SEC Issues Final Rule to Implement Dodd-Frank Reporting Requirement Relating to Conflict Minerals

On August 22, 2012, the Securities and Exchange Commission issued its long-awaited final rule under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to the use of conflict minerals.[1] The final rule, which under Dodd-Frank should have been issued April 15, 2011, is intended to reduce the flow of funds from the extraction and sale of certain minerals that have been used to finance armed conflict in the Democratic Republic of Congo (DRC) and surrounding countries by increasing accountability for parties involved in the supply chains for these products.

The final rule will require an estimated 6,000 companies that file annual reports with the SEC to review their supply chains and publicly disclose their use of tantalum, tin, tungsten, and gold, if any of those minerals are "necessary to the functionality or production of a product" that they manufacture or contract to manufacture. The SEC has created a new form for companies to use for their annual disclosures, known as Form SD. The first Form SD will cover the 2013 calendar year, and will be due by May 31, 2014.

While many industries could be affected, manufacturers of electronics, such as mobile phones, digital cameras, and computers, and companies in the automotive, construction, medical equipment, and aerospace sectors utilize large quantities of the four minerals. When issuing the final rule, the SEC estimated that the financial burden would be approximately US$3-$4 billion at the outset for companies to develop their compliance programs, and between US$207 and US$609 million annually for ongoing compliance.[2]

Under the final rule, companies will need to (1) assess whether and how the four minerals are used in their products in order to determine whether they need to file a Form SD; (2) if they are covered, conduct a "reasonable country of origin" inquiry to determine whether the relevant minerals originated in the DRC or an adjoining country; and (3) if the minerals may

1 Conflict Minerals, Release No. 34-67716 (Aug. 22, 2012) (SEC Release), *available at* http://www.sec.gov/rules/final/2012/34-67716.pdf. The final rule will be added to the Code of Federal Regulations, 17 C.F.R. § 240, 249b. "Item" numbers herein refer to the text of the final rule, which appears at pages 342-55 of the SEC Release.

2 In devising its cost estimate, the SEC did not include the likely additional costs borne by companies that do not report to the Commission but form part of a reporting company's supply chain. SEC Release at 332-333.

Contacts

John B. Bellinger III
+1 202.942.6599

Mara V.J. Senn
+1 202.942.6448

Samuel M. Witten
+1 202.942.6115

Khalil Gharbieh
+1 202.942.5982

have originated in the DRC or an adjoining country and may not be from scrap or recycled sources, perform due diligence to determine the minerals' source with the greatest possible specificity and file an independently-audited report in addition to the Form SD. These steps, which are explained more fully below and set forth in detail in the final rule, will require many companies to develop infrastructure to manage vast amounts of supply chain data, prepare compliance reports, and hire outside auditors to evaluate their due diligence efforts.

The final rule was issued after nearly two years of exhaustive deliberation within the Commission and debate in the general public among policy makers, pundits, a wide array of U.S. and international trade groups, foreign governments, manufacturers, and consumers. In total, the SEC reported having received 420 individual comment letters and approximately 13,400 form letters addressing its proposed rule.

The SEC's August 22 vote was split 3-2. The final rule clearly reflects the challenges the Commissioners faced in promulgating a rule in this complex area. It includes a number of refinements based on public comments, such as the possibility of—for a limited time—reporting that whether a company's conflict mineral purchases financed armed groups is "undeterminable." (During the transition period, covered companies still need to file, but may report that they are having trouble determining whether the relevant minerals came from the DRC or an adjoining country, or financed armed groups in those countries.) Despite the SEC's thorough process, questions will abound as companies across the globe try to assess their new obligations.

As expected, groups opposed to the final rule and the inevitable new burdens it will impose are considering their legal options. Litigation is likely, but the rule is final and companies must plan to comply with the rule beginning January 1, 2013.

The following presents a quick primer on key questions that will likely be of concern to many companies. As reflected below, the SEC noted that implementation of various aspects of the rule will require a fact-based inquiry under the standards set forth in the final rule. The questions and answers below are thus not exhaustive, but are meant to highlight the final rule's main provisions and some of the issues companies will need to confront immediately.

I. Does the Rule Cover My Company?

Which companies does the SEC's final rule cover?

The final rule applies to issuers that (1) file reports with the SEC pursuant to Section 13(a) or Section 15(d) of the Exchange Act, and (2) manufacture or contract to manufacture a product for which "conflict minerals" are necessary to the functionality or production of that product. The SEC has estimated that nearly 6,000 domestic and foreign issuers will be affected by the new rule.

