



April 22, 2015

Office of the Compliance Advisor Ombudsman (CAO)

COMPLIANCE APPRAISAL REPORT

IFC Investment in Lydian International Ltd. (Project #27657), Armenia

Complaint 01

Summary

Lydian International Limited (“the company”), is a listed junior mining exploration company based in the UK and focused on its Amulsar Gold Project in Armenia (“the project”). IFC first invested in the company in 2007 to finance exploration activities and feasibility studies around Lydian’s mineral resource properties in Kosovo, Armenia and Turkey. This initial investment was followed by 6 additional investments and 5 warrants exercises. To date, IFC holds a 7.9% equity share in Lydian, corresponding to CAD 17.3 million invested.

At the time of writing, the project was at an advanced feasibility stage. Following completion of a bankable feasibility study and a national EIA, the company was granted a mining license in November 2014. An ESIA in compliance with international standards is expected to be disclosed in April 2015, and the project is expected to move into the development and construction stage late 2015, targeting gold production in 2017.

A complaint was submitted to CAO in April 2014 by residents of Gndevaz and Jermuk villages near the project site with support from nine NGOs. The complainants highlight concerns about the adequacy of stakeholder consultation around the project, as well as the project’s potential future project impacts on the environment and surrounding communities. Issues raised include criticisms of the national EIA process conducted by the company, alleged violations of IFC’s Performance Standards and national regulations. Further, during the CAO assessment phase the project stakeholders raised additional concerns related to cultural heritage and potential negative impacts on a World Bank project in Armenia.

The purpose of this CAO compliance appraisal is to determine whether an investigation of IFC’s environmental and social (E&S) performance is required in response to a complaint. In deciding whether to initiate an investigation, CAO weighs factors including the magnitude of the E&S concerns raised by the complaint, results of a preliminary review of IFC’s E&S performance in relation to these issues, and a more general assessment of whether a compliance investigation is the appropriate response.

In this case, CAO concludes that the complaint raises substantial concerns about a range of potential or actual E&S impacts of the project. In reaching this conclusion CAO notes that IFC has, to date, only funded activities that are preparatory to the construction of the mine, and that no decision on whether to fund construction of the mine has been made. Nevertheless, IFC’s investments in the company have the clear objective of enabling construction of the mine which is expected to move forward within a short period of time. Given that IFC’s E&S requirements extend to the preparatory activities funded to date, CAO finds that the concerns raised by the complainants are relevant to IFC’s performance in relation to this investment. CAO has also

identified questions regarding IFC's review and supervision of its E&S requirements in relation to the project.

On the balance of considerations, CAO thus decides to conduct a compliance investigation of IFC's E&S performance in relation to this project. Terms of Reference for this compliance investigation will be issued in accordance with CAO's Operational Guidelines.

About CAO

CAO's mission is to serve as a fair, trusted, and effective independent recourse mechanism and to improve the environmental and social accountability of IFC and MIGA.

CAO (Office of the Compliance Advisor Ombudsman) is an independent post that reports directly to the President of the World Bank Group. CAO reviews complaints from communities affected by development projects undertaken by the two private sector arms of the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

For more information about CAO, please visit www.cao-ombudsman.org

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Acronyms

Acronym	Definition
FS	Feasibility Study
CAD	Canadian dollars
CAO	Office of the Compliance Advisor Ombudsman (IFC and MIGA)
E&S	Environmental and Social
EHS	Environmental, Health and Safety
EIA	Environmental Impact Assessment
ESAP	Environmental and Social Action Plan
ESIA	Environmental and Social Impact Assessment
ESMS	Environmental and Social Management System
ESRS	Environmental and Social Review Summary
ESRP	Environmental and Social Review Procedures
GIIP	Good International Industry Practice
IFC	International Finance Corporation
JV	Joint-venture
NGO	non-governmental organization
PDS	Project Data Sheet
PS	Performance Standards
SEP	Stakeholder Engagement Plan
SPI	Summary of Proposed Investment
SSV	Supervision Site Visit
TOR	Terms of Reference
TSX	Toronto Stock Exchange

I. Overview of the Compliance Appraisal Process

When CAO receives a complaint about an IFC or MIGA project, the complaint is referred for assessment. If CAO concludes that the parties are not willing or able to reach a facilitated solution, the case is transferred to the CAO compliance function for appraisal and potential investigation.

