Surprising Disclosure Requirements in the Dodd-Frank Act May Burden Many Companies

Although the title of the legislation belies their inclusion, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) contains significant additions to Securities and Exchange Commission (SEC) reporting requirements that are intended to promote greater international transparency by a wide array of companies. The level of transparency required by revisions to Section 13 of the Securities Exchange Act of 1934 (the Exchange Act) has extensive implications for reporting companies that are engaged in the production of electronic devices or are in the oil, gas mining or sectors. Section 1502 of the Act requires companies to due diligence the source and chain of custody of certain minerals found in and around the Democratic Republic of the Congo (DRC). Section 1504 of the Act requires certain companies to disclose all payments made to the U.S. government and non-U.S. governments in connection with the exploration, extraction, processing, export and other significant actions relating to oil, natural gas or mineral development.

The legal as well as the practical implications of such reporting requirements for many companies could be significant and some issuers and companies are advised to evaluate current and future compliance practices.

1. Section 1502

In response to growing violence in the DRC, Congress is attempting to cut off funding from the sale of certain "conflict minerals" from the region (for example, coltan, a mineral widely used in mobile phones and other electronic devices, is identified as one such conflict mineral) by requiring manufacturers of products using such "conflict minerals" to annually report their use to the SEC. While not all conflict minerals come from the DRC and the surrounding area, given the prevalence of electronic devices using coltan and the large supply of coltan from the DRC, it has been said that we are all carry a piece of the Congo in our pockets. As such, many companies utilizing these "pieces of the Congo" will be affected by Section 1502.

In addition to certain disclosure to the SEC and the public generally, Section 1502 also creates directives to the Secretary of State, the Secretary of Commerce, and the Comptroller General of the United States to further analyze the effects that trade in conflict minerals have on extreme levels of violence in and around the DRC.

A. APPLICABILITY AND REQUIREMENTS

Specifically, Section 1502 amends Section 13 of the Exchange Act by inserting new subsection (p), which applies to manufacturers of products in which "conflict minerals"[1] are necessary to the "functionality or production" of such products. Note that this does not restrict applicability to electronic companies alone, but applies to all publicly traded companies that use such conflict minerals in their products.

If a company falls within the purview of Section 1502, it is required to make certain disclosures. At a minimum, such company must disclose to the SEC and the public on its website whether conflict minerals originated in the DRC or "an adjoining country"[2]. Thus, an investigation will be needed in order to determine and document the origin of the applicable minerals.

B. REPORTING CHECKLIST: CONFLICT MINERALS FROM THE DRC AND ADJOINING COUNTRIES

If conflict minerals are determined to have originated in the DRC or any such adjoining country, then the affected company must additionally include in its report to the SEC, and make publicly available on its website, the following:

1. An "independent private sector audit" of the report submitted to the SEC, certified by such company (which "shall constitute a critical component of due diligence" and which shall not rely "on a determination of an independent private sector audit . . . previously determined by the Commission to be unreliable");

2. A description of the due diligence undertaken to determine the source and chain of custody of such minerals;

3. A description of the products manufactured or contracted to be manufactured that contain minerals that directly or indirectly finance or benefit armed groups in the DRC or an adjoining country (in other words, minerals that are not "DRC conflict free"[3]);

4. Identification of the entity that conducted the independent private sector audit;

5. Identification of the facilities used to process the conflict minerals;

6. Identification of the country of origin of the conflict minerals; and

7. A description of the efforts to determine the mine or location of origin "with the greatest possible specificity".

C. EFFECTIVENESS

The SEC is required to issue regulations implementing Section 1502 no later than April 17, 2011. Affected companies must then make disclosures to the SEC annually beginning in the "first full fiscal year" after promulgation of such specific regulations. Section 13(p) of the Exchange Act shall expire on the later of five years from enactment or the determination by the President of the United States that no armed groups continue to be directly involved and benefiting from commercial activity involving conflict minerals.

D. ANALYSIS OF SECTION 1502

At a minimum, the new reporting requirements necessitate the need for affected companies to review current due diligence processes in place to ascertain the origin and chain of custody of conflict minerals.[4] This review process, along with the retention of a third party auditor to certify the due diligence process in the new SEC disclosures, signal the incurrence of additional costs, and, depending on the results of such a review and certification process, may result in further cost increases associated with sourcing conflict minerals from areas other than the DRC region.

In addition, easy, worldwide public access to due diligence results could very well create public relations issues for a company or, worse, subject a company to litigation under statutes such as the Alien Tort Statute, which allows non-U.S. citizens to sue in the United States for violations of international law, including the aiding and abetting of a violation of international law, stemming, for example, from the knowing use of conflict minerals in a company's products. Such potentially significant future costs further emphasize the need to carefully understand Section 1502 reporting requirements and revise current sourcing practices and procedures, with an eye towards not only legal repercussions but the practical effects of manufacturing products that contain conflict minerals.

2. Section 1504

In support of the commitment of the U.S. government to international transparency relating to the commercial development of oil, natural gas or minerals and the application of energy wealth within resource-rich, though too often poverty stricken, countries, the Act also contains additional broad disclosure requirements to the SEC related to payments by resource extraction issuers to the U.S. government and to non-U.S. governments as well.

Section 1504 amends Section 13 of the Exchange Act by inserting new subparagraph (q), which requires each "issuer" that is required to file an annual report with the SEC[5] and that engages in the commercial development of oil, natural gas and minerals to disclose information relating to any payment to a non-U.S. government (including any company owned by a non-U.S. government) or the U.S. government made by such issuer, any subsidiary or any other entity under the control of such issuer for the purposes of the commercial development of oil, natural gas or minerals (which includes 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).