What is a "conflict mineral"?

The final rule defines the term "conflict mineral" as "columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives, which are limited to tantalum, tin, and tungsten."[3] Such minerals are referred to as "conflict minerals" under the final rule independent of the location from where they are mined. They are called "conflict minerals" even if they are "DRC conflict free," *i.e.* they do not "directly or indirectly benefit armed groups" in the DRC and adjoining countries: Angola, Burundi, Central African Republic, the Republic of Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia (collectively, Covered Countries).[4]

However, the final rule does not apply to conflict minerals that were outside the supply chain—either because the minerals were outside of the Covered Countries or were smelted or fully refined—prior to January 31, 2013.[5] The final rule also does not apply to conflict minerals derived from recycled or scrap sources, which are defined, respectively, as "reclaimed end-user or post consumer products" and "scrap processed metals created during product manufacturing."[6]

3 Item 1.01(d)(3). The U.S. Secretary of State may identify additional derivatives of the three metal ores if the Secretary determines that such derivatives are financing conflict in the DRC or adjoining countries.

4 Item 1.01(d)(4); SEC Release at 39-40.

5 Item 1.01(d)(7); SEC Release at 128-29.

6 Item 1.01(d)(6); SEC Release at 231.

What does it mean to "manufacture or contract to manufacture" a product?

The SEC did not define the term "manufacture" (noting that it is a term that is "generally understood"),[7] though it indicated that the term does not include mining activities or the mere servicing, maintaining, or repairing of a product that contains conflict minerals.[8] As for "contract[ing] to manufacture," the SEC explained that the term's applicability depends on the degree of influence the issuer exercises over the materials, parts, ingredients, or components to be included in any product containing conflict minerals.[9] Significantly, the SEC provided that it would not view affixing a company brand or label to a generic third-party product as "contracting to manufacture" that product.[10] Similarly, it would not view merely negotiating the price, insurance, training, tech support, or other terms not directly related to the product's manufacture as "contracting to manufacture" that product.[11]

In what circumstances are conflict minerals "necessary to the production" of a product?

The SEC explained that conflict minerals can only be "necessary to the production" of a product if the completed product contains conflict minerals.[12] Importantly, the SEC declined to specify a *de minimis* threshold for the conflict mineral content in a product, despite requests from some commentators to do so. However, the Commission excluded from the final rule's purview products that are merely created using conflict minerals as catalysts, or using tools or machines which themselves contain conflict minerals.[13] The SEC also identified as a relevant factor whether the conflict mineral "is intentionally added in the product's production process, including the production process of any component of the product."[14] This standard, like many others, is likely to be discussed and analyzed heavily as companies attempt to determine whether they are covered under the final rule.

7 SEC Release at 60.
8 *Id.* at 60, 70.
9 *Id.* at 64-65.
10 *Id.* at 65.
11 *Id.*
12 *Id.* at 83.
13 *Id.* at 85, 89-94.
14 *Id.* at 82.

In what circumstances are conflict minerals "necessary to the functionality" of a product?

Whether conflict minerals are "necessary to the functionality" of a product is likewise a fact-dependent inquiry. The SEC listed the following factors as potentially determinative, either individually or in the aggregate: "(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; or (c) if a conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration."[15]

II. My Company Is Covered. What Does the Rule Require?

What must a covered company do to determine whether its conflict minerals originated in the DRC or adjoining countries?

The final rule provides that a covered company must carry out a reasonable country-of-origin inquiry (RCOI), which must be reasonably designed to determine whether (1) its conflict minerals originated in Covered Countries, and (2) whether such minerals came from recycled or scrap sources.[16] The steps required will vary depending on the issuer's industry and circumstances, but for most filers will likely involve at a minimum contacting each of its relevant suppliers to inquire about their conflict minerals' country of origin.

