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Nuts & Bolts of the New SEC Conflict Minerals Rule

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Introduction

- Here to talk about new conflict minerals rule adopted by the SEC in August 2012
- Imposes disclosure requirements on public companies that use certain minerals (gold, tungsten, tin or tantalum) or mineral-bearing materials in the manufacture of products
- Also affects other companies not directly subject to the rule (*e.g.*, mining companies, non-public company suppliers)

Introduction

- Companies have been bombarded with client alerts discussing the rule
- We try here to be more nuts and bolts
  - Overview
  - What steps to take now
  - Consequences of failure to comply
- Detailed slides
  - Available to participants
  - Can follow-up with us

Overview of Conflict Minerals Disclosure Rule

- In August, SEC adopted rules that require disclosure of "conflict minerals" in an issuer's supply chain, as required by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")
- "Conflict Minerals" are columbite-tantalite (coltan), tantalum, cassiterite, tin, gold, and wolframite (tungsten)
- Covered countries: Angola, Burundi, Central African Republic, Democratic Republic of the Congo, Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia
- Conflict minerals are used in a wide array of products and other applications. Companies will need to review all aspects of their business to determine if any part of their company uses conflict minerals

Overview of Conflict Minerals Disclosure Rule

- Each SEC reporting issuer that uses conflict minerals "necessary to the functionality or production of a product that it manufactures, or contracts to manufacture" must file a new Form SD with the SEC by May 31, 2014 covering products that are manufactured during the 2013 calendar year
- Stockpiles of materials and components which have already been refined or smelted, or are outside of the covered countries, before January 31, 2013 are considered "outside the supply chain" and therefore no disclosure or analysis is required
- Companies should ideally begin now to make inquiries and set up protocols to gather information to determine if they are potentially impacted in light of the January 31, 2013 date
- SEC expects rules to apply to approximately 6,000 issuers or 40% of all reporting companies
- By the SEC's own estimate, initial compliance could cost between $3 and $4 billion, and annual compliance an additional $200 to $600 million annually

Determining If the Rule Applies to a Company

- Rule applies to all public companies required to file reports with the SEC
  - Includes foreign issuers
- Rule also indirectly impacts non-public companies in the supply chain

Determining If the Rule Applies to a Company

- Threshold questions:
  - Does the company manufacture or contract to manufacture products that contain conflict minerals?
  - Are conflict minerals necessary to the functionality or production of any product manufactured or contracted for manufacture?
  - Do the conflict minerals originate from a covered country?
    - To determine, conduct “reasonable country of origin analysis”

Conclusions of "Reasonable Country of Origin Inquiry" – No Covered Countries

- If, after inquiry, issuer:
  - Determines its necessary conflict minerals did not originate in a Covered Country, or
  - Determines its necessary conflict minerals came from recycled or scrap sources, or
  - Has no reason to believe that its necessary conflict minerals may have originated from a Covered Country, or
  - Reasonably believes that its necessary conflict minerals came from recycled or scrap sources

  Then issuer would describe this determination and the inquiry conducted on Form SD and on its website

Conclusions of "Reasonable Country of Origin Inquiry" – Covered Countries Involved

- If, after inquiry, issuer determines, or has reason to believe, that any of its conflict minerals originated in a covered country and did not come from recycled or scrap sources, the issuer is required to conduct due diligence on the source and chain of custody of its conflict minerals
  - Due diligence must follow a "nationally or internationally recognized framework" to determine source of the conflict minerals and whether the minerals financed or benefited armed groups
- If issuer determines that its conflict minerals are from a covered country, or if the issuer cannot determine the source of its conflict minerals, then the issuer is required to file a Conflict Minerals Report as an exhibit to its Form SD

Conflict Minerals Report

- The Conflict Minerals Report must contain the following information:
  - A description of the issuer's due diligence procedures
  - A copy of a report prepared by an independent private sector auditor that expresses an opinion or conclusion on the design of the issuer's due diligence procedures and the accuracy of the issuer's description of its due diligence process in its conflict minerals report.
  - Whether the company's products are "DRC Conflict Free" or "DRC Conflict Undeterminable"
  - If products are not "DRC Conflict Free," a disclosure of the products and steps to mitigate risks that conflict minerals benefit an armed group

Public Company Manufacturers Directly Subject to Rule (Including Component Manufacturers)

Step 1: Are Conflict Minerals Contained in the Product?

- List of conflict minerals directly purchased
- List of manufactured materials/components incorporated into the product that may contain Conflict Minerals
  - Interviews with Purchasing, Production and Engineering personnel
  - Product specs/design
  - Purchasing records
  - Contracts with vendors

Step 1: Are Conflict Minerals Contained in the Product?

- Phone calls and possible follow-up letter to vendors/manufacturers of material/component (if uncertainty as to conflict minerals)
  - Does material/component contain Conflict Mineral?
  - Inquiries made by vendor to support conclusion
  - Documentation supporting conclusion
- Review website for vendor/manufacturer
- (If necessary) Inquiries to competitors, trade associations, and vendors of similar materials/components

Step 1: Are Conflict Minerals Contained in the Product?

