Bloomberg BNA

Corporate Law & Accountability Report™

DISCLOSURE

Latest Updates on the Securities and Exchange Commission's Conflict Minerals Rule

BY ZACH BREZ & JON DANIELS

I. Introduction

The first major deadline for compliance with the Securities and Exchange Commission's (SEC) conflict minerals rule is rapidly approaching. As companies scramble to finalize their initial disclosures under the rule,[1] there has been a sudden flurry of activity relating to this seemingly obscure provision. First, the SEC published new guidance on the rule in an attempt to provide companies with additional clarity on key issues. More recently, the D.C. Circuit Court of Appeals struck down a central provision of the rule and generated uncertainty as to the precise contours of the rule's requirements. This article provides a brief overview of these recent developments and their practical impact for companies.

Updates to the SEC's Conflict Minerals Rule

In response to recent developments relating to the Conflict Minerals Rule, Zach Brez and Jon Daniels of Ropes & Gray LLP suggest that issuers:

- keep a watchful eye out for any further developments regarding the rule;
- continue with current preparations for filing and compliance; and
- remain wary of the reputational, commercial and legal impetus to provide robust disclosures regarding conflict minerals usage.

II. Background of the Rule

In August 2012, the SEC adopted a rule requiring issuers to identify and disclose the use and origin of certain so-called "conflict minerals."[2] The impetus for this rule was the humanitarian concern that trade in such

Zachary Brez is a New York-based partner and co-chair of the securities and futures enforcement practice at Ropes & Gray LLP. The focus of his practice is working with clients to investigate, mitigate and advise about pressing enforcement, regulatory and litigation matters. Jon Daniels is a government enforcement associate at Ropes & Gray LLP. His practice is focused on regulatory investigations involving the Foreign Corrupt Practices Act, insider trading, financial fraud, and related litigation matters.

[1] A recent survey by Pricewaterhouse Coopers, for example, made clear that "[m]ost companies have a lot of work left to do to reach the May 31st deadline for filing reports on their use of so-called conflict minerals with the SEC." *See* John Kester, *Companies Dawdle as Conflict Minerals Filing Deadline Approaches*, Wall Street Journal, April 9, 2014, *available at* http://blogs.wsj.com/cfo/2014/04/09/companies-dawdle-as-conflict-minerals-filing-deadline-approaches/.

[2] The conflict minerals rule was enacted by the SEC pursuant to authority it had been granted by Section 1502 of the

minerals may be exploited by violent groups in the Democratic Republic of Congo and its adjoining countries (collectively, the DRC region) to finance human rights abuses. The rule currently targets four particular minerals that are believed to be contributing the most to the problems in the DRC region: tantalum, tin, tungsten and gold.[3]

The rule established a three-step process for companies to follow. First, an issuer must determine whether it is covered by the rule. The rule applies only in circumstances where these minerals are ''necessary to the functionality or production'' of items manufactured by—or contracted to be manufactured by—the issuer. Significantly, there is no *de minimis* exception: the rule thus applies to issuers even if their products utilize only a miniscule amount of such minerals. Second, companies subject to the rule must engage in a ''reasonable country of origin inquiry.'' Put simply, these issuers are required to investigate the source of any conflict minerals contained in their products and determine whether the minerals came from the DRC region.[4] At the conclusion of this inquiry, if an issuer either knows or has reason to believe that the minerals in question may have originated from the DRC region, then it must proceed to the third part of the process. Under step three, the issuer must conduct a more comprehensive due diligence inquiry—including an independent private sector audit (IPSA)—that evaluates the source and chain of custody of the conflict minerals and determines the origin with greater certainty. The issuer must then draft a Conflict Minerals Report detailing the diligence conducted and describing its results. According to the rule, this Report must note whether certain products have ''not been found to be 'DRC conflict free,' '' and must also detail the origin of the minerals used in those products.[5]

Issuers covered by the rule must file an initial submission detailing their findings—including the Conflict Minerals Report, if necessary—on a newly-created Form SD starting on May 31, 2014[6] for the calendar year ending December 31, 2013, and annually thereafter. However, the SEC provided a two-year phase-in period[7] during which issuers can describe certain products as ''DRC conflict undeterminable'' if they are unable to discern whether they originated in the DRC region.