The RCOI must be conducted in good faith. The SEC indicated that an issuer need not achieve complete certainty nor receive representations from all of its suppliers that minerals do not originate in Covered Countries. Moreover, the Commission stated that an issuer could reasonably rely on representations from processing facilities that have been designated "conflict-free" by an independent auditor or recognized industry group.[17] That said, an issuer cannot ignore warning signs, such as when a smelter claims that

15 *Id.*
16 Item 1.01(a).
17 SEC Release at 150.

its minerals were sourced from several countries, including one of the Covered Countries.[18]

If, upon completing the RCOI, an issuer determines that its conflict minerals did not originate in the Covered Countries, or that they came from recycled or scrap sources, only limited further action is required. Since the SEC has acknowledged the difficulty of "proving a negative," a lesser burden applies even if the issuer can only determine that it "has no reason to believe its conflict minerals may have originated in the Covered Countries," or that it "reasonably believes its conflict minerals are from recycled or scrap sources." Under these circumstances, an issuer must only disclose its determination and briefly describe the RCOI and its results in the new specialized disclosure form, known as "Form SD."[19]

If an issuer does have reason to believe that its conflict minerals originated in the Covered Countries (and did not come from scrap or recycled sources), then it must exercise due diligence on the source and chain of custody of its conflict minerals and file a Conflict Minerals Report as an exhibit to its Form SD, as described in Section III below.[20]

What is a "Form SD" and when is it due?

The final rule requires covered companies to submit their conflict minerals disclosures on the newly-created Form SD, and not in their annual 10-K, 20-F, or 40-F reports.[21] The disclosure is due by May 31 of each year irrespective of a company's fiscal year-end, and addresses conflict minerals present in products for which manufacturing was completed in the preceding calendar year.[22]

18 *Id.* at 147-57.

19 Item 1.01(b); SEC Release at 151-52, 162.

20 Item 1.01(c); SEC Release at 152.

21 A copy of the new Form SD and instructions on its use are available at pages 344-46 of the SEC's Release. Notably, resource extraction issuers will also use the new Form SD to disclose certain payments made to the U.S. government or foreign governments for commercial rights to oil, natural gas, and minerals under the SEC final rule implementing Section 1504 of Dodd-Frank—a final rule which the SEC also approved on August 22, 2012. However, the Section 1504 Form SD reporting timeline differs from that of the Section 1502 (conflict minerals) Form SD: the former covers the issuer's fiscal year (beginning in fiscal years ending after September 30, 2013) and is due no later than 150 days after its fiscal year end, while the latter covers a calendar year (beginning January 1, 2013) and is due annually by May 31.

22 SEC Release at 106, 122-23.

In addition to filing Form SD with the SEC, the issuer must post the form on its website for one year and include the website address on its Form SD. Again, depending on the outcome of an issuer's RCOI, it may need to submit a Conflict Minerals Report as an exhibit to its Form SD (and also post the report on its website for one year).

The SEC declined many commentators' request for a phase-in period, which would have delayed the final rule's effective date. Covered companies must submit their first Form SD by May 31, 2014, which must address products for which manufacturing was completed during the 2013 calendar year.[23]

What are the potential penalties for misleading statements or noncompliance?

The final rule requires that issuers "file" their Form SD disclosure and Conflict Minerals Report rather than merely "furnish" them to the Commission, thereby triggering potential liability under Section 18 of the Exchange Act. That section permits private parties to sue issuers for damages caused by their reliance on false or misleading statements in a filed document.[24] Issuers that fail to comply with the final rule would violate their reporting obligations under Exchange Act Section 13(a) or 15(d), in addition to those under the conflict mineral statute.[25]

III. What Does a Conflict Minerals Report Involve?

For what companies is a Conflict Minerals Report necessary?

If, after its RCOI, an issuer knows or has reason to believe that its conflict minerals originated in the Covered Countries and did not come from scrap or recycled sources, it must exercise due diligence on the source and chain of custody of its conflict minerals and, in most instances, produce a Conflict Minerals Report describing such due diligence measures. The aim of such required measures is to trace the minerals' path from mine to smelter or refiner in order to determine whether the minerals financed or benefitted armed groups.

23 *Id.* at 120.

24 15 U.S.C. § 78r(a).

25 *See* SEC Release at 117 & n.342.

What is the applicable standard for due diligence required for a Conflict Minerals Report?

The final rule requires that an issuer's due diligence follow a nationally or internationally recognized framework.[26] The SEC noted that the Organisation for Economic Co-operation and Development's "Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas" (OECD Guidance) is presently the only internationally-recognized document of which it is aware.[27] However, the final rule does not mandate that issuers use the OECD Guidance. Moreover, the SEC acknowledged that issuers may need to use disparate due diligence procedures for different conflict minerals or different aspects of its supply chain, and stated that issuers should simply describe the various due diligence procedures employed.[28]

What are the possible outcomes following the exercise of due diligence?

