

The New SEC Conflict Minerals Rule: Overcoming the Challenges of Compliance

Robert A. Friedel

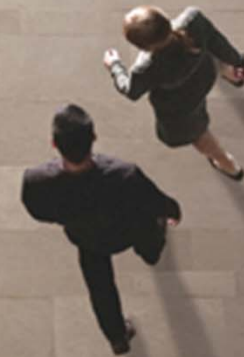
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October 10, 2012



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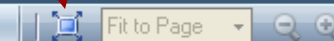
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Pepper Hamilton LLP
Attorneys at Law



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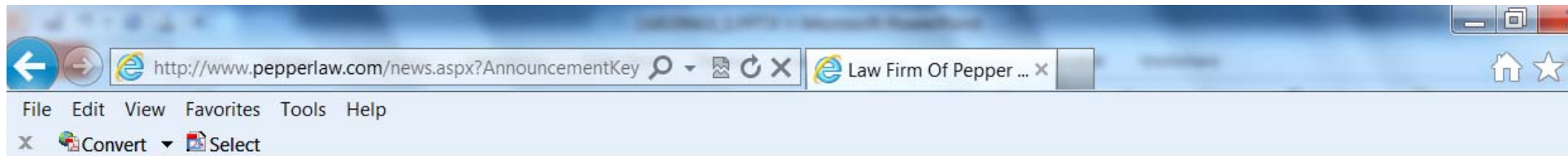
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NEWS

NEWS

Dodd-Frank Act and Financial Services Reform Resource Center

Monday, September 24, 2012

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) will affect almost every facet of the U.S. financial services industry. This legislative behemoth, intended to restore public confidence in the financial services industry, prevent future financial meltdowns, and manage systemic risk, will restructure existing regulatory agencies, enhance the powers of federal regulators, and create advisory bodies that will touch upon a broad spectrum of financial services activities, institutions, and professionals.

Despite the comprehensive nature of the Dodd-Frank Act, the legislation leaves an extraordinary number of matters to be addressed through rulemaking and other regulatory action, establishes broad discretion for federal regulators, and may require additional legislative corrections during the next session of Congress.

To prepare for and survive the new legislative and regulatory requirements that will undoubtedly come in the wake of the Dodd-Frank Act, financial institutions and financial professionals must understand who the legislation covers, what activities it will affect, and how to best achieve business objectives in light of – or in spite of – the legislation.

The Pepper Hamilton Financial Services Reform Resource Center provides timely and informative resources for financial institutions, financial professionals, and others affected by the Dodd-Frank Act.

The following attorneys are part of Pepper Hamilton's Financial Services Reform Response Team:



Freeh Association.

The Freeh Group is now part of Pepper Hamilton LLP.

We are pleased to announce that
The Hon. Louis J. Freeh
and the lawyers of Freeh Sporkin & Sullivan, LLP
have joined Pepper Hamilton LLP
and Pepper Hamilton LLP has acquired
Freeh Group International Solutions, LLC

August 28, 2012

Jane C. Luxton



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- Partner in the Environment and Energy Practice Group at Pepper Hamilton LLP, resident in the Washington, DC office
- Chair of the firm's Sustainability, Clean Tech and Climate change team
- Longstanding mining and metals experience
- Author of numerous publications on conflict minerals

SEC Final Rule on Conflict Minerals



- Mandated by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; purpose is to deprive illegal armed groups in Central Africa of sources of money
- SEC rule adopted by 3-2 vote, August 22, 2012
- 77 Fed. Reg. 56,273 (Sept. 12, 2012)
- Rule applies starting January 1, 2013; first reports due May 31, 2014
- Directly regulates companies that file SEC reports (U.S. and foreign companies), but will draw in entire supply chain

Rule's Requirements

- Companies that file SEC reports and manufacture or “contract to manufacture” products that contain “conflict minerals”: tin, tantalum, tungsten, gold (3TGs)
- Must investigate their supply chain to ascertain origins of these metals to see if they came from the Democratic Republic of the Congo (DRC) or eight adjacent countries: Angola, Burundi, Central African Republic, Rwanda, South Sudan, Tanzania, Uganda, and Zambia
- New clarification regarding scrap/recycled materials; clarification on R&D
- “Transition” period during which companies may report conflict mineral as “DRC Conflict Undeterminable”
 - 2 years for most companies, 4 years for small companies
 - Company must still do extensive due diligence and report on mitigation, steps taken to improve diligence
- No de minimis exemption

Products That Contain 3TGs



- Electronics, appliances
- Automotive and aerospace parts
- Cans, foil, packaging
- Medical devices
- Energy (power plant turbines, solar panels)
- Equipment
- Tools
- Apparel, shoes (including PVC)
- Chemicals, pesticides (organotin)
- Jewelry
- Lighting

Three-Step Analysis

1. Examine all products you manufacture to see if they contain conflict minerals
2. If yes, conduct a reasonable country of origin inquiry to determine whether mineral originated in: (a) DRC or adjacent country; (b) another geographic region; or (c) recycled or scrap materials. Disclose research and nature of inquiry in new Form SD. If answer is (b) or (c), obligations fulfilled (for this year)
3. If (a), or answer unknown, more stringent due diligence required to ascertain chain of custody. Independent third party audit required. Results must be reported on Form SD.

