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A Primer for Public Companies on the New Conflict Mineral Reporting Rules

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In August 2012, the SEC adopted rules requiring most public companies to provide disclosures about their use of "conflict minerals" that originate in the Democratic Republic of the Congo (DRC) or an adjoining country. These rules were required by Section 1502 (the Conflict Minerals Statutory Provision) of the Dodd-Frank Wall Street Reform and Consumer Protection Act which added Section 13(p) to the Securities Exchange Act of 1934. After considerable debate and input from various parties, in August 2012, the SEC adopted (by a 3–2 vote) new rules and a new form relating to the use of conflict minerals.

The new rules impose additional disclosure requirements on issuers that use conflict minerals in, or to produce, their products. The SEC estimates that approximately 6,000 companies could be impacted by the new rules, with initial compliance costs of between U.S. $3 billion and U.S. $4 billion (compared to some industry estimates ranging up to U.S. $16 billion). The new rules are controversial in part because they involve using the U.S. securities laws and the SEC's exercise of its rulemaking authority to promote the humanitarian goal of ending the conflict in the DRC. Thus, it is not surprising that in mid-October, the National Association of Manufacturers and the U.S. Chamber of Commerce filed suit in the U.S. Court of Appeals for the District of Columbia challenging several aspects of the new rules. It does not appear that the SEC will stay the conflict minerals rules. However, given the recent elections, it seems prudent for companies to proceed as if the new rules will be implemented on schedule.

The implementation date for the new rules is January 1, 2013, with affected issuers submitting the initial Form SD by May 31, 2014. Companies are therefore urged to consider the impact of the new rules immediately.

The new rules adopt a three-step analytic process to guide issuers through the applicable disclosure requirements, with each step building on the prior step. (See Annex A, a flowchart summarizing the steps and related disclosures required by the new rules.) Depending on the outcome of the three-step analytic process, an issuer may have to submit a report to the SEC that includes a description of the measures it took to exercise due diligence on the conflict mineral's source and chain of custody. To facilitate the new disclosure required by the rules, the SEC has also adopted a new Form SD. The new rules contain a temporary category for a transition period of two years for all issuers and four years for smaller reporting companies.

We believe that many issuers subject to the new rules will have to develop special risk management or supply chain management programs. To assist companies in assessing their need to file Form SD and, if required, in developing these procedures and programs, we provide a summary of the new rules below.

Why Congress Required the Rules

In enacting the Conflict Minerals Statutory Provision, Congress indicated

that it intended to further the humanitarian goal of ending the long and extremely violent conflict in the DRC, which has been partially financed by the exploitation and trade of conflict minerals originating in the DRC. Congress's main purpose in adopting Section 1502 of the Dodd-Frank Act was to inhibit the ability of armed groups in certain countries to fund their activities by exploiting the global trade in these minerals. By reducing the use of such conflict minerals, Congress hoped to help reduce funding for these armed groups and thereby pressure them to end the conflict. Indeed, Section 1502(a) of the Dodd-Frank Act explains that the exploitation and trade of conflict minerals by armed groups is helping to finance the conflict and that the emergency humanitarian crisis in the region warrants these new disclosure requirements. To accomplish its goal, Congress chose to use the Exchange Act's disclosure requirements, which would raise public awareness about the origins of issuers' conflict minerals and would promote the exercise of due diligence on conflict mineral supply chains. However, unlike most SEC rules, the SEC observed that the purpose of the new rules is to achieve a social benefit.

Application of the New Rules

The new rules apply to substantially all issuers that file reports with the SEC under Section 13(a) or Section 15(d) of the Exchange Act. The rules apply equally to domestic companies, foreign private issuers, and smaller reporting companies. They do not apply to registered investment companies. The new rules adopt a three-step analytic process, in which each step builds on the prior step. Depending on the outcome of the three-step analytic process, an issuer may have to submit a report to the SEC that includes a description of the measures it took to exercise due diligence on the conflict mineral's source and chain of custody. We outline the three steps below.

