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Client Alert

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Why the SEC's New Conflict Minerals Rules Scare Me (And Why They Should Scare You)

You've probably seen a number of articles addressing the SEC's new disclosure requirements relating to conflict minerals, implemented pursuant to Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Although the basics are deceptively simple, once you dig a little deeper, you realize there's a lot hidden beneath surface. I've listed some of the top concerns below, followed by a summary of each and a description of the basics of the SEC's final rule:

- **The Rule May Apply to You Even Though You're Certain That It Doesn't**
- **This is not Your Typical Disclosure Rule—Conflict Minerals are Now Potentially Per Se Material**
- **You Will Need a Team of Employees and/or Consultants from a Cross-Section of the Organization to Comply with the Rule**
- **Unless You Have Absolutely No Products to Which the Rule Applies, You Will Have to Develop and Make Public a Conflict Minerals Policy**
- **Compliance is Going to be Expensive**
- **There are Things You Can Do Now to Avoid Application of the Rule or to Lessen the Costs of Compliance with it, But Time is Running Out**
- **Although Requirements are Relaxed During a Phase-In Period, Audits May Still be Required with Respect to the First Report Due for Calendar 2013**
- **Form SD and the Conflict Minerals Report Are Filed, Not Furnished.**

The Basics

- Conflict minerals are currently defined to be, in simplest terms, gold, tin, tantalum and tungsten.

- The SEC rule applies to issuers ("covered issuers") registered under the Securities Exchange Act of 1934 that manufacture or contract to manufacture products that contain conflict minerals that are necessary to their functionality or production.

- Covered issuers must initially conduct a "reasonable country of origin inquiry" to determine if the conflict minerals originated in The Democratic Republic of the Congo or adjoining countries or came from scrap or recycled sources.

- If, following such inquiry, the issuer has reason to believe that its conflict minerals may have originated in the covered countries and may not have come from scrap or recycled sources, the issuer must conduct due diligence on the source and chain of custody of its conflict minerals.

- All covered issuers must file a Report on Form SD, and depending upon the results of the above inquiry/due diligence, covered issuers will be required to include a conflict minerals report containing additional, more detailed information. All filed information must be posted on the issuer's website, as well.

- Those issuers required to perform due diligence will be required to represent whether their covered products are or are not "DRC conflict free," or for a limited two-year period (four years for small business issuers), are "DRC conflict undeterminable." The final rule defines a "DRC conflict free" product to mean a product that does not contain conflict minerals necessary to the functionality or production of the product that directly or indirectly finance or benefit defined armed groups in the covered countries.

- Again, depending on the results, those issuers conducting due diligence may be required to have an independent auditor audit whether their due diligence efforts were in conformity with, in all material respects, the criteria set forth in the due diligence framework utilized, and whether the issuer's description of the due diligence measures it performed is consistent with the due diligence process it undertook.

- These reporting requirements become effective for the calendar year 2013, with the first reports due to be filed on May 31, 2014.

The Concerns

- **The Rule May Apply to You Even Though You're Certain That It Doesn't**

The conflict minerals rule does not define the terms "product," "manufacture," "contract to manufacture,"

"necessary to the functionality" or "necessary to the production." As a result, a number of key interpretive questions remain unanswered. For example, if you sell tomato soup, is your product the soup or is it a (tin) can of soup? The answer is obviously very important in determining whether or not your product contains conflict minerals. Taking the question further, if you produce a decorative holiday package for your product, such as a collector's tin of cookies, could that change the answer and possibly cause the package to become the product? In addition, if you're a wholesaler that simply resells products, you could be covered to the extent that you exercise control over the manufacturing process. How much control is enough? The final release says that whether an issuer is deemed to contract to manufacture a product depends on (i) whether the issuer exerts "some actual influence" over the manufacturing of the product and (ii) the degree of influence that it exercises over the parts, materials, ingredients or components of a product. The degree of influence required will depend on the issuer's individual facts and circumstances. Taking the soup example, if the issuer exercises control over the quality of the soup, but not the can, could that be enough to subject the issuer to the rule? The final release notes that the degree of control that is sufficient to subject an issuer to the rule does not have to be "substantial." Hopefully, some of these interpretive issues will be addressed by the SEC staff, but most issuers can't wait until the interpretations are published to start thinking about these issues. Those that do may find that they've missed an opportunity to take proactive action now, as discussed further below.

