The Legal Intelligencer

Recent Developments in the SEC's Conflict Minerals Rule

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November 3, 2015

Since its adoption in 2012, the U.S. Securities and Exchange Commission's (SEC) conflict minerals rule has generated widespread controversy and prolonged litigation. Recent developments suggest that the conflict minerals litigation will continue for some time to come. Meanwhile, as a result of disclosures over the past two years, best practices and reporting trends are emerging. Interestingly, as the rule is litigated, nongovernmental organizations (NGOs), activist groups and other constituencies are encouraging companies to go beyond the minimum reporting requirements of the rule and adopt emergent leading practices in responsible sourcing initiatives.

Background of the Rule

In August 2012, the SEC adopted the final conflict-minerals rule implementing disclosure requirements aimed at reducing armed conflict in the Democratic Republic of Congo and its nine adjoining countries (DRC region). The rule requires companies to conduct a reasonable country-of-origin inquiry for any conflict minerals (gold, tantalum, tin and tungsten) that are necessary to the functionality or production of products that companies manufacture or contract to manufacture. Unless a company has no reason to believe any of its conflict minerals originated in the DRC region, it must then perform due diligence on the source and chain of custody of its conflict minerals.

The rule implemented a two-year transition period for large issuers, during which companies that declared their products "DRC conflict-undeterminable" were not required to obtain an independent private-sector audit (IPSA) of their due diligence measures. Under the rule, beginning with the 2015 reporting period, issuers (other than smaller reporting companies) are required to obtain an IPSA and describe their products as either "DRC conflict-free" or "not been found to be DRC conflict-free."

Not surprisingly, the conflict minerals rule has generated litigation. In April 2014, the U.S. Court of Appeals for the D.C. Circuit held that the rule's requirement that companies describe their products as "not been found to be DRC conflict-free" is compelled speech that violates the First Amendment. In response to this ruling, the SEC issued a statement April 29, 2014, indicating

that companies are not required to identify their products as "DRC conflict-free," having "not been found to be DRC conflict-free" or "DRC conflict-undeterminable." The April 29, 2014, statement further provides that, pending additional action by the SEC, an IPSA will not be required unless a company voluntarily chooses to describe a product as "DRC conflict-free" in its conflict minerals report, which is due by May 31 (or the first business day thereafter) each year since 2014.

In accordance with the SEC's April 29, 2014, statement, a majority of filing companies did not use the labels "DRC conflict-free" or "DRC conflict-undeterminable" in their disclosure for the 2013 and 2014 reporting periods that were filed in 2014 and 2015, respectively.

Status of Litigation Against the SEC

On Aug. 18, a three-judge panel of the D.C. Circuit, in a 2-1 vote, reaffirmed its April 2014 decision that the rule's requirement that companies describe their products as "not been found to be DRC conflict-free" violates the First Amendment. On Oct. 2, the SEC and Amnesty International filed petitions seeking an en banc rehearing of the August decision, making it likely that the conflict minerals litigation will continue for some time.

The recent litigation activity, however, does not affect the disclosure status quo. The conflict minerals rule, as modified by the SEC's April 29, 2014, statement, remains in effect and companies should continue with their conflict minerals compliance programs. Companies are required to file their Form SD and, if applicable, conflict minerals report for the 2015 reporting period by May 31, 2016. However, as provided in the SEC's April 29, 2014, statement, companies are not required to identify their products as "DRC conflict-free" or having "not been found to be DRC conflict-free." Moreover, pending further action by the SEC, an IPSA will not be required unless a company voluntarily chooses to describe a product as "DRC conflict-free." While it is possible that the SEC could modify its April 29, 2014, statement and require IPSAs under additional circumstances, it seems unlikely to do so for the 2015 reporting period.

The Current Reporting Landscape

The effect of the conflict minerals rule on decreasing violence in the DRC region remains unclear. A study on conflict minerals compliance by Tulane University and Assent Compliance revealed that companies spent a total of $709 million (an average of half-a-million dollars per issuer) and six million staff hours between July 2013 and June 2014 to comply with the rule. However, 90 percent of the 1,262 companies that filed conflict minerals disclosures with the SEC in 2015 indicated that they were unable to determine if their products were conflict-free, the primary goal of conflict minerals due diligence. Many companies continue to face difficulty obtaining information from their supply chain as well as linking smelter and refiner information

they do obtain to specific products. Furthermore, the Responsible Sourcing Network reports that some companies have instituted a formal embargo of the DRC region, or have sent an implicit signal through their supply chains not to source from the DRC region—actions that could have devastating consequences for millions of artisanal miners not associated with the violence.

Nevertheless, implementation of responsible sourcing initiatives has led to positive developments. The Responsible Sourcing Network recently issued a comprehensive report, "Mining the Disclosures 2015: An Investor Guide to Conflict Minerals Reporting in Year Two," analyzing the disclosure of 155 large cap companies. The report highlights Intel Corp. as having reported a 100 percent conflict-free product line and a handful of other companies as being close to sourcing 100 percent conflict-free tantalum from the DRC region. According to the Responsible Sourcing Network, when companies increase their ability to trace conflict minerals in specific products back to the smelter and refiner level and beyond, and insist on conflict-free sourcing from the DRC region, they are "changing the status quo."

Due Diligence and Reporting Best Practices

The Responsible Sourcing Network's report identifies 21 key performance indicators for conflict-minerals due diligence and reporting. The report underscores how NGOs, activist groups and other constituencies expect companies to go beyond the minimum reporting requirements of the rule and actively promote a conflict-free minerals trade in the DRC region. A few of the best practices identified by the Responsible Sourcing Network are:

Inclusion of a full list of likely smelters and refiners in the Form SD or conflict minerals report, even if a company is not certain those smelters and refiners processed conflict minerals for its specific products.

- Discussion of specific actions taken to ensure being conflict-free does not lead to an embargo of the DRC region, including adoption of a formal policy not to discriminate against suppliers or smelters and refiners that source from the DRC region.
- Implementation of a continuous or annual risk-assessment system, rather than performing only an initial review of suppliers.
- Verification of smelter and refiner information provided by suppliers, instead of relying solely on supplier responses.
- Description of how each step in the Organization for Economic Cooperation and Development's international due diligence framework was implemented by the company.

The Responsible Sourcing Network indicates that transparency in reporting remains a key issue—many companies are not disclosing key details of their due diligence. Furthermore, while 83 percent of the surveyed companies used a determination synonymous with the label "DCR

conflict-undeterminable," 24 percent used an incorrect or misleading determination, often leading to an implication that a company's products are "DRC conflict-free."

Recommendations

As due diligence and reporting best practices continue to develop, companies should expect increased scrutiny from NGOs, activist groups, consumers and other constituencies with respect to such companies' conflict minerals disclosures. Companies may want to consider what steps they can take to further enhance their conflict-minerals compliance programs and adopt some of the best practices identified by the Responsible Sourcing Network and others. In addition, companies should begin drafting their Form SDs and conflict minerals reports well in advance of the May 31, 2016, reporting deadline in order to ensure their disclosure thoroughly reflects their efforts and accomplishments in implementing responsible sourcing initiatives and compliance programs.

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