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A Broader Perspective

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To: Our Clients and Friends

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SEC Issues Proposed Rules for "Conflict Minerals" Disclosure

The Securities and Exchange Commission has issued proposed rules to implement the "conflict minerals" disclosure requirements in Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposing release, Release No. 34-63547, can be accessed **here**.

Section 1502 amended the Securities Exchange Act of 1934 (the "Exchange Act") by adding Section 13(p). Section 13(p) requires the SEC to promulgate disclosure rules concerning the use of certain minerals that originate in the Democratic Republic of the Congo or its adjoining countries (the "DRC countries"). In adopting Section 1502, Congress expressed its hope that the reporting requirements of the securities laws would help to curb the violence in the eastern Democratic Republic of the Congo by requiring transparency of all conflict mineral sourcing in the DRC countries. Congress stated its concern in Section 1502(a) that "the exploitation and trade of conflict minerals originating in [that region] is helping to finance conflict that is characterized by extreme levels of violence . . . , particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation." This provision of Dodd-Frank is another example of Congress using the disclosure requirements applicable to public companies to implement social policy.

The new law and related proposed rules (primarily contained in a new Item 104 to Regulation S-K) have broad applicability. Any reporting company, including foreign private issuers and smaller reporting companies, that manufactures or contracts to manufacture products for which "conflict minerals" are "necessary to the functionality or production" of those products must comply.

Section 1502 defines "conflict minerals" as columbite-tantalite (coltan), cassiterite, gold and wolframite, or any of their derivatives. Because of the wide uses of these minerals, this could have far reaching implications for many public companies. Already we have heard some issuers have initiated diligence procedures, delivering extensive questionnaires to companies in their supply chain. Public companies should consider carefully whether and how these rules apply to their required disclosures and how they might proceed to implement compliance procedures.

In approving the proposed rules, the Chairman of the SEC acknowledged that the Commission lacks expertise on the mining of conflict minerals and the disclosure matters mandated by the statute. Accordingly, the proposed rules follow closely the statutory language, giving very little guidance on key provisions. In its request for comments, the Commission specifically identified many of these difficult issues. The comment period for the proposed rules ends on January 31, 2011. It is expected that the SEC will adopt final rules in the spring of 2011 and that these rules will be applicable to 2012 fiscal years (for disclosure in 2013 annual reports).[1]

Overview of the New Requirements

The conflict mineral disclosure requirements apply to each reporting company for which conflict minerals are "necessary to the functionality or production" of a product manufactured or contracted to be manufactured by that company. These companies would be required to disclose in their annual reports and on their websites whether their conflict minerals originated in the DRC countries. If not, the issuer would be required to state this determination and disclose the process it used to reach the determination. If so, or if the issuer is unable to conclude that its conflict minerals did not originate in the DRC countries, the issuer would be required to disclose this conclusion and provide a conflict minerals report, audited by an independent private sector auditor, as an exhibit to its annual report and on its website.

The statute does not define, and the proposed rules do not define or further clarify, "necessary to the functionality or production" of a product.

Three Steps to Application of the Disclosure Requirements

The Proposing Release describes a three step process. First, an issuer must determine whether it is subject to the rule. The key is whether the reporting company manufactures or contracts to be manufactured a product for which conflict minerals are necessary to the functionality or production of the product. The SEC expects the rule to apply to many industries and companies.[2]

Second, if an issuer is subject to the rule, it must determine whether the conflict minerals it uses originated in the DRC countries. If, after a "reasonable country of origin inquiry," the issuer determines that the conflict minerals did not originate in the DRC countries, the issuer in its annual

[1] As the SEC is required to adopt rules by April 2011, a calendar year issuer would first have to provide conflict minerals disclosure after the end of its 2012 fiscal year. A May 31-issuer, however, would have to provide disclosure in its annual report for the fiscal year of June 1, 2011 through May 31, 2012.