Step One:

The first step is for an issuer to determine whether there are any conflict minerals that are "necessary to the functionality or production" of a "product" "manufactured or contracted to be manufactured" by that issuer. As part of this analysis, an interpretive question that we have encountered is exactly what is a product? While the SEC did not define these important terms, it provided some guidance that helps with this analysis as described below.

Whether an issuer will be deemed to "contract to manufacture" a product depends on the degree of influence it exercises over the materials, parts, ingredients, or components to be included in any product that contains conflict minerals or their derivatives. The SEC guidance indicates that an issuer will not be considered to "contract to manufacture" a product if it does no more than take the following actions:

> (1) Specifies or negotiates contractual terms with a manufacturer that do not directly relate to the manufacturing of the product (unless it specifies or negotiates taking these actions so as to exercise a degree of influence over the manufacturing of the product that is practically equivalent to contracting on terms that directly relate to the manufacturing of the product);
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> (2) Affixes its brand, marks, logo, or label to a generic product manufactured by a third party; or
>
> (3) Services, maintains, or repairs a product manufactured by a third party.

The determination of whether a conflict mineral is deemed "necessary to the functionality" or "necessary to the production" of a product depends on the issuer's particular facts and circumstances. In determining whether a conflict mineral is "necessary to the functionality" of a product, an issuer should consider:

> (1) Whether the conflict mineral is intentionally added to the product or any component of the product and is not a naturally occurring by-product;
>
> (2) Whether the conflict mineral is necessary to the product's generally expected function, use, or purpose; and
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> (3) If the conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration.

In determining whether a conflict mineral is "necessary to the production" of a product, an issuer should consider:

> (1) Whether the conflict mineral is intentionally included in the product's production process, other than if it is included in a tool, machine, or equipment used to produce the product (such as computers or power lines);
>
> (2) Whether the conflict mineral is included in the product; and
>
> (3) Whether the conflict mineral is necessary to produce the product.

For a conflict mineral to be considered "necessary to the production" of a product, the mineral must be both actually contained in the product and necessary to the product's production. Accordingly, the rules do not apply to the tools, machines or equipment used to produce a product (assuming they are not contained in the product). Conflict minerals that are used as a catalyst or in a similar manner in another process are provided a limited exemption from the new rules. If an issuer determines that its products do not involve contain conflict minerals after undertaking the analysis described above, the issuer is not required to take any action, make any disclosure, or submit any reports under the new rules.

In addition, the SEC has clarified that a "product" for purposes of these rules is an item that the issuer places into the stream of commerce by offering it to third parties for consideration. So, for example, the

rules do not apply to prototypes or demonstration materials.

Step Two:

If an issuer determines that it has a product captured by step one described above, it will have additional disclosure obligations and will need to proceed with the analysis to determine the nature and extent of its disclosure obligations. Specifically, such an issuer is required to conduct a "reasonable country of origin inquiry" (RCOI) and thereafter file a Form SD. The RCOI is intended to determine whether the conflict minerals in the issuer's products originated from a "Covered Country" or from recycled or scrap sources. The SEC did not provide guidance on the actions an issuer must take in order to undertake a RCOI; instead, it noted that each such inquiry depends upon the issuer's facts and circumstances. The final rules clarify that any RCOI must be undertaken in "good faith" by an issuer. While the SEC did not prescribe the steps required for a RCOI, it did note that an issuer would satisfy the RCOI standard if it "seeks and obtains reasonably reliable representations indicating the facility at which its conflict minerals were processed and demonstrating that those conflict minerals did not originate in Covered Countries or were from recycled or scrap sources."