A compliance appraisal also can be triggered by the CAO vice president, IFC/MIGA management, or the president of the World Bank Group.

The focus of the CAO compliance function is on IFC and MIGA, not their client. This applies to all IFC's business activities, including the real sector, financial markets and advisory. CAO assesses how IFC/MIGA assured itself/themselves of the performance of its business activity or advice, as well as whether the outcomes of the business activity or advice are consistent with the intent of the relevant policy provisions. In many cases, however, in assessing the performance of the project and IFC's/MIGA's implementation of measures to meet the relevant requirements, it will be necessary for CAO to review the actions of the client and verify outcomes in the field.

In order to decide whether a compliance investigation is warranted, CAO first conducts a compliance appraisal. The purpose of the compliance appraisal process is to ensure that compliance investigations are initiated only for those projects that raise substantial concerns regarding environmental and/or social outcomes, and/or issues of systemic importance to IFC/MIGA.

To guide the compliance appraisal process, CAO applies several basic criteria. These criteria test the value of undertaking a compliance investigation, as CAO seeks to determine whether:

- There is evidence of potentially significant adverse environmental and/or social outcome(s) now, or in the future.
- There are indications that a policy or other appraisal criteria may not have been adhered to or properly applied by IFC/MIGA.
- There is evidence that indicates that IFC's/MIGA's provisions, whether or not complied with, have failed to provide an adequate level of protection.

In conducting the appraisal, CAO will engage with the IFC/MIGA team working with the specific project and other stakeholders to understand which criteria IFC/MIGA used to assure itself/themselves of the performance of the project, how IFC/MIGA assured itself/themselves of compliance with these criteria, how IFC/MIGA assured itself/themselves that these provisions provided an adequate level of protection, and, generally, whether a compliance investigation is the appropriate response. After a compliance appraisal has been completed, CAO can close the case or initiate a compliance investigation of IFC or MIGA.

Once CAO concludes a compliance appraisal, it will advise IFC/MIGA, the World Bank Group President, and the Board in writing. If a compliance appraisal results from a case transferred from CAO's dispute resolution, the complainant will also be advised in writing. A summary of all appraisal results will be made public. If CAO decides to initiate a compliance investigation as a result of the compliance appraisal, CAO will draw up terms of reference for the compliance investigation in accordance with CAO's Operational Guidelines.

II. Background

Investment

Lydian International Limited (“the company”) is a junior mining company based in the UK and listed on the Toronto Stock Exchange (TSX). The company is focused on its Amulsar Gold Project in Armenia (“the project”). The Amulsar Gold Project is managed by Geoteam CJSC, a 100% owned Armenian subsidiary of Lydian. IFC first invested in the company in 2007 to finance exploration activities and feasibility studies of Lydian’s mineral resource properties in Kosovo, Armenia and Turkey. This initial investment was followed with 6 additional investments and 5 warrants exercises.

To date, IFC holds a 7.9% equity share in Lydian, corresponding to CAD 17.3 million. The European Bank for Reconstruction and Development (EBRD) is also a shareholder in the company and holds 6.9% equity.

At the time of writing, the project was at an advanced feasibility stage. A bankable feasibility study and a national EIA were completed in July 2014, and a mining license was granted to the company in November 2014. An ESIA in compliance with international standards is expected to be disclosed in April 2015. The project is expected to move into the development and construction stage late 2015, targeting first full gold production in 2017.¹

Complaint and CAO Assessment

A complaint was submitted to CAO in April 2014 by residents of Gndevaz and Jermuk villages with support from nine NGOs. The complainants highlight concerns about potential future project impacts on the environment and surrounding communities. Issues raised include criticisms of the national EIA process conducted by the company, alleged violations of IFC’s Performance Standards and national regulations. More specifically, the complainants raise the following allegations:

- Absence of grievance mechanism, restricted stakeholder consultation and intimidation;
- Potential threats to the development of tourism in the resort of Jermuk;
- Adverse impact on the ecosystems of Lake Sevan ecosystem, and the catchment basins of the Arpa and Vorotan rivers;
- Water and soil pollution due to the use of chemical admixtures;
- Radioactive contamination of the area due to reserves of uranium in Amulsar;
- Unlawful land acquisition for the construction of a heap leach facility;
- Impacts on endangered red-listed species.

