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The Dodd-Frank Act: New Disclosure Requirements for Reporting Issuers Engaged in Extractive Enterprises or Using Conflict Minerals

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”) was signed into law by President Obama. In addition to the Dodd-Frank Act’s well-publicized financial regulatory reforms, the Act contains three provisions that will impose additional disclosure requirements relating to the extraction and use of natural resources. Section 1502 of the Dodd-Frank Act requires disclosure relating to the activities of issuers who use “conflict minerals” originating in the Democratic Republic of the Congo or adjoining countries.

Section 1503 introduces enhanced safety disclosure for issuers engaged in the operation of mines. Section 1504 requires disclosure of certain payments made by natural resource companies to governments for the commercial development of oil, natural gas or minerals.

The Dodd-Frank Act directs the SEC to issue new rules to implement these provisions, and the SEC’s rulemaking will provide further definition with respect to the new disclosure requirements. SEC rules implementing these provisions are required by August 20, 2010 in the case of Section 1503, and April 17, 2011 in the case of Sections 1502 and 1504. These new disclosure requirements will affect issuers that are subject to the reporting requirements of the Securities and Exchange Commission (the “SEC”) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), including foreign issuers that file annual reports with the SEC on Form 20-F or Form 40-F.

Section 1502: Conflict Minerals

Section 1502 of the Dodd-Frank Act imposes additional disclosure requirements for an issuer if “conflict minerals” are necessary to the functionality or production of products manufactured by such issuer.

An issuer will be subject to the Section 1502 disclosure obligations if two factors are met. First, “conflict minerals” must be involved. The statute defines “conflict minerals” to include (i) columbite-tantalite (coltan), cassiterite, gold, wolframite or their derivatives; and (ii) any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo (“DRC”) or a country bordering the DRC. These minerals are commonly used in a number of industries, most notably in the jewelry and electronics industries, as well as by manufacturers who regularly use tin, gold or tungsten. Second, conflict minerals must be “necessary to the functionality or production” of a product manufactured by the issuer. The Dodd-Frank Act does not elaborate on the meaning of this phrase, so any further interpretive guidance will need to come from SEC rulemaking.

Subject issuers will be required to disclose annually whether the conflict minerals originated in the DRC or a country bordering the DRC. If so, the issuer will be required, in a report filed with the SEC and published on the company’s website, to provide a description of the measures taken to exercise due diligence on the source and chain of custody of the conflict minerals used. Such report must: (i) be audited by an independent private sector firm in accordance with standards established by the Comptroller General and rules established by the SEC in consultation with the Secretary of State; (ii) state the entity that conducted the audit; (iii) describe the products manufactured or contracted to be manufactured that contain minerals that are not DRC conflict free (i.e., minerals that either directly or indirectly finance or benefit armed groups in the DRC or a country bordering the DRC); (iv) describe the facilities used to process the conflict minerals; (v) disclose the country of origin of the conflict minerals; and (vi) describe the efforts taken to determine the mine or location of origin with the greatest possible specificity.

In enacting Section 1502, Congress hoped to remedy what it perceived as the exploitation and trade of conflict minerals originating in the DRC that help finance conflict characterized by extreme levels of violence in the eastern DRC, particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation. The purpose of Section 1502 is to promote transparency and consumer awareness regarding the use of conflict minerals and, ultimately, to discourage the use of conflict minerals by manufacturing and processing companies. Senator Sam Brownback, who introduced an early form of Section 1502 in the proposed Congo Conflict Minerals Act in 2009, said at the time that “the legislation...brings accountability and transparency to the supply chain of minerals used in the manufacturing of many electronic devices. I hope that the legislation will help save lives.” As such, Section 1502 represents the intrusion of foreign policy into federal securities legislation and a further departure from the stated mission of the SEC “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”

The SEC has until April 17, 2011 (270 days after the Dodd-Frank Act was passed into law on July 21, 2010) to enact regulations implementing and administering Section 1502. While Section 1502 outlines the disclosure required by subject issuers, there remains significant latitude for SEC interpretation. Consequently, it is not clear how burdensome compliance with the new rules under Section 1502 will be. The extent and practicalities of the required independent private sector audit are unclear, and the audit and other due diligence processes mandated by Section 1502 may be time-consuming and costly. This is especially true considering that Section 1502 provides that a determination of the independent private sector audit or other due diligence processes will not satisfy the new disclosure requirements if they have been determined by the SEC to be unreliable.

Issuers will need to comply with the new disclosure requirements on an annual basis, commencing with the issuer's annual report for the first full fiscal year that begins after the SEC's regulations become effective. Regardless of whether conflict minerals are actually used, however, Section 1502 will create additional compliance costs, as issuers will need to ensure awareness of the various inputs and levels of their supply chains.