- If no conflict minerals in product (or components of product), you do not have to do anything more
  - Recommended (not Required): Prepare/retain documentation supporting conclusion

Step 2: Is the Conflict Mineral in the Product Necessary to Its Function or Production?

- "Necessary to the Functionality or Production"
  - No bright-line test / No definitions / Facts and circumstances
  - For both, mineral must be contained in the product
  - For both, "significant factor" if mineral was "intentionally added" rather than a naturally-occurring by-product or impurity

Step 2: Is the Conflict Mineral in the Product Necessary to Its Function or Production?

- "Necessary to the functionality"
  - In addition to being contained in the product and intentionally added to the product, SEC discusses two factors:
    - Necessary to any of the product's generally-expected functions, uses or purposes
      - Basic function? Ancillary function? SEC: Too subjective
      - Some products have many generally-expected functions—mineral need only be necessary to one of them
    - If mineral is incorporated for ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration

Step 2: Is the Conflict Mineral in the Product Necessary to Its Function or Production?

- "Necessary to the production"
  - As before, must be contained in the product and intentionally added to the production process
  - If mineral is used in manufacturing process as a catalyst but is not in final product, not "necessary to the production"
    - NB: Even trace amounts in final product is sufficient to satisfy the "necessary to production" requirement
  - A mineral in a tool or machine used to produce the product is not considered "necessary to the production" of a product
  - Neither are minerals contained in "indirect equipment" such as computers or power lines

Step 3: Reasonable, Good Faith Country of Origin Inquiry

- Does Conflict Mineral derive from a covered country, or from scrap/recycled materials?
- Key is reasonableness and good faith of inquiry
- Dependent on company's "size, products, relationships with suppliers"
- "Contemplates the weighing of a number of relevant factors, including the cost of compliance"
- "A certainty is not required …."

Step 3: Reasonable, Good Faith Country of Origin Inquiry

- Inquiry satisfied if manufacturer "obtains reasonably reliable representations" indicating that the smelter/refinery did not use minerals from covered countries or minerals came from recycled/scrap materials
  - Representation can come from smelter/refinery or the manufacturers' immediate supplier
- No requirement of representations from all suppliers, unless reason to believe minerals from these other suppliers came from covered countries

Step 3: Reasonable, Good Faith Country of Origin Inquiry

- Recommended Steps
  - Letter to vendor/component manufacturer
    - Has vendor conducted reasonable, good faith country of origin inquiry?
      - Summary of inquiry undertaken and conclusions
      - Identity of refinery/smelter which processed the conflict mineral
      - Other companies in supply chain
  - Letter to smelter/refinery or upstream suppliers (if known)
    - Country of origin of minerals
    - Any conflicts free designation or audits?

Step 3: Reasonable, Good Faith Country of Origin Inquiry

- Recommended Steps
  - Review upstream supplier or smelter/refinery conflict minerals representations/reports on web-site or in SEC filings
  - Contracts with vendors
    - Representation that materials do not contain conflict materials
    - Representation that vendor has conducted a reasonable, good faith country of origin inquiry and has concluded that any conflict minerals did not come from covered countries, or are from recycled/scrap materials
    - Representation that vendor has not used and will not use any conflict minerals from covered countries, or only uses conflict minerals from scrap/recycled sources
  - Consider switching vendors that cannot provide requested information or contract representations
  - If significant vendor, possible due diligence into vendor's representations (individually or as part of industry group)

Step 3: Reasonable, Good Faith Country of Origin Inquiry

- Recommended Steps (long term)
  - Work with competitors/trade associations to vet smelters/refineries and other upstream companies
    - Audits/due diligence
    - “Certification” of certain suppliers
- Suppliers have economic incentive to cooperate

Step 3: Reasonable, Good Faith Country of Origin Inquiry

- If, pursuant to country of origin inquiry, conflict minerals are not from covered country, or are from recycled/scrap material, or no reason to believe otherwise
  - Disclosure on Form SD and on website

Step 4: Due Diligence on Source and Chain of Custody

- Nationally or Internationally Recognized Due Diligence Framework (if available)
  - OECD Due Diligence Guidance (2011)
  - Supplement on Tin, Tantalum, and Tungsten (2011)
  - Supplement on Gold (including recycled/scrap materials) (2012)
- State Department Statement Regarding Conflict Minerals Due Diligence (July 15, 2011)
- World Gold Council Conflict Free Gold Standard (2012)

Step 4: Due Diligence on Source and Chain of Custody

- Due Diligence Components:
  - Establish strong company management systems
    - Company policies/goals
    - Dedicated personnel with relevant skill sets
    - Funding
    - Grievance mechanism/whistle blower protection
    - Communication of policy to public
    - Incorporate supply chain policy into contracts with suppliers
  - Identify and assess risk in supply chains
    - Smelters/refineries that process minerals from many countries
    - Smelters/refineries doing business with mines in covered countries
    - Red flags

