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D.C. Circuit to Decide Validity of SEC Conflict Minerals Rule, But Companies Should Consider Preliminary Steps to Comply

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Industry groups are urging the U.S. Court of Appeals for the D.C. Circuit to reverse a July 23 district court decision (28 CCW 233, 7/31/13) and invalidate a rule issued by the U.S. Securities and Exchange Commission that imposes costly investigative and disclosure requirements on certain companies that use “conflict minerals” in the manufacturing process (28 CCW 262, 8/21/13). The district court held that the SEC had not acted arbitrarily or capriciously in promulgating the conflict minerals rule and that the disclosure requirement did not violate the First Amendment.

Due to the great effort and expense involved in complying with the rule, and the SEC’s recent poor track record in the D.C. Circuit, many companies have not begun their compliance efforts even though the first deadline for reporting under the rule is now less than eight months away. As we discuss below, the industry groups challenging the rule have mounted several strong arguments for its invalidation; nonetheless, in the light of the comprehensive district court decision, the chances of a successful

challenge to the rule are 50/50 at best. In these circumstances, we believe that companies that have not yet done so should consider taking the preliminary information-gathering steps outlined below so that they will be better-positioned to comply with the rule’s initial May 31, 2014 disclosure deadline if the appellate court upholds the rule.

Background on the SEC’s Rule

The district court’s decision and the appeal relate to a final rule issued by the SEC on August 12, 2012, which establishes investigation and disclosure requirements for companies that manufacture products containing “conflict minerals” (27 CCW 265, 8/29/12). In the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress required the SEC to promulgate the rule to increase public pressure on companies to cease using minerals that are helping to finance conflict and accompanying human rights abuses in the Democratic Republic of the Congo and nine adjoining countries (“Covered Countries”).

“Conflict minerals” are defined in the rule, without regard to country of origin, as:

- gold,

- cassiterite (tin),
- columbite-tantalite (tantalum), and
- wolframite (tungsten).

The term also includes any derivatives of these minerals and any other minerals or derivatives that the U.S. Secretary of State determines are financing conflict in the Covered Countries.

The rule imposes investigative and disclosure requirements on a company only if (i) the company files reports with the SEC under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, and (ii) conflict minerals are “necessary to the functionality or production” of a product manufactured or contracted to be manufactured by the company. Whether conflict minerals are “necessary to the functionality or production” of a company’s product may at times be less than clear; the SEC has provided some guidance, which companies should consult. What is clear, however, is that for this criterion to be applicable, a conflict mineral must be intentionally incorporated into a company’s manufactured product (or into a part or component that has been incorporated into that product).

Under the rule, a company that satisfies the two criteria set forth above must make a “reasonable country of origin inquiry” in good faith to determine whether any of the conflict minerals in its product originated in the Covered Countries or if the minerals are from scrap or recycled sources. The scope of this inquiry will depend on many factors, including the company’s size, number of products and relationship with its suppliers, and the cost of making the inquiry. The key is

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that the company act “reasonably” in light of all the facts and circumstances.

The results of this inquiry will determine the scope of the company’s disclosure and further investigatory requirements. If, pursuant to the “reasonable country of origin” inquiry, the company determines that the conflict minerals in its products do not derive from a Covered Country, or do derive from recycled/scrap materials, or the company has no reason to believe otherwise, then the company need make only minimal disclosures on its website and file SEC Form SD. If, on the other hand, there is reason to believe, following the “reasonable country of origin” inquiry, that the conflict minerals in the company’s product are not from recycled/scrap materials and may have derived from a Covered Country, then the rule imposes more onerous requirements, including conducting a “due diligence” inquiry pursuant to a nationally or internationally recognized due diligence framework and, depending upon the results of that due diligence inquiry, potentially preparing a conflict minerals report, commissioning a private sector audit and stating on their websites that their products are not conflict-free.

The first reports under the conflict minerals rule are due May 31, 2014, for products manufactured between January 1 and December 31, 2013.

The District Court Upholds the Rule

Three plaintiffs—the National Association of Manufacturers, the U.S. Chamber of Commerce and the Business Roundtable—challenged the conflict minerals rule, arguing that it is arbitrary and capricious and that it violates the First Amendment by compelling speech on companies’ own websites. The district court rejected both aspects of the challenge and granted summary judgment to the SEC on July 23, 2013, in a 63-page opinion.¹

Finding that the rule was not arbitrary and capricious, the district court held, among other things, that the SEC was not required to conduct a broad cost-benefit analysis of the rule because the benefits “related to humanitarian objectives” rather than economic ones. The court also rejected the industry groups’ claim that the rule should have contained a *de*

minimis exception for manufacturers that use small amounts of conflict minerals in their products.