The Section 1502 disclosure requirements will terminate upon the President determining that no armed groups continue to be directly involved and benefiting from commercial activity involving conflict minerals, but in any event not before July 20, 2015 (five years after enactment of the Dodd-Frank Act). Section 1502 will also be subject to annual reviews by the Comptroller General to evaluate the statute's effectiveness in promoting peace and security in the DRC and bordering countries, beginning on July 20, 2012.

Section 1503: Reporting Requirements Regarding Mine Safety

Section 1503 of the Dodd-Frank Act requires issuers that either directly or indirectly through a subsidiary operate a "coal or other mine" to disclose, in each periodic report filed with the SEC, certain mine safety information relating to the period covered by such report. We expect that the SEC rules implementing Section 1503 will require foreign private issuers to include the required disclosure in their annual reports on Form 20-F or Form 40-F. These reporting obligations apply to issuers who operate a "coal or other mine," the definition of which is consistent with the definition in the Federal Mine Safety and Health Act of 1977 (the "Mine Safety Act"), and includes any area of land from which minerals are extracted in non-liquid form, or if in liquid form, are extracted with workers underground. Nearly all of the new disclosure requirements mandated by Section 1503 refer to standards of the Mine Safety Act and the Mine Safety and Health Administration (the "MSHA") and, therefore, would not apply to mining operations outside of the United States.

This periodic mine safety disclosure will include, for each coal or other mine operated by the issuer or its subsidiaries during the period covered:

- The total number of violations of mandatory health or safety standards that could significantly and substantially contribute to a mine safety or health hazard under Section 104 of the Mine Safety Act for which the mine operator received a citation from the MSHA;
- The total number of orders issued under Section 104(b) of the Mine Safety Act;
- The total number of citations and orders for unwarrantable failure of the mine operator to comply with mandatory health or safety standards under Section 104(d) of the Mine Safety Act;
- The total number of flagrant violations under Section 110(b)(2) of the Mine Safety Act;
- The total number of imminent danger orders issued under Section 107(a) of the Mine Safety Act;
- The total dollar value of proposed assessments from the MSHA under the Mine Safety Act; and
- The total number of mining-related fatalities.

The issuer's periodic reports will also need to include a list of coal or other mines operated by the issuer (or a subsidiary) that receive written notice from the MSHA of either a pattern, or the potential to have a pattern, of violations of mandatory health or safety standards that are of such a nature as could have significantly and substantially contributed to mine health or safety hazards under Section 104(e) of the Mine Safety Act. Further, the issuer will need to disclose any pending legal action before the Federal Mine Safety and Health Review Commission involving such coal or other mine.

Issuers are also required, beginning upon enactment of the Dodd-Frank Act, to file a Form 8-K for each coal or other mine operated by the issuer or a subsidiary upon receipt of either an imminent danger order issued under the Mine Safety Act or a written notice from the MSHA that the mine has a pattern, or the potential to have a pattern, of violations of mandatory health or safety standards that could have significantly and substantially contributed to mine health or safety hazards under Section 104(e) of the Mine Safety Act. The SEC will need to update Form 8-K to add a new item under which this disclosure is to be made. It is unlikely that foreign private issuers will be subject to this requirement, as such companies are not subject to current reporting on Form 8-K.

Section 1503 was introduced in May 2010 as an amendment to the Act by Senator Rockefeller, who at the time noted that “there is no requirement to publicly disclose safety records, which has allowed companies to operate without critical checks and balances. West Virginia suffered a terrible loss recently ... and we owe it to our miners and their families to do more to make mine safety a top priority.”

Section 1503 takes effect on August 20, 2010, thirty days after the enactment of the Dodd-Frank Act. Accordingly, affected mining companies have a relatively short period of time to ensure they have adequate internal procedures in place to comply with these new disclosure requirements. The new Form 8-K disclosure requirements take effect with respect to triggering events on or after August 20, 2010.¹ The new periodic reporting requirements affect any quarterly report on Form 10-Q or annual report on Form 10-K issued on or after August 20, 2010. Section 1503 is subject to SEC implementing regulations, which may help clarify these increased disclosure obligations for mining companies.

Section 1504: Disclosure of Payments by Resource Extraction Issuers

Section 1504 of the Dodd-Frank Act imposes requirements on certain resource extraction issuers to disclose, in their annual reports filed with the SEC, information regarding payments made by the issuer, a subsidiary of the issuer, or an entity under the control of the issuer, to either the U.S. Federal Government or a foreign government for the purpose of the commercial development of oil, natural gas or minerals. Section 1504 defines “commercial development of oil, natural gas, or minerals” to include the 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.

