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Latest Updates on the SEC's Conflict Minerals Rule

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Practice Tips

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.

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, 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 (29 CCW 121, 4/16/14), even while SEC commissioners said they would continue to enforce parts of the rule (see related story, page 146). This article provides a brief overview of these recent developments and their practical impact for companies.

II. Background of the Rule

In August 2012, the SEC adopted a rule pursuant to Section 1502 of the Dodd-Frank Act requiring issuers to identify and disclose the use and origin of certain so-called ''conflict minerals'' (27 CCW 265, 8/29/12). The impetus for this rule was the humanitarian concern that trade in such 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 believed to be contributing the most to the problems in the DRC region: tantalum, tin, tungsten and gold.

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.

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.

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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 (or, Monday, June 2, since May 31 is a Saturday this year) for the calendar year ending December 31, 2013, and annually thereafter. However, the SEC provided a two-year phase-in period for most issuers 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. D.C. Circuit Decision

On April 14, 2014, the Court of Appeals for the D.C. Circuit handed down an opinion in a closely-watched case challenging the conflict minerals rule.[1]

The district court had rejected all of the challenger's claims and granted summary judgment in favor of the SEC (28 CCW 233, 7/31/13).[2]

On appeal, the D.C. Circuit upheld virtually every aspect of the rule. But on 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.''[3]

The Court of Appeals remanded the case to the district court.[4] 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 29, SEC Chair Mary Jo White made clear that the Commission would continue to implement the provision. 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.

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.[5] 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.''[6]

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 their 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.''

The SEC formalized its guidance by issuing an order on May 2, 2014, staying the effective date for compliance with the portions of the conflict minerals rule that would require statements that were held by the D.C. Circuit to violate the First Amendment. However, the SEC declined to stay the remainder of the rule.[7]

Industry groups May 5 filed a motion with the D.C. Circuit to stay the rule and asked that the court decide by May 26 (see related story, page 146).[8]

IV. Practical Guidance

As a practical matter, it remains difficult to determine the full impact of this decision, and the full impact may not be felt until after 2015, after the phase-in period allowing for temporary ''DRC conflict undeterminable'' designations has passed. 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. Regardless 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. 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.[9]

Finally, 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.[10]

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[1] *Nat'l Ass'n of Mfrs. v. SEC*, No. 13-5252, 2014 BL 102614 (D.C. Cir. Apr. 14, 2014).

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

[3] *Nat'l Ass'n of Mfrs.*, 2014 BL 102614 at *10.

[4] *Id.* at *11.

[5] 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 (Apr. 29, 2014).

[6] *Id.*

[7] In the Matter of Exchange Act Rule 13p-1, Order Issuing Stay, SEC Release No. 34-72079 (May 2, 2014), *available at* http://www.sec.gov/rules/other/2014/34-72079.pdf.

[8] Appellants' Emergency Motion for Stay of the SEC's Conflict Minerals Rule, Nat'l Assoc. of Mfrs. et al. v. Securities and Exchange Comm'n, No. 13-5252 (D.C. Cir. May 5, 2014).

[9] 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.

[10] *See* Press Release, Eur. Comm'n, EU proposes responsible trading strategy for

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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.[11] Furthermore, pressure from various social justice organizations and the threat of reputational harm associated with the use of conflict minerals has forced many companies 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.

Issuers should still pay attention to the guidelines in the SEC's second round of conflict minerals rule guidance, issued April 7, 2014 in the form of Frequently Asked Questions (FAQs).[12] As with its initial guidance,[13] the 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 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 been rendered obsolete following the D.C. Circuit opinion invalidating the rule's disclosure requirement.

Some issues to still pay close attention to from the FAQs include:

■ **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 IPSA. The FAQs provide a great deal of insight into the scope and form of these audits.

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 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, as this is not required under the rule.

[T]he majority of the rule appears to have remained intact. ... Issuers would be prudent to continue with their current preparations.

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.[14] As a final point, issuers may be able to reduce their expense by hiring a non-CPA to perform the audit.[15]

■ **Disclosure Issues.** The FAQ guidance also deals 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. 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.

■ **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.

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

minerals from conflict zones (Mar. 5, 2014), *available at* http://europa.eu/rapid/press-release_IP-14-218_en.htm.

[11] 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.

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

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

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

[15] The FAQs clarify that it is not necessary to have the audit performed by a CPA, however companies should take care to ensure that the auditor can meet the requirements for performance audits under the Yellow Book.

into all such suppliers during the current calendar year.

V. Conclusion

The uncertainty generated by this decision could not have come at a more difficult time as issuers prepare to file their first reports under the rule in early June. 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.

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