III. New SEC Guidance

On April 7, 2014, the SEC released its second round of guidance on the conflict minerals rule in the form of Frequently Asked Questions (FAQs).[8] As with its initial guidance,[9] the new questions and answers track closely the language of the rule and commentary from the SEC's Adopting Release, or they reflect an already-emerging industry approach to certain issues. Nonetheless, the guidance does provide important new insight regarding certain key areas and also establishes clarity regarding existing interpretations. When reviewing the FAQs, however, it is important to recognize that portions of the guidance have already been rendered obsolete following the D.C. Circuit opinion invalidating the rule's disclosure requirement.

Issues Relating to Independent Private Sector Audits

As discussed above, an issuer that either knows or has reason to believe that the minerals in question may have originated from the DRC region must engage in an extensive due diligence inquiry that includes an independent private sector audit. The FAQs provide a great deal of insight into the scope and form of these audits.

First, the guidance specifies that the auditor is *not* required to be a certified public accountant (CPA) in order to perform the IPSA of an issuer's Conflict Minerals Report. According to the rule, the IPSA must be in accordance with standards set forth by the General Accounting Office (GAO). The GAO informed the SEC that its auditing standards—the so-called ''Yellow Book''—permit auditors to use either the provisions for Attestation Engagements or Performance Audits. Performance Audits allow non-CPAs to perform audits so long as they meet applicable Yellow Book requirements. In short, since the GAO rules that serve as the guidelines for the IPSA do not mandate that an auditor be a CPA, the IPSA similarly does not have such a requirement.

The FAQs also addressed the scope of the IPSA. The Commission explained that the IPSA does not have to examine the reasonableness or the completeness of the issuer's due diligence measures. Instead, the IPSA is limited to two discrete objectives. First, the audit must confirm that the design of the issuer's due diligence framework is consistent with a nationally—or internationally—recognized due diligence framework used by the issuer.[10] Second, the IPSA must determine whether the description of the due diligence process in the issuer's Conflict Minerals Report is consistent with the actual due diligence process undertaken by the issuer.

Anything beyond these two objectives is not covered by the IPSA. As one example, the reasonable country of origin inquiry is *not* within the scope of the IPSA—even if such procedures *are* included within the recognized due diligence framework utilized by the issuer and ex-

Dodd-Frank Act and is codified under Section 13(p) of the Securities Exchange Act of 1934.

[3] These minerals are integral to a wide variety of products and industries, including numerous types of electronics, industrial tools and equipment and jewelry.

[4] The rule provides an exception for minerals that originated from scrap or recycled materials.

[5] As discussed further below, the D.C. Circuit Court of Appeals recently invalidated the requirement under the rule that companies disclose whether their minerals are ''conflict free.''

[6] Since May 31 is a Saturday this year, the deadline is extended to the following Monday, June 2, 2014.

[7] The phase-in period is extended to four years for smaller issuers.

[8] Frequently Asked Questions (April 7, 2014): Conflict Minerals, *available at* http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm#q13.

[9] Frequently Asked Questions (May 30, 2013): Conflict Minerals, *available at* http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm#q1.

[10] According to the guidance, the rule does not require an issuer to provide a full description of the design of its due diligence process in the Conflict Minerals Report. However, the description must be sufficient for the auditor to form an opinion as to whether it is consistent with the due diligence actually undertaken.

   ISSN 2330-6300

amined by the auditor as part of the first IPSA objective. As a result, the IPSA is only required to evaluate and opine on due diligence activities that occur *after* the reasonable country of origin determination.

The guidance also clarified that an issuer is not required to obtain an IPSA of its Conflict Minerals Report during the temporary phase-in period for the rule if any of their products can be described as ''DRC conflict undeterminable''—even if the issuer's due diligence determines that some of its other products contain conflict minerals. On the other hand, if an issuer determines that one of its products is ''DRC conflict undeterminable,'' then it may not describe *any* of its other products in the Conflict Minerals Report as ''DRC conflict free.''[11] As noted above, these disclosures required in the Conflict Minerals Report (and discussed in the guidance) subsequently were held to be unconstitutional by the D.C. Circuit.

Disclosure Issues

The guidance also dealt with the required description during the phase-in period for a product that is based upon various combinations of conflict minerals. If any of the minerals are ''DRC conflict undeterminable,'' then the issuer may not describe the product as ''DRC conflict free'' even if the product would otherwise qualify as such. If the issuer does determine—either during or after the transition period—that any of the minerals in the product financed or benefited groups in the DRC region, however, then the guidance suggests that it is required to describe the product as ''having not been found to be 'DRC conflict free.' '' Again, this guidance appears to have limited value following the Court of Appeals ruling.