Gray Areas

- “Manufacture”
- “Contract to manufacture”
- “Necessary to functionality”
- “Necessary to production”
- “Reasonable” country of origin inquiry
- “Reason to believe,” “no reason to believe”
 - “May have originated in Covered Countries”
 - “May not have come from recycled or scrap sources”

Drivers

- SEC
- Investors
- Shareholders
- Customers
 - Supply chain
 - Consumers
- Competitors
- NGOs

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- Partner in the Corporate and Securities Practice Group of Pepper Hamilton LLP, resident in the Philadelphia office
- Actively involved in federal securities compliance counseling
- Regularly counsels NYSE, Nasdaq and other publicly traded companies on the latest developments and requirements affecting public companies, including SEC regulations and stock exchange rules, as well as developments in statutory and case law

Scope of Applicability



- New rules apply to companies “required to file reports with the Commission ...”
- IPO companies
- Stock Exchange Listed companies
- Companies listed on OTC Bulletin Board
- Companies with equity securities held of record by 2,000 or more persons and total assets exceeding \$10 million as of last fiscal year end

Special Situations

- Privately held companies
 - not applicable
- 144A High Yield Debt issuers
 - not applicable unless registered exchange offer is conducted
 - “voluntary filers” not subject to new rule
- “Smaller Reporting Companies” (SEC reporting companies with less than \$75 million in public float)
 - applicable
- Pink Sheet / OTCQX companies that do not file SEC reports
 - not applicable

Special Situations (cont'd)



- Foreign issuers
 - not applicable to 12g3-2(b) companies
 - not applicable to companies with only Level 1 ADRs
 - applicable to companies that have engaged in a registered U.S. securities offering or which have securities listed on a U.S. securities exchange
 - competitive advantage over U.S. companies
- Acquisition of a non-reporting manufacturer by an SEC-reporting company
 - reporting company may delay covering newly acquired product lines in its Form SD reports until end of calendar year beginning at least eight months after acquisition date

Transition Period



- During the transition period (two or four years):
 - no private sector audit required
 - may declare products “DRC conflict undeterminable” if
 - company knows that conflict minerals originated in the DRC or an adjoining country, but does not know that the conflict minerals financed or benefited armed groups in those countries, or
 - due diligence did not clarify
 - the conflict minerals’ country of origin,
 - whether the conflict minerals financed or benefited armed groups in those countries, or
 - whether the conflict minerals came from recycled or scrap sources

After Transition Period

- After the transition period, a company must declare that its products have not been found to be “DRC conflict free” if
 - company determines that its conflict minerals originated in the DRC or an adjoining country, and
 - company is unable to verify that those conflict minerals did not directly or indirectly finance or benefit armed groups in those countries

Penalties for Non-Compliance



- Securities Exchange Act of 1934
 - cease and desist order
 - director / officer bar
 - civil and criminal penalties
- Liability to shareholders for material misstatements or omissions
 - Section 18
 - Rule 10b-5
 - possible class action
- Loss of Form S-3 eligibility for one year

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- Partner in the White Collar Litigation and Investigations Practice Group at Pepper Hamilton LLP, resident in the Philadelphia Office
- Regularly conducts complex internal investigations for Fortune 500 corporations, educational institutions and government entities
- Previously chief of commercial and consumer fraud and deputy chief of economic crimes for the U.S. Attorney's Office for the Eastern District of Pennsylvania

Basics of Due Diligence

- Reasonable Country of Origin Inquiry
- Conduct Surveys of Suppliers
- If Supplies Are Not Traceable Require 3rd-Party Certifications
- Use Leverage in Contracts to Require Suppliers to Make Disclosures

What it Should Look Like



- Reactive and Proactive
- Part of other Compliance Systems
- Inform Employees and the Public of Compliance

Purposes of Completing Due Diligence



1. Comply with the Conflict Minerals Rule
2. Set up Your Company's Defense to an Enforcement Action
3. Set Up Your Company's Defense to a Class Action Lawsuit
4. Whistleblowers

Maximize Impact of Due Diligence



- Written policies regarding suppliers and disclosure
- Make it easy for suppliers and employees to report problems
- Employee buy-in through training
- Tone from the top

An FCPA Analogy

- Garth Peterson is the head of Morgan Stanley's Shanghai Office of its Global Real Estate Business
- Took \$1.8 million in Morgan Stanley's funds to pay bribes to a Chinese official in exchange for the official helping Peterson get business
- Of course, Peterson kept some of it himself

What happened to Peterson?



