Skadden

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

September 5, 2012

SEC Adopts Conflict Minerals Rules

On August 22, 2012, the SEC adopted final rules to implement the conflict minerals provisions in Section 1502 of the Dodd-Frank Act, which require companies to make disclosures concerning their use of conflict minerals originating in the Democratic Republic of the Congo (the "DRC") and adjoining countries.

Key Points

- The SEC's conflict mineral rules apply only to public companies that manufacture products or, depending on the facts and circumstances, contract for products to be manufactured.
- Those companies must determine whether conflict minerals are "necessary to the functionality or production" of any of their products. If they are, then additional work is required to determine the source of the conflict minerals.
- Conflict minerals are used in a wide array of products.
- Compliance with these new rules is expected to impose significant costs on companies.
- Although the first disclosures are not due until May 31, 2014 (with respect to products manufactured between January 1, 2013 and December 31, 2013, regardless of a company's fiscal year), companies should begin to analyze whether they are subject to the rules and determine the procedures necessary to perform the required supply chain due diligence.

Overview, Background and Timing

The rules apply to all public companies (*i.e.*, companies that file reports under Section 13(a) or Section 15(d) of the Exchange Act), including smaller reporting companies and foreign private issuers, and require that companies determine whether conflict minerals are necessary to the functionality or production of products that they manufacture or contract to be manufactured. The list of conflict minerals (and their derivatives), which may be augmented by the U.S. Secretary of State, are cassiterite (tin), columbite-tantalite (tantalum), gold and wolframite (tungsten). If conflict minerals are necessary to the functionality or production of their products, companies must undertake a reasonable country of origin analysis to determine whether any of the conflict minerals originated in the DRC, Angola, Burundi, Central African Republic, Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda or Zambia (collectively, the "Covered Countries").

The Congressional intent of Section 1502 of the Dodd-Frank Act, which amended the Exchange Act, was not to further those goals typically associated with the federal securities laws – protecting investors and fostering capital formation. Rather, the Congressional purpose was to address the humanitarian goal of ending the violent conflict

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Brian V. Breheny
Washington, D.C.
202.371.7180
brian.breheny@skadden.com

Marc S. Gerber
Washington, D.C.
202.371.7233
marc.gerber@skadden.com

Andrew J. Brady
Washington, D.C.
202.371.7344
andrew.brady@skadden.com

* * *

1440 New York Avenue, NW,
Washington, D.C. 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

in the DRC, which has been partially financed by the exploitation and trade of conflict minerals originating in the DRC. This humanitarian aim does not come without significant costs. The SEC estimates the initial compliance costs at $3 billion to $4 billion, and annual compliance costs at $200 million to $600 million. These costs will be borne by public companies (and their shareholders and consumers) across wide stretches of the economy as conflict minerals are used in products such as mobile phones, computers, jet engines, jewelry and many other products with electronic components such as metal wires, electrodes and electric contacts.

Disclosure in response to the new rules is required to be set forth in a new specialized disclosure report (Form SD) and, if applicable, in a Conflict Minerals Report, which must be filed as an exhibit to Form SD. In addition, companies must make their conflict minerals disclosure available on their websites.

Companies required to file Form SD must do so annually by May 31, regardless of a company's fiscal year-end. The conflict minerals information disclosed in Form SD must cover all products containing conflict minerals the manufacture of which was completed during the preceding calendar year from January 1 to December 31. Companies will be required to file their first Form SD on or before May 31, 2014, containing conflict minerals disclosure for the reporting period from January 1, 2013 to December 31, 2013.[1]

Next Steps

Although the deadline for the first Form SD filings is almost 21 months away, most companies likely have a significant amount of work to do to analyze whether their products contain conflict minerals and whether those conflict minerals are necessary to the functionality or production of their products, to determine from where those conflict minerals originated, and to conduct the necessary supply chain due diligence. As a starting point, companies should form working groups to develop their action plans. Those working groups should include, among others, supply chain managers, product engineers and members of the legal staff.

