SEC Proposes Rules Relating to Conflict Minerals, Mine Safety Reporting and Payments by Resource Extraction Companies

On December 15, 2010, the Securities and Exchange Commission proposed rules relating to disclosure of (i) use of "conflict minerals" from the Democratic Republic of the Congo and adjoining countries, (ii) mine safety information and (iii) payments made to governments by resource extraction issuers relating to the commercial development of oil, natural gas or minerals. The proposed rules implement Sections 1502, 1503 and 1504 of the Dodd-Frank Act.

A description of the proposed rules, which may be found at the SEC's website here, is provided below.

I. Conflict Minerals Disclosure Requirements

A. Summary

Section 1502 of the Dodd-Frank Act requires companies that file reports with the SEC to disclose whether conflict minerals necessary to the functionality or production of a product manufactured, or contracted to be manufactured, by the company originated in the Democratic Republic of the Congo ("DRC") or an adjoining country (collectively, the "DRC Countries"). If such conflict minerals did originate in the DRC Countries, the company must submit to the SEC and upload to the company's website a conflict minerals report that describes measures taken to exercise due diligence on the source and chain of custody of such conflict minerals. Measures taken must include an independent private sector audit of such report submitted. The report must contain a description of the products manufactured that are not DRC conflict free, the name of the entity that conducted the independent private sector audit, the facilities used to process any conflict minerals, the country of origin of the conflict minerals and the efforts to determine the mine or origin, with the greatest possible specificity, of such conflict minerals.

The proposed rules prescribe three steps for a company to follow in determining whether it is required to include disclosure regarding conflict minerals in its annual report and the extent of the disclosure requirements applicable to it:

- Step One – Determining Issuers Covered by the Conflict Mineral Provision
- Step Two – Determining Whether Conflict Minerals Originated in the DRC Countries and the Resulting Disclosure
- Step Three – Contents of Conflict Minerals Report and Supply Chain Due Diligence

B. Conflict Minerals Definition

The term "conflict minerals" currently[1] means columbite-tantalite (coltan), cassiterite (the metal ore used to produce tin), gold, wolframite or their derivatives. The new disclosure requirements will likely apply to many

[1] The US Secretary of State may designate other minerals as conflict minerals.

companies because these conflict minerals have vast uses including in tin plating, tin solders for joining pipes and electronic circuits, electronic components (found in, for example, mobile phones, computers, videogame consoles and digital cameras), carbide tools, jet engine components, jewelry, communications and aerospace equipment, metal wires, electrode contacts in lighting, heating applications and welding applications.

C. Step One – Determining Issuers Covered by the Conflict Minerals Provision

Who must disclose?

The proposed rules would apply to any issuer (including domestic companies, foreign private issuers and smaller reporting companies) that files reports under the Exchange Act for whom conflict minerals are "necessary to the functionality or production of a product manufactured, or contracted to be manufactured," by such issuer. The proposed rules would apply both to issuers that manufacture products themselves and issuers that contract to have their products manufactured by others if conflict minerals are necessary to the functionality or production of those products. The SEC indicates in the proposing release that this would include, for example, each public company retailer that contracts to have products manufactured to offer under its own private label. The proposed rules would also extend to issuers that mine conflict minerals because they are considered to be manufacturing conflict minerals during the extraction of such minerals.

When is a conflict mineral necessary to the functionality or production of a product?

The SEC has chosen not to define when a conflict mineral is "necessary to the functionality or production of a product." If a mineral is necessary, there is no materiality threshold and the product must be addressed in the disclosure without regard to the amount of the mineral involved. The SEC also suggests that even if a conflict mineral is not included anywhere in the final product, if that conflict mineral is intentionally included in the production process and is necessary to that process, disclosure would be required. However, no disclosure would be required if the conflict mineral is only necessary to the functionality or production of a physical tool or machine used to produce a product. As an example, the SEC stated if a wrench containing conflict minerals that were necessary to the functionality or production of that wrench were used to produce an automobile that contains no conflict minerals, they would not consider the conflict minerals of the wrench necessary to the production of the automobile.

