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Digging Into SEC Mineral Disclosure Policies

Law360, New York (June 17, 2013, 11:25 AM ET) -- On May 30, 2013, the Division of Corporation Finance of the U.S. Securities and Exchange Commission provided guidance in the form of frequently asked questions with respect to two recent SEC rules: (i) disclosure requirements regarding the use in products manufactured or contracted to be manufactured by an issuer of conflict minerals originating in the Democratic Republic of Congo or an adjoining country (DRC), and (ii) disclosure requirements for certain payments to governments by resource extraction issuers.[1]

The SEC adopted these rules on Aug. 22, 2012, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, creating new Form SD for these specialized disclosure requirements.[2]

The conflict minerals disclosure rules require issuers to follow a three-step process in determining whether, and to what extent, to make the required disclosures. The first step is to determine whether a company is subject to the rule. If it is, the second step is to conduct a reasonable country of origin inquiry to determine whether the conflict minerals originated in the DRC. Depending on the outcome of that inquiry, the third step is to conduct supply chain due diligence and, if necessary, to prepare a conflict minerals report.

The resource extraction payments disclosure rules require resource extraction issuers to disclose annually certain information on payments they make to the U.S. government and foreign governments for the purpose of the commercial development of oil, natural gas or minerals.

Although both sets of rules were accompanied by extensive adopting releases, ambiguities remain, which have resulted in a substantial number of compliance questions as issuers analyze the applicability of the new rules to their operations and what disclosures, if any, must be provided. The FAQs do not address all of the questions that issuers are struggling with, but they do provide helpful interpretations with respect to some of the more commonly raised issues and also provide insights into how the staff may be looking at applying these new rules.

FAQs Applicable to Both the Conflict Minerals and Resource Extraction Payments Rules

Form S-3 Eligibility

The FAQs made clear that the failure to timely file a Form SD regarding conflict minerals or resource extraction payments will not make an issuer ineligible to use a Form S-3 registration statement. While the Form SD is a mandatory filing to the extent required by applicable SEC rules, a failure to file that form timely will not prevent an issuer from raising capital using the streamlined procedures of a short-form registration statement if the issuer is otherwise eligible to use Form S-3. Even though the failure to timely file a Form SD will not impact Form S-3 eligibility, it remains important that issuers develop appropriate disclosure controls and procedures as the Form SD is a report that is filed with the SEC and is therefore covered by the certifications filed by an issuer's chief executive officer and chief financial officer.

Subsidiaries

The issuer must include applicable disclosures with respect to subsidiaries. In the case of conflict minerals, the disclosure is required with respect to the issuer and all of its consolidated subsidiaries. In the case of resource extraction payments, the disclosure is required with respect to the issuer and its subsidiaries, as well as any other entity over which the issuer has control (e.g., a joint venture with a national oil company). Accordingly, issuers should implement disclosure controls and procedures to make appropriate inquiries throughout their organizations when determining if they are subject to the conflict minerals and/or resource extraction payment disclosure rules.

Key Points of the Conflict Minerals FAQs

Voluntary Filers

The conflict minerals FAQs make clear that the conflict mineral rules apply to issuers that voluntarily file reports with the SEC under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"). This means that any issuer that files reports with the SEC, whether or not it is required to do so, must comply with the conflict minerals disclosure rules, if applicable.

Customary Mining Activities

Issuers that only engage in mining and ancillary activities customarily associated with mining, such as transporting, crushing, milling, mixing and smelting the mined ore, are not considered to be manufacturing those minerals. The staff's position is a helpful clarification that mining companies do not become subject to the conflict minerals disclosure rules as a result of these ancillary activities. For example, the staff noted that gold mining of lower grade ore can involve a number of ancillary activities and the performance of those activities does not subject an issuer to the new conflict minerals disclosure rules.

Etched Logos

Issuers specifying that a logo, serial number or other identifier be etched on a generic product manufactured by a third party is not considered to be "contracting to manufacture the product." In other words, a company may direct that the branding of an "off-the-shelf" product be accomplished through a permanent marking of the product, as opposed to being affixed to the product, without being deemed to be contracting to manufacture the product for the purpose of the conflict minerals disclosure rules.

