Complying with the SEC's Conflict Minerals Rules

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Introduction

On August 22, 2012, the U.S. Securities and Exchange Commission (the "SEC") adopted new rules (the "Conflict Minerals Rules")[1] pursuant to Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[2] requiring specialized due diligence and disclosure regarding the use of "conflict minerals" by issuers registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Conflict Minerals Rules are intended to help end human rights abuses in the Democratic Republic of the Congo ("DRC") and adjoining countries by reducing the financing of armed groups that benefit from commercial activity involving conflict minerals.

The Conflict Minerals Rules affect a large number of issuers, including issuers in which many Sovereign Wealth Funds ("SWFs") may have a direct or indirect interest, and complying with the rules will be costly and time-consuming. Many issuers will need to revise their policies and procedures affecting their supply chains in order to ensure compliance with the Conflict Minerals Rules and such revisions may result in increased costs for such issuers.

Issuers Affected by the Conflict Minerals Rules

The Conflict Minerals Rules affect all issuers that meet the following conditions:

> The issuer files reports with the SEC as required under Section 13(a) or 15(d) of the Exchange Act (including foreign issuers);
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> The issuer manufactures, or contracts to manufacture, a product; and
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> Conflict minerals are "necessary to the functionality or production" of such product.

Although the conflict minerals reporting requirements only apply to SEC-registered issuers, it is important to note that companies throughout the issuer's supply chain are affected by these rules. They will be expected to assist the reporting issuers with the due diligence required to comply with the rules, and may be asked to provide representations or certifications with respect to the source of the conflict minerals and their due diligence process.

When the Conflict Minerals Rules Take Effect

Under the Conflict Minerals Rules, annual reports on Form SD will be required every May 31, with the first report on Form SD due on May 31, 2014. The period covered by the reports will be the calendar year preceding the filing due date, regardless of the issuer's fiscal year.

Definition of Conflict Minerals

Conflict minerals are used in a large number of common products. Under Section 1502 of the Dodd-Frank Act, conflict minerals include cassiterite; columbite-tantalite (coltan); gold; wolframite; tantalum, tin, and tungsten (which are derivatives of other conflict minerals, often called "the 3Ts"); and other

minerals that the United States Secretary of State may determine to be financing conflicts in the DRC and certain other covered countries.

The Conflict Minerals Analysis

Step 1: Determine Issuer's Use of Conflict Minerals

Issuers that are subject to SEC reporting requirements must make two initial determinations in order to determine whether they are required to make disclosures under the Conflict Minerals Rules: (1) whether the issuer manufactures, or contracts to manufacture, a product, and (2) whether conflict minerals are "necessary to the functionality or production" of such product. If both questions are answered in the affirmative, then the issuer will be required to continue to Step 2 of the diligence analysis.

Does the issuer manufacture, or contract to manufacture, a product?

The Conflict Minerals Rules apply only to issuers that manufacture, or contract to manufacture, a product. The Conflict Minerals Rules do not define these terms, but the SEC's adopting release provides some guidance that issuers can use in making these determinations.

> **Manufacture** – In the adopting release, the SEC states that it considers the term "manufacture" to be generally understood, but clarifies that it does not consider an issuer that only services, maintains, or repairs a product containing conflict minerals to be manufacturing the product. The SEC considers issuers who manufacture products through assembly, such as auto and electronics manufacturers, to be covered by the rules.
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> **Contract to Manufacture** – The SEC states that, in general, the determination of whether an issuer has contracted to manufacture will depend on the degree of influence exercised by the issuer over the materials, parts, ingredients, or components to be included in the product, based on the facts and circumstances of the issuer's business and industry. The SEC specifies that issuers should not be viewed as contracting to manufacture if their actions are limited to (a) specifying or negotiating contractual terms with a manufacturer that do not directly relate to the manufacturing of the product, such as training, technical support, or price; (b) affixing their brand, marks, logo, or label to a generic product manufactured by a third party; or (c) servicing, maintaining, or repairing a product manufactured by a third party.

With respect to mining companies, the SEC has clarified that issuers that mine, or contract to mine, conflict minerals are not considered to be engaged in manufacturing unless they are otherwise engaged in manufacturing (either directly or indirectly through contract) in addition to mining.

Are conflict minerals necessary to the product?

