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"*Show Me the Money…and the Minerals*"

New SEC Rules Require Enhanced Disclosure of Government Payments by Resource Extraction Issuers and Use of Conflict Minerals

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Background

In 2010, the U.S. Congress passed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank). Among the many rulemaking initiatives mandated by Dodd-Frank were requirements for the U.S. Securities and Exchange Commission (SEC) to issue rules requiring disclosure by SEC reporting companies of: (1) certain payments made to the U.S. federal government or foreign governments by resource extraction issuers (being companies engaged in the development of oil, natural gas or minerals); and (2) the use of "conflict minerals" (being certain minerals, including gold, cassiterite, coltan, tin, tantalum and tungsten, originating in the Democratic Republic of Congo (DRC) and adjoining countries). The SEC first published for comment a draft of these rules in December 2010. After a long public review process, the SEC narrowly adopted final rules on August 22, 2012.

The rules have two goals: (1) increase the transparency of payments by extraction issuers to prevent corruption in the resource industry by government officials;[1] and (2) further the humanitarian goal of ending the conflict in the DRC, which is widely considered to be financed, in part, by the trade in conflict minerals. Industry participants have strong and conflicting opinions as to the appropriateness and effectiveness of these rules. For example, Transparency International has already welcomed the final rules and is of the view that the payment disclosure by extraction issuers rule "is a milestone in the long campaign for transparency in the extractive industry and sets a global benchmark." On the other hand, on October 10, 2012 the American Petroleum Institute, the U.S. Chamber of Commerce, the Independent Petroleum Association of America and the National Foreign Trade Council filed a complaint in the U.S District Court of Columbia against the SEC seeking, among other things, a judicial declaration that the requirement to disclose payment to foreign governments violates the First Amendment.

The new rules reflect a growing trend towards transparency and accountability for payments to government officials. Similar requirements are being considered in a number of other jurisdictions. In Canada, the Prospectors and Developers Association of Canada supports mandatory disclosure of

[1] Senator Lugar (R-IN) explained on the Senate floor before Dodd-Frank's passage:
"Transparency empowers citizens, investors, regulators, and other watchdogs and is a necessary ingredient of good governance for countries and companies alike. Adoption of the Cardin-Lugar amendment would bring a major step in favor of increased transparency at home and abroad. Its passage would empower investors to have a more complete view of the value of their holdings. It would bring more information to global commodity markets, which would benefit price stability. More importantly, it would help empower citizens to hold their governments to account for the decisions made by their governments in the management of valuable oil, gas, and mineral resources and revenues."

extractive company payments to government officials and is working with other industry participants to develop a framework for regulatory requirements in this area. Elsewhere, the Hong Kong Stock Exchange has introduced mandatory disclosure rules for companies listed there and the European Union is likely to introduce similar legislation later this year for E.U.-listed companies.

Overview of Disclosure of Payments by Resource Extraction Issuers

The following is a brief summary of the final rule for Disclosure of Payments by Resource Extraction Issuers:

Applicability

Starting with fiscal years ending after September 30, 2012, the new rule will apply to all SEC-reporting resource extraction companies, including Canadian issuers with securities listed on a U.S. stock exchange. The new rule does not apply to Canadian issuers that are only listed on Canadian stock exchanges and are not required to file reports with the SEC.

Disclosure Requirement

The rule applies to a resource extraction issuer, which is an issuer that engages in the commercial development of oil, natural gas or minerals.[2]
A resource extraction issuer is required to file an annual report, not later than 150 days after the end of each fiscal year, that discloses certain payments made by the issuer, its subsidiaries and other entities controlled by the issuer to the U.S. federal government or foreign governments.

Types of Payments

The types of payments that must be disclosed are payments that advance the commercial development of oil, natural gas and minerals including:

- taxes (including taxes levied on corporate profits, income and production, but excluding consumption taxes such as value added, personal income or sales taxes);
- royalties;
- fees (including licencing, concession, entry and rental fees);
- production entitlements;
- bonuses (signature, discovery and production bonuses);
- dividends (provided the payments are paid to the government under different terms than other shareholders); and
- payments for infrastructure improvements (which does not include social and community payments such as payments to build a hospital or school).

De minimis payments of less than $100,000 during a fiscal year, whether as a single payment or a series of related payments, need not be disclosed.

[2] The rule is intended to only require disclosure of activities that are directly related to the commercial development of oil, natural gas or minerals, but not ancillary or preparatory activities, such as the manufacture of a product used in the commercial development of oil, natural gas or minerals. The SEC final rule provides further guidance as to what would and would not be considered to be "commercial development".

Form of Disclosure

The final rule requires that the disclosure be made under a new Form SD that specifies, in respect of any payment disclosed, the following information:

- 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 final rule does not define what constitutes a "project"; this will depend on the business context, industry context and issuer size.[4]

Considerations for Canadian Issuers

Although the new SEC rules will initially apply to a relatively limited number of Canadian issuers, they reflect the growing international movement towards greater disclosure of payments to governments. Similar requirements may very well be adopted in Canada sometime in the near future.
Canadian issuers already subject to these rules should consider:

- contacting U.S. legal counsel to get a full understanding of the new disclosure regime and how it applies to them;
- educating directors and management as to what kind of payments will need to be disclosed;
- evaluating current operations to determine where and what kind of payments may be made to the U.S. federal government or foreign governments;
- implementing a payment tracking system on a "project" basis;
- reviewing agreements with foreign governments to see if there are confidentiality restrictions on disclosing the amount of payments (a controversial aspect of the new rule is that it does not provide an exemption if local laws or agreements have a confidentiality restriction on disclosing such payments); and
- considering if any existing public disclosure needs to be updated to reflect any issues with compliance with the new disclosure regime and what affect this disclosure could have on operations in the local jurisdiction.