In addition to the issues raised in the original complaint, project stakeholders raised two other concerns during the CAO assessment phase:

- Potential impacts on historical and cultural artifacts;
- Negative impacts on the World Bank CARMAC Project for Armenia (Community Agricultural Resource Management and Competitiveness)

CAO notes that some issues raised relate to the prospective design, development and operation of the mine rather than to specific actions taken during the exploration stage. However, CAO considers that these issues remain relevant at the pre-construction stage of the mining venture to the extent that they were or ought to have been addressed in the EIA and the ESIA prepared

¹ Geoteam website, <http://www.geoteam.am/en/home.html>

by the Company as part of the project, particularly given that development and construction of the mine is expected to commence imminently.

III. Analysis

This section outlines the IFC E&S policies and procedures as they apply to the project. It then analyses IFC's performance against these standards during preparation and implementation of the project and in the context of the issues raised by the complainants.

IFC Policies and Procedures

IFC's investment in the company was made in the context of its 2006 Policy on Social and Environmental Sustainability ("the Sustainability Policy") and Performance Standards (PS), together referred to as the Sustainability Framework. Through the Sustainability Policy, IFC commits to "ensure that the projects it finances are operated in a manner consistent with the requirements of the Performance Standards" (para. 5).

IFC implements the commitments set out in the Sustainability Policy through its Environmental and Social Review Procedures (ESRP), which are updated periodically. The Lydian investment was approved under ESRP version 1.0² and supervised under the subsequent updated versions of the ESRP.

When financing a project, IFC first conducts an appraisal aimed at assessing the full business potential, risks, and opportunities associated with the investment. Once the project is approved and IFC has invested in a client, the investment is monitored throughout the project cycle to ensure compliance with the conditions in the loan agreement and IFC's applicable policies and standards. This CAO compliance appraisal considers IFC's performance at these two stages in the project cycle as relevant to the issues raised by the complainants.

Pre-investment Environmental and Social Review

At the pre-investment stage, IFC reviews the E&S risks and impacts of a proposed investment and agrees with the client on measures to mitigate these risks in accordance with the Performance Standards. For the purposes of this compliance appraisal, a key question is whether IFC conducted an adequate pre-investment review of the risks associated with its investment in the company. A further issue is whether relevant E&S obligations were incorporated into the investment agreement.

Requirements

As required by the Sustainability Policy, IFC's E&S review should be "appropriate to the nature and scale of the project" and commensurate to risk (para. 13). In conducting the E&S review IFC considers the E&S risks as assessed by the client and the "the commitment and capacity of the client" to manage these risks (para. 15). IFC also considers the client's "track record" in relation to E&S issues.³ A central principle of the Sustainability Policy is that "IFC does not finance new business activity that cannot be expected to meet the Performance Standards over a reasonable period of time" (para. 17).

² IFC Environmental and Social Review Procedures, version 1.0, April 30, 2006

³ ESRP 3, para.3.2.3, version 1, April 2006.

IFC's pre-investment review of the project

IFC's initial investment in Lydian focused on three prospects in Kosovo, one prospect in Turkey and the Amulsar Gold Project in Armenia, which at the time was part of a JV agreement with Newmont. An E&S appraisal was conducted on the company's project sites in Kosovo and Armenia in May 2007. The Kosovo sites were visited by an IFC E&S Specialist, whereas the Amulsar project site was visited by IFC's Country Officer in Armenia. The conclusions of IFC's appraisal of Amulsar Gold Project state that the project had broad community support and would not have any negative environmental impacts. At the same time, IFC noted that the company had a limited E&S management capacity and operated in countries with weak E&S regulatory frameworks.

