoles, and digital cameras, and as an alloy for making carbide tools and jet engine components. Cassiterite is commonly used to produce tin, which is used in alloys, tin plating, and solders for joining pipes and electronic circuits. Gold is used for making jewelry and, due to its superior electric conductivity and corrosion resistance, is also used in electronic, communications, and aerospace equipment. Finally, wolframite is used to produce tungsten, which is used for metal wires, electrodes, and contacts in lighting, electronic, electrical, heating, and welding applications.

Based on the widespread use of conflict minerals, the SEC expects the conflict minerals rules to apply to more than 5,000 companies across a wide spectrum of industries. The SEC estimates that, of the 13,545 Form 10-Ks filed annually, over 5,500 are filed by companies that would be affected by the proposed rules and form amendments. Over 440 foreign companies that report to the SEC are also expected to be affected.[6] The proposed rules do not include an exemption

3 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.

4 *Id.*

5 *Id.*

6 The SEC estimates that approximately 5,551 Forms 10-K, 377 Forms 20-F, and 66 Forms 40-F will be affected by the proposed amendments. Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948, 80966 n.172 (Dec. 23, 2010).

for smaller reporting companies.

The implementation of Section 1502 will allow investors and others to review and make judgments on whether a company's actions are contributing to armed violence and instability in the DRC or adjoining countries.

Proposed SEC Rules Implementing Section 1502 of Dodd-Frank—Conflict Minerals

The SEC proposed rules implementing Section 1502 on conflict minerals include a disclosure requirement for conflict materials that is divided into three steps:

First, companies that file reports under the Exchange Act must determine whether conflict minerals are necessary to the functionality or production of a product manufactured by such company or that it has contracted to manufacture. A company would be considered to be "contracting to manufacture" a product if it has any influence over the product's manufacturing, or if it offers a generic product under its own brand name or a separate brand name, regardless of whether the company has any influence over the manufacturing specifications of the product, provided it has contracted to have the product manufactured specifically for itself.[7] While the SEC is not proposing to define "necessary to the functionality or production" of a product, the proposed rule makes it clear that if a conflict mineral is necessary, the product is covered without regard to the amount of the mineral involved.[8]

If the company determines that it does not manufacture or contract to manufacture any products for which conflict minerals are necessary to the functionality or production of those products, then no disclosures or other actions would be required. Otherwise, the company must proceed to the second step.

Under the second step, the company must determine after a "reasonable country of origin inquiry" whether its conflict minerals originated in the DRC or adjoining countries. If a covered company concludes that the conflict minerals necessary for its products did not originate in the DRC or an adjoining country, the company would disclose this determination and the reasonable country of origin inquiry process it used in reaching this determination in the body of its annual report.[9] If, however, the company concludes that its conflict minerals originate in the DRC or adjoining countries, or is unable to conclude that its conflict minerals did not originate in the DRC or adjoining countries, the company would disclose this conclusion in its annual report and move to the third step.

Under the third step, if any conflict minerals necessary to the functionality or production of a product manufactured or contracted to be manufactured by the company originated in the DRC or adjoining countries, or if the company is unable to determine that its conflict minerals did not originate in the DRC or adjoining countries, the company must furnish a separate Conflict Minerals Report, including an independent private sector audit, as an exhibit to its annual report and on its website. A Conflict Minerals Report must provide a description of the measures taken by the company to exercise due diligence on the source and chain of custody of its conflict minerals.

The due diligence measures required of covered companies would include an independent private sector audit of the company's Conflict Minerals Report conducted in accordance with standards established by the Comptroller

7 The proposed rule would not apply to retailers that sell only the products of third parties if those retailers have no contract or other involvement regarding the manufacturing of those products, or if those retailers do not sell those products under their own label or a separate label that they have established and do not have those products manufactured specifically for them. *See* Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948, 80952 (Dec. 23, 2010).

8 The proposed rule also clarifies that the product is covered if the conflict mineral is intentionally included in a product's production process and is necessary to that process, even if that conflict mineral is not ultimately included anywhere in the final product. Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948, 80953 (Dec. 23, 2010).