Overview of Conflict Mineral Disclosure

[3] The rule does provide that it is the SEC belief that "project" is a commonly used term and is generally understood by resource extraction issuers and investors. Further guidance is provided that would permit an issuer to disclose payments at the entity level if the payment is made for obligations at the entity level such as corporate taxes or dividends.

The following is a brief summary of the final Conflict Minerals rule:

Applicability

Starting on May 31, 2014, and on or before May 31 of every year thereafter, all SEC-reporting issuers, including Canadian issuers with securities listed on a U.S. stock exchange, must disclose, in respect of the previous calendar year, whether they used any "conflict minerals" (including gold, cassiterite, coltan, tin, tantalum and tungsten) originating in the DRC and adjoining countries (Covered Countries). Conflict minerals also include any other minerals or derivatives determined by the U.S. Secretary of State to be financing conflict in Covered Countries. The new rule does not apply to Canadian issuers that are not required to file reports with the SEC.

The new rule sets out a three step process for determining an issuer's disclosure obligations.

Step 1 – Applicability of the Rule

- Determine if conflict minerals are necessary to the functionality[5] or production[6] of a product manufactured[7] or contracted by the issuer to be manufactured[8].

- The final rule specifically provides that an issuer that mines or contracts to mine conflict minerals is not manufacturing or contracting to manufacture unless the issuer engages in other manufacturing processes.

Step 2 – Determine the Country of Origin of the Conflict Minerals

- If the rule applies, then the issuer is required to conduct a "reasonable country of origin inquiry"[9] to determine whether its conflict minerals originated from a Covered Country.

- If the issuer determines that the conflict minerals did not originate from a Covered Country or came from recycled or scrap sources, then the issuer shall disclose its determination and the results of a "reasonable country of origin inquiry".

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[4] The final rule does not define "necessary to the functionality". However, the SEC provides guidance that "an issuer should consider: (a) whether a conflict mineral is contained in and intentionally added to the product or any component of the product and is not a naturally-occurring by-product; (b) whether a conflict mineral is necessary to the product's generally expected function, use, or purpose; or (c) if a conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration."

[5] The final rule does not define "necessary to the production". However, the SEC provides guidance that "an issuer should consider whether a conflict mineral is contained in the product and intentionally added in the product's production process, including the production process of any component of the product; and whether the conflict mineral is necessary to produce the product."

[6] The final rule does not define "manufacture". However, the SEC provides guidance that it does not consider "an issuer that only services, maintains, or repairs a product containing conflict minerals to be 'manufacturing' a product."

[7] The final rule does not define "contract to manufacture". However, the SEC provided guidance that they "believe that manufacturing issuers that contract the manufacturing of certain components of their products should, for purposes of the Conflict Minerals Statutory Provision, be viewed as responsible for the conflict minerals in those products to the same extent as if they manufactured the components themselves."

[8] This type of inquiry is not specified in the rule. However, the SEC notes that "if an issuer reasonably designs an inquiry and performs the inquiry in good faith, and in doing so receives representations indicating that its conflict minerals did not originate in the Covered Countries, the issuer may conclude that its conflict minerals did not originate in the Covered Countries, even though it does not hear from all of its suppliers, as long as it does not ignore warning signs or other circumstances indicating that the remaining amount of its conflict minerals originated or may have originated in the Covered Countries."

- If the issuer determines that the conflict minerals originated from a Covered Country and did not come from recycled or scrap materials or cannot determine the source of the conflict minerals was not a Covered Country, then the issuer shall disclose this determination and prepare a Conflict Minerals Report (Step 3).

Step 3 – Prepare a Conflict Minerals Report

- A Conflict Minerals Report must include: (1) a description of the measures the issuer employed to exercise due diligence on the source and chain of custody of its conflict minerals, including a certified independent private sector audit of the Conflict Minerals Report, (2) a description of its products manufactured or contracted to be manufactured containing conflict minerals that it was unable to determine did not "directly or indirectly finance or benefit armed groups" in the Covered Countries (the issuer would identify such products by describing them in the Conflict Mineral Report as not "DRC conflict free") and (3) disclose which facilities were used to process those conflict minerals, those conflict minerals' country of origin and the efforts to determine the mine or location of origin.

Considerations for Canadian Companies
In order to deal with this new disclosure regime, Canadian issuers that are subject to the conflict minerals rule and that use conflict minerals should consider:

- contacting U.S. legal counsel for a complete understanding of the new regime and how it applies to them;

- analyzing their products to determine if conflict minerals are necessary to the functionality or production of those products;

- implementing a tracking system for origin of conflict minerals used in their products;

- reviewing supply chain arrangements and modifying agreements to include representations from suppliers that any conflict minerals do not originate from Covered Countries;

- engaging third party auditors for the purposes of a Conflict Mineral Report; and

- considering if any existing public disclosure needs to be updated to reflect any issues with compliance with the new disclosure regime and what effect this disclosure could have on operations.

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