The guidance clarified that an issuer is *not* required to provide disclosure regarding conflict minerals from scrap or recycled sources in its Conflict Minerals Report. Instead, the Report is only required to address the due diligence performed on its conflict minerals that are *not* from such sources. However, the Form SD must still include the requisite disclosures regarding conflict minerals that come from recycled or scrap sources. The FAQs explained that since the IPSA does not cover disclosures in the Form SD, then it also does not cover the disclosures relating to scrap or recycled sources.

Due Diligence Process

The guidance also clarified the timing of due diligence. Although the due diligence measures required under the rule apply to conflict minerals in products manufactured during the entire calendar year, the actual due diligence undertaken by the issuer does not have to be exercised constantly throughout the entire year. Instead, such due diligence measures can begin prior to or extend beyond the calendar year.

Practical Guidance

The private sector audit requirement represents a significant undertaking, both in terms of the time required for its completion and the financial cost to the issuer. Companies can better control their expense and efforts on this front by limiting the scope of the IPSA to the precise requirements of the rule. To this end, companies should carefully review the terms of their agreed-upon audit and compare its parameters to the rule's obligations—as elucidated in the recent guidance—to make sure that it does not include unnecessary evaluation and review. For example, companies should make sure that the IPSA does not include a superfluous analysis of the reasonable country of origin inquiry. Issuers should also ensure that auditors are not unnecessarily examining the reasonableness of the diligence undertaken. In addition, companies should take extra care to determine whether they can reasonably conclude that any of their products contain minerals that can be described as ''DRC conflict undeterminable.'' Such a determination will allow these issuers to completely avoid incurring the expense and effort required by an IPSA.[12] As a final point, issuers may be able to reduce their expense by hiring a non-CPA to perform the audit.[13]

Issuers should regularly implement due diligence procedures that evaluate the entire calendar year. However, companies should keep in mind that such procedures are not required to be performed constantly but instead can be implemented as necessary to accomplish this goal. As one example, a reasonable due diligence approach might involve requesting updated information from existing suppliers that have already undergone extensive due diligence in the past, rather than performing an entirely new due diligence inquiry into all such suppliers during the current calendar year.

Finally, companies should review their Form SD to make sure that they have included the requisite disclosures regarding any conflict minerals that derived from scrap or recycled sources.

IV. D.C. Circuit Decision

On April 14, 2014, the U.S. Court of Appeals for the D.C. Circuit handed down an opinion in a closely-watched case challenging the conflict minerals rule.[14] The district court had rejected all of the challenger's claims and granted summary judgment in favor of the SEC.[15]

On appeal, the D.C. Circuit upheld virtually every aspect of the rule. The court sustained the SEC's decision to exclude a *de minimis* exception as a reasonable implementation of the statute's goals. The court rejected the petitioner's argument that the due diligence threshold set forth in the rule was arbitrary and capricious. The court upheld the SEC's expansive interpretation that the statute applies beyond direct manufacturers and extends to issuers who contract to manufacture conflict minerals. The rule's temporary phase-in period allowing issuers to describe certain products as ''DRC conflict undeterminable'' was considered to be a logical

[11] The rationale behind this result is that such a determination must be based on due diligence that requires, in part, an IPSA of the Report—which will not have been conducted because a ''DRC conflict undeterminable'' designation makes such an audit unnecessary.

[12] This is true regardless of what happens with the disclosure requirement after the D.C. Circuit opinion.

[13] In such a circumstance, companies should take particular care to ensure that the auditor can meet the requirements for performance audits under the Yellow Book.

[14] *Nat'l Ass'n of Mfrs. v. SEC*, No. 13-5252, 2014 BL 102614 (D.C. Cir. Apr. 14, 2014). The petitioners brought several claims under the Administrative Procedure Act, the Exchange Act and the First Amendment.

[15] *See Nat'l Ass'n of Mfrs. v. SEC*, 956 F. Supp. 2d 43, 46 (D.D.C. 2013).

and justifiable approach. Finally, the SEC's analysis of the costs and benefits of the rule was held to be reasonable.

