Market Trends 2018/19: Conflict Minerals Disclosure and Compliance

A Lexis Practice Advisor® Practice Note by Michael R. Littenberg and Nellie V. Binder, Ropes & Gray LLP

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This article discusses Rule 13p-1 (17 C.F.R. § 240.13p-1) under the Securities Exchange Act of 1934, as amended (the Exchange Act), and Form SD, which are collectively referred to herein as the Rule (also known as the Conflicts Minerals Rule). The article covers the latest developments relating to the Rule, current trends in Form SD filings, international developments (including the European Union conflict minerals regulation), and the market outlook for 2019.

The Securities and Exchange Commission (SEC) adopted the Rule in 2012 pursuant to Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (111 P.L. 203, 124 Stat. 1376) (Section 1502). The Rule requires companies that file reports with the SEC under Section 13(a) or 15(d) of the Exchange Act, including voluntary filers, foreign private issuers, and emerging growth companies (collectively referred to as companies), to make certain inquiries concerning the use and origin of specified minerals and their derivative metals in the companies' products. The minerals and metals covered by the Rule are (1) cassiterite, columbite-tantalite (coltan), and wolframite; (2) their derivatives tin, tantalum, and tungsten; and (3) gold. These minerals and metals are often referred to as 3TG.

If a company determines that it manufactures or contracts to manufacture products that contain 3TG that are necessary to the products' functionality or production, it must conduct a "reasonable country of origin inquiry" (RCOI). The goal of the RCOI is to determine whether the necessary 3TG originated in the Democratic Republic of the Congo (the DRC) or one of its nine adjoining countries (the Covered Countries), or whether the 3TG originated from recycled or scrap sources. If the company determines that the 3TG originated in a Covered Country (or it has reason to believe that the 3TG may have originated in a Covered Country) and the 3TG was not from recycled or scrap sources (or it has reason to believe that the 3TG may not be from recycled or scrap resources), it must then do heightened due diligence to gather information on the source and chain of custody of that 3TG. Due diligence must be conducted in accordance with a nationally or internationally recognized due diligence framework. The only framework that is viewed as satisfying this requirement is the Organisation for Economic Co-operation and Development's Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (the OECD Guidance Framework).

If a company has products that are in-scope under the Rule, it must, at a minimum, file a Form SD that briefly describes its RCOI and the results of that inquiry. Companies that must conduct the heightened due diligence required by the Rule to gather information of the source and chain of custody of 3TG generally must prepare a more detailed Conflict Minerals Report and file it as an exhibit to the Form SD (a Conflict Minerals Report). Among other things, the Conflict Minerals Report generally is required to include a description of the measures the company has taken to exercise due diligence

on the source and chain of custody of the 3TG in its in-scope products, a description of the in-scope products, the facilities used to process the necessary 3TG in the products, the country of origin of the necessary 3TG, and the efforts to determine the mine or location of origin with the greatest possible specificity.

Under the Rule, companies must file their Form SD by May 31 of each year, regardless of their fiscal year end. The annual Form SD disclosure covers 3TG contained in products that were manufactured or contracted to be manufactured during the most recently completed calendar year (the Reporting Year). Both the Form SD and the Conflict Minerals Report exhibit, if applicable, must be filed, rather than furnished, with the SEC.

For more information on the Rule and Form SD, see Conflict Minerals Disclosure Checklist, Conflict Minerals Rule Compliance, and Conflict Minerals Rule Compliance Checklist.

Developments under the Rule

In 2012, shortly after the Rule was adopted, it was challenged in court by several business groups. On April 3, 2017, which was prior to when filings for the 2016 Reporting Year were due, the U.S. District Court for the District of Columbia issued a final judgment in the litigation, on remand from the court of appeals, finding that:

- Section 1502 and the Rule violate the First Amendment to the U.S. Constitution to the extent that the statute and the Rule require companies to report to the SEC and state on their websites that any of their products "have not been found to be 'DRC conflict free.'"
- The Rule is unlawful to the extent that it requires companies to report to the SEC and state on their websites that any of their products "have not been found to be 'DRC conflict free.'"

The court remanded to the SEC to take action in furtherance of the court's decision. The SEC has not seen urgency in amending the Rule—doing so is listed as a long-term action on the SEC's Regulatory Flexibility Agenda—since the statement published by the SEC in April 2014 in connection with an earlier phase in the litigation adequately addresses the court's final judgment. In its April 2014 Statement, the SEC indicated that, notwithstanding the requirements set forth in the Rule, companies are not required to identify products as "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable." In addition, the statement indicated that, pending further action, an independent private sector audit (an IPSA), which otherwise would have been required under the Rule under certain circumstances, will not be required unless a company voluntarily elects to describe a product as "DRC conflict free" in its Conflict Minerals Report.