- **This is not Your Typical Disclosure Rule—Conflict Minerals are Now Potentially Per Se Material**

Most disclosure rules are designed to elicit information that is important to investors in making decisions about whether to buy or sell an issuer's securities or whether to vote their shares, generally based on financial, executive compensation and corporate governance-related information. The conflict minerals rule is designed with one purpose in mind: to help dissuade issuers from making business decisions (i.e., the purchase of conflict minerals) that will result in money being funneled to support armed groups that are perpetrators of human rights abuses in the covered countries, and as a result, to further the humanitarian goal of ending the violent conflict in those countries. To the extent investors do care about an issuer's use of conflict minerals, it is likely to be for these humanitarian reasons, and not for the reasons investors typically evaluate an issuer's performance. As a result, the conflict minerals rules may result in significant expenditures as well as management time and effort being directed towards an area that an issuer's investors may not find of particular concern or interest and which may only relate to a very small portion of the issuer's business. **There is no de minimis exception of any type to this rule.** For some companies, it is possible that the cost of complying with the rule could exceed the profits or even the revenues from covered products. Despite the fact that conflict minerals impact a small, seemingly immaterial portion of an issuer's business, that does not mean that the issuer will not be required to devote a material amount of money and management time to investigating the applicability of and complying with the rule.

- **You Will Need a Team of Employees and/or Consultants from a Cross-Section of the Organization to Comply with the Rule**

Typical disclosure rules are addressed primarily by legal and financial personnel. Information is frequently gathered throughout an organization, but the brunt of the analysis and work is born by legal and accounting staff. Not so with the conflict minerals rule. You will in effect be building a compliance program: developing policies, performing a "deep dive" into your supply chain (in order to conduct reasonable country of origin inquiries and due diligence) and evaluating not just legal disclosures but public relations issues, manufacturing and purchasing decisions and perhaps product sales or discontinuation decisions. As such, you will likely need the involvement of top management, purchasing, finance, engineering, production control, investor and public relations, and logistics personnel, as well as legal staff. Coordinating such a large group of individuals from such diverse areas will require significant advance planning. In addition, issuers may require outside consultants in all of these areas, as well as independent auditors. Creating an external cross-functional team adds even more complexity to the process, and with limited resources available, the longer issuers wait, the more difficult it may become to assemble the necessary resources.

- **Unless You Have Absolutely No Products to Which the Rule Applies, You Will Have to Develop and Make Public a Conflict Minerals Policy**

The final rule states that an issuer's policies with respect to the sourcing of conflict minerals will generally form a part of the issuer's reasonable country of origin inquiry, and as a result will generally be required to be disclosed on Form SD. Organization of Economic Co-operation and Development (OECD) guidelines, which are currently the only acceptable due diligence guidelines for compliance with the rule, provide that as part of a due diligence framework, issuers should adopt and clearly communicate to suppliers and the public a company policy for the supply chain of minerals originating in conflict-afflicted and high risk areas. The policy should incorporate the standards against which due diligence is conducted. The content of the policy can vary greatly, from a decision to exclude conflict minerals from all products to a mere recognition of the issue; however, development of a public company policy will require input from top management and is not something that should be rushed or can be undertaken lightly. Policy decisions can have true economic impact on the issuer's business, whether through decisions that result in increased product costs or that eliminate non-material but profitable products, or as a result of boycotts or other bad publicity that could follow the announcement of a policy that does not minimize the risk of an issuer's products contributing to human rights abuses. Because of the potentially significant impact of these policy decisions, top management and the board of directors will need to understand the rule and support the policy.

- **Compliance is Going to be Expensive**

The SEC estimates that approximately 6000 issuers will be directly impacted by the rule, and that the initial compliance costs for the conflict minerals rule will be about $3 to $4 billion across all affected companies, with estimates for ongoing compliance costs at about $200 to $600 million annually. Private sources

have speculated that costs could be significantly greater, with some estimating as high as $16 billion. It is likely that most impacted issuers will need to allocate significant funding in their budgets for fiscal years covering calendar 2013.

- **There are Things You Can Do Now to Avoid Application of the Rule or to Lessen the Costs of Compliance with it, But Time is Running Out**

The rule applies to products manufactured after January 1, 2013; however, products that contain conflict minerals that are outside the supply chain (i.e., smelted or refined or physically removed from the covered countries) as of January 31, 2013 are exempt from the rule. As a result, in addition to decisions regarding whether products containing conflict minerals may be discontinued or reconfigured to exclude conflict minerals or whether such products that remain in production will be required to be manufactured using conflict minerals that are not sourced from the covered countries, issuers should also consider whether necessary conflict minerals can be procured and taken outside the supply chain prior to the January 31, 2013 cut off. Also, the time is now to begin communications with suppliers. At a minimum, suppliers should be notified that the issuer is developing a compliance program to respond to the rule, that the supplier will be an integral part of that program and that the issuer will be following up soon with the details of its policy and requests for information. It's important to gain an early understanding of the complexity of your supply chain. Remember that it may be necessary to reach back through a stream of numerous indirect suppliers in order to reach a reasonable conclusion regarding country of origin. In addition, issuers need to consider now whether they are going to change the terms of standard supply contracts, purchase orders or RFPs, or perhaps switch suppliers, in order to comply with the issuer's policy or to minimize the risk that conflict minerals that contribute to human rights abuses will be used in their products.