After conducting the RCOI, the issuer must file a Form SD. The disclosures in the Form SD will vary depending on the findings of the RCOI. If, based on the RCOI, an issuer (a) knows that its conflict minerals did not originate in the Covered Countries or did come from recycled or scrap sources, or (b) has no reason to believe that the conflict minerals may have originated in the Covered Countries and may not be from recycled or scrap sources, then the issuer is required to file a Form SD, but it is not required to prepare or file the more detailed Conflict Minerals Report discussed below. The Form SD should (1) disclose the issuer's determination, (2) describe the RCOI it undertook in reaching the determination, and (3) disclose the results of the inquiry. The issuer is also required to make its description publicly available on its Internet website and provide its Internet URL in the Form SD.

Step Three:

After conducting step two, a due diligence obligation arises. If, based on its RCOI, an issuer knows or has reason to believe that the conflict minerals (1) may have originated in the Covered Countries and (2) may not be from recycled or scrap sources, then the issuer must undertake "due diligence" on the source and chain of custody of its conflict minerals as described below in the third step. A company's due diligence is required to conform to a nationally or internationally recognized due diligence framework. As a starting point, the SEC has indicated that the OECD Due Diligence Guidance satisfies the new rules and may be used. It is also likely that other standards may develop over time.

If at this phase, the issuer determines that its conflict minerals did originate from a Covered Country or the issuer has reason to believe that such minerals may have originated in a Covered Country and are not from recycled or scrap sources, it is required to file a Conflict Minerals Report with its Form SD. The Conflict Minerals Report will state the issuer's determination as to whether its products are (1) "DRC Conflict Free" or (2) "Not DRC Conflict Free." The Conflict Minerals Report must be audited under a standard set forth in the final rules.

If the issuer is unable to determine whether the conflict minerals in its products originated in a Covered County or financed or benefitted armed groups in Covered Countries, the final rules also provide for a temporary category: – "DRC Conflict Undeterminable." This temporary category is available for a transition period of two years for all issuers and four years for smaller reporting companies. During this period, issuers may describe their products as "DRC Conflict Undeterminable" if they are unable to determine that their minerals meet the statutory definition of "DRC Conflict Free" for either of two reasons:

> (1) They proceeded to step three based upon the conclusion, after their RCOI, that they had conflict minerals that originated in the Covered Countries and, after the exercise of due diligence, they are unable to determine if their conflict minerals financed or benefited armed groups in the Covered Countries, or
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> (2) They proceeded to step three based upon the conclusion, after their RCOI, that they had a reason to believe that their conflict minerals may have originated in the Covered Countries and may not have come from recycled or scrap sources and the information they gathered as a result of their subsequently required exercise of due diligence failed to clarify:
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> > (a) the conflict minerals' country of origin,
> > (b) whether the conflict minerals financed or benefited armed groups in those countries, or
> > (c) whether the conflict minerals came from recycled or scrap sources.

However, if these products also contain conflict minerals that the issuer knows directly or indirectly financed or benefited armed groups in the Covered Countries, the issuer may not describe those products as "DRC Conflict Undeterminable." Also, during the transition period, issuers with products that may be described as "DRC Conflict Undeterminable" are not required to have the otherwise required audit of the conflict minerals diligence. Such issuers, must still file a Conflict Minerals Report describing their due diligence, and must additionally describe the steps they have taken or will take, if any, since the end of the period covered in their most recent prior Conflict Minerals Report, to mitigate the risk that their conflict minerals benefit armed groups, including any steps to improve their due diligence.

Example: An issuer has conducted due diligence because, based on its RCOI, it has reason to believe that its necessary conflict minerals may have originated in the Covered Countries and may not have come from recycled or scrap sources. The issuer has determined that its conflict minerals did not, in fact, originate in the Covered Countries, or it determined that its conflict minerals did, in fact, come from recycled or scrap sources.

Question: Is such an issuer required to submit a Conflict Minerals Report?

Answer: No. That issuer is not required to submit a Conflict Minerals Report. However, that issuer is still required to submit a Form SD disclosing its determination and briefly describing its inquiry and its due diligence efforts and the results of that inquiry and due diligence efforts, which should demonstrate why the issuer believes that the conflict minerals did not originate in the Covered Countries or that they did come from recycled or scrap sources.