The payments covered by the new disclosure requirements include 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 the commercial development of oil, natural gas or minerals. In making this assessment, the SEC must consider, to the extent practicable, the guidelines set out by the Extractive Industries Transparency Initiative, an international organization promoting transparency and improved governance in the oil, gas and mining industries. Section 1504 provides that a payment that is of a *de minimis* amount will not require disclosure.

The disclosures required under Section 1504 must be made in the issuer’s annual report, and must be submitted to the SEC in an interactive data format. The required disclosures include: (i) the type and total amount of such payments made for each project relating to the commercial development of oil, natural gas or minerals; and (ii) the type and total amount of such payments made to each government. Specifically, the Section 1504 requires the interactive data to identify, for any payments made by a resource extraction issuer, the following information:

¹ Until Form 8-K is amended, such disclosure could be provided under Item 8 of Form 8-K.

- 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 issuer that made the payments;
- The government that received the payments, and the country in which the government is located;
- The project of the issuer to which the payments relate; and
- Any other information that the SEC considers necessary or appropriate in the public interest or for the protection of investors.

The SEC has until April 17, 2011 (270 days after the Dodd-Frank Act was passed into law on July 21, 2010) to issue regulations implementing Section 1504. The new disclosure requirements under Section 1504 of the Dodd-Frank Act will take effect beginning with the annual report for the first fiscal year ending on or after the first anniversary of the date on which the SEC issues final rules implementing Section 1504.

Section 1504 delegates substantial discretion to the SEC. Key definitions are open-ended and subject to further elaboration by the SEC. Consequently, the scope of Section 1504 is still largely to be determined. For example, Section 1504 applies to payments made for, and to issuers engaged in, the “commercial development of oil, natural gas, or minerals”, which the statute defines broadly and grants authority to the SEC to further delineate. Similarly, Section 1504 applies to payments to a foreign government or the U.S. federal government but provides an expansive and open-ended definition of what constitutes a “foreign government”: a foreign government, a department, agency, or instrumentality of a foreign government, or a company owned by a foreign government, as determined by the SEC.

Section 1504 has its origins in the proposed Energy Security Through Transparency Act (the “Transparency Act”), which was introduced in Congress in September 2009. While Section 1504 of the Dodd-Frank Act is more limited in scope, it is conceptually similar to the disclosure requirements proposed in the Transparency Act. The Transparency Act discussed a broad range of policy concerns, including promoting good governance in extractive industries, promoting energy security, improving the transparency of revenue payments to governments, and increasing the public information available to shareholders of public companies. Undoubtedly, many of the same concerns underpin Section 1504 and will be considered by the SEC in its rulemaking process in implementing Section 1504.

In particular, Section 1504 states that the SEC rules issued should, to the extent practicable, support the federal government’s commitment to international transparency promotion efforts relating to the commercial development of oil, natural gas, and minerals. In furtherance of this focus on transparency, Section 1504 directs the SEC, to the extent practicable, to make publicly available online a compilation of the information required to be submitted pursuant to Section 1504’s new disclosure requirements.

Another concern in relation to Section 1504 is its relationship to the U.S. Foreign Corrupt Practices Act (the “FCPA”). Interestingly, the legislative debates that led to the enactment of the FCPA in the late 1970s expressed a clear preference for prohibition-based restrictions on payments from businesses to foreign governments, rather than a disclosure-based system. Accordingly, the FCPA currently limits the types of payments that public companies can make to foreign officials and governments. It does not impose any requirement that companies disclose payments that are FCPA-compliant. Section 1504 represents a shift in policy, creating a hybrid prohibition- and disclosure-based scheme governing payments to foreign governments for those companies that engage in the commercial development of oil, natural gas, or minerals. Pending further interpretive guidance by the SEC, Section 1504

potentially imposes on affected issuers increased compliance costs (in addition to FCPA compliance costs currently faced by such companies), including both the internal costs of establishing appropriate disclosure procedures, and the cost of having to publicly disclose payments made to foreign governments, which may implicate public relations concerns, and could put U.S. reporting issuers at a competitive disadvantage in commercial negotiations with foreign governments *vis-à-vis* companies not subject to Exchange Act reporting.

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Sections 1502, 1503, and 1504 of the Dodd-Frank Act have the potential to significantly increase the disclosure obligations and compliance costs of issuers that are engaged in, or have operations that relate to, the extraction of oil, natural gas, or minerals. However, the broad ambit of these sections remains subject to further refinement and definition by the SEC, which will likely consider the policy goals of transparency and public awareness that underlie all three provisions. Sections 1502, 1503 and 1504 of the Act are potentially very broad, and may substantially increase compliance costs of affected issuers. Shearman & Sterling LLP will be working closely with our clients to review the proposed SEC rules once they are published. In preparation for the new rules, issuers should consider whether their existing disclosure controls and procedures will be sufficient to satisfy these new disclosure requirements.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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