On April 7, 2017, following the final judgment of the court in the litigation, the SEC's Division of Corporation Finance released a further statement on the Rule indicating that, in light of the regulatory uncertainties relating to the Rule, the staff of the SEC will not recommend enforcement action if companies only file a Form SD, and not a Conflict Minerals Report, to the extent otherwise required to be filed as an exhibit under the Rule. See Updated Statement on the Effect of the Court of Appeals Decision on the Conflict Minerals Rule (April 7, 2017), available at https://www.sec.gov/news/public-statement/corpfin-updated-statement-court-decision-conflict-minerals-rule. Most companies have chosen not to rely on that SEC statement in connection with their subsequent Reporting Year filings, instead continuing to file a Conflict Minerals Report. Among other reasons, companies have done so to ensure credit from external stakeholders for their compliance efforts, as later discussed.

Following the election of President Trump, there was speculation that the Rule might be repealed or amended. Shortly after the change-over in the administration, on January 31, 2017, then-acting chairman of the SEC, Michael Piwowar, a Republican commissioner who replaced the prior Democratic chair, published a statement directing the SEC staff to consider whether the SEC's April 2014 Statement is still appropriate and whether any additional relief is appropriate in the interim, and opening up a comment period on the Rule. See Statement on the Commission's Conflict Minerals Rule (January 31, 2017), available at https://www.sec.gov/corpfin/statement-on-sec-commission-conflict-minerals-rule.html. In addition, in early February 2017, a draft of a Presidential Memorandum that would have suspended the Rule was leaked. Under Section 1502, the SEC is required to revise or temporarily waive the requirements of the Rule, for up to two years, if the president transmits to the SEC a determination that doing so is in the national security interest of the United States. Legislation in the House also sought to repeal or defund the SEC's ability to enforce the Rule. At the present time, there does not appear to be sufficient political momentum behind revision, waiver, or repeal of the Rule.

Form SD Filing Trends

Form SD filing trends for the 2018 Reporting Year are expected to be substantially similar to those for the 2017 Reporting Year, both in terms of the number of filings and filing content.

Since the first Reporting Year, the number of filings has largely been consistent, when mergers and acquisitions and other transformative transactions are taken into account. The breakdown between companies only filing a Form SD and those filing a Form SD and Conflict Minerals Report exhibit also has remained consistent. For the 2017 Reporting Year, 1,098 companies filed a Form SD. Of those companies, approximately 79% submitted a Conflict Minerals Report exhibit. In comparison, for the 2016 Reporting Year, 1,157 companies filed a Form SD and approximately 79% submitted a Conflict Minerals Report.

During the first few years after the Rule took effect, there were significant enhancements in companies' processes and procedures to trace the 3TG in their in-scope products. Each year also saw more supply chain transparency. Both of the foregoing resulted in significant year-over-year changes to disclosure. Companies also enhanced their disclosure in response to NGO rankings. In the last few years, processes and procedures have remained more or less static at most companies and transparency has leveled off. In addition, most companies already have addressed those NGO disclosure and compliance recommendations that they are prepared to take into account.

For the 2018 Reporting Year, most filings are expected to continue to be between 7 and 20 pages. Companies also will continue to organize the discussion of processes and procedures in their Conflict Minerals Reports to follow the OECD Guidance Framework. Many companies also will continue to view their filings under the Rule in the context of their broader package of mandatory and voluntary corporate social responsibility disclosures, meaning that they will continue to go well beyond the minimum requirements of the Rule in their filings, to ensure that they are receiving credit from NGOs and other stakeholder constituencies for their efforts to trace the source of the 3TG in their supply chains and, more generally, to responsibly source 3TG. In particular, with the increasing focus on ESG (Environmental, Social and Governance) factors by mainstream investors, companies are paying greater attention to conflict minerals compliance indicators that are included in ESG ratings.

One area of compliance that has continued to see evolution is the number of IPSAs, with the number decreasing each of the last few years. Under the SEC's April 2014 Statement, a company is not required to obtain an IPSA unless it voluntarily indicates in its Conflict Minerals Report that it has a product that is DRC conflict free. For the 2017 Reporting Year, 14 companies obtained an IPSA, compared to 16 for the 2016 Reporting Year, which was, in turn, down from the high-water mark of 19 for the 2015 Reporting Year. Since the IPSA trigger is voluntary, the number of IPSAs is expected to remain low, as most companies do not perceive the benefit of an IPSA outweighing the cost and time involved.