An Environmental and Social Review Summary (ESRS) was disclosed in May 2007.⁴ This states that, while all Performance Standards are applicable to this investment, only PS 1 to 4 would be immediately relevant given project risks. The ESRS also states that the relevance of PS5 (Land acquisition and involuntary resettlement) and PS8 (Cultural heritage) would be determined upon completion of the mine feasibility study. It further notes that "the site visits and review of project information suggests that there will be no impacts related to biodiversity and natural resources (PS6)." The project was classified as a Category B project, meaning that it would have limited potential E&S risks and/or impacts.

Board documentation pertaining to IFC's initial investment in the company was finalized in June 2007. The Board documentation notes that IFC had conducted a detailed assessment and concluded that the project had broad community support. It is also noted that the involvement of a major international mining company (Newmont) as the largest investor in the project should provide comfort regarding the quality of Lydian's management team and assets as well as assurance that Lydian's assets would be developed in line with industry best practice.⁵

An Environmental and Social Action Plan (ESAP)⁶ was prepared by IFC and endorsed by the company. The ESAP included the following requirements for the company:

- Develop a corporate ESMS for exploration activities with a mutually acceptable timeframe for implementation, within a year after investment signing;
- Carry out environmental and social baseline studies for the Amulsar property, to be prepared in compliance with Armenia Environmental laws and regulations as well as with IFC requirement, within three months after the investment decision is made for development;
- Report annually on progress regarding public consultation and community development.

As presented to the Board, IFC anticipated that the company would comply with all IFC requirements by 2008, and that a decision on whether the Amulsar project should move into development would be taken by mid-2009.

The shareholders agreement signed in July 2007 requires the company to comply with the ESAP and submit to IFC annual monitoring reports (AMR) on its activities.

⁴ IFC investment in Lydian Resources Company Ltd., Environmental and Social Review Summary, May 2007, <http://goo.gl/3gx7hs>

⁵ Note, in March 2010 Lydian announced that it would purchase Newmont's stake in the Amulsar gold project. <http://goo.gl/DzOQMN>

⁶ IFC investment in Lydian Resources Company Ltd., Environmental and Social Action Plan, May 2007, <http://goo.gl/B8Dha2>

Conclusion

On the basis of the material reviewed in the course of this compliance appraisal, it is unclear to CAO whether IFC's pre investment E&S review was commensurate to risk and thus whether IFC had a reasonable expectation that the project would meet the requirements of the Performance Standards. In particular, CAO has questions as to the conclusions of IFC's E&S review in relation to the project's impacts and the extent of community support for the project, given that IFC environmental or social staff did not conduct a visit to the project site. Further, CAO has questions as to IFC's reliance Newmont's involvement as providing assurance that Lydian's assets would be developed in line with industry best practice, noting that Newmont subsequently exited the project.

Project Supervision

IFC is required to monitor its client's E&S performance throughout the life of the investment. As set out in the ESRP, "the purpose of E&S supervision is to develop and retain the information needed to assess the status of compliance with the Performance Standards (PSs), general and sector-specific Environmental Health and Safety (EHS) Guidelines, and the Environmental and Social Action Plan (ESAP or Action Plan)".⁷ For the purposes of this compliance appraisal, a key question is whether the project was supervised according to IFC policies and procedures in relation to the issues raised in the complaint.

Requirements

Project supervision is based on annual monitoring reports (AMR) submitted by the client and reviewed by IFC, discussions with the client, and site visits as required by IFC's ESRP. Ultimately, if the client fails to comply with its E&S commitments, IFC is required to "work with the client to bring it back to compliance to the extent feasible, and if the client fails to reestablish compliance, IFC will exercise remedies as appropriate".⁸

Performance Standard 1 (PS1 – Social and Environmental Assessment and Management Systems) underscores the importance of managing social and environmental performance throughout the life of a project.

In relation to the issues raised in the complaint, PS1 states that "risks and impacts will be analyzed in the context of the project's area of influence. This area of influence encompasses, as appropriate: (i) the primary project site(s) and related facilities that the client (including its contractors) develops or controls, [...] (iii) areas potentially impacted by cumulative impacts from further planned development of the project, any existing project or condition, and other project-related developments that are realistically defined at the time the Social and Environmental Assessment is undertaken" (para. 5).

PS1 further requires that "risks and impacts will also be analyzed for the key stages of the project cycle, including preconstruction, construction, operations, and decommissioning or closure" (para.6).