It is worthwhile noting that "payment" is broadly defined and includes "taxes, royalties, fees (including

license fees), production entitlements, bonuses" and other material benefits that the SEC determines are part of the commonly recognized revenue stream for commercial mineral development, though such payments must exceed an unspecified "de minimus" amount. In determining such other material benefits that are part of the commonly recognized revenue stream, the SEC shall consider, to the extent practicable, the guidelines of the Extractive Industries Transparency Initiative, a coalition of governments, companies, civil society groups, investors and international organizations (of which the United States is not a member) that sets forth a global framework for companies to disclose payments to non-U.S. governments and for such governments to disclose what they receive.

A. REPORTING CHECKLIST: PAYMENTS BY RESOURCE EXTRACTION ISSUERS

Specifically, each such issuer must comply with the following requirements in its disclosure:

1. Specify the type and total amount of such payments made on a project basis relating to the commercial development of oil, natural gas or minerals;
2. Specify the type and total amount of such payments made to each government;
3. Provide such information in an interactive electronic data format containing electronic tags; and
4. Specify and identify by an electronic tag each of the following as it relates to the requirements under Sections II.A.1 and II.A.2 above:

a. the total amount of such payments by category;

b. the currency used or such payments;

c. the financial period in which such payments were made;

d. the particular business segment of the resource extraction issuer making such payments;

e. the government receiving such payments; and

f. the particular project to which such payments relate.

B. EFFECTIVENESS

The new reporting requirements under Section 1504 will apply to a resource extraction issuer's annual report relating to its fiscal year ending not earlier than one year after the issuance of the final rules by the SEC. The SEC, in turn, has 270 days from the date of enactment of the Act (such day being April 17, 2011) to issue such final rules.

C. ANALYSIS OF 1504

Until the SEC issues the final rules relating to Section 1504, a number of significant questions will remain unanswered, postponing any definitive analysis of the implications of these reporting requirements. For example, the definition of "resource extraction issuer" is exceptionally broad and it is unclear how closely a company's activities must relate to the commercial development of oil, natural gas or minerals in order to bring it within the purview of Section 1504. Would a manufacturer of parts used by a large multinational oil company be deemed a resource extraction issuer? What about a payroll company that provides only limited services to oil and gas companies engaged in activities outside the United States? Also, do the same disclosure requirements apply for payments to the U.S Government as non-U.S. governments? Further, the "de minimis" threshold fails to provide a threshold amount or associate a dollar figure with de minimis payments.

Perhaps most significantly, "payment" does not differentiate between lawful payments and illegal or improper payments. As such, it would appear that this disclosure requirement overlaps with requirements under the Foreign Corrupt Practices Act (FCPA), which prohibits payments to foreign government officials to assist in obtaining or retaining business. There are several practical implications of such an overlap; disclosures of payments to foreign governments as a resource extraction issuer could lead to closer scrutiny under FCPA disclosure requirements, and a discrepancy between a company's disclosures under the FCPA and Section 1504 or between any disclosure by the company and a foreign government's disclosure could trigger an expensive investigation, costly to a company in terms of financial costs and resource

allocations at a time when many companies can least afford it. Also, foreign governments may very well object to counterparties publicly disclosing heavily negotiated, previously highly confidential payments, which may cause such foreign governments to award contracts to companies not required to file annual reports with the SEC. In addition, violations of Section 1504 could provide a basis for shareholder class action lawsuits or other actions by investors when ultimately disclosed.

Though many ambiguities remain to be addressed by the SEC in the final rules regarding Section 1504, if a company believes that it may be subject to the new reporting requirements, it should consider submitting comments on the rules during the comments period and review its existing compliance and recordkeeping procedures to determine any changes that may be needed.

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Footnotes

1 Conflict minerals are defined as (a) coltan, tin ore, gold, wolframite or their derivatives or (b) any other minerals or their derivatives determined by the Secretary of State to be financing conflict in the DRC or adjoining country, although notice of such determination must be published not later than one year prior to the effectiveness of such designation. See Footnote 2 below for a discussion of "adjoining country".

2 An "adjoining country" is defined in Section 1502(e)(1) as "a country that shares an internationally recognized border" with the DRC. Currently, Angola, Zambia, Tanzania, Burundi, Rwanda, Uganda, Sudan, Central African Republic or Congo fall within such definition.

3 "DRC conflict free" means products that do not contain minerals that directly or indirectly finance or benefit armed groups in the DRC or an adjoining country, and "armed group", in turn, means an armed group that is identified as perpetrators of serious human rights abuses in the annual Country Reports on Human Rights Practices under section 116(d) and 502B(b) of the Foreign Assistance Act of 1961 related to the DRC or an adjoining country.

4 It is important to emphasize that, as defined by the Act, "conflict minerals" refers to certain types of minerals and must not necessarily come from any particular geographic area such as the DRC. As such, a company using coltan, tin ore, gold, or wolframite, or any of their derivates, in any of its products, regardless of the origin of such minerals, must comply with Section 1504.

5 Though not explicitly stated, it is anticipated that these disclosure rules will also apply to non-U.S. private issuers filing annual reports on Form 20-F or Form 40-F, although the extent to which such non-U.S. private issuers must also comply is unknown until the final rules are issued by the SEC (discussed below).

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