Generic Components

The FAQs make clear that if an issuer purchases generic components containing conflict minerals to include in a product, it must conduct a reasonable country of origin inquiry with respect to conflict minerals included in the generic components, even if it did not contract to manufacture such components. Accordingly, as a disclosure control, issuers should confirm that they are evaluating the content of generic parts used when they manufacture or contract to manufacture their products.

Packaging

The packaging or container sold with a product is not to be considered part of the product, even if a product's package or container is necessary to preserve the product following purchase. The staff interpretation explains that the packaging or container sold with a product is not considered part of the product and is generally discarded. On the other hand, if a company manufactures and sells the packaging or containers independent of the product inside, the packaging or container itself would be a product, subject to the conflict minerals disclosure rules.

Equipment Used to Provide Service

When an issuer uses equipment in order to provide a service that it sells, the staff does not consider such equipment to be the issuer's product for the purpose of the conflict minerals disclosure rules, even if the issuer manufactures or contracts to manufacture such equipment. As an example, the staff noted that a cruise line company that contracts to manufacture cruise ships does not have to file reports on Form SD regarding cruise ships. In its response, the staff made clear that it does not interpret equipment used to provide services to be products subject to the conflict minerals disclosure rules.

Resale of Equipment

Issuers do not have to file reports on Form SD with respect to tools, machines or equipment used in the manufacture of their products, even if they subsequently resell such equipment. Entry of used tools, machines or equipment into the stream of commerce after a company no longer needs them does not transform these items into products of that company for the purposes of the conflict minerals disclosure rules.

Model Numbers

Issuers do not need to disclose in Form SD the model numbers of products that have not been found to be DRC conflict free or that are DRC conflict undeterminable. The staff reiterated that the conflict minerals disclosure rules permit an issuer to describe its products based on its own facts and circumstances because each individual company is in the best position to describe its products in terms commonly understood within its industry. While issuers have flexibility in describing their products, they nevertheless must clearly disclose that such products "have not been found to be 'DRC conflict free'" or are "DRC conflict undeterminable," as applicable.

Report and Audit Needed Even if "DRC Conflict Free"

Issuers that manufacture or contract to manufacture products that contain conflict minerals from the DRC must file a Form SD with a conflict minerals report and obtain an independent private sector audit, even if they determine the products to be "DRC conflict free." However, issuers do not have to disclose "DRC conflict free" products in their conflict minerals report or make certain other disclosures (such as describing processing facilities and country of origin) with respect to the "DRC conflict free" products.

IPO Transition Period

Following an issuer's initial public offering, the staff clarified that it will not object if the issuer starts conflicts mineral reporting for the first reporting calendar year that begins no sooner than eight months after the effective date of its IPO registration statement. This staff interpretation will provide a useful transition period for newly public companies, comparable to the transition period directly provided in the conflict minerals disclosure rules in the acquisition context.

Key Points of the Resource Extraction Payments FAQs

Contract Drilling and Other Oil Field Services Companies

The staff clarified that issuers involved only in providing contract drilling and other oil field services (and presumably equipment) associated with exploration, extraction, processing and export activities would generally not be considered resource extraction issuers for purposes of the resource extraction disclosure rules. While noting that these activities are "related to" the commercial development of resources, the staff took the same approach as the Extractive Industries Transparency Initiative (EITI) did, in providing that only companies directly engaged in the extraction or production of oil, natural gas or minerals should disclose payments to governments or governmental agencies.[3]

The staff's position resolved a major uncertainty that many service and equipment companies had been grappling with since the effective date of the rules. This staff Interpretation also stated that in the event that any payment otherwise falling within the definition of "payment" under the rules is made by a service provider to a government or governmental agency on behalf of a resource extraction issuer, that payment must be disclosed by the resource extraction issuer.

What is a "Mineral" for Purposes of the Resource Extraction Disclosure Rules?

A "resource extraction issuer" is defined in the statute and resource extraction disclosure rules as an issuer engaged "in the commercial development of oil, natural gas, or minerals." There is no specific definition of the word "minerals" in the statute or rules. The FAQs provide that for purposes of the statute and rules, disclosure is required with respect to "any material commonly understood to be a mineral," and would include any material for which disclosure is required under the SEC's Industry Guide 7 under the Securities Act of 1933 — "Description of Property by Issuers Engaged or to Be Engaged in Significant Mining Operations."