- Pleaded guilty to conspiracy
- Permanently barred from the securities industry
- \$250,000 in civil penalties and repayment \$3.4 million acquired as a result of the scheme
- Sentenced in the criminal case to 9 months in prison



Declination!!

Morgan Stanley's Internal Controls



- Written policies and reminders
- 500 compliance officers worldwide
- Employee training
- Reviewed specific deals
- Extensive due diligence on prospective business partners

Peterson is Truly a Rogue



- Evaded Morgan Stanley's internal controls by:
 - Using shell corporations
 - Lied to Morgan Stanley
 - Lied on his firm's financial disclosure forms
 - Hid \$700,000 payments to the Chinese official

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Due Diligence Requirements and Top Eight Pitfalls To Avoid



Due Diligence - OECD Five-Step Framework

- Strong Company Management System
 - Adopt and Communicate Policies – Internal and External
 - Structure Management Support
 - Establish Controls and Transparency
 - Strengthen Procurement and Contract Language with Suppliers (Background Screening)
 - Grievance Mechanism
- Risk Assessment of the Supply Chain
 - Supply Chain Mapping and Investigation/Fact Finding
 - Risk Analysis

Due Diligence Requirements and Top Eight Pitfalls To Avoid



- Risk Response Strategy
 - Report Risk Findings to Management and Partners
 - Risk Management and Mitigation Plan
 - Implementation, Tracking and Monitoring of Mitigation Efforts
 - Re-assessments of Risk
- Independent Third-Party Inquiry of Supply Chain
- Internal and External Reporting on Supply Chain Due Diligence

Due Diligence Requirements and Top Eight Pitfalls To Avoid



TOP EIGHT DUE DILIGENCE PITFALLS TO AVOID

- Lack of Role Clarity, Definition, and Procedural Guidelines around who owns the Various Due Diligence Components and Initiatives, and who is Responsible for Integration and Monitoring of these Functions.
- Lack of Sufficient Coordination and Sharing of Information Among the Various Conflict Minerals Due Diligence Requirements and Initiatives.
- Lack of Integration and Information Sharing between the Various parts of your Conflict Minerals Due Diligence and other Compliance functions and programs (e.g., FCPA).
- Independent Due Diligence Inquiries into Supply Chain are seen as just an Audit Function



- Background Investigations of Supply Chain Companies is a Rubber Stamp Process that lacks Depth and Due Diligence Value.
- Lack of Due Diligence Gap Reviews or Benchmarking, and “Adequacy” and “Effectiveness” Assessments.
- Lack of Adequate Recording, Investigation, Tracking, Resolution, and Reporting Guidelines and Systems for Grievance Mechanisms.
- Lack of Appropriate Due Diligence Related Training and Expertise, Including Training on Responding to Grievances.

Facilitated Questions



GraphicMaps.com

Fast Facts:

“Conflict minerals” are tantalum, tin, gold, or tungsten, also known as the “3TGs.”

Facilitated Questions



Fast Facts:

Companies are subject to the new rules if they are required to file reports with the Securities and Exchange Commission.

Facilitated Questions



Fast Facts:

Compliance Date: Issuers must comply with the final rule for the calendar year beginning January 1, 2013 with the first reports due May 31, 2014.

Facilitated Questions

Fast Facts:

Subject companies are required to file a new form with the SEC called Form SD.

Facilitated Questions

Fast Facts:

Potential civil and criminal penalties - for violation of new rules, include being barred from service as a public company director or officer.

Facilitated Questions



Fast Facts:

Transition period: four years for “smaller reporting companies;” two years for all other companies

Facilitated Questions

Fast Facts:

No exception from compliance with new rules for de minimis usage of conflict minerals in the product.

Facilitated Questions

Fast Facts:

New rules apply if conflict minerals are necessary to the functionality or production of a product manufactured or contracted to be manufactured by the company.

Facilitated Questions

Fast Facts:

Products are “DRC Conflict Free” if conflict minerals used are from scrap or recycled sources, after appropriate inquiry.

Facilitated Questions



charlottebiz.blogspot.com

Fast Facts:

Products are “DRC Conflict Free” if conflict minerals used did not originate in the DRC or an adjoining country, after appropriate inquiry.

Facilitated Questions



World Atlas

Fast Facts:

Products are “DRC Conflict Free” if conflict minerals used did originate from the DRC or an adjoining country and the company is able to verify that the conflict minerals did not directly or indirectly finance or benefit armed groups in those countries.

Facilitated Questions



Fast Facts:

Companies should adopt written policies regarding suppliers and disclosure to facilitate compliance with the new rules.

Facilitated Questions



Fast Facts:

Independent 3rd party inquiry of supply chain is part of a well-conceived due diligence plan.

Questions & Answers

**For more information, visit
www.pepperlaw.com.**

