HUNTON& WILLIAMS

Conflict Minerals – FAQs and Recent Developments

Open Questions, Industry Group Lawsuit and New Initiatives

Summary

Effective January 1, 2013, companies that file Exchange Act reports with the SEC are required to identify whether their products contain certain "conflict minerals" originating from the Democratic Republic of Congo (DRC) and adjoining countries (an area comprising most of Central Africa). This client alert outlines certain open questions created by the new rules, provides a briefing on the industry group lawsuit challenging the new rules and summarizes new state, local and private conflict minerals initiatives. For a detailed description of the new conflict minerals disclosure requirements, please see our companion client alert: *Conflict Minerals – Nuts and Bolts*. For tips and best practices on complying with the new rules, please see our companion client alert: *Conflict Minerals – Compliance Guide*.

Frequently Asked Questions

Why do the final rules leave so many terms undefined and create so many interpretive issues? We believe a number of factors contributed to the tone and structure of the final rules. As a threshold matter, the final rules involve a diverse array of issues such as human rights, international relations, global politics, supply chain management, chemistry, metallurgy and manufacturing technology. These topics are far afield from the agency's core experience and historical role as a securities regulator, and placed the Commissioners and agency Staff on a steep learning curve. Second, though hundreds of commenters provided input and many multi-stakeholder groups were formed, commenters reached little consensus on many of the key issues. In the absence of consensus, the Commission was left having to make difficult choices on a topic in which it has little historical familiarity, and many of the underlying concepts of the rules defy easy explanation or simple definition. Third, given the broad scope of the rules and their impact throughout the global supply chain, it simply was not possible or feasible to address every hypothetical situation involving every industry affected. Fourth, we believe the Commission sought to take a principles-based approach, rather than a rules-based one, to many of the interpretive questions so that over time industry and market practices would gain acceptance. Finally, given the large number of human rights groups and other nongovernmental organizations that are closely monitoring issues concerning labor and supply chain issues generally, as well as the conflict minerals issue more specifically, we believe the Commission sought to use the influence of these groups to help shape emerging industry practices and to act as a counterbalance, were certain companies or industries to stray too far from emerging best practices.

Will the Commission or the Staff issue any further interpretive guidance? The release accompanying the final conflict minerals disclosure rules is 356 pages in length. Some SEC officials initially stated that while the SEC has received numerous questions and requests for clarification regarding the final rules, the SEC Staff did not have any plans to issue additional guidance (*e.g.*, FAQs) because the release accompanying the final rules provides extensive guidance to reporting companies. Conversely, at an industry conference in November 2012, two senior officers from the SEC's Division of Corporation Finance suggested that some guidance might indeed be forthcoming. Nevertheless, recent turnover in senior staff at the SEC and the nomination of a new SEC chairman call into question the imminence of any guidance from either the Commission or the Staff. Because the Commission chose to remain silent on many key issues, we question whether the Staff would be in a position to reopen issues when the Commission itself did not reach consensus on them. Ultimately, the Staff's guidance must have some legal basis, and it could be difficult to find that basis when the Commission has made a policy choice in favor of a principles-, as opposed to rules-, based approach on many of these issues. In the absence of further official clarification or direction on these questions, reporting companies should closely observe their peers and industry groups to keep abreast of any consensus or industry standards that begin to develop.

What is a "product"? The SEC did not define this term in the final rule. Accordingly, we must look to its generally understood meaning, which is something produced and marketed or sold into the stream of commerce. The final rule does not require a reporting company to report on conflict minerals in materials, prototypes and other demonstration devices because they are not considered to be products; however, once such items enter into the stream of commerce and are offered to third parties, the reporting company must consider them in its reporting obligations. Several questions regarding what is a product remain to be answered, including: Is packaging part of a product (see below)? Are sales of obsolete equipment or inventory covered (*e.g.*, a rental car company's planned fleet sales vs. as-needed sales of old computer equipment)? What about leased equipment (*e.g.*, a cable box) or promotional items (*e.g.,* a kid's meal toy) ancillary to a reporting company's core products or services?

What about packaging? The lack of a definition of "product" in the rules raises several related questions, including whether a product's packaging is considered part of the product and, therefore, whether it is covered by the rule. As an example, if a reporting company sells a food product in a tin can, but the food product itself does not contain a conflict mineral, should the tin can be considered in the company's conflict minerals analysis? The SEC has not issued any guidance on this topic, and the adopting release for the final rule does not discuss packaging. Some commentators draw an analogy to the SEC's exclusion of merely ornamental conflict minerals (*e.g.*, gold embellishment) as not "necessary to the functionality" of certain products; however, others believe that a blanket exclusion of packaging would be too broad and could potentially undercut Congressional intent. Unless the SEC issues further guidance, or an industry standard develops, reporting companies will be forced to rely on the facts and circumstances of a product and its packaging and make their own determinations. The critical question is whether the packaging is necessary to the functionality or production of the product. For example, if the tin in the can is necessary to prevent spoilage, then an argument could be made that the packaging is an integral part of the product. On the other hand, the availability of alternative packaging that does not include conflict minerals could also factor into the analysis. Another consideration is whether the packaging itself has any intrinsic value. For example, disposable packaging presumably has little or no value, contrasted with a commemorative gold box that presumably does. A potential offshoot of this uncertainty is that reporting companies are likely to explore ways to replace conflict minerals in packaging (as well as in their core products).