Exporting Without an Ownership Interest in the Resource

An issuer engaged in transportation activities moving a resource from one country to another country is generally considered to be "exporting" the resource. However, the issuer generally would meet the definition of "resource extraction issuer" and be subject to the requirements to disclose its payments to governments if the issuer has an ownership interest in the resource being transported. If the issuer does not have an ownership interest in that transported resource, then the transportation activities generally are not considered to be directly related to the export of the resource, and the issuer generally would not be considered to be a resource extraction issuer.

Types of Payments and Disclosures

The FAQs also clarified a number of questions with regards to specific types of payments made by resource extraction issuers to governments. For example, a question was raised whether payments from a resource extraction issuer to a majority-owned government transportation service that supplies people or materials to a job site are required to be reported. The staff responded that because the payments are made in connection with a service activity that is considered to be "ancillary or preparatory" to the commercial development of resources, disclosure of those payments is not required.

Payments of penalties and fines to governmental agencies related to resource extraction activities are not reportable as "fees." For purposes of the resource extraction disclosure rules, disclosure is required of specified payments including, among other categories, fees and other material benefits that the SEC determines, consistent with the EITI guidelines, are part of the commonly recognized revenue stream for the commercial development of resources. Penalties and fees, according to the staff, are not within the type of fees mentioned in the EITI guidelines, and therefore they are not part of the commonly recognized revenue stream for the commercial development of the subject resources.

Payment information presented by a resource extraction issuer cannot be provided on an accrual basis for financial accounting purposes. The staff noted that the rules only contemplated the payment information to be presented on an unaudited, cash basis for the year in which the payments are made.

A resource extraction issuer may have many sources of income from a particular country. That resource extraction issuer likely pays corporate-level income tax to that country's government based on the consolidated amount of its income in that country and not segregated out by resource extraction activity.

According to the FAQs, the income taxes that are paid with respect to the issuer's covered commercial development activities that must be disclosed for that country may be reported in one of two ways: (i) either on a segregated basis, separating out the amounts of income taxes that the issuer pays on its other business activity income in that country, which may be difficult to do if the provider of the resource extraction activities is not a separate taxpayer, or (ii) on an aggregate basis, reporting the total income taxes paid for that country but noting that the disclosed aggregate amount includes payments made for purposes other than the commercial development of oil, natural gas or minerals.

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As noted earlier, there are a number of open questions issuers are trying to address in determining how to apply the new requirements. While the FAQs address some of these questions, there are a number that remain unanswered and we hope that the staff will continue to issue FAQs providing additional guidance interpreting the application of the new rules.

—By Laura D. Richman, Marc H. Folladori and Michael L. Hermsen, Mayer Brown LLP

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[1] The FAQs relating to the conflict minerals disclosure rules are available at http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm. The FAQs relating to the resource extraction payments disclosure rules are available at http://www.sec.gov/divisions/corpfin/guidance/resourceextraction-faq.htm.

[2] For a detailed description of the conflict minerals disclosure rules, see Mayer Brown LLP's Legal Update dated Sept. 5, 2012, entitled U.S. Securities and Exchange Commission Adopts Final Conflict Minerals Disclosure Rule, which is available at http://www.mayerbrown.com/US-Securities-and-Exchange-Commission-Adopts-Final-Conflict-Minerals-Disclosure-Rule-09-05-2012/. For a detailed description of the resource extraction payments disclosure rules, see Mayer Brown LLP's Legal Update dated September 4, 2012, entitled SEC Adopts Dodd-Frank Resource Extraction Payments Disclosure Rules, which is available at http://www.mayerbrown.com/SEC-Adopts-Dodd-Frank-Resource-Extraction-Payments-Disclosure-Rules-09-04-2012/.

[3] Section 13(q)(1)(C) under the Exchange Act directs the SEC in its rulemaking to determine the types of payments to be included as "part of the commonly recognized revenue stream for the commercial development of oil, natural gas or minerals." It provides that the payments and benefits to be included should be "consistent with the guidelines of the EITI (to the extent practicable)."