D. Step Two – Determining Whether Conflict Minerals Originated in the DRC Countries and the Resulting Disclosure

Reasonable country of origin inquiry

If an issuer determines that conflict minerals are necessary to the functionality or production of a product it either manufactures or contracts to be manufactured, such issuer would be required to make a "reasonable country of origin inquiry" into whether its conflict minerals originated in any of the DRC Countries. The proposed rules do not prescribe the manner in which an issuer must conduct this inquiry, but the SEC does indicate in the proposing release that it may be reasonable if an issuer received "reasonably reliable representations" from the facility producing such conflict minerals that such conflict minerals did not originate in DRC Countries. The proposed rules require that the issuer disclose what reasonable country of origin inquiry it made to determine the location. The reliability of such inquiry will be based solely on whether the information the issuer used provides a reasonable basis to be able to trace the origin of any conflict mineral it uses. The reasonableness standard indicates that an issuer does not need to determine with absolute certainty whether the conflict minerals originated in the DRC Countries.

Disclosure based on the outcome of the reasonable country of origin inquiry

If the issuer determines the conflict minerals did not originate in the DRC Countries, the issuer would be required to disclose so in its annual report and on its website. In the annual report, the issuer would be required to disclose the inquiry it undertook to make its determination along with the internet address where the online disclosure is located and maintain reviewable business records to support its determination. The disclosure would be required to remain on the issuer's website at least until the issuer files its subsequent annual report.

If the issuer determines the conflict minerals originated in the DRC Countries or if the issuer is unable to determine that such conflict minerals did not originate in the DRC Countries, the issuer would be required to disclose so in its annual report and on its website. In addition, the issuer would be required to include a Conflict Minerals Report as an exhibit to its annual report, make such report available online and include the Internet address to such report in the annual report. The Conflict Minerals Report would be required to be posted to the issuer's website at least until the issuer filed its subsequent annual report.

E. Step Three – Content of Conflict Minerals Report and Supply Chain Due Diligence

Content of Conflict Minerals Report

The proposed rules would require that the Conflict Minerals Report include a "description of the measures taken by the registrant to exercise due diligence on the source and chain of custody of the conflict minerals," including an independent private sector audit of such report. The issuer would be required to certify[2] that it obtained an independent private sector audit report and include the audit report and certification in the Conflict Minerals Report along with the name of the auditor. The Conflict Minerals Report would be required to contain a description of the products that are not "DRC conflict free." "DRC conflict free" means the "product does not contain conflict minerals that directly or indirectly finance or benefit armed groups in the DRC or an adjoining country." The Conflict Minerals Report would also disclose the country of origin of conflict minerals, the facilities used to process conflict minerals and the efforts to determine the mine or origin with the greatest possible specificity. Issuers unable to conclude that conflict minerals did not originate in DRC Countries would be required to describe their products that contain conflict minerals of indeterminate origin as not "DRC conflict free," but such issuers could also add that they were unable to determine the source of the conflict minerals. Such issuers would also be required to obtain an independent private sector audit of their Conflict Minerals Report.

Due diligence on the source and chain of custody of conflict minerals

The proposed rules do not provide specific guidelines concerning the due diligence to be undertaken by issuers when making their supply chain determinations as part of the Conflict Minerals Report because the SEC believes "conduct undertaken by a reasonably prudent person may vary and evolve over time." Even if the SEC were to prescribe a framework for conducting diligence, as a practical matter, conducting diligence to determine the source of minerals would be (and indeed will be) challenging because minerals from various sources may be smelted together and due to the inherent dangers of conducting inquiries the results of which could impact the profitability of groups fueling the conflict.

[2] As proposed, the certification would be made by the company and would not be signed by any officer.

The proposed rules would require that issuers disclose whatever due diligence they used to make their determinations, including whether or not they used nationally or internationally recognized standards for supply chain due diligence. The SEC noted that conformity with nationally or internationally recognized standards or guidance for due diligence regarding conflict minerals supply chains would be evidence the issuer used due diligence in its determinations. As noted above, a critical component of this due diligence is an independent private sector audit of the Conflict Minerals Report.

F. Special Rules for Recycled and Scrap Minerals

The proposed rules call for different treatment of conflict minerals from recycled and scrap sources because of the difficulty in determining the origin of such materials. Conflict minerals will be treated as recycled if they are reclaimed end-user or post-consumer products. Minerals that are partially processed, unprocessed or byproducts from another ore will not be considered recycled. Conflict minerals exclusively obtained from recycled or scrap sources will be considered to be DRC conflict free. An issuer using conflict minerals from recycled or scrap sources would be required to disclose in its annual report (and post to its website) that its conflict minerals were obtained from recycled or scrap sources and produce a Conflict Minerals Report that describes the due diligence undertaken in determining its conflict minerals came from recycled or scrap sources, including an independent private sector audit of such report. The issuer would also be required to certify that it obtained an independent private sector audit report, include the audit report and certification in the Conflict Minerals Report along with the name of the auditor and post such report to its website.