9 The company also would be required to provide on its internet website its determination that its conflict minerals did not originate in the DRC or adjoining countries, disclose in its annual report that this information is available on its website and the internet address of that site, and maintain records demonstrating that its conflict minerals did not originate in the DRC or adjoining countries. Such a company would not have any further disclosure or reporting obligations with regard to its conflict minerals. *See* Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948, 80949-50 (Dec. 23, 2010).

General of the United States. The company furnishing the report would be required to certify that it obtained an independent private sector audit of the report and make the report available to the public on its website. Further, the Conflict Minerals Report must include a description of the products manufactured or contracted to be manufactured that are not "DRC conflict free,"[10] the facilities used to process those conflict minerals, the country of origin of those conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity.

The proposed rules specify that if a conflict mineral was obtained from recycled or scrap materials, such minerals would be considered "DRC conflict free" because the origins of recycled or scrap minerals are difficult to trace. Companies using conflict minerals from recycled or scrap sources would still be required to furnish a Conflict Minerals Report, including a certified independent private sector audit, disclosing that their conflict minerals are from recycled or scrap sources. The report would describe the measures taken to exercise due diligence in determining that their conflict minerals were recycled or scrap.

The SEC's proposing release on conflict minerals seeks comments on or before January 31, 2011. Many of the questions raised in the release will be of serious concern to companies involved in the manufacturing of products using conflict minerals. For example, the SEC seeks comments on:

- Whether the proposed rules should be extended to all individuals and entities, regardless of whether they are SEC reporting issuers,[11] private companies, or individuals who manufacture products for which conflict minerals are necessary to the functionality or production of the products;
- Whether exemptions should be adopted for foreign private issuers or smaller reporting companies, or the rules should be adjusted or delayed for certain companies;
- Whether the SEC should define the term "manufacture" and if so, how the term should be defined;
- Whether the SEC's rules should apply both to companies that manufacture and companies that contract to manufacture products in which conflict minerals are necessary to functionality or production;
- Whether the SEC should require a minimum level of influence, involvement, or control over the manufacturing process before a company must comply with the rules;
- Whether the rules should define the phrase "necessary to the functionality or production of a product" and if so, how;
- Whether the conflicts mineral disclosure should be required in a new, separate annual report rather than adding it to Form 10-K, Form 20-F, and Form 40-F annual reports;
- The information required to be disclosed in the Conflict Minerals Report, and whether issuers should be required to furnish an independent private sector audit report as part of the report;
- Whether a reasonable country of origin inquiry standard is an appropriate standard for determining whether an issuer's conflict minerals originated in the DRC or adjoining countries;
- Whether issuers should be able to rely on reasonably reliable representations from their processing facilities, either directly or indirectly through their suppliers, to satisfy the reasonable country of origin inquiry standard; and
- Whether the SEC's rules should require an issuer to

10 "DRC conflict free" products are those that do not contain conflict minerals that "directly or indirectly finance or benefit armed groups" in the DRC or adjoining countries. If any of the company's products contain conflict minerals that do not "directly or indirectly finance or benefit" these armed groups, the company may describe such products as "DRC conflict free," whether or not the minerals originated in the DRC or adjoining countries. Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948, 80950 (Dec. 23, 2010).

11 The SEC's proposed rules would apply to any issuer that files reports with the SEC under Sections 13(a) or 15(d) of the Exchange Act for which conflict minerals are "necessary to the functionality or production of a product manufactured" or contracted to be manufactured by such company. Conflict Minerals, Release No. 34-63547 (Dec. 15, 2010), 75 F.R. 80948, 80950-51 (Dec. 23, 2010).

use due diligence in its supply chain determinations and the other information required in a Conflict Minerals Report, and if so, what due diligence measures the rules should prescribe.

Companies that may be affected by the SEC's proposed rules may wish to consider submitting comments on these and other questions raised in the SEC's proposing release.