But on the central feature of the rule—the requirement that companies disclose their use of conflict minerals and note if they are not ''DRC conflict free''—the SEC and human rights groups suffered a major defeat. The appeals court held that the disclosure requirement was unconstitutional: ''[b]y compelling an issuer to confess blood on its hands, the statute interferes with [the issuer's] exercise of the freedom of speech under the First Amendment.''[16] Significantly, the SEC was unable to demonstrate that its approach represented the least restrictive means of achieving its goal. Indeed, the court noted that the Commission failed to provide any evidence that alternative approaches to achieving the statute's objective without the same imposition on an issuer's freedom of speech—including two possibilities offered by petitioners—would be less effective.[17]

The Court of Appeals remanded the case to the district court for ''further proceedings consistent with [the] opinion.''[18] The Court also issued an order concurrently with the decision that withheld the issuance of its mandate until seven days after disposition of a timely petition for rehearing or petition for rehearing en banc. Based on this order, the earliest date on which the Court is likely to issue its mandate is June 5, 2014—several days *after* the deadline for issuers to file their first reports.

The SEC has not yet announced whether it intends to appeal the decision. On April 28, 2014, two SEC Commissioners issued a joint statement suggesting that the entire conflict mineral rule should be stayed—including all regulatory obligations for issuers—pending the outcome of the litigation. The Commissioners also suggested that Congress should ''reconsider whether [the conflict minerals rule] achieves the benefits that it was supposed to attain.''[19] The following day, however, SEC Chair Mary Jo White—who had previously expressed skepticism regarding the conflict minerals rule[20]—made clear that the Commission would continue to implement the conflict minerals rule. In testimony before the U.S. House of Representatives Financial Services Committee, Chair White emphasized that the D.C. Circuit ''went out of its way'' to uphold the majority of the rule and made clear that the court's decision should not delay application of the rule's requirements.'').[21]

Later that day, Keith Higgins, the SEC's Director of the Division of Corporation Finance, provided additional insight into the SEC's view of the Court of Appeals Decision.[22] Significantly, Higgins stated that ''the Division expects companies to file any reports required under [the rule] on or before the due date'' and that this filing ''should comply with and address those portions of [the rule] and Form SD that the Court upheld.''[23] As an example, companies are still required to describe and disclose their reasonable country of origin inquiry, and issuers filing a Conflict Minerals Report must still include a description of the due diligence undertaken. Higgins emphasized that issuers are no longer required to describe its products as ''DRC conflict free,'' having ''not been found to be 'DRC conflict free,' '' or ''DRC conflict undeterminable.'' He noted that if an issuer voluntarily decides to describe any of its products as ''DRC conflict free,'' it would only be allowed to do so if the issuer had obtained the requisite IPSA. However, Higgins made clear that, ''[p]ending further action,'' an IPSA will *not* be required for any issuers unless the company *voluntarily* decides to describe a product as ''DRC conflict free.'' Finally, Higgins stated that the ''Division will consider the need to provide additional guidance in advance of the filing due date.''

Practical Guidance

As a practical matter, it remains difficult to determine the full impact of this decision.[24] As discussed above—and as emphasized in Chair White's recent testimony and Director Higgins' statement—the majority of the rule appears to have remained intact: for example, companies will still be required to conduct the reasonable country of origin inquiry and perform diligence. Re-

---

[16] *Nat'l Ass'n of Mfrs.*, 2014 BL 102614 at *9. The court justified its reasoning by noting that ''it is far from clear that the description at issue—whether a product is 'conflict free' is factual and non-ideological. . . . It requires an issuer to tell consumers that its products are ethically tainted, even if they only indirectly finance armed groups. An issuer, including an issuer who condemns the atrocities of the Congo war in the strongest terms, may disagree with that assessment of its moral responsibility. And it may convey that 'message' through 'silence.' '' *Id.*

[17] For example, the petitioners suggested that issuers could provide their own description of the products at issue rather than using the ''conflict free'' label required by the rule. Alternatively, the government could create its ''own list of products that it believes are affiliated with the Congo war, based on information the issuers submit to the Commission.'' As the court noted, ''if issuers can determine the conflict status of their products from due diligence, then surely the Commission can use the same information to make the same determination''—and the resulting ''centralized list compiled by the Commission in one place may even be more convenient or trustworthy to investors and consumers.'' In other words, the court suggested that the SEC could achieve a similar—and possibly better—result without unnecessarily forcing companies to espouse views that they do not actually hold.