- **Conflict Minerals Are Not from Covered Countries.** Upon exercising due diligence, if an issuer (1) determines that its conflict minerals in fact did not originate in the Covered Countries or in fact came from scrap or recycled sources, or (2) no longer has any reason to believe that its conflict minerals originated in the Covered Countries or now reasonably believes the conflict minerals came from scrap or recycled sources, then a Conflict Minerals Report is no longer necessary. The issuer can file its Form SD with a description of its RCOI and the results, without any exhibit.
- **Conflicts Minerals Are DRC Conflict Free.** If an issuer determines that conflict minerals originated in the Covered Countries but did not finance or benefit armed groups, then its minerals are "DRC conflict free." It must then submit a report from an independent private sector auditor as part of its Conflict Minerals Report, certifying that such an audit was obtained and identifying the auditor.
- **Conflict Minerals Are Not DRC Conflict Free.** Where an issuer cannot determine that its conflict minerals did not finance or benefit armed groups, its minerals are "not DRC conflict free." In addition to an independent private sector audit, the issuer's Conflict Minerals Report must include a description of the facilities used to process conflict minerals, the country of origin of those conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity.[29] The Conflict Minerals Report must also include a description of the issuer's products that are not "DRC conflict free."[30]
- **DRC Conflict Undeterminable.** For 2014 and 2015, the first two years in which conflict mineral disclosures are due—and for the first four years for smaller reporting companies[31]—issuers have the option to report that they cannot determine whether their conflict minerals financed or benefited armed groups.[32] If so, the issuers need not obtain an independent private sector audit, but must submit a Conflict Minerals Report describing its products which are "DRC conflict undeterminable" and providing the same due diligence information mentioned above: a description of the facilities used to process conflict minerals, the country of origin of those conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity. In addition, such issuers must explain the steps they will take or have taken since their last Conflict Minerals Report to mitigate risks that their conflict minerals finance armed groups.[33]

What will be the responsibilities of auditors?

To qualify to audit an issuer's Conflict Minerals Report, an auditor must meet the Government Accountability Office's

26 Item 1.01(c)(1)(i).

27 SEC Release at 28, 206-08; OECD, Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (2011), *available at* http://www.oecd.org/dataoecd/62/30/46740847.pdf

28 SEC Release at 206-08.

29 Item 1.01(c)(2).

30 *Id.*

31 Such companies must meet the "small business issuer" criteria enumerated in 17 C.F.R. 240.12b-2, including annual business revenue of less than US$25 million.

32 Item 1.02(2); SEC Release at 186-89.

33 SEC Release at 186.

independence requirements.[34] Under the final rule, a Conflict Minerals Report audit has two objectives: (1) to evaluate whether the design of the issuer's due diligence process conforms to the due diligence framework the issuer claims to employ; and (2) to evaluate whether the due diligence measures the issuer actually performed are consistent with its stated process.[35] Auditors must apply Government Accountability Office's generally accepted government auditing standards (GAGAS).[36]

Looking Ahead

By any measure, the rule will present challenges across a wide array of industries. Companies need to begin to consider the key threshold issues of who is covered, what the framework for due diligence needs to be, the possible outcomes of due diligence inquiries, when independent auditing will be required and what the scopes of those audits need to be, and what the deadlines and requirements are for compliance.

Beyond the immediate domestic impact of the SEC's final rule, it is important to note that other countries and international organizations will be looking closely at the SEC's action, which could influence corporate social responsibility initiatives elsewhere. The sustained interest in conflict mineral regulation in multiple parts of the world suggests that the release of the SEC's final rules may usher in a proliferation of related initiatives that could have an impact on multinational companies subject to the jurisdiction of countries that issue such rules.[37]

34 *Id.* at 215.

35 *Id.* at 217-18.

36 U.S. Gov't Accountability Office, GAO-12-331G, Government Auditing Standards 2011 Revision (Dec. 2011), *available at* http://www.gao.gov/assets/590/587281.pdf.

37 A prior Arnold & Porter Advisory discussed interest in conflict mineral legislation in the European Union and elsewhere, and noted that the SEC's rules would be studied by other jurisdictions considering similar legislation or rules. *See* SEC's Forthcoming Conflict Mineral Rules Form Part of Emerging Regulatory Landscape (Oct. 2011), *available at* http://www.arnoldporter.com/public_document.cfm?id=18017&key=19H1.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

John B. Bellinger III
+1 202.942.6599
John.Bellinger@aporter.com

Mara V.J. Senn
+1 202.942.6448
Mara.Senn@aporter.com

Samuel M. Witten
+1 202.942.6115
Samuel.Witten@aporter.com

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Khalil.Gharbieh@aporter.com