In addition, companies will need to design procedures to monitor their use or potential use of conflict minerals on an ongoing basis, including as they develop new products, implement design changes to existing products and consider changing suppliers for components used in their products.

Further, companies will need to consider conflict minerals issues in connection with their integration plans as they make acquisitions. The rules provide a grace period in connection with acquisitions of companies not otherwise subject to the conflict minerals rules. Specifically, companies may delay reporting with respect to products manufactured by the acquired company until filing the Form SD covering the annual period beginning no sooner than eight months after the effective date of the acquisition.

Three-Step Process

The conflict minerals rules require that companies undertake a three-step process in order to determine the level of disclosure, if any, that they must provide.

1. Companies need to determine whether the new rules apply to them. The rules apply if a company is required to file reports under Exchange Act Section 13(a) or Section 15(d)

---

1 For transition purposes, the rules exclude any conflict minerals that are "outside the supply chain" prior to January 31, 2013. Conflict minerals are "outside the supply chain" only in the following instances: after any columbite-tantalite, cassiterite and wolframite minerals have been smelted; after gold has been fully refined; or after any conflict minerals, or their derivatives, that have not been smelted or fully refined are located outside of the Covered Countries.

and conflict minerals are necessary to the functionality or production of products that the company manufactures or contracts to be manufactured.

2. Companies must conduct a reasonable country of origin inquiry to determine if the necessary conflict minerals they used originated from any of the Covered Countries. If, based on its reasonable country of origin inquiry, a company determines that its necessary conflict minerals did not originate in the Covered Countries, the company would provide disclosure in Form SD regarding such determination.

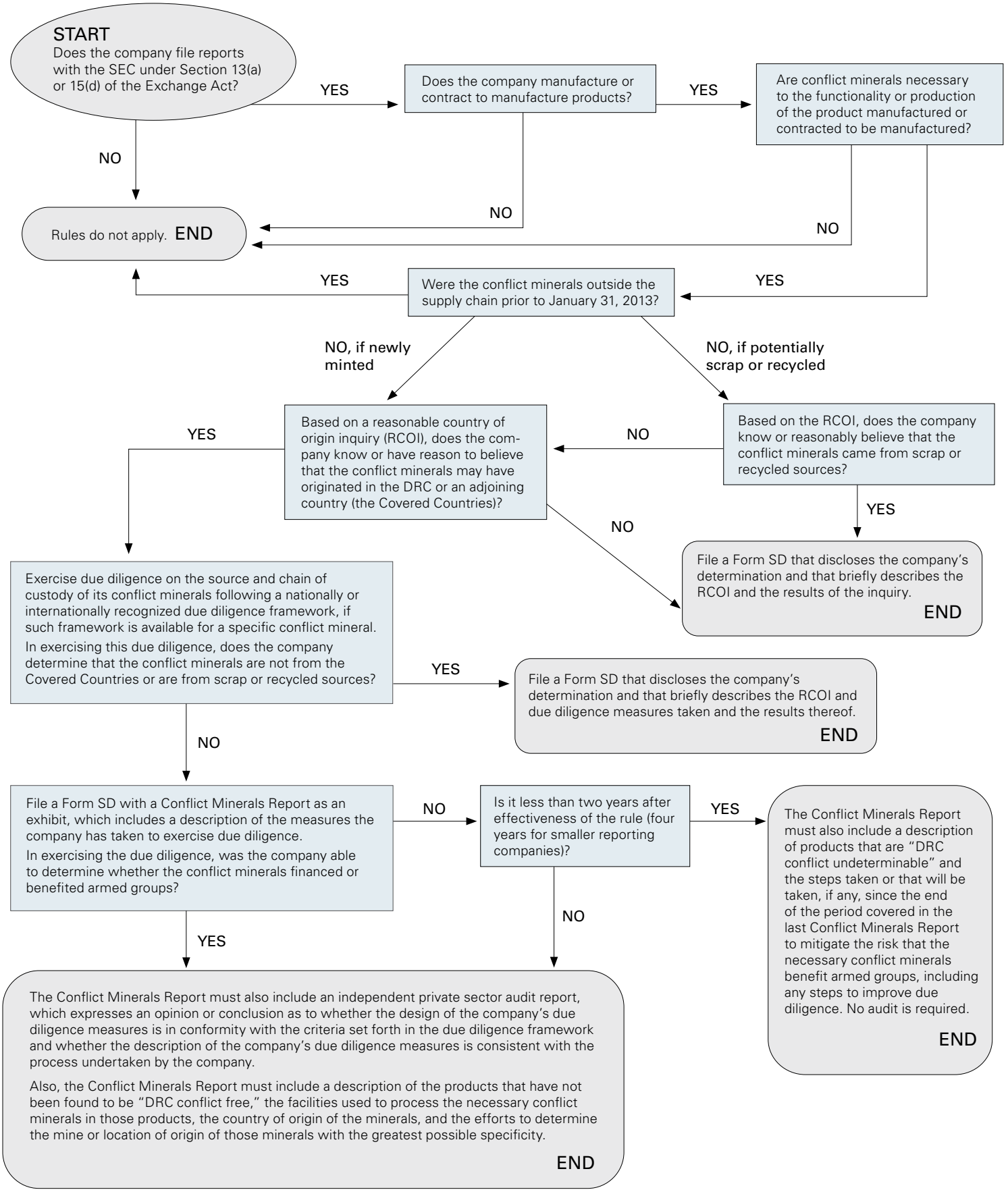
3. If a company is unable to arrive at a conclusion from its reasonable country of origin inquiry or, based on that inquiry, concludes that at least some of its necessary conflict minerals did originate, or may have originated, in the Covered Countries, the company must then conduct due diligence on the source and chain of custody of its conflict minerals and prepare a more detailed Conflict Minerals Report, which would be included as an exhibit to Form SD and would be audited by an independent third party.

