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Alert
SEC Disclosure and Corporate Governance

New SEC Staff Guidance on Dodd-Frank Conflict Minerals and Resource Extraction Payment Disclosure Obligations

In late May, 2013, the Division of Corporation Finance of the Securities and Exchange Commission published interpretive guidance for public companies now considering the potential applicability of certain new specialized disclosure obligations. These disclosure obligations were added by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) to the Securities Exchange Act of 1934 (Exchange Act) relating, respectively, to "conflict minerals" originating in the Democratic Republic of the Congo (DRC) or an adjoining country, and certain US and foreign governmental payments made by "resource extraction issuers". This guidance takes the form of two sets of Frequently Asked Questions (FAQs) published by the Division on May 30, 2013. One focuses on the conflict minerals disclosure requirements of new Exchange Act Section 13(p)(added by Section 1502 of the Dodd-Frank Act), Rule 13p-1 thereunder, and Item 1.01 of Form SD (Conflict Minerals FAQs, available at http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm). The other focuses on disclosure of the resource extraction payments information called for by new Exchange Act Section 13(q)(added by Section 1504 of the Dodd-Frank Act), Rule 13q-1 thereunder, and Item 2.01 of Form SD (Resource Extraction FAQs, available at http://www.sec.gov/divisions/corpfin/guidance/resourceextraction-faq.htm).

Highlights of the SEC Staff's May 30 FAQs are set forth below, following a brief summary of the specialized disclosure requirements relating to conflict minerals and governmental resource extraction payments. For a more comprehensive discussion and analysis of these requirements, which includes practical tips on compliance, please see our prior Alert dated January 8, 2013.[1]

Conflict Minerals

Exchange Act Section 13(p), Rule 13p-1, and Form SD, Item 1.01 (applicable only to conflict minerals) require any US or non-US company that files periodic reports – which we now know, from the Staff's Conflict Minerals FAQ # 1, extends to companies reporting on a voluntary basis (*e.g.*, per debt covenants) – to determine whether any conflict mineral (*i.e.*, tin, tantalum, tungsten, and gold) is "necessary to the functionality or production" of a

product that is manufactured, or contracted to be manufactured, by that company. If the answer to this threshold question is yes, the company must proceed to conduct a good-faith, "reasonable country of origin inquiry" that has been "reasonably designed" to determine whether any of its conflict minerals either originated in the DRC or an adjoining country (Covered Country), or was derived from recycled or scrap materials. Finally, if the company knows or has reason to believe that its "necessary" conflict minerals may have originated in a Covered Country, and may not have come from recycled or scrap sources, the company must exercise "due diligence" with respect to the source and chain of custody of those minerals using the due diligence framework approved by the Organisation for Economic Cooperation and Development (OECD). Depending on the outcome of this analysis, affected companies will be obligated by May 31, 2014 to file with the SEC and post on their websites a Form SD containing a Conflict Mineral Report covering calendar year 2013.

Highlights of Conflict Minerals FAQs

Packaging doesn't count, unless the package itself is the issuer's "product". Even if special packaging or a particular type of container is required to preserve or otherwise assure a product's "usability" until and/or after it is purchased, this package or container will **not** be considered part of the product itself. Examples we can think of (which are not listed in the FAQ) include soda sold in cans or bottles, milk sold in plastic cartons or bottles, cookies sold in boxes or tins, and drugs sold in vials, bottles, or tubes. Instead, "[o]nly a conflict mineral that is contained in the product" that the issuer manufactures (or contracts with a third party to manufacture) must be analyzed for purposes of determining whether such conflict mineral is "necessary to the functionality or production" of the product. Of course, if the issuer manufactures or sells packages or containers on a standalone basis, independent of any other product that might be stored therein (such as an empty thermos bottle manufactured by and sold in an issuer's sporting goods stores), these packages or containers would be considered a product subject to analysis under applicable disclosure requirements. *See* Conflict Minerals FAQ # 6.

Products of consolidated subsidiaries are subject to the conflict minerals disclosure rules. If a product that contains "necessary" conflict minerals is manufactured (or contracted to be manufactured) by a consolidated subsidiary of the issuer – rather than directly by the issuer – the "issuer must determine the origin of [such] conflict minerals, and make any required disclosures regarding conflict minerals, for itself and all of its consolidated subsidiaries". Conflict Minerals FAQ # 3. If only by negative inference, this interpretation suggests that the products of controlled but non-consolidated joint ventures and similar entities affiliated, but not consolidated, with the issuer would not be "scoped in" – assuming that the issuer does not contract with the joint venture or other entity for the manufacture of products that include one or more "necessary" conflict minerals.