With regard to stakeholder engagement, PS1 states that "effective consultation: (i) should be based on the prior disclosure of relevant and adequate information, including draft documents and plans; (ii) should begin early in the Social and Environmental Assessment process; (iii) will focus on the social and environmental risks and adverse impacts, and the proposed measures and actions to address these; and (iv) will be carried out on an ongoing basis as risks and

⁷ ESRP 6, para.1, version 5, August 16, 2010.

⁸ IFC Policy on Environmental and Social Sustainability, para. 45, January 2012.

impacts arise” (para. 21). The client is also required to “establish a grievance mechanism to receive and facilitate resolution of the affected communities’ concerns and grievances about the client’s environmental and social performance” (para. 23).

IFC’s supervision of the project

General supervision

IFC’s supervision of its investment in Lydian commenced in 2007 and is documented in annual reviews of the company’s AMRs, and annual supervision site visits (SSV).

Follow-on investments and warrants exercises

In May 2009, IFC made a follow-on equity investment in the company, focusing on the Amulsar project. However, no specific site due diligence was conducted as IFC relied on its existing supervision of the company in this respect. IFC documentation related to this follow-on investment notes that Newmont was expected to exercise its option to increase its share of the JV to 80% by the end of 2009 and the project could reach production by 2011. Also, IFC noted that the company had been meeting all targets included in the agreed ESAP and that the ESAP was revised/expanded in 2009 to reflect the project status at the time. Thereafter, IFC made further investments and warrants exercises in the company on a regular basis (see annex for more details).

Development and implementation of an ESMS for exploration activities

A continued concern in IFC’s supervision documentation from 2007 to 2013 was the company’s lack of an adequate corporate ESMS for exploration activities and early work construction (EWC), as required per the ESAP. As a result, in July 2013, IFC advised the company that no further financing could be provided until this issue was addressed. Later in 2013, IFC’s supervision documents acknowledged the development of a corporate ESMS.

Project area of influence and stakeholder engagement activities

At the early stages of the project, IFC noted concerns regarding the company’s engagement with communities around the Amulsar site especially as consultation had mostly been with village mayors and not the wider communities. Also, IFC raised questions regarding the methodology applied by the company to identify communities within the project’s area of influence. As a result, IFC urged the company to refine its stakeholder engagement process and widen the project’s area of influence to include Jermuk village. Subsequently in October 2011 in response to IFC, the company developed a stakeholder engagement plan (SEP) to facilitate improved engagement with the communities. IFC documentation does not provide an assessment of the grievance mechanism put in place by the company.

In relation to the complainants concerns regarding the potential impacts of the project on Lake Sevan, CAO notes that Lake Sevan was not considered as part of the area of influence of the project.

Supervision of EIA and ESIA process

As the project progressed, the company submitted several national EIAs in order to obtain exploration, EWC and mine development licenses. Upon revision of the project design, a further national EIA was produced and this was approved by the Minister of Nature Protection in October 2014. In November 2014, a new mining license was granted. In addition to the national EIAs already prepared, the company was required to conduct and prepare an ESIA that complies with IFC E&S requirements and GIIP. CAO notes that IFC has been working closely with the company and its international consultants to support the development of the ESIA, which at the time of writing was expected to be disclosed in April 2015.

Radioactivity

Regarding risks of radioactive contamination as raised in the complaint, the company's Feasibility Study disclosed in 2014 notes that the potential of radioactivity arising from the project had been assessed and reviewed by an international firm accredited in radiation protection.⁹ The Feasibility Study also states that concentrations have been compared to international standards (United Nations Scientific Committee on the Effects of Atomic Radiation, UNSCEAR) and found to be below these levels.

Land acquisition and selection of a location for the HLP facility

The selection of a location for a Heap Leach Pad (HLP) facility has evolved. In 2013, IFC questioned the HLP location selection process, as it considered that communities were not adequately engaged in the process, and there was no evidence of any agreements with communities and/or private land owners for the installation of this infrastructure. Later in 2013, IFC noted that the Government of Armenia rejected the company's mining license application due to the selected HLP facility location. However, the license was granted in November 2014 after the company selected a new location for the HLP. CAO has questions with regards to the adequacy of stakeholder engagement and associated land acquisition processes in relation to the selection of the HLP facility location.