These rules are summarized in a flow chart, below (based on a similar flow chart included in the SEC adopting release).

A more detailed description of the rules follows the flow chart on the next page.

Skadden

Conflict Minerals Flow Chart



Step One – Determine whether the company is covered by the conflict minerals rules

The conflict minerals rules apply to any company (i) that files reports with the SEC under Section 13(a) or Section 15(d) of the Exchange Act, including domestic companies, foreign private issuers and smaller reporting companies, and (ii) for which conflict minerals are "necessary to the functionality or production" of a product that the company manufactures or contracts to be manufactured.

Manufacture or Contract to Manufacture. The rules only apply to companies that manufacture products or that contract for products to be manufactured. The rules do not define the word "manufacture," given the SEC's view that the term is generally understood. The SEC notes in the adopting release that a company that only services, maintains or repairs a product containing conflict minerals would not be considered a "manufacturer" of those products.

Similarly, the rules do not define when a company has contracted for a product to be manufactured. The SEC indicates in the adopting release that the determination will depend on the degree of influence exercised by the company on the manufacturing of the product, based on the individual facts and circumstances. This analysis would consider the degree of influence a company exercises over the materials, parts, ingredients or components to be included. According to the adopting release, such influence need not be "substantial."

To assist companies in making this determination, the SEC indicates that if a company's actions involve no more than the following activities, it should not be viewed as contracting to manufacture a product:

- specifying or negotiating contractual terms with a manufacturer that do not directly relate to the manufacturing of the product, such as training or technical support, price, insurance, indemnity, intellectual property rights, dispute resolution or other like terms or conditions concerning the product, unless the company 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;
- affixing its brand, marks, logo or label to a generic product manufactured by a third party; or
- servicing, maintaining or repairing a product manufactured by a third party.