[2] Columbite-tantalite is the metal ore from which tantalum is extracted. Tantalum is used in electronic components, including mobile telephones, computers, videogame consoles, and digital cameras, and as an alloy for making carbide tools and jet engine components. Gold is used for making jewelry and, due to its superior electric conductivity and corrosion resistance, is also used in electronic, communications, and aerospace equipment. Wolframite is the metal ore that is used to produce tungsten, which is used for metal wires, electrodes, and contacts in lighting, electronic, electrical, heating, and welding applications. Cassiterite is the metal ore that is most commonly used to produce tin, which is used in alloys, tin plating, and solders for joining pipes and electronic circuits.

report must state its conclusion and describe the processes undertaken to conduct the reasonable country of origin inquiry. [3] The issuer must also publish its conclusion on its website and maintain reviewable business records demonstrating that the conflict minerals did not originate in a DRC country.

Third, an issuer that has determined that the conflict minerals it uses have originated in the DRC countries, or an issuer that is unable to determine that its conflict minerals did not originate in the DRC countries, must state its conclusion in its annual report and on its website, and include a conflict minerals report as an exhibit to its annual report and on its website. The conflict minerals report must describe the due diligence the issuer performed on the source and chain of custody of its conflict minerals and include a description of (i) the issuer's products that are not "DRC conflict free," (ii) the facilities used to process the conflict minerals, (iii) the conflict minerals' country of origin, and (iv) the efforts used to determine the mine or location of origin with the greatest possible specificity.

Key Concepts Yet to be Defined

The SEC expressly declined to provide a definition of the term "manufactured" in the proposed rule, stating that the word is generally understood. The release does state that companies engaged in the business of mining conflict minerals will be deemed to "manufacture" such minerals and thus be subject to the disclosure requirements of the rule. Although the term "contracted to manufacture" is similarly not defined in the proposed rules, the SEC states that the rules are intended to apply to companies that have any influence over the manufacturing of the product, as well as to those selling generic products under their own brand name or private label that the issuer established, regardless of whether the issuer has any influence over the manufacturing of the product. On the other hand, the SEC states clearly that the proposed rules would not apply to retailers that sell only the products of third parties so long as those retailers have no contract for or other involvement in their manufacture and do not use their own brand name or private label on such products.

Similarly, the proposed rules do not define "necessary to the functionality or production of a product." The SEC requests comment on whether such a definition is appropriate. The release acknowledges the absence of any materiality threshold: the rule applies regardless of the amount of the mineral, so long as it is necessary. Additionally, the release states that where a conflict mineral is intentionally included in a product's production process and is necessary to that process, the mineral would also be considered "necessary," for purposes of the rule, even if the final product does not ultimately include the conflict mineral. By contrast, the necessity of conflict minerals to the functionality or production of a physical tool or machine used in the production process would not be considered necessary to the ultimate product.

Determining Whether the Conflict Minerals Originate in a DRC Country

If conflict minerals are necessary to the functionality or production of a product manufactured by or for the issuer, the proposed rules require that the issuer conduct a reasonable country of origin inquiry.

[3] The disclosure would appear in an annual report on Form 10-K for a domestic issuer, Form 20-F for a foreign private issuer and Form 40-F for an eligible Canadian issuer.

The specifics of such an inquiry are not set forth in the rule, as the SEC concludes that it would necessarily depend on the particular facts and circumstances. The release explains that the reliability of any such inquiry would be based solely on whether the information used provides a reasonable basis for an issuer to be able to trace the origin of any particular conflict mineral it uses. Companies would not be permitted to conclude that it is unreasonable to attempt to determine the origin of its conflict minerals solely because of the large amount of conflict minerals used in its products or the large number of products that contain conflict minerals. The SEC clarifies that the reasonable country of origin inquiry need not determine with absolute certainty whether conflict minerals originated in the DRC countries. Based on the language of Section 1502, the SEC further states that the reasonable country of origin inquiry could be less exhaustive than the due diligence on the source and chain of custody required in connection with the conflict minerals report, as described below.

