The Legal Intelligencer

SEC Adopts Conflict Mineral Disclosure and Due Diligence Rules

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The tragedies occurring in the Democratic Republic of Congo (DRC) are devastating. Humanitarian organizations, including the United Nations, believe that the mining and trading of conflict minerals has helped finance armed groups and contributed to the continued violence in the DRC. The U.S. Congress has chosen to make a statement against the atrocities through its legislative power. Congress believes that reducing the use of conflict minerals will reduce the funding available to militia groups and thus result in less violence. As such, in 2010, as part of the Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Congress adopted the Conflict Minerals Statutory Provision, which required the Securities and Exchange Commission to adopt rules requiring reporting companies that use conflict minerals to disclose whether those minerals originated in the DRC or one of DRC's neighboring countries (a covered country). By requiring such disclosure, Congress expects there to be increased public awareness of the use of conflict minerals and greater due diligence on supply chain matters.

On August 22, the SEC adopted final rules to implement the disclosure required by the Conflict Minerals Statutory Provision. The rules require companies to utilize a three-step test to determine what disclosure, if any, is required, and they apply to all reporting companies, including foreign private issuers, emerging growth companies and smaller reporting companies. The SEC actually estimates that approximately 40 percent of reporting companies will be impacted by these rules. Thus, many companies should consider the applicability of the rules.

Required Disclosure

The rules set forth a three-step process for determining what disclosure is required. First, a company must consider whether it uses conflict minerals that are "necessary to the functionality or production of products that the company manufactures or contracts to manufacture." Second, a company must conduct a "reasonable country of origin inquiry." Finally, the company must perform due diligence on the source and chain of custody of its conflict minerals.

Step One

Under step one, a company must evaluate whether it uses conflict minerals that are necessary to the functionality or production of products that the company manufactures or contracts to manufacture. Conflict minerals are defined to include columbite-tantalite, cassiterite, gold, wolframite, and their derivatives tantalum, tin and tungsten, as well as any other derivatives of those minerals and any other minerals and their derivatives that the secretary of state identifies as conflict minerals. While the SEC did not define "necessary to the functionality" or "necessary to the production," it has provided some guidance. In each case, the determination is based on the facts and circumstances at hand.

To determine whether a conflict mineral is "necessary to the functionality" of a product, a company should consider (1) whether the mineral is contained in or intentionally added to the product; (2) whether the mineral is necessary to the product's general use, function or purpose; and (3) if the mineral is used for purposes of decoration or embellishment, whether the product's primary purpose is decoration or embellishment. Companies must consider all conflict minerals included in its products, regardless of whether the company itself added the mineral or whether the company incorporated a component containing conflict minerals that was manufactured by a third party. When considering the function of a product, companies should consider all product functions. If a product has multiple functions, the conflict mineral need only be necessary for one function in order to be considered necessary to the product as a whole.

To determine whether a conflict mineral is "necessary to the production" of a product, a company should consider (1) whether the conflict mineral is intentionally added to the production process or whether it is used only as a catalyst in the production process and (2) if used as a catalyst, whether the conflict mineral is otherwise necessary for the production of the product and is contained in the product, even in trace amounts. A conflict mineral contained in a tool used in the production process would not be considered "necessary to the production" of the product because it is the tool, not the mineral, that is necessary to for production.

If the company determines that it does not use conflict minerals necessary to the functionality or production of a product, it should stop the analysis here, otherwise it must move to step two.

Step Two

For step two, a company must conduct a reasonable country of origin inquiry designed to determine whether conflict minerals originated from a covered country or from recycled or scrap materials. The level of inquiry required to meet the reasonable standard will depend on a variety of facts, including the company's size, products, relationship with suppliers and other factors.

The SEC offers several suggestions of what may be considered reasonable inquiry but does not provide an exhaustive list. Representations from the facility at which the minerals were processed or from the company's immediate suppliers may suffice so long as the company has reason to believe the representations are true and correct. A company is not required to confirm the origin of all conflict minerals. Rather, if the company has designed a process and performs the process in good faith, it can reasonably conclude that its conflict minerals did not originate from covered countries, even if it only obtained the representation from most, but not all,

suppliers. A company may not ignore suggestions or red flags that the remaining minerals originated from a covered country.