Absent any additional involvement, a company that offers a generic product under its own brand name or a separate brand name will not be considered contracting to manufacture that product.

Necessary to a Product's Functionality or Production. The rules only apply to companies that manufacture or contract to manufacture products in which conflict minerals are "necessary to the functionality or production" of those products. The rules do not define when conflict minerals are "necessary to the functionality" or "necessary to the production" of a product. A company must make that determination based on its particular facts and circumstances. To assist companies in making these determinations, the SEC lists in the adopting release certain factors that companies should consider.

A company should consider the following factors to determine whether its conflict minerals are "necessary to the functionality" of a product:

- 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 byproduct;
- whether a conflict mineral is necessary to the product's generally expected function, use or purpose; and

- if a conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration.

Depending on the facts and circumstances, any of the above factors, individually or in the aggregate, may be determinative of whether conflict minerals are "necessary to the functionality" of a product.

The adopting release advises companies to consider the following factors to determine whether conflict minerals are "necessary to the production" of a product:

- whether a conflict mineral is contained in the product and intentionally added in the product's production process, including the production process of any component of the product; and
- whether the conflict mineral is necessary to produce the product.

Although either of the two factors above, individually or in the aggregate, can be determinative of whether conflict minerals are considered "necessary to the production" of a product, the SEC indicates that the intentional addition of a conflict mineral to the production process is a significant factor in the analysis.

In addition, the adopting release addresses some particular situations:

- *Catalysts.* A conflict mineral used as a catalyst or in any other manner in the production process will not be considered "necessary to the production" of a product if the conflict mineral is not contained in the product. On the other hand, containing even trace amounts of a conflict mineral is sufficient to satisfy the "necessary to the production" requirement.
- *Tools, machines, and indirect equipment*. A conflict mineral in a physical tool or machine used to produce a product will not be considered "necessary to the production" of a product. Likewise, indirect equipment used to produce a product, such as computers and power lines, that may contain conflict minerals will not be considered "necessary to the production" of a product.
- *Prototypes*. Prototypes and other demonstration devices are not considered products, so conflict minerals in those items are not viewed as necessary to the production or functionality of a product. However, a company that offers those items to third parties for consideration is required to report on any conflict minerals necessary to the functionality or production of such products.

Step Two – Conduct a 'reasonable country of origin inquiry' to determine whether conflict minerals originated in a Covered Country

If a company determines that conflict minerals are necessary to the functionality or production of a product that it manufactures or contracts to be manufactured, it is required to conduct a "reasonable country of origin inquiry" to ascertain whether those conflict minerals originated in Covered Countries or came from recycled or scrap sources.

The SEC rules do not specify the steps that a company must take to conduct a reasonable country of origin inquiry. Rather, the necessary steps will depend on a company's particular facts and circumstances, such as the company's size, products, relationships with suppliers and other factors. In addition, the SEC notes in the adopting release that the necessary steps will depend on the available infrastructure for such an inquiry at a given time and may evolve with the further development of industry tracing processes. Under the rules, the reasonable country of origin inquiry must be reasonably

designed to determine whether the company's conflict minerals originated in the Covered Countries or came from recycled or scrap sources and must be performed in good faith.

As described in the adopting release, the SEC would view a company as satisfying the requirement if the company seeks and obtains reasonably reliable representations from suppliers identifying the facility at which the conflict minerals were processed and demonstrating that the conflict minerals did not originate in the Covered Countries or that they came from recycled or scrap sources. However, the company must have a reason to believe the representations are true given the facts and circumstances, such as a facility obtaining a "conflict free" designation from an appropriate industry group. The adopting release notes that a company can satisfy the requirement even if it has not obtained representations from every one of its suppliers. However, a company may not ignore warning signs or other circumstances indicating that the remaining amount of its conflict minerals originated or may have originated in the Covered Countries. The adopting release also notes that a company's policies with respect to the sourcing of conflict minerals generally will form a part of the company's reasonable country of origin inquiry and, therefore, generally would be disclosed in the company's Form SD.