G. Timing of Application of Rules

Issuers must provide conflict mineral disclosures after their first full fiscal year following the promulgation of the SEC's final rules, which is required under the Dodd-Frank Act to occur by April 15, 2011. Issuers would be required to disclose whether their necessary conflict minerals originated in the DRC Countries in the year for which such reporting is required based on the date the issuer takes possession of a conflict mineral or the date the issuer takes possession of a product in which a conflict mineral was necessary in the production of such product.

II. Mine Safety Disclosure

Section 1503 of the Dodd-Frank Act, which section took effect on August 20, 2010, requires that any reporting company that is an operator, or that has a subsidiary that is an operator, of a coal or other mine located in the United States include disclosures regarding mine safety in its periodic and current reports filed with the SEC. Though these requirements are currently effective, the SEC has proposed rules to define the scope and application of the mine safety disclosure requirements prescribed by the Dodd-Frank Act. Section 1503 enumerates a list of required disclosure items in an issuer's periodic reports:

- For each coal or other mine, identification of the mine and disclosure of:
  - The total number of violations of mandatory health or safety standards that could significantly and substantially contribute to the cause and effect of a coal or other mine safety or health hazard under section 104 of the Federal Mine Safety and Health Act of 1977 (the "FMSHA") for which the operator received a citation from the Mine Safety and Health Administration (the "MSHA");
  - The total number of orders issued under Sec. 104(b) of the FMSHA;

- The total number of citations and orders for unwarrantable failure of the mine operator to comply with mandatory health or safety standards under Sec. 104(d) of the FMSHA;
- The total number of flagrant violations under Sec. 110(b)(2) of the FMSHA;
- The total number of imminent danger orders issued under Sec. 107(a) of the FMSHA;
- The total dollar value of proposed assessments from the MSHA under the FMSHA; and
- The total number of mining-related fatalities.

- A list of coal or other mines, of which the registrant or a subsidiary of the registrant is an operator, that receive written notice from the MSHA of:
  - A pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards under section 104(e) of the FMSHA; or
  - The potential to have such a pattern.
- Any pending legal action before the Federal Mine Safety and Health Review Commission involving such coal or other mine.

The proposed rules would also require an issuer to provide a description of each category of violation, order and citation reported in response to the list above so investors can understand the basis for the violations, orders or citations.

Receipt of any imminent danger order issued under the FMSHA or any written notice from the MSHA that the mine has patterns of violations of mandatory health or safety standards or the potential to have a pattern of such violations must also be disclosed on Form 8-K within four business days of receipt of such order or notice. Disclosure in the Form 8-K would be required to include the date of receipt of the order or notice, a brief description of the category of order or notice and the name and location of the mine involved.

III. Disclosure of Payments to Governments by Resource Extraction Issuers

Section 1504 of the Dodd-Frank Act requires each resource extraction issuer to include in its annual report information relating to any payment made by the issuer, a subsidiary of the issuer, or an entity under the control of the issuer to a foreign government or the U.S. federal government for the purpose of the commercial development of oil, natural gas or minerals. Such disclosure would be required to include:

- The type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals;
- The type and total amount of such payments made to each government;
- The total amounts of the payments, by category;
- The currency used to make the payments;
- 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 country in which the government is located; and
- The project of the resource extraction issuer to which the payments relate.

The information would be required to be submitted in interactive data format in exhibits to the issuer's annual report.

The payment disclosure requirements in Section 1504 of the Dodd-Frank Act apply to any issuer (including any foreign private issuer) required to file an annual report with the Commission that engages in the commercial development of oil, natural gas or minerals. Under the proposed rules, commercial development includes exploration, extraction, processing, exporting and other significant actions, including the acquisition of a license for any such activity. The proposed rules define "payments" to include taxes, royalties, fees, production entitlements and bonuses, in each case that are not de minimis. The term "foreign government" is not limited to foreign federal governments; it also includes foreign subnational governments (states, counties, districts, municipalities) as well as any company owned by a foreign government.

The proposed rules relating to payment disclosure will take effect not earlier than one year after the date on which the SEC issues the final rules, which must occur by April 15, 2011.

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The SEC is accepting comments on the proposed rules until January 31, 2011.

If you would like to discuss these or any other securities law matters, please contact any member of Ropes & Gray's Securities & Public Companies practice or your usual Ropes & Gray advisor.