A late conflict minerals Form SD will not impair an issuer's ability to use a short-form shelf registration statement on Form S-3 (or F-3). Because a Form SD must be filed under Exchange Act Section 13(p), rather than Section 13(a), 14(a) (or 14(c)), or 15(d) of the Exchange Act, the untimely filing of a Form SD will not "impact an issuer's eligibility" to use Form S-3 (or F-3). *See* Conflict Minerals FAQ # 12.[2]

Phase-in period for IPO companies. Newly public companies will be able to delay compliance with the conflict minerals disclosure requirements until the first reporting calendar year that begins no sooner than eight months after the effective date of its initial public offering registration statement. (As noted above, the reporting period covered by a Form SD, Part 1, for conflict minerals, is a calendar year rather than a fiscal year). This new Staff position represents an extension of the express accommodation made by the SEC, in Instruction 3 to Item 1.01 of Form SD, permitting an issuer previously not subject to the conflict minerals reporting regime that acquires or otherwise obtains control over another issuer that manufactures (or contracts to manufacture) products with "necessary" conflict minerals, to defer Form SD reporting on the acquired company's products until the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition. *See* Conflict Minerals FAQ # 11.

Products used in providing a service are not covered. Equipment used by an issuer to provide services is not a "product" within the meaning of the new rules. *See* Conflict Minerals FAQ # 7. To illustrate, the Staff indicated that an issuer that operates a cruise line would not be obligated to file Form SD reports regarding any conflict minerals that might be included in the issuer's cruise ships. This would be the case even if the issuer actually manufactured the ships (or contracted to have them manufactured by a third party), as long as the issuer uses the ships in the course of operating its cruise line service and ensures that the ships are either retained by or returned to that issuer or are "intended to be abandoned by the customer following the terms of the service".

Even generic components of an issuer's products are covered by the conflict minerals rules. Generic components that the issuer purchases for use in products that it manufactures (or contracts with a third party to manufacture) are subject to a conflict mineral regulatory analysis. Thus, if the issuer were to determine that such a generic component actually contains a conflict mineral, the issuer would have to undertake a "reasonable country of origin inquiry" as described above. *See* Conflict Minerals FAQ # 5 ("[T]here is no distinction between the components of a product that an issuer directly manufactures or contracts to manufacture and the 'generic' ones it purchases to include in a product".) This reasoning seems consistent with the SEC's statement, in the Conflict Minerals Adopting Release, that "in determining whether a conflict mineral is 'necessary' to a product, an issuer must consider any conflict mineral contained in its product, even if that conflict mineral is only in the product because it was included as part of a component of a product that was manufactured originally by a third party".[3] The Staff's FAQ clarifies that the generic character of a particular component is irrelevant to whether that component must be assessed for the presence of "necessary", and therefore potentially reportable, conflict minerals.

An issuer's specification that its brand, logo, and/or serial number be etched on, or otherwise affixed to, a generic product does not mean that the issuer has entered into a "contract to manufacture" with the entity that made this generic product for purposes of the conflict minerals disclosure rules. Although the SEC did make clear (in the Conflict Minerals Adopting Release) that an issuer would not be viewed as "contracting [with a third party] to manufacture" a generic product if it took some action to affix its brand, marks, logo, or label to a generic product manufactured by a third party, issuers continued to raise questions with the Staff on the scope of this interpretive guidance. In Conflict Minerals FAQ # 4, the Staff stated that, "[e]tching or otherwise marking a generic product that is manufactured by a third party, with a logo, serial number or other identifier is not considered to be 'contracting to manufacture'" within the meaning of the conflict minerals rules.