If, based on its reasonable country of origin inquiry, a company determines either (i) that its necessary conflict minerals did not originate in the Covered Countries or did come from recycled or scrap sources or (ii) that it has no reason to believe that its conflict minerals may have originated in the Covered Countries or it reasonably believes that its conflict minerals are from recycled or scrap sources, the company is not required to take further steps to diligence its conflict minerals. The company would file a Form SD and, under a "Conflict Minerals Disclosure" heading, disclose its determination and briefly describe the reasonable country of origin inquiry and the results of its inquiry. The Form SD also would include a link to a company's website with the same disclosure.

Step Three – Required supply chain due diligence, the related audit and the Conflict Minerals Report

If a company determines, based on its reasonable country of origin inquiry, either (i) that its necessary conflict minerals originated in the Covered Countries and did not come from recycled or scrap sources or (ii) that 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 company must exercise due diligence on the source and chain of custody of its conflict minerals. The results of the due diligence will determine the disclosure required.

Supply Chain Due Diligence. A company's due diligence on the source and chain of custody of its conflict minerals must follow a nationally or internationally recognized due diligence framework. Although no particular framework is required, the only framework currently in existence that meets the SEC's requirements is the "OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas."[2]

If, as a result of that due diligence, the company determines that its conflict minerals did not originate in a Covered Country or that its conflict minerals came from recycled or scrap sources, the company would expand the disclosure in its Form SD to describe the due diligence efforts and its determination. In that instance, the company would not need to have an audit conducted or prepare the Conflict Minerals Report described below.

Audit. Unless a company determines that its conflict minerals did not originate in a Covered Country or that they came from recycled or scrap sources, a company's due diligence on the source and chain of custody of its conflict minerals must include an independent private sector audit of the Conflict

---

2 Available at http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/46740847.pdf.

Minerals Report (with a transition exception, described below). The objective of the audit, as stated in the rules, is to express an opinion or conclusion as to whether the design of the company's due diligence measures (as set forth in its Conflict Minerals Report) is in conformity in all material respects with the criteria set forth in the nationally or internationally recognized due diligence framework used by the company, and whether the company's description of the due diligence measures it performed is consistent with the due diligence process that the company undertook. The audit would be conducted pursuant to existing Government Auditing Standards.

Auditor Independence. The SEC indicated that performing the independent private sector audit of the Conflict Minerals Report would not impair the independence of an auditor engaged to audit a company's financial statements. If one firm provides both services, the engagement to perform the independent private sector audit of the Conflict Minerals Report would be considered a "non-audit service" subject to the SEC's pre-approval requirements, and the fees related to the independent private sector audit of the Conflict Minerals Report would be included in the "All Other Fees" category in disclosures of fees paid to principal accountants.

Content of the Conflict Minerals Report. Any company that determines that its necessary conflict minerals originated in the Covered Countries and did not come from recycled or scrap sources is required to file a Conflict Minerals Report. In addition, any company that, after its reasonable country of origin inquiry, had reason to believe that its conflict minerals may have originated in the Covered Countries and may not have come from recycled or scrap sources and, after the exercise of due diligence, is unable to conclude that its conflict minerals did not originate in the Covered Countries or that they did come from recycled or scrap sources, must also file a Conflict Minerals Report.

A company's Conflict Minerals Report must include the following:

- a description of the measures taken by the company to exercise due diligence on the source and chain of custody of its conflict minerals;
- a description of the company's products that have not been found to be "DRC conflict free;"
  - > a product is "DRC conflict free" if it does not contain conflict minerals necessary to the functionality or production of that product that directly or indirectly financed or benefited armed groups in the Covered Countries (*i.e.*, groups identified as perpetrators of serious human rights abuses in annual country reports prepared by the U.S. Department of State);
- identification of the facilities used to process the necessary conflict minerals (*i.e.*, the smelter or refinery through which the minerals passed);
- identification of the country of origin of the conflict minerals;
- a description of the efforts to determine the mine or location of origin with the greatest possible specificity;
- an audit report resulting from the independent private sector audit of the Conflict Minerals Report; and
- a company statement that it obtained an independent private sector audit of its Conflict Minerals Report.