If a company (1) determines that its necessary conflict minerals did not originate in a covered country; (2) determines that its necessary conflict minerals originated from scrap or recycled sources; (3) has no reason to believe that its conflict minerals originated from a covered country; or (4) reasonably believes its conflict minerals are from recycled or scrap sources, it may stop its analysis here. A company that ends its inquiry here must file a specialized disclosure form (Form SD) in which the company must disclose this determination and include a description of the inquiry it made in reaching this determination.

Step Three

Once a company knows or has reason to believe that its conflict minerals originated from a covered country and did not come from scrap or recycled materials, it must conduct due diligence on its conflict minerals' source and chain of custody. Companies are required to use a nationally or internationally recognized framework when conducting this due diligence. A significant aspect of the due diligence process is obtaining an audit report. An independent auditor is required to express an opinion on whether the design of the company's due diligence process conforms, in all material respects, with the framework utilized by the company and whether the description of the due diligence process in a Conflict Minerals Report, described below, is consistent with the process the company undertook. If, based on this due diligence, the company determines that its conflict minerals did not originate in a covered country, the company is required to disclose this determination and its due diligence process in its Form SD, but will not have to file a Conflict Minerals Report. Companies that determine that their conflict minerals originated in a covered country or are unable to determine the source of their conflict minerals are required to file a Conflict Minerals Report. In the Conflict Minerals Report, a company must describe its due diligence process; include a copy of the audit report; and describe its products that are not "DRC conflict free," including a "description of the facilities used to process the conflict minerals, the origin of those conflict minerals, and the efforts taken to determine the mine or location of origin with the greatest possible specificity." Products are considered "DRC conflict free" if they "do not contain minerals that directly or indirectly finance or benefit armed groups" in covered countries.

Temporary Relief

Companies are required to begin analyzing the use of conflict minerals beginning January 1, 2013, and must file initial special disclosure reports on or before May 31, 2014. However, companies may describe their products as "DRC conflict undeterminable" instead of "DRC conflict free" for a period of time if they are unable to determine that their conflict minerals did not originate in a covered country. For all issuers, this temporary relief is available for two years (2013 and 2014). Smaller reporting companies are afforded an additional two years of relief (through 2016). If a company describes its products as "DRC conflict undeterminable," it must also describe the steps it has taken (or will take) to reduce the risk that its necessary conflict minerals benefit armed groups, including steps to enhance its due diligence. During this relief

period, companies that state that their products are "DRC conflict undeterminable," are not required to provide an audit report. Once this relief period ends, companies that are still unable to determine whether their products contain necessary conflict minerals that originated in a covered country will need to describe their products as not "DRC conflict free."

Reactions to the Rule

Reaction to the new rules has been mixed. Companies and industry associations are wary of the compliance burdens and costs the new rules will impose. The SEC estimates that in order to apply the rules, companies will need to spend $3 billion to $4 billion initially, and then $206 million to $609 million annually. Some legislators have applauded the SEC for its work; others question the appropriateness of the rule. The rules were approved by the SEC by a close margin vote of 3-2. Commissioner Daniel Gallagher, although sympathetic to the violence in the DRC, voted not to approve the rules, stating that the conflict mineral rules are "not about investor protection, promoting fair and efficient markets, or capital formation. Warlords and criminals need to fund their nefarious operations. Their funding is their lifeline; it's a chokepoint that should be cut off. That is a perfectly reasonably foreign policy objective. But it's not an objective that fits anywhere within the SEC's threefold statutory mission." Senator Dick Durbin, D-Ill., and Representative Jim McDermott, D-Wash., the authors of the Conflict Minerals Statutory Provision, applauded the work of the SEC, stating, "The rules ... will provide transparency and accountability to an area of the market that long existed in the shadows; give consumers and investors much needed source-information about the products they buy."

Recommendations

All companies, but particularly those with manufacturing operations, should begin preparations to comply with the new conflict mineral rules. Companies should begin to develop and document their due diligence process. Supply and manufacturing contracts should be reviewed to determine whether any amendments are necessary, particularly if the company intends to seek representations regarding the use of conflict minerals from its suppliers or service providers. While the rules will require significant compliance efforts, early preparation will help reduce the costs and burdens.

Beyond the rules and work required to satisfy them, the question remains, however, whether securities disclosure filings are truly the best place to stop the violence in the DRC, no matter how noble and commendable the cause. •

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