The proposing release suggests that one way an issuer could satisfy the standard of conducting a reasonable country of origin inquiry is by receiving a reasonably reliable representation from the facility at which its conflict minerals were processed that those conflict minerals did or did not originate in the DRC countries. Such a smelter certification could come directly from the facility or indirectly through the issuer's suppliers, so long as the issuer reasonably believed the representations to be true based on the facts and circumstances. The release makes explicit reference to certifications from smelters identified as processing only "DRC conflict free" minerals under recognized national or international standards. Although smelter certifications and supplier declarations may suffice as reasonable inquiry at present, the SEC believes that as information systems improve over time, additional efforts may be required to satisfy the requirement.

Conflict Minerals Report

Under the proposed rule, an issuer must exercise due diligence on the source and chain of custody of its conflict minerals and describe the due diligence it exercised in a conflicts minerals report if:

- The issuer determines that its conflict minerals originated in the DRC countries or
- The issuer is unable to determine that its conflict minerals did not originate in the DRC countries.

Within such report, an issuer would be required to describe its products that are not "DRC conflict free", the country of origin of those conflict minerals, the facilities used to process those conflict minerals and efforts to determine the mine or location of origin with the greatest possible specificity. The description of the due diligence measures taken by the issuer must include a certified independent private sector audit conducted in accordance with the standards established by the Comptroller General of the United States.

The release does not provide specific guidance for the required supply chain due diligence, stating that "the conduct undertaken by a reasonably prudent person may vary and evolve over time" and citing ongoing work by the Organization for Economic Cooperation and Development to develop due diligence

standards for conflict mineral supply chains.[4] The proposing release suggests that issuers who follow such standards of or guidance for supply chain due diligence would meet the required due diligence under the new rule. The rule states that the independent private sector audit would constitute a critical component of the due diligence.

A company that is unable to determine whether the conflict minerals it uses originate in the DRC countries will be also be required to provide a conflict minerals report that includes an independent private sector audit report as an exhibit to its annual report. While the SEC expects that these issuers may not be able to provide all the information required by the conflict minerals report, these companies are nevertheless required to exercise due diligence in making supply chain determinations and to describe their due diligence efforts regarding the facilities used to process the conflict minerals, the conflict minerals' country of origin, if possible, and the efforts to determine the mine or location of origin with the greatest possible specificity.

Conflict Mineral Reports Furnished, not Filed

Because the conflict minerals report would be "furnished" to the SEC and not "filed," the conflict minerals report would not be subject to liability under Section 18 of the Exchange Act. Consistent with the terms of Section 1502 of Dodd-Frank, failure to comply with the proposed rules would give rise to liability for violations of Sections 13(a) or 15(d), as applicable.

The conflict mineral reports also would not be incorporated by reference into any registration statement filed pursuant to the Securities Act of 1933 unless the company expressly elects to do so. Similarly, an issuer filing a Form S-1 registration statement for an initial public offering would not be required to include a conflict minerals report.

Recycled Products and Stockpiles

Due to the difficulty of looking through the recycling or scrap process to determine the origin of the minerals in products derived from recycled or scrap minerals, the proposed rules provide a modified disclosure system for such products. Products made with recycled or scrap conflict minerals may be considered DRC conflict free, but the issuer must nevertheless provide a conflict minerals report and related independent audit report. The conflict minerals report in this instance must describe the measures the company took to exercise due diligence in determining that its conflict minerals were recycled or scrap.

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[4] In note 145, the SEC makes reference to relevant work of the United Nations Security Council (United Nations Security Council Resolution 1986 (2009) [S/RES/1896 (2009)] and cites the OECD's Draft Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (2010), available at http://www.oecd.org/dataoecd/13/18/46068574.pdf.

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