Temporary Relief – 'DRC Conflict Undeterminable'

Recognizing that the infrastructure and processes to conduct the due diligence and trace conflict minerals through the supply chain are not yet fully developed, the SEC rules include a temporary "DRC conflict undeterminable" category. Companies may avail themselves of this alternative if they have conducted their supply chain due diligence and are unable to conclude:

- that their conflict minerals did not originate in the Covered Countries;
- that their conflict minerals that originated in the Covered Countries did not directly or indirectly finance or benefit armed groups; or
- that their conflict minerals came from recycled or scrap sources.

Rather than require such companies to describe their products as not having been found to be "DRC conflict free" during this period, the alternative reporting standard allows companies to describe products containing those necessary conflict minerals as "DRC conflict undeterminable."[3]

Companies with products that are "DRC conflict undeterminable" are required to exercise due diligence on the source and chain of custody of their conflict minerals and submit a Conflict Minerals Report. The Conflict Minerals Report must include the following:

- a description of the company's due diligence;
- a description of the company's products found to be "DRC conflict undeterminable;"
- a description of the steps the company has taken or will take, if any, since the end of the period covered in its most recent prior Conflict Minerals Report to mitigate the risk that its necessary conflict minerals benefit armed groups, including any steps to improve its due diligence;
- a description of the facilities used to process the conflict minerals, if known;
- identification of the country of origin of the conflict minerals, if known; and
- a description of the efforts to determine the mine or location of origin with the greatest possible specificity, if applicable.

These companies will not, however, be required to obtain an independent private sector audit of the Conflict Minerals Report during the temporary period.

The "DRC conflict undeterminable" alternative will be permitted for all companies during the first two reporting cycles under the rules, *i.e.*, Form SD for calendar years 2013 and 2014. For smaller reporting companies, this alternative will be permitted during the first four reporting cycles, *i.e.*, Form SD for calendar years 2013 through 2016.

If, after the expiration of the temporary alternative reporting period, a company remains unable to determine that its necessary conflict minerals did not originate in the Covered Countries, that its conflict minerals that originated in the Covered Countries did not directly or indirectly finance or benefit armed groups, or that its conflict minerals came from recycled or scrap sources, it will be required to describe its products as having not been found to be DRC conflict free in its Conflict Minerals Report. Such companies will also be required to provide an independent private sector audit of their Conflict Minerals Report.

---

3 Companies may not, however, describe products as "DRC conflict undeterminable" if they have determined that such products contain other necessary conflict minerals that have financed or benefited armed groups in the Covered Countries.

Recycled and Scrap Materials

Products with conflict minerals that are solely from recycled or scrap sources are deemed "DRC conflict free." Under the rules, conflict minerals are considered to be from "recycled or scrap sources" if they are from recycled metals, which are reclaimed end-user or post-consumer products, or scrap processed metals created during product manufacturing. Recycled metal includes excess, obsolete, defective and scrap metal materials that contain refined or processed metals that are appropriate to recycle in the production of tin, tantalum, tungsten and/or gold. However, minerals partially processed, unprocessed or a byproduct from another ore are not considered to be recycled metal.

In connection with due diligence as to whether conflict minerals come from recycled or scrap sources, the adopting release notes that currently the OECD's supplement for gold is the only nationally or internationally recognized due diligence framework for any conflict mineral from recycled or scrap sources. Accordingly, with respect to conflict minerals other than gold, a company is required to exercise due diligence in determining that its conflict minerals were from recycled or scrap sources without the benefit of a due diligence framework until a nationally or internally recognized due diligence framework becomes available.