Notwithstanding the significant improvements in traceability and reporting since the inception of the Rule, most companies continue to be unable to determine the origin of the 3TG specific to their in-scope products. In addition to gaps in supply chain transparency and reporting and inaccuracies in the data reported, most suppliers report 3TG content in their products at a "company level," meaning that they are reporting potential 3TG content for all of their products, not just the 3TG in the products supplied to the specific customer. Although most companies are not able to tie reported smelters and refiners to their specific products, the risk of sourcing from smelters and refiners that may be supporting conflict has decreased over time, since the number of smelters and refiners that are conformant with an independent third-party audit protocol (conflict-free) has dramatically increased since the adoption of the Rule. There are now over 250 conformant smelters and refiners, with approximately 97% of tantalum, 96% of tin, and 89% of tungsten smelters, and 70% of gold refiners engaged with an audit program. As a result, even though companies are receiving data from suppliers at the suppliers' company level and gaps in reporting still exist, a large percentage of the smelters and refiners being identified are conformant with or active in an audit program.

However, it continues to be a criticism of NGOs that most companies remain focused primarily on compliance and reporting rather than risk identification and risk mitigation. NGOs continue to be especially critical of the affirmative steps being taken by most companies, as described in their filings, to ensure that their direct and indirect suppliers source responsibly, including through participation by companies in multi-stakeholder initiatives focused on both the upstream (between the mine and the smelter or refiner) and the downstream (after smelter or refiner processing). NGOs would like to see more participation by companies in these initiatives, and, without participation in these initiatives, it is difficult to receive high scores in NGO rankings. NGOs also are critical of the level of disclosure concerning risks identified and supplier-specific risk mitigation frameworks and activities.

Industry Insights

Form SDs and Conflict Minerals Reports vary in content and length, primarily by company size, but also to a lesser extent by industry. Companies in industries that receive the

most NGO focus and larger companies tend to have more expansive disclosure than other companies. The technology sector is generally viewed by NGOs as outperforming other industries. Laggard industries identified by NGOs include drug manufacturing, oil and gas, travel and leisure, building materials, business services, and steel.

Many companies, especially in the electronics industry and larger companies, are members of the Responsible Minerals Initiative (the RMI). The RMI's membership includes more than 350 companies and industry associations from over 10 different industries. The RMI provides companies with tools and resources to make sourcing decisions that improve regulatory compliance and support responsible sourcing from conflict-affected and high-risk areas. Among other things, the RMI (1) has developed and regularly updates the Conflict Minerals Reporting Template, which is the de facto standard used by suppliers to disclose smelters and refiners in their supply chains and provide related compliance information; (2) produces white papers and guidance documents on responsible 3TG sourcing and reporting; (3) holds an annual workshop that brings together representatives from industry, government, and civil society for updates, in-depth discussions, and guidance on best practices on responsible mineral sourcing; and (4) runs the Responsible Minerals Assurance Process (RMAP), which provides independent, third-party audits of smelter and refiner management systems and sourcing practices.

International and Other Developments

The European Union published its Conflict Minerals Regulation (the Regulation) in May 2017. The Regulation generally will require importers of 3TG into the European Union to establish management systems to support due diligence, conduct due diligence, and make certain disclosures concerning the 3TG that they import. These obligations will take effect on January 1, 2021.

The Regulation does not impose compliance obligations on manufacturers of components or finished products, unless they are directly importing 3TG minerals or metals covered by the Regulation into the European Union. Importers, distributors, and retailers of components and finished products also do not have compliance obligations under the Regulation. Some aspects of the Regulation, which are discussed below, are over time likely to affect compliance and disclosure practices by U.S. companies.

In contrast to the Rule, which is focused on responsible sourcing from the Covered Countries, the Regulation takes a global approach, looking at conflict-affected and high-risk areas worldwide. The Regulation does not call out specific countries or regions by name. Instead, it contains a general principles-based definition of what it means to be a conflict-affected and high-risk area. These include (1) areas in a state of armed conflict; (2) fragile post-conflict areas; (3) areas with weak or non-existent governance and security, such as failed states; and (4) areas with widespread and systematic violations of international law, including human rights abuses.

During August 2018, the European Commission (the EC) released nonbinding guidelines to help companies identify conflict-affected and high-risk areas. These guidelines cover the following four areas: (1) general concepts and steps relating to due diligence in the mineral supply chain, including the concept of risk-based due diligence and the five-step OECD Guidance Framework; (2) the definition of conflict-affected and high-risk areas; (3) open-source information to identify conflict-affected and high-risk areas; and (4) red flags for enhanced due diligence, as part of the risk assessment of mineral supply chains. The EC also intends to select experts through a tender process to draw up an indicative, non-exhaustive list of conflict-affected and high-risk areas. The list is scheduled for release in 2019, and the EC intends to update it on a regular basis. As a consensus develops around additional conflict-affected and high-risk areas beyond the DRC, this will affect both sourcing expectations and how companies conduct their inquiries, even if they are not subject to the Regulation.