Conflict minerals must be necessary to the functionality or the production of the product in order to trigger the Conflict Minerals Rules. Although the Conflict Minerals Rules do not define these terms, the adopting release provides some guidance regarding the interpretation of these terms.

> **Necessary to the functionality** – The SEC provides the following three factors for issuers to consider when making the determination of whether conflict minerals are necessary to the

functionality of a product: (a) whether a conflict mineral is contained in and intentionally added to the product or any component of the product and is not a naturally occurring by-product; (b) whether a conflict mineral is necessary to the product's generally expected function, use, or purpose (for example, the SEC notes that a smart phone has multiple purposes, such as making/receiving phone calls, accessing the internet, and listening to music, and that a conflict mineral that is necessary to any of those purposes is necessary to the functionality of the product); and (c) if a conflict mineral is incorporated for purposes of ornamentation, decoration, or embellishment, whether the primary purpose of the product is ornamentation, decoration, or embellishment (for example, the gold in a gold pendant is necessary for the functionality of the pendant because the purpose of the pendant is for ornamentation).

Necessary to the production – The adopting release states that whether a conflict mineral is necessary to the production of a product must be determined based on the facts and circumstances. The SEC expressly states that the conflict mineral must be contained in the product in order to trigger the Conflict Minerals Rules. Therefore, a conflict mineral used as a catalyst or in another manner related to the production (such as in a physical tool or machine) will not trigger the rules if the mineral does not remain in the final product. Similarly, use of indirect equipment, such as power lines or computers, in the production will not trigger the Conflict Minerals Rules.

There is a limited exception if the conflict minerals were "outside the supply chain" prior to January 31, 2013. Conflict minerals are outside the supply chain if, by January 31, 2013, the minerals either (1) had been fully smelted or refined or (2) were located outside of the covered countries. In such cases, the Conflict Minerals Rules do not apply and no disclosures are required.

There is no de minimis exception for the use of conflict minerals. Therefore, even a very small amount of conflict minerals that is necessary to the production or functionality of a product will bring the issuer's product under the ambit of the Conflict Minerals Rules.

Step 2: Determine Country of Origin of Conflict Minerals

If an issuer determines that it is subject to the Conflict Minerals Rules under Step 1, it must then conduct a "reasonable country of origin inquiry" in order to determine whether the conflict minerals originated in a covered country. The covered countries currently include: the DRC, Angola, Burundi, Central African Republic, the Republic of Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia.

The SEC does not specify standards for a reasonable country of origin inquiry. The adopting release clarifies that the reasonable country of origin inquiry will depend on the issuer's facts and circumstances (including the issuer's size, products, relationships with suppliers, and other factors) and the available infrastructure at the time of the inquiry. The inquiry must be reasonably designed to make the required determination and must be conducted in good faith.

Although it does not prescribe steps for a reasonable country of origin inquiry, the adopting release states that an issuer will have satisfied a reasonable country of origin inquiry if it obtains reasonably reliable representations indicating the facility at which the conflict minerals were processed. The

representations could come from the facility itself or from the issuer's immediate suppliers, but the issuer must have reason to believe that the representations are true based on the facts and circumstances. If the issuer determines that the conflict minerals originated from recycled or scrap materials, the issuer may not be required to trace the origin of the conflict materials further so long as the conflict materials meet certain prescribed requirements.

If, based on the reasonable country of origin inquiry, the issuer determines that the conflict minerals did not originate in a covered country, or originated from recycled or scrap materials, then the issuer is required to file a Form SD disclosing these determinations and describing the reasonable country of origin inquiry. If, however, based on the reasonable country of origin inquiry, the issuer determines that the conflict minerals may have originated in a covered country, or may not have originated from recycled or scrap materials, then the issuer must proceed to Step 3 of the diligence process.

Step 3: Conduct Supply Chain Due Diligence and File Conflict Minerals Report

Any issuer that determines in Step 2 that its conflict minerals originated in a covered country, or may not have come from recycled or scrap material, is subject to heightened due diligence and disclosure on the source and chain of custody of the conflict minerals. The due diligence must follow a nationally or internationally recognized due diligence framework, if such a framework is available for the applicable conflict mineral. To date, the only recognized general due diligence framework is the guidance provided by the Organisation for Economic Co-operation and Development ("OECD"). If additional frameworks are recognized, then the SEC has adopted transition provisions that govern how a company must adjust its due diligence process after the framework becomes available.