What about promotional items or items that are given away? As noted above, the rule is focused on "products." In general terms, promotional items that are given away for free and not sold to customers are not products, and should not be covered by the rule. This understanding can become muddier, however, when one considers promotional items that are packaged with a product and/or used as an incentive to induce the immediate purchase of a product (*e.g.*, a kid's meal toy), or that are necessary for a customer to use the reporting company's core product (*e.g.,* a cable box). Reporting companies facing these tougher questions should consult with their outside advisers and review any industry standards that may be developing; however, in the end, the internal compliance team must make a facts-and-circumstances determination. In addition, reporting companies should avoid creative arguments involving promotional items or "giveaways" that stretch the bounds of common sense (*i.e.*, reporting companies should not claim to be selling a cardboard box, while giving away the contents of the box for free).

How do reporting companies identify with specificity the mine or location of origin of their conflict minerals? This is one of the most difficult questions facing reporting companies whose products have necessary conflict minerals originating from a Covered Country. Several commentators have noted that the U.S. Department of State has difficulty identifying which mines are under the control of armed groups, and which are not, as mines and mineral deposits may change hands several times throughout the course of a year. Many believe that the difficulty in determining whether a conflict mineral supports armed groups will result in an unintended boycott of conflict minerals from the Covered Countries. Certain

industry groups, NGOs and governments are cooperating to prevent this type of informal shutdown of the mineral trade in the Covered Countries through conflict-free certification programs[1]; however, these initiatives are still developing and it is likely that many reporting companies will find the simplest path to compliance will be to adopt either a formal, or informal, policy against purchasing conflict minerals from the Covered Countries.

What types of records must a reporting company keep? The final rule does not require a reporting company to retain reviewable business records to support its reasonable country of origin inquiry (RCOI) determination. We, however, recommend that a reporting company maintain appropriate records, because they may be useful in demonstrating compliance with the rule and defending the company's final analysis. Moreover, maintenance of records may also be required by a nationally or internationally recognized due diligence framework applied by the company.

Is a reporting company's analysis subject to disclosure controls? The adopting release is clear that the Form SD itself is not subject to the CEO and CFO certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act. Still, because a Form SD is filed with the SEC, its preparation must be considered as part of the broader standards concerning disclosure controls and procedures under Sarbanes-Oxley Act Section 302 and the SEC's Rules 13a-15 and 15d-15. There is no one-size-fits-all solution to how a company's disclosure controls and procedures will need to change (if at all) based on the conflict minerals rules and the new required report. A registrant with a heavy industrial or manufacturing base would likely have to devote more compliance resources to the issue than one in the service industry or whose products do not contain conflict minerals.

How will the rules be enforced? The SEC has not announced any particular enforcement program, and it is not yet clear how much of a priority the Staff will place on reviewing filings in 2014, but by analogy we can draw from the experiences surrounding other new disclosure regimes that have been implemented in recent years. In the absence of official guidance from the Commission or the Staff, it would not be uncommon for Commissioners or senior staffers to give speeches and presentations at industry events laying out their preferences and expectations for a new set of rules. After the first wave of filings, it is possible that examiners in the Division of Corporation Finance could issue individual comment letters to specific registrants, or the Division as a whole may issue more comprehensive disclosure guidance highlighting best practices or areas where large numbers of registrants appear to have missed the mark. Given the two- and four-year transition periods contained in the final rules, the Staff's process of providing feedback may occur more gradually than other recent amendments to public company disclosure rules, such as the rules on Compensation Discussion & Analysis, in which the Staff was very active in providing specific comments and publicizing its more general reactions after the first reporting cycle. In all but cases involving egregious violations of the rules, we would not expect the Division of Corporation Finance to make a large number of enforcement referrals to the Division of Enforcement in the short to medium term. Over the longer term, it is possible that the Division of Enforcement will seek to bring enforcement cases against registrants that are perceived as materially flaunting the rules. As part of the Division of Enforcement's recent reorganization, a special unit focusing exclusively on the Foreign Corrupt Practices Act has been formed. This unit has been steadily improving working relationships with foreign regulators and developing increasingly sophisticated techniques for investigating transnational violations of the securities laws. These relationships and techniques would be readily transferable to future investigations of cases involving the conflict minerals rules. Outside of SEC enforcement, a private right of action exists under Section 18 of the Exchange Act for shareholders who perceive irregularities in the filed reports, and

[1] For example, refer to the conflict-free smelter program jointly sponsored by the Electronic Industry Citizenship Coalition (EICC) and the Global e-Sustainability Initiative at http://www.conflictfreesmelter.org/

we should expect the advocacy and NGO community to also be very outspoken in publicly highlighting perceived violations of the rules.

Industry Group Lawsuit

On October 19, 2012, the National Association of Manufacturers and the Chamber of Commerce of the United States of America filed a petition for review in the U.S. Court of Appeals for the District of Columbia Circuit, asking the court to modify or set aside the SEC's conflict minerals rules in whole or in part. On October 22, the petition was amended to add the Business Roundtable as a petitioner. Amnesty International has intervened in the case in support of the conflict minerals rules, which it believes are a "vital tool to end the conflict in the Congo." On January 16, 2013, the petitioners filed their opening brief, raising the following arguments for the court to consider:

- The petitioners argue that the SEC failed to consider the effects of the rule because:
    - the SEC failed to determine whether the rule would benefit the DRC;
    - the SEC underestimated the costs of the rule; and
    - the SEC's decisions increased the rules' costs without corresponding benefits.
- The petitioners also argue that the SEC misinterpreted Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and arbitrarily rejected alternatives that would have significantly reduced costs. Specifically:
    - the SEC misinterpreted Section 1502 as precluding a *de minimis* exception to the rule;
    - the RCOI is contrary to Section 1502 and rests on a faulty cost-benefit analysis;
    - the rule's inclusion of non-manufacturers is contrary to Section 1502; and
    - the rule's phase-in period is arbitrary and capricious.
- Finally, the petitioners argue that Section 1502 compels speech in violation of the First Amendment to the United States Constitution. Petitioners specifically point to the requirement that reporting companies state that certain of their products are not DRC Conflict Free.

On January 23, 2013, separate amici briefs in support of the petitioners were filed by a coalition of industry groups[2] and by a group of experts on the Democratic Republic of Congo.

The court, at the petitioners' request and with the consent of the SEC, has set an expedited review schedule for this matter, with all briefing to be concluded by March 28, 2013. Most believe that this schedule will allow the court to issue a decision prior to the end of calendar year 2013, and possibly as early as late summer or early fall. *Reporting companies, however, <u>should not wait</u> for the outcome of this*

[2] The coalition of industry groups includes the American Coatings Association, Inc., the American Chemistry Council, the Can Manufacturers Institute, the Consumer Specialty Products Association, the National Retail Foundation, the Precision Machined Products Association and The Society of the Plastics Industry, Inc.

case before taking actions to ensure compliance with the new rules as adopted by the SEC. The outcome of this case is far from clear, and while the first Form SD is not due until May 31, 2014, the disclosures will cover all of calendar year 2013. In addition, even if the new rule is modified or set aside in whole or in part, unless the court strikes down Section 1502 itself based on the petitioners' First Amendment challenge, the SEC will be obligated to continue with conflict minerals rule-making. As evidenced by Amnesty International's request to intervene in this case, NGOs and other advocacy groups will continue to keep this issue at the forefront of the social responsibility debate.

State, Local and Private Initiatives

In addition to new SEC conflict minerals rules, companies will be subject to an increasing number of state, local and private initiatives designed to curb the international trade in conflict minerals. In 2011, the California state assembly passed a bill that prohibits state agencies from entering into contracts with companies that fail to comply with the SEC conflict minerals rules. Maryland followed suit in early 2012 by enacting similar legislation. Massachusetts and Rhode Island have also considered similar measures. Notably, the proposed Massachusetts legislation goes beyond noncompliance with the SEC conflict minerals and prohibits state contracts with companies "where conflict minerals are necessary to the functionality or production of a product manufactured by the person," presumably picking up any company that determines that its products are not DRC Conflict Free, even if they are otherwise in compliance with the SEC conflict minerals rules. Cities such as Pittsburgh, Pennsylvania, and St. Petersburg, Florida, have passed resolutions calling for consideration of whether electronic products are conflict free in purchasing decisions, and expressly favoring verifiably conflict free products. In addition, led largely by student advocacy efforts, universities such as Stanford and Duke have adopted proxy voting guidance for their endowments, requiring a "yes" vote on shareholder resolutions seeking company information on their use or avoidance of conflict minerals. It is possible that an increasing number of institutional investors could follow suit.

Ready to Assist

We have assembled an interdisciplinary team of lawyers experienced in commercial contracting, corporate governance and securities law compliance who stand ready to assist both public and private companies in their compliance efforts. We are able to provide assistance on a wide variety of matters, including reviewing and revising current supply agreements, drafting annual supplier certifications, advising on internal compliance structures and preparing the necessary SEC disclosures. We are also ready to advise private companies as they cooperate with their reporting company partners on their compliance efforts. Please feel free to contact your regular Hunton & Williams attorney or any of the lawyers listed on this client alert.

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