Background on Section 1504: Disclosure of Payments to Foreign Governments

Section 1504 of the Dodd-Frank Act amended the Exchange Act to require disclosure of payments to foreign governments by resource extraction issuers. Section 1504, and the proposed SEC rules, define "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.[12] 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"[13] of corruption in countries that have significant natural resources. The provision is based on the Energy Security Through Transparency Act (ESTT)[14] introduced by Senators Dick Lugar and Benjamin Cardin.

Under the proposed rules, the SEC would require a resource extraction issuer to disclose in its annual reports certain categories of payments made to a foreign government, including sub-national governments, or to the US federal government. Relevant payments must be made to further the development of oil, natural gas, or minerals, not be de minimis,[15] and include taxes, royalties, fees (including license fees), production entitlements, and bonuses, if such payments are determined by the SEC to be part of the commonly recognized revenue stream for the development of oil, natural gas, or minerals. The proposed rules define commercial development of oil, natural gas, or minerals to include exploration, extraction, processing, and export, or the acquisition of a license for any such activity. The proposed definition is not intended to include activities that are "ancillary or preparatory" to commercial development.[16] Thus, under the proposed rules, the SEC would not consider "a manufacturer of a product used in the commercial development of oil, natural gas, or minerals to be engaged in the commercial development of the resource."[17] The SEC has provided a few examples in the proposing release to explain this distinction based on particular goods and services,[18] but companies that are not clear whether their activities fall within or outside of the scope of the definition of "commercial development of oil, natural gas, or minerals" may wish to ask the SEC to provide further guidance on this subject.

12 Pub. L. No. 111-203, §1504; Disclosure of Payments by Resource Extraction Issuers, Release No. 34-63549 (Dec. 15, 2010), 75 F.R. 80978, 80979 (Dec. 23, 2010). The SEC confirms that foreign private issuers that are engaged in commercial development of oil, natural gas, or minerals and that file annual reports on Forms 20-F and 40-F are subject to the disclosure requirements under Section 1504. *Id.* at 80980.

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

14 The ESTT, as introduced in the Senate, urges the administration to undertake to become an "implementing" country of the Extractive Industries 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, *available at:* http://www.arnoldporter.com/public_document.cfm?id=15550&key=7A2.

15 The proposed rules, as they stand, do not set forth a standard to determine whether payment amounts should be considered de minimis or not. *See* Disclosure of Payments by Resource Extraction Issuers, Release No. 34-63549 (Dec. 15, 2010), 75 F.R. 80978, 80984 (Dec. 23, 2010).

16 *Id.* at 80981.

17 *Id.*

18 Thus, the SEC notes: "For example, a manufacturer of drill bits or other machinery used in the extraction of oil would not fall within the definition of commercial development. Similarly, transportation activities generally would not be included within the proposed definition. On the other hand, an issuer engaged in the removal of impurities, such as sulfur, carbon dioxide, and water, from natural gas after extraction but prior to its transport through the pipeline would be included in the definition of commercial development because such removal is generally considered to be a necessary part of the processing of natural gas in order to prevent corrosion of the pipeline." *Id.*

A resource extraction issuer, under the proposed rules, would not only be required to disclose payments that it made but also those made by a subsidiary or another entity controlled by the issuer. Thus, a resource extraction issuer would need to determine whether, based on all the relevant facts and circumstances, it controls a particular entity. The SEC directs that "[a]t a minimum, under [its] proposal, payments made by a subsidiary or entity under the control of a resource extraction issuer would be subject to disclosure…if the resource extraction issuer must provide consolidated financial information for the subsidiary or other entity in the issuer's financial statements included in its Exchange Act reports."[19]

The proposed rules would require a resource extraction issuer, through the use of electronic tags,[20] to provide substantial information about covered payments, including the 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 and the financial period in which the payments were made; the business segment of the resource extraction issuer that made the payments; the government that received the payments; and the project of the resource extraction issuer to which the payments relate.[21]

The SEC estimates that approximately 860 filers of Form 10-K's would be affected by the proposed amendments, as well as approximately 240 foreign companies that file annual reports with the SEC on Forms 20-F and 40-F.[22] The proposed rules for resource extraction issuers do not include an exemption for smaller reporting companies.