Governmental Resource Extraction Payments

Under Exchange Act Section 13(q), Rule 13q-1, and Item 2.01 of Form SD, any US or non-US issuer that falls within the definition of "resource extraction issuer" must file a Form SD no later than 150 days after the close of its fiscal year if the issuer has made a triggering payment (or series of payments) of $100,000 or more during the year to a foreign government, or to the US federal government, for the purpose of "commercial development of oil, natural gas, or minerals".[4] A "resource extraction issuer" is any company required to file Exchange Act reports with the SEC that is engaged in the "commercial development of oil, natural gas, or minerals". Covered governmental payments include those made not only by the issuer but also by any "subsidiary" or other entity under the "control" of the issuer.[5] Because of the breadth of the SEC's definition of "control", an issuer may find that it must report payments made by joint venture partners or other affiliates whose financial results are not required to be consolidated with those of the issuer under applicable GAAP – in sharp contrast to the scope of the conflict minerals rules, which do not extend beyond the activities of an issuer's consolidated subsidiaries (as discussed above).

The new resource extraction payment disclosure rules apply to issuers whose fiscal years end after September 30, 2013, which for calendar-year registrants means that the first report will be due no later than May 30, 2014.

Fortunately, an issuer whose fiscal year begins before September 30, 2013 will be able to file a partial-year report limited to payments made during a "stub" period beginning on October 1 and running through December 31, 2013.

Highlights of Resource Extraction FAQs

Pure holding companies that file periodic reports with the SEC can be "resource extraction issuers" if they control an entity that engages in the "commercial development of oil, natural gas, or minerals". A holding company that is an Exchange Act registrant but does not directly engage in any of the enumerated activities constituting the "commercial development of oil, natural gas, or minerals" (see the next paragraph for the definition of "commercial development of oil, natural gas, or minerals"), nevertheless will be subject to reporting under Exchange Act Section 13(q) and the related rules if either a subsidiary, or another entity over which the issuer has control, engages in those activities and makes a triggering governmental payment (or series of payments) of $100,000 or more. *See* Resource Extraction FAQ # 1.

A company that provides services associated with the "commercial development of oil, natural gas, or minerals", but is not directly engaged in the extraction or production of these natural resources, is generally not considered a "resource extraction issuer". A company whose activities are limited to the provision of services associated with the "***commercial development of oil, natural gas, or minerals***" – a defined term (in Rule 13q-1) that means ***the exploration, extraction, processing, and export*** of any of these natural resources, as well as the ***acquisition of a license*** to engage in any such activity – "generally would not be considered a resource extraction issuer". Resource Extraction FAQ # 2. In reaching this conclusion, the Staff "recognize[d] that many companies are involved in activities related to the commercial development of resources, but [nevertheless] may not be conducting activities that are considered to be one of the activities covered by Section 13(q) and the rules issued thereunder". Two examples of such an excluded service are outlined in the FAQ: (1) the provision of "hardware and logistics to help companies explore for or extract resources"; and (2) the provision of hydraulic fracturing or drilling services to an operator that enable the operator to extract any of the enumerated resources. As if to underscore the compliance challenges presented by the new rules, the Staff cautioned that a resource extraction issuer **would** be obligated to report any covered governmental payments made on its behalf by a service provider that itself would not fall within the definition of a "resource extraction issuer" within the meaning of the new rules.

When do "transportation" activities that normally fall outside the new resource extraction disclosure rules cross the line into "export" activities that may trigger the application of these rules? Resource Extraction FAQ # 4 states that "[t]ransportation activities generally would not be included within the definition of 'commercial development' [of oil, natural gas, or minerals] **unless** the activities are directly related to the export of the resource." (emphasis added). However, the Staff would view the transportation of a resource across an international border – for example, from host Country A to Country B – to constitute a covered "export" activity if the company providing transportation services has an ownership interest in the resource. Conversely, the Staff "generally would not view transportation activities by an issuer that does not have an ownership interest in the resource as directly related to the export of the resource, and therefore, the issuer would not be considered a 'resource extraction issuer.'"

Would payments made by a resource extraction issuer to a majority-owned governmental transportation service hired to transport people or materials to an extractive job site be covered by the new rules? No, because the Staff believes that such payments are made in connection with transportation activities outside the ambit of the term "commercial development of oil, natural gas, or minerals". *See* Resource Extraction FAQ # 5.

Penalties and/or fines paid to governmental agencies by resource extraction issuers are not reportable as "commercial development" payments. As the Staff explains in Resource Extraction FAQ # 6, Exchange Act Section 13(q) defines the term "payment", for purposes of the resource extraction disclosure rules, as including (among other items) "fees and other material benefits that the Commission determines, consistent with the EITI

[Extractive Industries Transparency Initiative] guidelines, are part of the commonly recognized revenue stream for the commercial development of oil, natural gas or minerals." The Staff determined that penalties and fines are not subject to disclosure under Section 13(q) and the SEC's implementing rules for two reasons: (1) penalties and fines are not among the types of fees specifically mentioned in the EITI guidelines; and (2) the SEC otherwise did not identify penalties and fines as part of the requisite "commonly recognized revenue stream for the commercial development of oil, natural gas or minerals."