- **Although Requirements are Relaxed During a Phase-In Period, Audits May Still be Required with Respect to the First Report Due for Calendar 2013**

Issuers that are required to conduct due diligence because their reasonable country of origin inquiry results in a belief that their conflict minerals have or may have originated in the covered countries and may not come from recycled or scrap sources will generally be required to obtain an audit report unless their due diligence efforts result in a conclusion that the conflict minerals did not originate in the covered areas or did come from recycled or scrap sources; provided, however, that for the first two calendar year periods covered by the rule (four years for smaller reporting companies), issuers that are unable to determine if their conflict minerals are "DRC conflict free" for specified reasons, including because their due diligence efforts have not clarified the minerals' countries of origin, whether the minerals financed or benefited armed groups in the covered countries, or whether they came from recycled or scrap sources, are not required to have their due diligence efforts audited. (Note that the price to be paid in order to take advan-

tage of this temporary exemption is a requirement that the issuer's conflict minerals report describe the steps it has taken or will take in order to mitigate the risk that its conflict minerals benefit armed groups, including any steps to improve its due diligence.)

It's currently anticipated that a large number of products may fall within the "DRC conflict undeterminable" exception; however, for those who are able to determine that their conflict minerals did originate in the covered countries (and did not originate from scrap or recycled sources) and either did or did not directly or indirectly finance or benefit armed groups in the covered countries, audits will be required even during the initial relevant two- or four-year period. As a result, issuers who have even a strong suspicion that they may be subject to the rule and that their conflict minerals may have originated in the covered countries should begin to consider whom they would wish to engage to perform any required audits. An issuer's current independent auditor will be allowed to perform the service (assuming it is properly pre-approved as a non-audit service), but there is speculation that the largest accounting firms may reach capacity with respect to this service as the largest issuers reserve their services early in the process. In addition, consideration should be given to how engagement of an issuer's independent auditor to provide this additional non-audit service could impact the ratio of audit fees to non-audit fees disclosed in the issuer's annual proxy statement, which could impact a proxy advisory firm's recommendation of whether the engagement of the independent auditor should be ratified. (Note that in addition to certified public accountants, firms that are qualified to conduct performance audits pursuant to the Government Accountability Office's Government Auditing Standards may also provide conflict minerals due diligence audit services.)

- **Form SD and the Conflict Minerals Report Are Filed, Not Furnished**

The Form SD and any required accompanying conflict minerals report must be "filed" pursuant to the Exchange Act, rather than "furnished." As a result, heightened risk of liability exists. In addition to material misstatements or omissions in the filing that may be actionable pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which potential liability would apply to furnished documents as well, issuers may also be subject to liability under Section 18 of the Exchange Act, which applies only to documents filed under the Exchange Act. Section 18 provides for liability, with respect to a false or misleading statement made in the filing, to any person who sold or purchased a security in reliance on the statement, unless the person sued can prove that he acted in good faith and had no knowledge that the statement was false or misleading. A Rule 10b-5 plaintiff must prove causation, reliance on the materially misleading statement or omission (although reliance may be established by the "fraud on the market" theory, which is not available to a Section 18 plaintiff) and that the defendant acted with "scienter," meaning that the defendant acted knowingly (although some courts have allowed proof of recklessness to suffice). The risk of Section 18 liability could be more of a theoretical than a real concern, however, as Rule 10b-5 seems to have been a more than adequate weapon in most recent misleading disclosure actions. Between the difficult reliance and causation elements of the claim, and the statutory defense, Section 18 has not been

attractive to plaintiffs and has been rarely used. The real concern here may be a more practical one—failure to timely file Form SD will result in the issuer's loss of Form S-3 eligibility for one year (absent an SEC staff waiver). The real question is to what extent the SEC staff might take the position that a Form SD that either fails to include a conflict minerals report at all or with respect to certain conflict minerals is so deficient as to justify a determination that the filing requirement was not met. This could be a real concern to issuers that take aggressive positions regarding the application of the rule to them and their products or aggressive positions regarding their ability to reasonably rely on representations of third parties (perhaps ignoring too many red flags).

These are just a few of the hidden concerns/difficult interpretive issues that are presented by the SEC's final conflict minerals rule. Any public company that sells any tangible "thing" is going to be faced with these issues to some degree, and failure to identify now the specific interpretive issues facing the company, the company's policy with respect to those issues, the personnel needed to address them, and the game plan for compliance with the rule, could place the issuer in a dangerous "catch up" situation, with many of the current options for mitigation no longer available.