Miscellaneous Information about New Filing Obligations

Reporting on a Form SD is based on a calendar year for all issuers. An issuer with conflict minerals necessary to the functionality or production of a product it manufactures or contracts to be manufactured is required to file its Form SD by May 31 of each year, reporting on the preceding calendar year. The Form SD, including the Conflicts Minerals Report, if required, is considered "filed" for the purposes of Section 18 of the Exchange Act. An issuer must make its conflict minerals disclosure or its Conflict Minerals Report available on the issuer's Internet website for one year.

The final rule allows issuers that obtain control over a company that manufactures or contracts for the manufacturing of products with conflict minerals that previously had not been obligated to provide a Form SD for those minerals to delay reporting on the acquired company's products until the end of the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition.

Conclusion

The debate continues about using the U.S. securities disclosure laws and the SEC's exercise of its rulemaking authority to promote the humanitarian goal of ending the conflict in the DRC. It remains to be seen whether the activities of the parties causing the human rights abuses will be curtailed by the new rules. What is certain is that the new rules will apply broadly and be costly. Given the wide use of conflict minerals in products, many companies will be required to undertake at least part of the three-step analytic process in determining how the new rules apply to them, with some issuers incurring substantial ongoing costs. Many companies have been working on these issues for several months, while others are at the beginning of the assessment process.

Companies should be evaluating their products under the "first step" test to determine whether conflict minerals are "necessary for the functionality or production" of these products. We expect that best practices regarding the new rules will develop over time (including such items as supplier certifications, contractual representations and third-party verification of refineries and smelters as "DRC Conflict Free") to assist issuers undertaking this process.

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Definition of "Conflict Minerals":

The term "conflict mineral" is defined in Section 1502(e)(4) of the Dodd-Frank Act as (1) columbite-tantalite, also known as coltan (the metal ore from which tantalum is extracted), cassiterite (the metal ore from which tin is extracted), gold, wolframite (the metal ore from which tungsten is extracted), or their derivatives; or (2) any other mineral or its derivatives determined by the secretary of state to be financing conflict in the DRC or an adjoining country. The new reporting requirements apply to these four minerals and their derivatives of tantalum, tin, and tungsten. These minerals are used in a wide variety of products, including electronic components and circuit boards, various tools, jet engine components, jewelry, wires, electrodes, and electrical contacts. Given the wide use of conflict materials, various industry organizations have estimated that up to 6,000 companies will be directly affected by these new rules, and a much larger number of participants in the supply chain will be indirectly affected.

Definition of "Adjoining Country":

The term "adjoining country" is defined in Section 1502(e)(1) of the Dodd-Frank Act as a country that shares an internationally recognized border with the DRC, which currently includes Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia. In the proposing release, the SEC referred to the DRC and its adjoining countries as the "DRC Countries." In the final rules, the SEC used the term "Covered Countries" instead. The SEC indicated that both terms have the same meaning.

Important Links:

The adopting release for this rule can be found on the SEC's website at www.sec.gov/rules/final/2012/34-67716.pdf.

The SEC's disclosure forms can be accessed on the agency's website at www.sec.gov/about/forms/secforms.htm