Step 4: Due Diligence on Source and Chain of Custody

- Design/implement strategy to respond to risks
  - Reporting to upper management
  - Change suppliers
  - Seek contractual representations
  - Deal with credible companies
  - Industry-wide cooperation
  - Require due diligence by smelters/refineries
- Independent third party audit of smelter/refinery
- Report publicly on due diligence

Step 4: Due Diligence on Source and Chain of Custody

- If, based on due diligence, conflict minerals do not come from covered country or did come from recycled/scrap materials
  - No Conflict Minerals Report (or audit report) is required
  - Disclosure on Form SD and on website

- Otherwise: Must file Conflict Minerals Report

Conflicts Minerals Report

- Due diligence measures taken
- Private sector audit
  - Due diligence design conforms with national/international recognized framework
  - Due diligence measures consistent with design
  - No audit of whether conclusions of due diligence are correct
  - First 2 years (4 years for small issuers), no audit required if after due diligence, minerals are DRC Conflict Undeterminable

Conflicts Minerals Report

- Whether products are “DRC Conflict Free” or “DRC Conflict Undeterminable”
  - DRC Conflict Free: necessary conflicts minerals in the product do not directly or indirectly finance or benefit armed groups identified by State Department as perpetuating human rights abuses
    - Conflict Minerals from recycled/scrap sources are always DRC Conflict Free
  - If products are “DRC Conflict Undeterminable” or not DRC Conflict Free:
    - Conflict Minerals Report must disclose steps to be taken to mitigate risk that conflict minerals benefit armed group
    - Report must describe products, the smelter/refinery processing the minerals, country of origin, and efforts to determine location of origin

Upstream Components/Materials Manufacturers Not Directly Subject to Rule

- As practical matter, should undertake Steps 1 and 3 to satisfy anticipated customer and downstream manufacturer inquiries
  - Determine if conflict minerals are in product
  - Conduct reasonable, good faith country of origin inquiry
- Potential benefit: Improved market position

Smelters/Refineries

- Need to ensure and document (to extent practicable) minerals do not come from covered countries (or, if they do, do not support armed groups)
  - Relationships with credible mining companies
  - Inquiries/contractual assurances that mining company or affiliate does not extract or transmit minerals in covered country
  - Business relationships only with mining companies certified as conflict free
  - Publicly available audits
- Potential benefit: Improved market position

Smelters/Refineries

- Red Flags
  - Minerals are claimed to originate in a country with no or limited reserves
  - Minerals are mined by a company with facilities or affiliates in a covered country

Mining Companies

- Due diligence that any mining in covered countries does not benefit armed groups
- Conflict free designation by recognized body (*e.g.*, World Gold Council)
- No ores or concentrates from non-credible mining companies
- If ore or concentrate supplier has facilities in covered country
  - Contractual representations
  - Inquiries/due diligence
  - Cease doing business
- No dealings with smelters/refineries that are not DRC Conflict Free, or insist on segregation of minerals

Challenges to the Rule

- On October 19, the Chamber of Commerce and the National Association of Manufacturers filed a petition for review with the U.S. Court of Appeals for the D.C. Circuit (Business Roundtable also joined)
- The suit challenges the final rule and requests that the "rule be modified or set aside in whole or in part"
- Main bases for challenge:
  - Faulty economic analysis (no attempt to calculate benefits)
  - Failure to include *de minimis* exception
  - Including non-manufacturers who "contract to manufacture"
  - First Amendment violation

Challenges to the Rule

- So what is an issuer to do?
  - The rule has not been stayed by the court, and there does not appear to be a request by the parties to do so
  - Agreed-upon schedule has case fully briefed by **March 2013** with hope that D.C. circuit will decide by **end of 2013**
  - Prudent to continue with planning

Potential Liability

- Section 18
  - Because Form SD is considered “filed” with the SEC, a private right of action exists for investors under Section 18 of the ’34 Act
  - Under Section 18, a person who makes a false or misleading statement of a material fact may be found liable to anyone who, in reliance on such statement, purchased or sold securities at a price affected by such statement and suffered damages
  - But an investor must clear a high hurdle:
    - Did not know statement was false
    - Actually relied on the statement
    - Statement actually affected share price
  - Issuer has defense of good faith and lack of actual knowledge

Potential Liability

- Anti-Fraud Liability Under Rule 10b-5
  - Elements of 10b-5 case
    - Misrepresentation or omission of a material fact
    - Scienter
    - Reliance
    - Loss causation
    - Damages
- Interplay of Both Section 18 and Rule 10b-5 with the Conflict Minerals Rule

Potential Consequences

- Whether or not rule is effective at time first report is due:
  - Advocacy and consumer groups are watching
  - Reputational/public relations issues could arise
  - There are opportunities for differentiation—both as public filers and non-filing manufacturers
  - Public companies may insist on conflict-free sourcing even if rule not effective
  - Beware: Significant lead time necessary to get compliance system up and running

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