The SEC's proposed rules on disclosures of resource extraction payments include 90 questions on which comments are sought on or before January 31, 2011. Many of these questions will be of serious concern to companies involved in the extraction of oil, natural gas, or minerals. For example, the SEC seeks comments on:

- Whether the rules should apply to foreign private issuers and if so, whether those issuers be permitted to follow their home country rules and disclose in their Form 20-F the required home country disclosure.
- Whether the rules should define "commercial development of oil, natural gas, or minerals" as including the activities of exploration, extraction, processing, and export as proposed.
- How the rules should define "payment" and whether there are specific types of taxes, fees, and benefits that should be excluded from the list of payments that must be disclosed.
- Whether and how the rules should define the words "de minimis," the category of payment that the statute exempts from disclosure.
- How the rules should define the word "project" for which disclosures of payments must be made, since the statute requires disclosure of covered payments "for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals"[23] but does not define "project."

19 *See* Disclosure of Payments by Resource Extraction Issuers, Release No. 34-63549 (Dec. 15, 2010), 75 F.R. 80978, 80987 (Dec. 23, 2010).

20 Section 1504 and the proposed SEC rules require the submission of payment information in an interactive data format.

21 The proposed rules fail to clarify whether the SEC requires disclosure of payments that could be illegal under a country's anti-corruption laws, including those of the United States. The relationship between the compliance obligations in these rules and potential exposure to liability under the U.S. Foreign Corrupt Practices Act is discussed in Mara V.J. Senn and Rachel L. Frankel, "Wall Street reform law creates foreign government payment legal hazards," *Oil & Gas Journal* 06 Sep. (2010) *available at:* http://www.arnoldporter.com/public_document.cfm?u=WallStreetreformlawcreatesforeignpaymentlegalhazards&id=16880&key=12A0. *See also* Arnold & Porter LLP Advisory, "Dodd-Frank CSR Provisions Mandate Disclosure of Overseas Payments and Use of Conflict Materials" (2010) (discussing implications regarding the disclosure of payments that could be illegal under anti-corruption laws, including the Foreign Corrupt Practices Act), *available at:* http://arnoldandporter.com/public_document.cfm?u=DoddFrankCSRProvisionsMandateDisclosureofOverseasPaymentsandUseofConflictMaterials&id=16406&key=10G2.

22 The SEC estimates that, of the 13,545 Form 10–Ks filed annually, approximately 861 are filed by issuers that would be affected by the proposed rule and form amendments for resource extraction issuers. Of the 942 Form 20-F annual reports filed, the SEC estimates that 166 are filed each year by companies that would be affected. Of the 205 Form 40-F annual reports filed each year, approximately 74 are filed by companies that would be affected. *See* Disclosure of Payments by Resource Extraction Issuers, Release No. 34-63549 (Dec. 15, 2010), 75 F.R. 80978, 80994-95 (Dec. 23, 2010).

23 Pub. L. No. 111-203, § 1504.

- How the rules should address the requirement that a resource extraction issuer must disclose payments made by a subsidiary or an entity under its control, and specifically how "control" should be defined.
- Whether the SEC should provide an exception to disclosure when disclosure potentially would cause a resource extraction issuer to violate a host country's laws.
- Whether the SEC should consider a company to be "owned by a foreign government," and thus a "foreign government" under the statute and the rules, if the company at issue is not at least majority-owned by a foreign government.
- Whether the rules should provide an exception for otherwise reportable payments if they are subject to contractual confidential requirements.

Conclusion

The SEC has shown through the detail in its requests for comments that it recognizes that the new Dodd-Frank Act requirements are broad and complex. The comment period provides an opportunity for the thousands of potentially affected issuers to express their concerns about the scale of the required disclosures and suggest ways to shape SEC rules consistently with the statutory requirements.

While there is room for substantive comments on the proposed rules, it is also likely that the final rules will in many key respects simply track the very broad new disclosure requirements of the statute. Thus, while concerned issuers should review the rules and consider submitting comments, entities that believe they will be covered under the new law should at the same time begin to review and evaluate relevant policies, practices, and record-keeping, to ensure that they will be able to comply with the new requirements.

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

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