European Union disclosure developments also are over time expected to result in enhancements to disclosures made in filings under the Rule, as well as in other voluntary corporate social responsibility disclosures by U.S. companies. The EC has announced that it intends to launch a transparency database in 2019 to provide a single location for downstream companies that are not subject to the Regulation (i.e., generally manufacturers, importers, distributors, and retailers of components and finished products) to voluntarily report on their 3TG due diligence practices. The database is intended to create greater transparency as well as peer pressure to report and engage in due diligence.

In addition, separate from the Regulation, entities that are subject to the EU's Non-Financial Reporting Directive, which requires reporting on the management of environmental and social issues, may need to report on their 3TG due diligence. According to the voluntary guidelines on nonfinancial reporting published by the EC in 2017, where relevant and proportionate, subject companies are expected to disclose information on due diligence to ensure responsible supply chains for 3TG from conflict-affected and high-risk areas.

According to the guidelines, disclosures should be consistent with the OECD Guidance Framework, including (1) relevant information on the performance of policies, practices, and results on due diligence and (2) the steps taken to implement the OECD Guidance Framework, taking into account the subject company's position in the supply chain. Subject companies also are expected to disclose key performance indicators relating to (1) the nature and number of risks identified, (2) the measures taken to prevent and mitigate these risks, and (3) how the company has strengthened its due diligence efforts over time.

In China, the China Chamber of Commerce of Metals, Minerals & Chemicals Importers & Exporters published voluntary due diligence guidelines that are aligned with the OECD Guidance Framework, to assist Chinese companies in meeting direct and indirect customer requirements under the Rule and the Regulation. These guidelines were published in December 2015. There has been speculation that China will at some point introduce binding conflict minerals requirements.

In response to the increasing focus on responsible sourcing generally, many companies are integrating their 3TG compliance with other materials sourcing initiatives, such as those relating to the responsible sourcing of cobalt, nickel, and lithium. Responsible cobalt sourcing in particular is an increasing focus of both NGOs and original equipment manufacturers. During December 2018, the RMI released Version 1.1 of its Cobalt Reporting Template (the prior version was the pilot). This template is based on the Conflict Minerals Reporting Template that companies use in connection with their compliance with the Rule. A small number of companies also discussed cobalt compliance in their 2017 Reporting Year Conflict Minerals Reports.

In addition, many companies are integrating their 3TG compliance initiatives with other complementary areas of compliance, in particular anti-human trafficking compliance and compliance with Office of Foreign Assets Control sanctions.

Market Outlook

For the reasons discussed above, the 2018 Reporting Year filings, which are due on May 31, 2019, are expected to be substantially similar to those made for the 2017 Reporting Year.

Over the longer term, as discussed earlier in this article, developments in Europe, and perhaps elsewhere, are expected to affect U.S. disclosure and compliance practices. Furthermore, as also discussed above, integration between 3TG compliance and other areas of supply chain and corporate social responsibility compliance will continue to increase. And, although the Rule is not expected to be repealed or modified any time soon, even if this were to occur, a significant number of companies currently subject to the Rule will continue to trace the source of the 3TG in their supply chains and report on those efforts as a compliance exercise, due to commercial customer and other stakeholder pressures.

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Michael Littenberg is a partner in the securities & public companies practice group at Ropes & Gray LLP. Michael has more than 25 years of experience representing U.S. and foreign public and private companies, investment banks, private equity funds and other private investment funds in transactional matters, including securities offerings and mergers and acquisitions. His clients range from large well-known institutions to growing companies across every major industry.

In addition, a significant part of Michael's practice involves counseling U.S. public companies and foreign private issuers and their boards, board committees, special committees, executive officers and investors in connection with ongoing compliance under the U.S. securities laws, including Dodd-Frank, Sarbanes-Oxley and the JOBS Act, exchange requirements and governance and executive compensation matters.

As part of his practice, for more than 25 years, Michael has been active in advising leading public and private companies on supply chain and corporate social responsibility matters, and he is widely viewed as the leading practitioner in this emerging area. Michael advises clients on, among other things, disclosure and compliance with legal requirements, the construction and implementation of compliance programs, mitigating customer, litigation, NGO and socially responsible investor risk and in their interactions with these constituencies.

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