If, after appropriate due diligence, the issuer determines that the conflict minerals did not originate in a covered country or did originate from recycled or scrap sources, then the issuer must file a Form SD that includes disclosure regarding the results of the inquiry, a discussion of the due diligence efforts and a discussion of its conflict minerals sourcing policies. In such case, it is not required to file a Conflict Minerals Report.

If the issuer's Step 3 diligence leads to any other conclusion, it must file a Conflict Minerals Report as an exhibit to Form SD. The Conflict Minerals Report requires the issuer to disclose whether, based on appropriate due diligence, the products are "DRC Conflict Free," "Not DRC Conflict Free," or, during the relevant transition period, "DRC Conflict Undeterminable."

> DRC Conflict Free – If the issuer determines that its products did not indirectly or directly benefit an armed group in a covered country, then the issuer may disclose that its products are "DRC Conflict Free." If the conflict minerals were obtained from recycled or scrap sources, they may be categorized as "DRC Conflict Free."
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> Not DRC Conflict Free – If the issuer determines that its products indirectly financed or benefitted an armed group in a covered country, then it must disclose that its products are "Not DRC Conflict Free."

For each of the above two determinations, the Conflict Minerals Report must meet certain certification and disclosure requirements. In addition, the issuer is required to obtain an independent private sector audit of the report. The audit report must include an opinion or conclusion on (i) whether the design of the due diligence process described conforms with a nationally or internationally recognized framework (such as the OECD framework) and (ii) whether the description of the issuer's due diligence measures in the Conflict Minerals Report is consistent with the due diligence process actually undertaken by the issuer.

In order to provide relief for issuers unable to determine the origin of their conflict minerals or whether the conflict minerals financed or benefitted armed groups in a covered country, the SEC created a temporary period during which issuers may state in their Conflict Minerals Report that their products are "DRC Conflict Undeterminable." The temporary relief is available to larger issuers for a two-year period, and to smaller reporting companies for a four-year period. If the issuer's products are "DRC Conflict Undeterminable," the issuer is not required to obtain an independent private sector audit. It will, however, be required to describe the relevant conflict minerals, outline the steps it has taken to mitigate the risk that the conflict minerals benefit armed groups in covered countries, and disclose available information about the origin of the conflict minerals.

Potential Liabilities

The Form SD and its exhibits will be deemed to be "filed" (and not "furnished") for purposes of the Exchange Act, and, as such, will be subject to liabilities under Section 18 of the Exchange Act, which requires that such disclosures not be false or misleading with respect to any material fact.

Challenges to the Conflict Minerals Rules

In October 2012, the National Association of Manufacturers and the Chamber of Commerce of the United States of America (later joined by the Business Roundtable) petitioned the United States Court of Appeals for the District of Columbia Circuit (the "DC Circuit") for review of the Conflict Minerals Rules asking for the rules to be vacated. The petitioners argue that the SEC failed to adequately consider the costs and benefits of the Conflict Minerals Rules and the available alternatives before enacting them and that the SEC misconstrued Congress's intent in the Dodd-Frank Act in its adoption of the Conflict Minerals Rules.

Amnesty International subsequently intervened in the case and a variety of interested parties filed *amicus* briefs, including briefs filed by current and former members of congress in support of the SEC and by various industry groups in support of the petitioners. The case was recently transferred from the DC Circuit to the United States District Court for the District of Columbia on jurisdictional grounds, and arguments are scheduled on motions for summary judgment in early July.

Impact on SWFs

The Conflict Minerals Rules will affect a vast number of issuers, and the costs of compliance, both for issuers and for further down the supply chain, will be substantial. The SEC anticipates that the Conflict Minerals Rules will affect approximately 6,000 issuers. The SEC estimates the cost of initial compliance is to be between $3 billion and $4 billion, with the cost of ongoing compliance to be between $207 million

and $609 million on an annual basis. Compliance will add to overall production costs for both issuers and their suppliers and may impact the financial results of entities in which SWFs have either a direct or indirect interest. Furthermore, failure to comply with the Conflict Minerals Rules may result not only in legal action against the legal issuer, but also in negative publicity for the non-complying issuer, its suppliers, and its investors.

Notes:

[1] See Exchange Act Release No. 67717 (August 22, 2012), available at http://www.sec.gov/rules/final/2012/34-67717.pdf.

[2] See 15 U.S.C. 78m(q)(2)(A).