The industry groups fared no better on their First Amendment challenge. Although agreeing that the First Amendment protects against government infringement of the right to refrain from speaking, the district court upheld the requirement that companies publicly state on their websites that certain products are not conflict-free as a valid restriction on commercial speech.

The Ruling Is Appealed

The industry groups filed a notice of appeal and on September 11, 2013 submitted their opening brief in the D.C. Circuit. Emphasizing the ubiquity of conflict minerals, including in trace amounts, in literally millions of products, the small percentage of such minerals that actually derive from the Covered Countries and the extreme expense of complying with the SEC’s rule, the industry groups present several strong arguments that the SEC violated the Exchange Act, and in addition acted arbitrarily and capriciously in (1) failing to allow an exception to the rule for companies that use *de minimis* amounts of conflict minerals; (2) imposing disclosure requirements on companies whose manufactured products “may” contain conflict minerals, as opposed to companies whose manufactured products “do” contain such minerals; and (3) extending the scope of the rule to companies that “contract to manufacture” conflict minerals, when the statutory language itself appears to limit the rule’s reach to companies that “manufacture” products containing conflict minerals. They also reassert their argument that the rule compels speech in violation of the First Amendment. Briefing is set to conclude by November 13, 2013, so it will likely be at least several months, and possibly many more, before the D.C. Circuit rules.

The D.C. Circuit has not been a hospitable venue for the SEC. That court has invalidated several SEC rules in recent years,² and a D.C. district court judge invalidated another SEC rule that, like the conflicts min-

² *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).

eral rule, was promulgated pursuant to the Dodd-Frank Act.³

The strength of the industry groups’ arguments, combined with these recent decisions in the D.C. Circuit, suggest that the industry groups have a reasonable chance of prevailing before the appellate court. Nonetheless, in light of the district court’s comprehensive opinion upholding the rule, there is certainly no guarantee that the industry groups will prevail, and, indeed, we believe that the chances of success are at best 50/50.

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Companies Should Consider Taking Preliminary Information-Gathering Steps

In anticipation of the rule being invalidated, and because of the costly nature of compliance, many companies have been delaying making inquiries and gathering information that they will need to comply with the rule’s May 2014 disclosure deadline, which is less than eight months away. In light of the briefing schedule that has been established in the D.C. Circuit, a decision by that court is unlikely to come down before the end of the year. At that point, and assuming that the rule is upheld, companies may not have sufficient time to make the inquiries and gather the information needed to meet the May 2014 deadline. As such, we believe that companies should consider taking some preliminary steps now so they

³ *Am. Petroleum Inst. v. SEC*, 2013 BL 177968 (D.D.C. July 2, 2013).

have sufficient time to fully comply if and when the rule is upheld:

1. Determine whether products contain conflict minerals. Companies that report to the SEC under Exchange Act Section 13(a) or 15(d) should determine if their products contain conflict minerals. A review of purchasing records and interviews with key purchasing and production personnel should be sufficient to determine if the company purchases conflict minerals as a raw material to be incorporated into its products. It may be more difficult, however, to determine whether any parts or components purchased from third parties and incorporated into a company's products contain conflict minerals. In addition to reviewing product information contained in purchase documents and on suppliers' websites and promotional literature, companies should consider sending letters to suppliers of their parts and components that potentially could contain conflict minerals inquiring whether the supplier, or anyone who supplies to the supplier, has incorporated any conflict minerals into the part or component, and the basis for the supplier's determination.

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2. Seek information from suppliers. If a company determines that it is using conflict minerals in its production process, or that conflict minerals are present in any part or component purchased from a supplier, it should also consider sending letters to those suppliers seeking information on whether the supplier has conducted a "reasonable country of origin" inquiry to determine whether the conflict minerals in the part or component derive from recycled/scrap materials or, if not, derive from one of the Covered Countries.

3. Revise contracts with suppliers. Companies should also consider inserting into their contracts with suppliers provisions that require the supplier to warrant that the parts or components that it is selling to the company: (i) do not contain conflict minerals; or (ii) if they do, based upon a reasonable country of origin inquiry, they derive from recycled/scrap materials; or (iii) if they do not derive from recycled/scrap materials, there is no reason to believe that they derive from one of the Covered Countries.

By taking these steps now, a company will be in a better position to comply with the May 31, 2014 deadline set forth in the conflict minerals rule, should that rule be upheld by the D.C. Circuit. Although some companies will need to take further steps under the rule (if it is upheld), the basic steps outlined above will put many companies in a position where they can determine either that they will not need to comply with the rule, or that compliance will merely require disclosure on their website and filing the form SD. Responses to these inquiries will also provide companies with an idea of the further steps they may have to take if the rule is upheld by the D.C. Circuit.