Biodiversity

IFC supervision documents show that fauna and flora surveys were conducted annually and several species listed in the Red Book of threatened species in Armenia were identified. IFC required the company's management to go beyond the local Red Book and check IBAT and IUCN Red Lists, as per the requirements of PS6. In June 2013, IFC acknowledged that a biodiversity baseline study had been conducted and that several areas and species qualified for critical habitat designation under PS6. However, the 2014 Feasibility Study indicated that activities at Amulsar had already permanently impacted some populations of *Potentilla porphyrantha* – a red-listed species.¹⁰ Additionally, the Feasibility Study states that the project is expected to affect several important habitats and species, and to have longer term impact on native and natural vegetation.

Cultural heritage

Based on findings at the project site, IFC documentation underscores the management of archeological resources in compliance with local and international guidelines as a key item to monitor. CAO notes that archeological baseline studies were conducted, and the 2014 Feasibility Study states that a Cultural Heritage Management Plan has been developed, together with the implementation of a Chance Finds Procedure during the construction phase to reduce impacts on archeological sites.

Conclusion

On the basis of the material reviewed in the course of this compliance appraisal, it is unclear to CAO whether IFC's supervision of the project was sufficient in relation to the concerns raised by the complainants. In particular, CAO has identified questions as to: (i) the adequacy of IFC's response to delays in the company's development of an ESMS and stakeholder engagement plan; (ii) the adequacy of IFC's engagement with the company around the selection of the location for the HLP facility and associated land acquisition processes; and (iii) the adequacy of IFC's supervision of the company's E&S impact assessment processes and the development of

⁹ Lydian. Amulsar Feasibility Study. 2014. <http://goo.gl/165WZZ>

¹⁰ *Ibid.*

required management plans including issues related to the definition of the project's area of influence and its impact on biodiversity.

IV. Decision

The purpose of a CAO compliance appraisal is to determine whether an investigation of IFC's environmental and social performance is required in response to a complaint. In deciding whether to initiate an investigation, CAO weighs factors including the magnitude of the environmental and social (E&S) concerns raised in a complaint, results of a preliminary review of IFC's E&S performance in relation to these issues, and a more general assessment of whether a compliance investigation is the appropriate response in the circumstances.

In this case, CAO concludes that the complaint raises substantial concerns about a range of potential or actual E&S impacts of the project. In reaching this conclusion CAO notes that IFC has, to date, only funded activities that are preparatory to the construction of the mine, and that no decision on whether to fund construction of the mine has been made. Nevertheless, IFC's investments in the company have the clear objective of enabling construction of the mine which is expected to move forward within a short period of time. Given that IFC's E&S requirements extend to the preparatory activities funded to date, CAO finds that the concerns raised by the complainants are relevant to IFC's performance in relation to this investment. CAO has also identified questions regarding IFC's review and supervision of its E&S requirements in relation to the project.

On the balance of considerations, CAO thus decides to conduct a compliance investigation of IFC's E&S performance in relation to this project. Terms of Reference for this compliance investigation will be issued in accordance with CAO's Operational Guidelines.

Annex – IFC Investments in Lydian International Ltd.

Transactions	Date	Investment (CAD)
Original Investment	Jul-07	2,000,000
Follow on Investment 1	Oct-07	80,000
Follow on Investment 2	Dec-07	1,250,000
Follow on Investment 3	May-09	1,390,938
Warrants Exercise	Jan-10	100,000
Follow on Investment 4	Mar-10	1,778,699
Warrants Exercise	Oct-10	400,000
Follow on Investment 5	Nov-10	3,253,110
Warrants Exercise	Dec-11	2,000,000
Warrants Exercise	Mar-13	1,953,937
Follow on Investment 6	Apr-14	1,731,000
Follow on Investment 7	Mar-15	1,363,264
	Total	17,300,948

Due to a move from the UK to Canada as part of Lydian's listing on the TSX, shares and warrants from the original investment and the first follow-on investment were in GBP and thus have been converted to CAD in the table above.