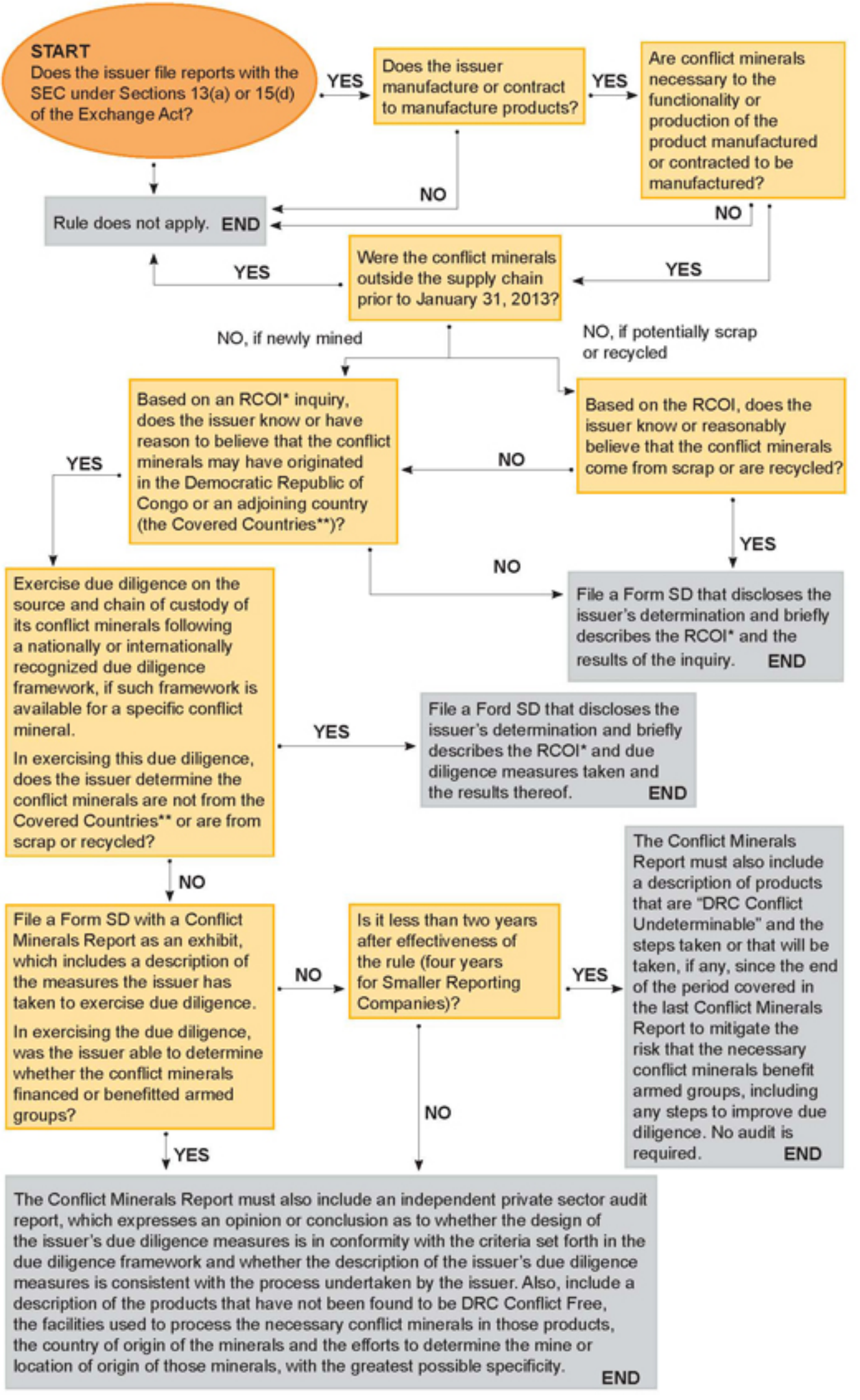
Section 1502 of the Dodd-Frank Act can be found at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

The OECD Due Diligence Guidance is available at www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/46740847.pdf.

The gold supplement to the OECD Due Diligence Guidance is available at www.oecd.org/corporate/guidelinesformultinationalenterprises/FINAL%20Supplement%20on%20Gold.pdf.

The GAO's Government Auditing Standards are available at www.gao.gov/assets/590/587281.pdf.

FLOWCHART SUMMARY OF THE SEC'S FINAL RULE ON THE USE OF CONFLICT MINERALS



Based on information in SEC Release No. 34-67716; File No. S7-40-10

* Reasonable Country of Origin Inquiry

** The Covered Countries are described as countries that share an internationally recognized border with the Democratic Republic of Congo – at present, Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia