HUNTON& WILLIAMS

Conflict Minerals – Nuts and Bolts

A Detailed Description of the New Conflict Minerals Disclosure Requirements

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). Given the complexities of the rule and the cooperation needed for compliance initiatives, companies should take action now to identify their products that may contain conflict minerals and institute sourcing diligence measures to determine the source of such minerals. Industry groups have filed a lawsuit to challenge the implementation of the conflict minerals disclosure requirements; however, the timing of the final resolution of the case and its outcome are uncertain. The first conflict minerals disclosures will be due on May 31, 2014, and will cover the calendar year beginning January 1, 2013.

This client alert provides a detailed description of the new conflict minerals disclosure requirements. For tips and best practices on complying with the new rules, please see our companion client alert: *Conflict Minerals – Compliance Guide*. For more information on the open questions created by the new rules, a briefing on the industry group lawsuit challenging the new rules and an update on state, local and private conflict minerals initiatives, please see our companion client alert: *Conflict Minerals – FAQs and Recent Developments*.

Background

Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to promulgate rules requiring issuers with conflict minerals that are necessary to the functionality or production of one or more of their products to disclose annually whether any of those minerals originated in the DRC or an adjoining country (the "Covered Countries"). Congress's stated intent was to end the extremely violent conflict and ongoing human rights abuses in the DRC, which have been fueled in large part by armed groups trading in conflict minerals. The SEC issued proposed rules on December 15, 2010,[1] and after hosting a public roundtable and receiving 420 individual comment letters, adopted final rules on August 22, 2012.[2]

Conflict Minerals Disclosure Rule and New Form SD

What are Conflict Minerals? Conflict minerals are currently defined as columbite-tantalite or coltan (the metal ore from which tantalum is extracted), cassiterite (the metal ore from which tin is extracted), gold, wolframite (the metal ore from which tungsten is extracted) and their derivatives. The Secretary of State has authority to add other minerals and derivatives that he or she determines are financing conflict in a Covered Country. Tantalum is used in electronic components, including mobile telephones, computers, video game consoles and digital cameras, and as an alloy for making carbide tools and jet engine components. Gold is used for making jewelry and is used in electronic, communications and aerospace equipment. Tungsten is used for metal wires, electrodes and contacts in lighting, electronic, electrical, heating and welding applications. Tin has a variety of uses, including alloys, tin plating and solders for joining pipes and electronic circuits.

Which Countries are Covered Countries? The Covered Countries include any country that shares an internationally recognized border with the DRC, which presently includes Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia.

[1] http://www.sec.gov/rules/proposed/2010/34-63547fr.pdf
[2] http://www.sec.gov/rules/final/2012/34-67716.pdf

Which Companies are Covered by the Rule? All companies that file reports with the SEC pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Foreign private issuers, emerging growth issuers and smaller reporting issuers are not exempt from the rule. From a practical perspective, many private companies and non-U.S. companies throughout the supply chain that supply raw materials or components to reporting companies, or that manufacture products for reporting companies, will also be impacted by the rule, since their reporting company customers require cooperation with their compliance initiatives.

What does the Rule Require? A reporting company that manufactures or contracts to manufacture a product for which conflict minerals are necessary to the functionality or production of such product must file a report on Form SD. Form SD must be filed annually no later than May 31 of each year. As noted above, the first Form SD is required to be filed by May 31, 2014, irrespective of the reporting company's fiscal year, and will cover calendar year 2013. The reports cover calendar year periods, not fiscal years. Form SD will be "filed" under the Exchange Act, rather than "furnished," meaning that the information is subject to Section 18 liability. In general, Section 18 creates a private right of action for securityholders to sue a public company in the event that a report is filed with the SEC containing a false or misleading statement with respect to a material fact. Additionally, the Form SD must be signed by an executive officer. The SEC created a helpful flowchart summary of the rule, which may be found at Appendix 1.

Step One. A reporting company that manufactures or contracts to manufacture products must determine whether conflict minerals are "necessary to the functionality or production" of any product manufactured or contracted to be manufactured by the reporting company. *If a reporting company does not meet this test, it is not subject to the rule*.

Key Considerations:

- *What is a "product"?* The SEC did not define this term in the rule. Accordingly, we must look to its generally understood meaning, which is something produced and marketed or sold into the stream of commerce. One important exclusion in the final rule was the exclusion of reporting companies that mine conflict minerals and do not engage in further manufacturing. In addition, 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.

- *When are conflict minerals "necessary"?* The SEC directs reporting companies to make a facts-and-circumstances determination of whether conflict minerals are necessary to the functionality or production of a product. The adopting release does provide some direction to reporting companies. When determining whether conflict minerals are "necessary to the functionality" of a product, a reporting company should consider: (1) whether the conflict mineral is intentionally added to the product or any component of the product and is not a naturally occurring byproduct; (2) whether the conflict mineral is necessary to the product's generally expected function, use or purpose; and (3) if the conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration. When determining whether conflict minerals are "necessary to the production" of a product, a reporting company should consider: (1) whether the conflict mineral is intentionally included in the product's production process, other than if it is included in a tool, machine or equipment used to produce the product (*e.g.*, computers or power lines); (2) whether the conflict mineral is included in the product (including a component of a product); and (3) whether the conflict mineral is necessary to produce the

product (see, however, the discussion of catalysts below). The SEC provided some clarity for these determinations when it stated in the commentary to the final rule that *a conflict mineral must be contained in the product to be considered necessary*. In addition, the SEC reiterated that a conflict mineral should not be considered necessary to the production of a product if it is contained in a tool or piece of equipment used to manufacture the product, *provided* that the finished product does not itself contain a conflict mineral.

- *What about small amounts of conflict minerals?* There is no *de minimis* exception in the rule. Consequently, the rules could be triggered by trace amounts of conflict minerals in individual products or components, or the presence of conflict minerals in a single product or component across a vast product portfolio that otherwise does not include conflict minerals. The final rule does exclude conflict minerals that are a part of the manufacturing process (*e.g.*, a catalyst or tooling), but that are not contained in the finished product.

- *What does it mean to "manufacture" a product?* The SEC declined to provide a definition of "manufacture" because it believes the term is generally understood. The SEC did clarify, however, that a reporting company that only services, maintains or repairs a product containing a conflict mineral would not be considered to be "manufacturing" the product.

- *What does it mean to "contract to manufacture" a product?* This term is also not defined in the final rule; however, the SEC looks at the degree of influence exercised by the reporting company on the manufacturing of the product (including the materials, parts, ingredients or components) based on the facts and circumstances surrounding the company's business and industry.

- *Are retailers and resellers exempt from the rule?* The SEC narrowed the scope of the manufacturer inquiry by adopting what is commonly referred to as the "retailer exemption." The retailer exemption provides that a reporting company will not be considered to be contracting to manufacture a product if its actions are limited to: (1) specifying or negotiating with a manufacturer contractual terms 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); (2) affixing its brand, marks, logo or label to a generic product manufactured by a third party; or (3) servicing, maintaining or repairing a product manufactured by a third party. The SEC also clarified that the term applies to contracting to manufacture a component of a product, not just the final finished product.

- *Will electric utilities be deemed "manufacturers"?* Based on a discussion concerning power lines in the adopting release, it seems clear that the generation, transmission and distribution of electric energy does not trigger the rules; thus, most electric utilities will not have to comply with the rules solely on the basis of their generation or transmission businesses. However, it is possible that products ancillary to the main utility business may not be eligible for the "retailer exemption." The prevailing sense is that most utilities will not trip up the rule, absent the sale of some unique product outside the core business of generation, transmission and distribution of electricity.

- *What about current stockpiles?* Conflict minerals that are "outside the supply chain" prior to January 31, 2013 (*i.e.*, smelted or refined, or located outside the Covered Country prior to

that date) are exempt from reporting. Some commentators have suggested that this exemption may actually encourage reporting companies to actively purchase and stockpile conflict minerals prior to that date in order to gain additional time before finding conflict-free sources or implementing product design changes.

Step Two. If a reporting company determines in Step One that a conflict mineral is necessary to the functionality or production of a product manufactured or contracted to be manufactured by the reporting company, it must conduct in good faith a reasonable country of origin inquiry (RCOI) that is reasonably designed to determine whether the conflict mineral originated in a Covered Country or is from scrap or recycled sources. If the reporting company determines that its necessary conflict minerals did not originate in a Covered Country or did come from recycled or scrap sources, or if it has no reason to believe that the conflict minerals may have originated in a Covered Country, or if it reasonably believes that its conflict minerals did come from recycled or scrap sources, the company does not move on to Step Three and must disclose on Form SD its determination and briefly describe its RCOI. In addition, the reporting company must disclose the same information on its publicly available Internet website. On the other hand, the reporting company must move on to Step Three if it knows that any of its necessary conflict minerals originated in a Covered Country and are not from recycled or scrap sources, or has reason to believe that its necessary conflict minerals may have originated in a Covered Country and has reason to believe that they may not be from recycled or scrap sources.

Key Considerations:

- *What is required in conducting the RCOI?* The SEC did not specify the steps necessary to conduct the RCOI; however, the SEC did state that the RCOI must be conducted in good faith and reasonably designed to determine, in light of a reporting company's particular facts and circumstances (*e.g.,* size, products, suppliers), whether the company's conflict minerals originated in a Covered Country or came from recycled or scrap sources. The RCOI does not require a reporting company to establish with certainty that its conflict minerals did not originate in a Covered Country or that they did come from recycled or scrap sources.

- *Can a reporting company rely on representations from its suppliers?* A reporting company may satisfy the RCOI standard if it seeks and obtains reasonable representations from its suppliers (including intermediate suppliers) that indicate the facility at which its conflict minerals were processed and that demonstrate that those conflict minerals did not originate in the Covered Countries or come from recycled or scrap sources. The reporting company must have a reason to believe the representations are true, and cannot ignore "warning signs," such as discovering that one of the smelters in its supply chain processes conflict minerals from many countries, including the Covered Countries, but is unable to determine whether the minerals it received from the "mixed smelter" were from the Covered Countries, *or* receiving a representation from a supplier that its conflict minerals originated from a country that has limited known reserves of the mineral. A reporting company presumably would have a reason to believe representations from a supplier that received a "conflict free" designation from a recognized industry group that required an independent private-sector audit, or if the supplier independently obtained such an audit and made it publicly available.

- *Are representations required from all of a reporting company's suppliers?* No. A reporting company may conclude that its conflict minerals did not originate from a Covered Country even if it does not receive representations from all its suppliers, provided that the company does not ignore warning signs such as those noted above.

- *What are recycled or scrap sources?* Conflict minerals are considered to be from recycled or scrap sources if they are from recycled metals, which are reclaimed end-user or postconsumer 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. Minerals partially processed, unprocessed or a byproduct from another ore are not included in the definition of recycled metal. Note, this definition of "recycled and scrap" conforms to that used by the Organisation for Economic Co-operation and Development (OECD).[3]

Step Three. If a reporting company knows that any of its necessary conflict minerals originated in a Covered Country and are not from recycled or scrap sources, or has reason to believe that its necessary conflict minerals may have originated in a Covered Country and has reason to believe that they may not be from recycled or scrap sources, the company must exercise due diligence on the source and chain of custody of its conflict minerals that conforms to a nationally or internationally recognized due diligence framework (if one exists). If, as a result of that due diligence, the reporting company determines that its conflict minerals did not originate in a Covered Country or it determines that its conflict minerals did come from recycled or scrap sources, a Conflict Minerals Report (CMR) is not required; however, the company must make disclosures, on Form SD and on its publicly available Internet website, consistent with those required under Step Two described above. Otherwise, the reporting company must file a CMR as an exhibit to Form SD and provide the CMR on its publicly available Internet website.

Key Considerations:

- *What type of due diligence is required?* Reporting companies at Step Three must follow a nationally or internationally recognized due diligence framework to determine the source and chain of custody of their conflict minerals. Currently, the OECD's "Due Diligence Guide for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas" is the only such framework (*see* footnote 3). Unfortunately, the OECD guidance is far from being a detailed step-by-step due diligence program. Rather, the OECD guidance sets forth a general five-step framework:

    1) establish strong company management systems;

    2) identify and assess risks in the supply chain;

    3) design and implement a strategy to respond to identified risks;

    4) carry out an independent third-party audit of supply chain due diligence at identified points in the supply chain (*e.g.*, smelters); and

    5) report on supply chain due diligence.

- *What does "DRC Conflict Free" mean?* It means that a product does not contain conflict minerals that directly or indirectly finance or benefit an armed group identified as a

[3] The OECD is an international body that is responsible for the only current nationally or internationally recognized conflict mineral due diligence framework. It can be found at: http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/46740847.pdf

perpetrator of serious human rights abuses in a Covered Country.[4] In addition, conflict minerals that a reporting company obtains from recycled or scrap sources are considered DRC Conflict Free.

- *What must the CMR include?* The answer depends on whether a reporting company determines that its conflict minerals are "DRC Conflict Free," "not DRC Conflict Free" or "DRC Conflict Undeterminable."
    - A CMR for DRC Conflict Free minerals must include:
        - a description of the measures the reporting company has taken to exercise due diligence on the source and chain of custody of the conflict minerals;
        - a statement that the reporting company has obtained an independent private-sector audit of the CMR (which constitutes an audit certification required by Section 1502); and
        - the identity of the auditor and the actual audit report, which must be in accordance with the Comptroller General of the United States (*i.e.*, the "Yellow Book").
    - A CMR for conflict minerals that have not been found to be DRC Conflict Free must include each of the items listed above for the DRC Conflict Free CMR, as well as:
        - a description of the products that contain the conflict minerals;
        - a description of the facilities used to process the conflict minerals;
        - the country of origin of the conflict minerals; and
        - the efforts taken to determine the mine or location of origin with the greatest possible specificity.
    - A CMR for DRC Conflict Undeterminable minerals must include each of the items listed above for a CMR for conflict minerals that have not been found to be DRC Conflict Free.
- *What is "DRC Conflict Undeterminable" and how long does that reporting category exist?* During a defined transition period, if a reporting company is unable to determine the origin of its conflict minerals, or whether its conflict minerals came from recycled or scrap sources, it must provide a CMR and may designate its conflict minerals as "DRC Conflict Undeterminable" rather than as having "not been found to be DRC Conflict Free." In addition, an independent private-sector audit is not required for such category of minerals during the

[4] Such armed groups are identified in annual Country Reports on Human Rights Practices under sections 116(d) and 502B(b) of the Foreign Assistance Act of 1961 (22 U.S.C. 2151n(d) and 2304(b)). The reports are currently available on the U.S. Department of State's website at: http://www.state.gov/j/drl/rls/hrrpt/

transition period. The transition period is four years for smaller reporting companies, and two years for all other reporting companies.

- *What if a reporting company acquires another company that has not previously been subject to the rules?* The rules permit issuers that obtain control over a company that manufactures or contracts for the manufacturing of products with necessary conflict minerals that previously had not been obligated to provide a Form SD for those minerals to delay reporting on the acquired company's products until the end of the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition.

- *What is the scope of the CMR audit?* The auditor must express a conclusion as to whether the design of the reporting company's due diligence measures conforms with the criteria set forth in the nationally or internationally recognized due diligence framework (*e.g.*, the OECD guidance), and whether the company's description of its due diligence measures in the CMR is consistent with the due diligence process that was actually undertaken. The auditor is not required to express an opinion as to whether the reporting company's due diligence measures were effective, or whether the company's minerals are DRC Conflict Free or DRC Conflict Undeterminable.

- *Can the auditors use the Performance Audit standard under the Generally Accepted Government Auditing Standards, rather than the Attestation Engagement standard?* Yes, the SEC stated in the final rule release that the Government Accountability Office staff has indicated that either standard will be applicable. The ability to use the Performance Audit standard could reduce costs and increase the pool of possible auditors because Performance Audits do not require that a licensed CPA perform the audit.