[18] *Nat'l Ass'n of Mfrs.*, 2014 BL 102614 at *11.

[19] Daniel M. Gallagher and Michael S. Piwowar, Commissioners of the U.S. Securities and Exchange Commission, Joint Statement on the Conflict Minerals Decision (April 28, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541665582.

[20] Mary Jo White, Chair, Securities and Exchange Comm'n, 14th Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture at Fordham Law School (Oct. 3, 2013) (''Seeking to improve safety in mines for workers or to end horrible human rights atrocities in the Democratic Republic of the Congo are compelling objectives, which, as a citizen, I wholeheartedly share. But, as the Chair of the SEC, I must question, as a policy matter, using the federal securities laws and the SEC's powers of mandatory disclosure to accomplish these goals.'').

[21] *See* Sarah N. Lynch, *U.S. SEC to move forward with conflict minerals rule*, Reuters, April 29, 2014, *available at* http://www.reuters.com/article/2014/04/29/sec-conflictminerals-compliance-idUSL2N0NL1OV20140429.

[22] Keith F. Higgins, Director, SEC Division of Corporation Finance, Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule (April 29, 2014).

[23] *Id.*

[24] Indeed, the full impact of the court's ruling may not be felt until after calendar year 2015, at which point the phase-in period allowing for the temporary ''DRC conflict undeterminable'' designation will have passed and more companies will find themselves in the situation contemplated by the court's decision.

   ISSN 2330-6300

gardless of what happens to the disclosure provision, it thus appears that companies will still be required to undertake a significant amount of effort to ensure compliance with the rule.

Even the disclosure ruling might ultimately have a smaller impact than some issuers might have hoped. Indeed, the court seemed to suggest that the SEC would have little difficulty modifying the disclosure obligation in such a way as to pass constitutional muster and highlighted two simple workarounds that were proposed by the petitioners. As a result, it seems likely that any reprieve from the disclosure requirement will be only temporary and issuers will soon be forced to reveal information about their use of conflict minerals in some form.[25]

The impact of the ruling might also be minimal because companies face a growing number of additional requirements to disclose their use of such minerals. The European Union has proposed its own conflict minerals legislation that in some ways would go beyond the requirements of the U.S. rule.[26] In addition, several U.S. cities and states are taking similar action: for example, they are favoring companies that utilize conflict free minerals when making procurement decisions.[27] Furthermore, pressure from various social justice organizations and the threat of reputational harm associated with the use of conflict minerals has forced many companies—even those that are not subject to the conflict minerals rule—to adopt a diligence and disclosure regime similar to that required by the SEC. In sum, there is a strong reputational, commercial and legal impetus for companies to perform the necessary diligence and provide robust disclosures regarding their use of conflict minerals, even apart from the SEC rule.

V. Conclusion

The uncertainty generated by this decision could not have come at a more difficult time for issuers as they prepare to file their first reports under the rule in early June.[28] The recent comments from the SEC on the D.C. Circuit ruling appear to have provided some much-needed clarity for issuers, but questions remain regarding the consequences of the court's decision. Issuers would be prudent to continue with their current preparations for filing and compliance. At the same time, issuers should keep a watchful eye out for any further developments regarding the rule—such as additional guidance from the SEC, or resolution of the legal issues—so that they can respond accordingly.

---

[25] Even if issuers are not required to explicitly describe whether their products are ''conflict free,'' human rights agencies, consumers and competitors will likely be able to use the information provided to achieve the same substantive result that would be generated by the current version of the rule.

[26] *See* Press Release, Eur. Comm'n, EU proposes responsible trading strategy for minerals from conflict zones (March 5, 2014), *available at* http://europa.eu/rapid/press-release_IP-14-218_en.htm.

[27] California and Maryland have passed legislation prohibiting state officials from awarding contracts to companies that fail to comply with the SEC's conflict minerals requirements; other states have considered similar legislation, including Rhode Island and Massachusetts. Even cities such as St. Petersburg and Florida have passed resolutions favoring companies that employ conflict free purchasing decisions and urging companies to remove conflict minerals from their supply chain.

[28] Indeed, it is unlikely that the legal issues relating to this case will be resolved by the time the first Form SD must be filed.