ALERT MEMORANDUM

New SEC Statement Gives Partial Relief under Conflict Minerals Rule

April 17, 2017

First the resource extraction payments rule, now the conflict minerals rule. On April 7, 2017, the SEC Division of Corporation Finance released a statement that offers partial relief to some issuers required to make filings under the Dodd-Frank mandated conflict minerals rule, although it doesn't go as far as some had hoped. The Division's new guidance states that "it will not recommend enforcement action to the Commission" if companies only file disclosure under Item 1.01(a) and (b) of Form SD, even if they are subject to Item 1.01(c). Effectively, this means that a company otherwise required to conduct detailed due diligence and prepare and file a conflict minerals report could choose not to do so and instead only file a brief Form SD. The deadline for filing Form SD for 2016 is May 31, 2017.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or any of our partners and counsel listed under Capital Markets or Corporate Governance in the "Our Practice" section of our website.

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Some background for those who have not been following the conflict minerals saga: Section 1502 of the Dodd-Frank Act, passed in 2010, required the SEC to adopt a rule requiring disclosures by reporting companies about the sources of specified minerals, with the aim of impeding the financing of armed conflict in the Democratic Republic of the Congo (DRC). Like the resource extraction payments rule, this mandate presented special challenges for the SEC, because Congress sought to use the SEC disclosure system to promote public policy objectives that were not directly related to investor protection, the usual purpose of corporate disclosures. In August 2012, the SEC adopted Rule 13p-1 under the Securities Exchange Act of 1934, which required affected companies to make certain annual disclosures on a new Form SD. Industry groups quickly challenged the rule in federal court on a number of grounds, but in 2013, a federal district court upheld the rule and in April 2014, the D.C. Circuit Court of Appeals affirmed that decision in all respects but one: it held that the rule, and possibly the underlying provision of the Dodd-Frank Act, violate the First Amendment to the U.S. Constitution to the extent they require a company to report to the SEC, and to state on its website, that any of its products have "not been found to be DRC conflict-free." That decision was reaffirmed by the same court in August 2015, and on April 3, 2017, the district court entered a final judgment, remanding to the SEC for further action.

Despite the holding that it is partly unconstitutional, the rule has remained in effect since 2014. After the April 2014 decision, the SEC Division of Corporation Finance issued a statement providing guidance on how to comply with the rule in light of the court's decision. Companies have been following that guidance since then, and 2017 will be the fourth year of filings under the rule. With the new U.S. administration, however, there has been considerable speculation about the fate of the rule. In January 2017, acting SEC Chair Piwowar directed the SEC staff to reconsider its guidance under the rule and whether additional relief might be appropriate, and the SEC solicited comments from interested parties on all aspects of the rule and the guidance. On March 27, 2017, the State Department issued a request for "input from stakeholders" by April 28, 2017 "to inform recommendations on how best to support responsible sourcing" of conflict minerals. And upon the final determination of the court case in April 2017, acting Chair Piwowar directed the SEC staff to begin preparing a recommendation for SEC action to address the constitutional defect, and the Division issued its new statement.

Under the new guidance, Rule 13p-1 remains in effect, and any reporting company that manufactures or contracts to manufacture products for which conflict minerals are necessary to those products' functionality or production must still file a Form SD. Under paragraph (a) of Item 1.01 of Form SD, a company must conduct a "reasonable country of origin inquiry" to determine whether its necessary conflict minerals originated in the covered countries or came from recycled or scrap sources. If the company determines it has no reason to believe that its necessary conflict minerals originated in a covered country or it reasonably believes that they came from recycled or scrap sources, under paragraph (b) of Item 1.01, it must disclose this determination on Form SD and its website and briefly describe its reasonable country of origin inquiry and the results of the inquiry.

If the company cannot reach this determination, paragraph (c) of Item 1.01 of Form SD requires it to conduct due diligence on the source and chain of custody of its conflict minerals and prepare a detailed conflict minerals report, to be filed as an exhibit to Form SD and posted on its website. After an initial transition period, an independent private sector audit would also have been required, but that requirement was stayed under the Division's 2014 guidance unless a company voluntarily characterized its products as "DRC conflict-free."

The Division's new guidance states that in light of the uncertainty regarding how the SEC will resolve the various issues related to the rule, the Division "will not recommend enforcement action to the Commission if companies, including those that are subject to paragraph (c) of Item 1.01 of Form SD, only file disclosure under the provisions of paragraphs (a) and (b) of Item 1.01 of Form SD."

The statement does not indicate what disclosure should be included in the Form SD if a company is subject to Item 1.01(c) and would otherwise have filed a conflict minerals report. Presumably such a company could:

- state that based on its reasonable country of origin inquiry, it is unable to conclude that it has no reason to believe its necessary conflict minerals came from the covered countries or that it reasonably believes they came from recycled or scrap sources;
- briefly describe its reasonable country of origin inquiry and the results of the inquiry; and
- state that paragraph (c) of Item 1.01 of Form SD would require it to file a conflict minerals report, but in reliance on the no-action position announced by the SEC's Division of Corporation Finance on April 7, 2017, it is not doing so.

The Division's "no-action" language is similar to that used by the Division in other contexts and should provide sufficient assurance that this approach would entail minimal SEC enforcement risk. Because Form SD is "filed" under the Exchange Act, it is subject to the liability provisions of Section 18 of the Exchange Act, as well as the general antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, so there would be a private right of action

were a Form SD found to be false or misleading in any material respect. However, it is difficult to imagine how not filing a conflict minerals report could be considered an omission of a material fact such that a company's disclosure would be false or misleading. Accordingly, the private litigation risk also seems minimal.

The Division's position and acting SEC Chair Piwowar's direction and statements have already attracted criticism, including from SEC Commissioner Stein, who reportedly suggested Piwowar was acting beyond his authority by engaging in de facto rulemaking. On March 29, 2017, four Senators wrote to the SEC Inspector General, asking him to conduct an investigation into Piwowar's January statement on the rule, noting that the acting Chair's "personal distaste for a congressional mandate is not sufficient grounds to attempt to weaken a final rule that has been approved by the SEC." Some NGOs have made similar arguments, raising the question whether they might attempt to sue the SEC to have the new guidance invalidated. It is difficult to predict whether a court might be willing to grant relief in such a proceeding, particularly given that the current guidance is in the form of a no-action position from the staff.

Beyond the legal analysis, any company considering reliance on the Division's new guidance – and in particular high-profile and consumer-oriented companies such as in the electronics industry – should consider the potential reputational impact of their approach to conflict minerals reporting, as well as potential reactions from their customers or shareholders. NGO criticism could heighten these concerns, and a company may want to avoid being an outlier among its peer group.

Some companies may decide to file a full conflict minerals report with their Form SD irrespective of the new guidance, particularly if they have made responsible sourcing part of their brand or – given the proximity to the May 31 filing deadline – if they have already completed most of the work. Those that do so should ensure that they conduct sufficient due diligence – also required under Item 1.01(c) – and in particular follow up on "red flags" in supplier responses, to avoid including potentially inaccurate or misleading disclosure in the report. They should also avoid statements that their products are "DRC conflict-free," as that could potentially give rise to the argument that an audit is required.

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