Can the required governmental payment information be presented on an accrual basis? No, because the rules "contemplate" that the governmental payment information will be presented on an unaudited, cash basis for the year in which the payments are made. Resource Extraction FAQ # 7. Note in this regard that the SEC's Resource Extraction Adopting Release states simply that "the final rules do not require that the resource extraction payment information be audited or presented on an accrual basis".[6]

Resource Extraction Issuers are not required to segregate income from resource extraction activities and disclose taxes paid only on that income in Form SD. A resource extraction issuer that has many sources of income in a particular country and pays corporate-level income tax on the consolidated amount asked the Staff whether it was required to segregate income from its resource extraction activities and disclose, in its Form SD, only those taxes paid on such activities. In responding, the Staff indicated that such segregation and disclosure was not mandatory, but that a resource extraction issuer could elect to segregate income earned from "commercial development" activities in a given country from all other income generated there, and thus could disclose income taxes paid solely on these "commercial development" activities. By the same token, a covered issuer that chooses not to segregate income information in this manner is free to disclose that the income tax information presented in the Form SD includes payments made for purposes other than "commercial development" activities.

A late resource extraction Form SD will not impair an issuer's ability to use a short-form registration statement on Form S-3 (or F-3). For the reasons discussed above in connection with Conflict Minerals FAQ # 12, the untimely filing of a resource extraction Form SD will not impair an issuer's Form S-3 or Form F-3 eligibility. *See* Resource Extraction FAQ # 9.

Conclusion

Although some of the new Staff FAQs do little more than reinforce guidance provided by the SEC in the Conflict Minerals and Resource Extraction Adopting Releases, others break new ground. We have focused here on those Staff interpretive positions – whether new or cumulative of existing SEC guidance – that we believe will facilitate issuer preparation for compliance with the new specialized disclosure requirements in May 2014 (to the extent applicable). Because all (conflict minerals) or some (resource extraction payments) of calendar year 2013 is covered by these rules, affected issuers should be in the process of collecting relevant information and establishing the disclosure controls and procedures needed to support the timely filing of Form SD reports. Again, for helpful practice tips we recommend that you review our January 2013 Alert (discussed in note 1, above, and accompanying text).

1 This Alert, which is available on Weil's website at http://www.weil.com/files/upload/Weil_Alert_Corp_Gov_SEC_Jan_2013.pdf,

also includes a discussion of the new Iranian sanctions disclosure requirements added to the Exchange Act – in the form of new Section 13(r) – by the Iran Threat Reduction and Syria Human Rights Act of 2012. Section 13(r) is applicable by its terms to all Exchange Act annual and quarterly reports due after February 6, 2013.

2 The Staff explained that, "[i]n determining eligibility for use of Form S-3, the requirement that the registrant has filed in a timely manner all reports and materials required to be filed within the prior twelve calendar months refers only to Exchange Act Section 13(a) or 15(d) reports and Exchange Act Section 14(a) and 14(c) materials". Conflict Minerals FAQ # 12, citing Compliance and Disclosure Interpretation Question 115.04 under Securities Act Forms.

3 *See* SEC Rel. No. 34-66716 (Aug. 22, 2012)("Conflict Minerals Adopting Release"), at p. 87, available at http://www.sec.gov/rules/final/2012/34-67716.pdf.

4 Exchange Act Rule 13q-1 and Item 2.01 of Form SD were adopted pursuant to SEC Rel. No. 34-67717 (Aug. 22, 2012) ("Resource Extraction Adopting Release"), available at http://www.sec.gov/rules/final/2012/34-67717.pdf.

5 *See* Exchange Act Rule 12b-2 (defining the terms "subsidiary", "control" and "affiliate" for purposes of the Exchange Act and the rules adopted by the SEC thereunder. The SEC expressed the view that the "control" analysis for purposes of Rule 12b-2 generally would be the same as that required for GAAP consolidation purposes. Resource Extraction Adopting Release, at 94n. 337.

6 Resource Extraction Adopting Release at 123.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of Weil's Public Company Advisory Group:

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