The Legal Intelligencer

Digging for Disclosure: SEC Conflict Minerals Rule Updates

Katayun I. Jaffari and Sandra M. Hashima, The Legal Intelligencer

July 1, 2014

June 2 marked the deadline for reporting companies to file their disclosures on conflict minerals as required under the U.S. Securities and Exchange Commission's (SEC) conflict minerals rule. The SEC had estimated that about 6,000 companies would be affected by the conflict minerals rule. On April 14, just weeks before the deadline, the U.S. Court of Appeals for the D.C. Circuit ruled that certain requirements under the SEC rule violated the First Amendment while upholding other provisions being challenged by trade groups. This article discusses the conflict minerals rule, litigation against the SEC as a result of the rule, and the current landscape of reporting in the aftermath of the circuit court's decision.

Background of the Rule

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included legislation requiring companies to disclose whether their products contain conflict minerals sourced from the Democratic Republic of the Congo (DRC) and nine adjoining countries (covered countries). The intent was to shed light on the growing concern that the mining and trade of tantalum, tin, gold and tungsten by armed groups financed conflicts in the region and subjected workers to various human rights abuses. Congress envisioned that requiring the determination and disclosure of the origin of such conflict minerals would eventually dissuade companies from using minerals sourced in the covered countries.

In August 2012, as required under the Dodd-Frank Act, the SEC adopted the final conflict minerals rule implementing the disclosure requirements. The rule introduced a three-step process for determining what should be disclosed. Companies must first determine whether its products contain the minerals and if those minerals are necessary for the functionality or the production process of the products, including products that companies contract to manufacture. Next, companies must conduct a "reasonable country of origin inquiry" to determine whether the necessary conflict minerals originated in the covered countries. Finally, if a company knows or has reason to believe, based on the inquiry, that any necessary conflict minerals originated in the covered countries, it must conduct due diligence on the source and chain of custody of those conflict minerals and, if necessary, provide a conflict minerals report.

The Litigation Against the SEC

Within weeks of the adoption of the final conflict minerals rule, the National Association of Manufacturers, the U.S. Chamber of Commerce and the Business Roundtable filed suit against the SEC. These trade groups raised two main claims. First, they argued that the rule violated the Administrative Procedure Act because the SEC rulemaking was "arbitrary and capricious" and it ignored its statutory obligations under the Securities Exchange Act of 1934 in implementing the rule. Second, they argued that requiring companies to publish the conflict minerals disclosure on their websites violated the First Amendment.

The U.S. District Court for the District of Columbia issued an opinion rejecting both claims July 23, 2013. The court found that the SEC acted appropriately in its rulemaking, noting that the SEC was not required to conduct a broad, wide-ranging benefit analysis of the rule considering that the benefits of the rule were humanitarian rather than economic. The court also found that the disclosure requirement did not violate the First Amendment. Applying an intermediate scrutiny standard, the court held that the disclosure of conflict minerals "directly and materially advance[s] Congress's interest in promoting peace and security in and around the DRC." It also held that the requirement to disclose information on company websites qualified as a "reasonable" fit between the rule's means and ends under the standard because the rule did not require companies to make disclosures aside from publishing the Form SD and/or conflict minerals report, which are "verbatim copies of disclosures already prepared and filed with the [SEC]."

Upon appeal, the D.C. Circuit agreed with the district court that the SEC acted appropriately in its rulemaking. However, the circuit court held that the requirement of a company to describe its products as conflict-free compelled companies to "confess blood on its hands" in violation of their right to free speech under the First Amendment. The case was remanded to the district court April 14. Because the earliest date the district court could issue an opinion was June 5, three days after the June 2 deadline to file disclosures, the SEC issued a partial stay of any disclosures that the circuit court held would be in violation of the First Amendment. The trade groups filed an emergency motion with the circuit court seeking a stay of the entire conflict minerals rule. The circuit court denied the motion May 14. To date, there has been no opinion from the district court.

The Current Reporting Landscape

Even before the circuit court decision, there was uncertainty about the ability of companies to fully comply with the requirements of the conflict minerals rule. An estimate by the SEC on the time and cost of preparing the reports indicated a daunting task: The reports would cost companies up to $4 billion in the first year and take about 480 hours on average to complete. Additionally, a report by PricewaterhouseCoopers in April noted that many companies surveyed found the disclosure and reporting process more demanding than expected. The same report found that with less than two months before the deadline, more than half of the companies surveyed had not begun drafting their filings. By the June 2 deadline, only 1,300 of the 6,000 companies that the SEC estimated would be impacted by the rule filed their disclosures on Form SD.

Whether the requirements imposed by the conflict minerals rule has any lasting impact remains to be seen. Reactions from nongovernmental organizations, activist groups and business publications on the rule and the disclosure process are mixed. Recent reports state that the disclosures in general are inconclusive and lacking substance with regard to information on conflict minerals. Many companies have stated that they could not get definitive answers about their supply chains, partly due to the lack of response from suppliers and the complexity of some manufacturing processes. Some activist groups have criticized the quantity and quality of information provided in the filings. On the other hand, there have been reports that the rule has helped reduce the involvement of armed groups in the DRC in mining operations for tungsten, tin and tantalum.

Recommendations

While the deadline to file initial reports has passed, companies need to remain diligent about the sourcing of their conflict minerals. Considering the criticisms about the initial reports, companies should continue to develop and improve their due diligence and reporting processes. The quality of information and responsiveness of suppliers should be a focus in order for companies to improve the robustness of their disclosures.

Katayun I. Jaffari *is a partner in Ballard Spahr's business and finance department. She has experience counseling public and private companies in the areas of corporate governance and securities law and compliance, as well as executive compensation and general corporate law matters. She can be reached at jaffarik@ballardspahr.com or 215-864-8475.* ***Sandra M. Hashima*** *is an associate in the firm's business and finance department and is a member of the mergers and acquisitions/private equity, health care, and life sciences and technology groups. She can be reached at hashimas@ballardspahr.com or 215-864-8873.*