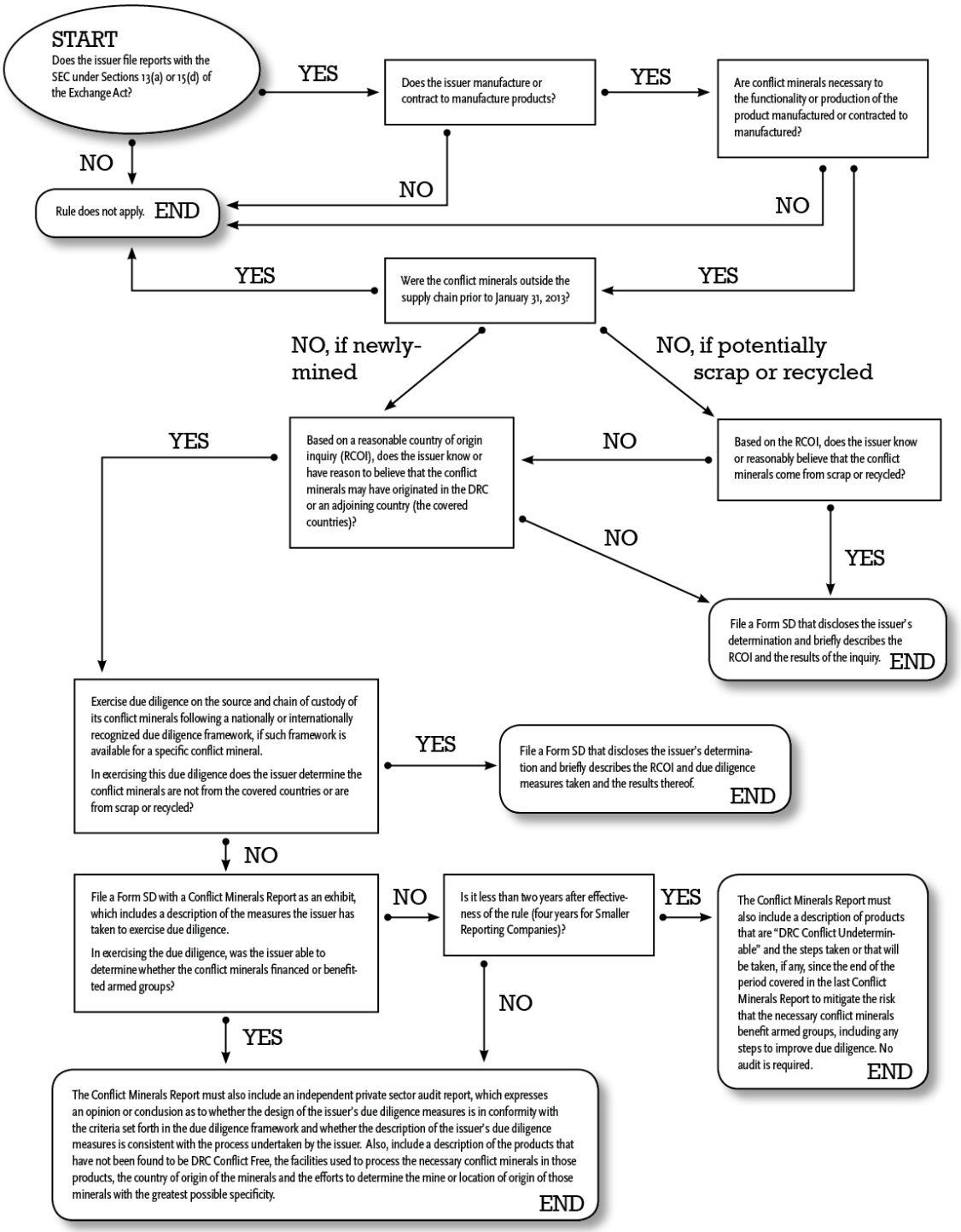
- *Can a reporting company's independent public accountant perform the CMR audit?* Yes, the SEC stated that it would not be inconsistent with the Reg. S-X independence requirements for a reporting company's independent public accountant to perform the independent private-sector audit of the CMR. It would, however, be considered a nonaudit service subject to the preapproval requirements of Reg. S-X, and any fees associated with the CMR audit would need to be included in the "All Other Fees" category of the principal accountant fee disclosures.

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.

Appendix 1

Source: United States Securities and Exchange Commission



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