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white paper

SEC Adopts Rules Implementing the Dodd-Frank Requirement for Conflict Minerals Reporting

September 2012

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On August 22, 2012, the Securities and Exchange Commission (the SEC) adopted annual disclosure requirements that implement Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which requires disclosures relating to conflict minerals (the Final Rules). Due to doubts as to whether they would accomplish their intended benefits, the SEC vote to adopt the disclosure requirements was close, with adoption passing by a 3-2 vote.

The minerals identified as "conflict minerals" are columbite-tantalite (coltan), cassiterite, gold, wolframite, and their derivatives—tantalum, tin, and tungsten—as well as any other derivatives of those minerals and any other minerals and their derivatives that the Secretary of State identifies as conflict minerals because they are financing conflict in the Democratic Republic of the Congo or an adjoining country (collectively, the DRC). The new annual calendar year disclosures will be required beginning with the 2013 calendar year, with the filing due on May 31, 2014, and on May 31 every year thereafter. The SEC's adopting release (the Adopting Release) can be accessed at http://www.sec.gov/rules/final/2012/34-67716.pdf.

Scope

The Final Rules apply to any registrant that is subject to the periodic reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), and that uses conflict minerals that are "necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured." There is no exemption for smaller reporting companies or foreign private issuers, and no exemption for a product that contains a *de minimis* amount of conflict minerals.

Purpose of the Rules

The SEC explains in the Adopting Release that Congress enacted Section 1502 of Dodd-Frank to further the humanitarian goal of addressing the human rights abuses in the DRC, which Congress believes have been partially financed by the exploitation and trade of conflict minerals originating in the DRC. This purpose is vastly different from those traditionally served by the federal securities laws' disclosure requirements.

Significant Changes from the Proposal

The Final Rules differ from the proposed rules in the following significant ways:

- The Final Rules exclude conflict minerals that come from recycled or scrap sources, that is, minerals that are derived from metals that come from reclaimed end-user or post-consumer products, or scrap-processed metals created during product manufacturing.
- The Final Rules exclude conflict minerals that were smelted or fully refined or were outside the DRC prior to January 31, 2013, that is, they were "outside the supply chain."
- The Final Rules exclude registrants that mine or contract to mine conflict minerals unless the registrant also engages in manufacturing.
- The Final Rules revise the trigger for when a registrant would be required to conduct due diligence and provide a Conflict Minerals Report. The proposed rules would have required such due diligence and the provision of a Conflict Minerals Report when the registrant determined that its conflict minerals originated in the DRC or came from recycled or scrap sources or when the registrant was unable to determine that its conflict minerals did not originate in the DRC. Under the Final Rules, a registrant is required to exercise due diligence if the registrant determines, based on a "reasonable country of origin inquiry," (i) that its conflict minerals originated in the DRC and did not come from recycled or scrap sources; or (ii) that it has reason to believe that its conflict minerals may have originated in the DRC and may not have come from recycled or

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scrap sources. A registrant that determines, based on this due diligence, that its conflict minerals did not originate in the DRC or that its conflict minerals did come from recycled or scrap sources does not need to provide a Conflict Minerals Report.

- The Final Rules require the disclosures about conflict minerals to be included in a new form, Form SD, and, when required, in a Conflict Minerals Report that is to be included as an exhibit to the Form SD, together with an independent private-sector audit report, rather than in a registrant's annual report on Form 10-K and in an exhibit to the Form 10-K. The Adopting Release explains the following about Form SD:
  - Form SD will be filed rather than furnished and, therefore, is subject to potential liability under Section 18 of the Exchange Act. Footnote 342 to the Adopting Release also points out that "issuers that fail to comply with the Final Rules could also be violating Exchange Act Sections 13(a) and (p) and 15(d), as applicable," as well as Exchange Act Section 10(b) and Rule 10b-5 thereunder, "for any false or misleading material statements in the information disclosed pursuant to the rule."
  - Form SD will not be incorporated by reference into a registration statement filed under the Securities Act of 1933, as amended (the Securities Act). Unless a registrant explicitly incorporates the Form into a registration statement filed under the Securities Act, Form SD will not be subject to liability under the Securities Act.
  - As long as a registrant does not expressly incorporate its Form SD into a registration statement filed under the Securities Act, the entity that provides an independent audit report will not be regarded as an expert under the Securities Act and will not have to give a consent.
  - A registrant's chief executive officer and chief financial officer will not cover Form SD in their certifications required by Rules 13a-14 and 15d-14 under the Exchange Act.
- The Final Rules provide a transition phase-in period (the Transition Period) during which a registrant may choose to identify a product as "DRC conflict undeterminable" if the registrant cannot determine, after exercising due diligence, (i) that the conflict minerals used in the manufacture of the product did not originate in the DRC or came from recycled or scrap sources; or (ii) that any conflict minerals used in the manufacture of the product that originated in the DRC did not directly or indirectly finance or benefit an armed group. During the Transition Period, which encompasses the first two Conflict Minerals Reports required by the Final Rules (or the first four such reports if the registrant is a smaller reporting company), a registrant may use the "DRC conflict undeterminable" terminology and avoid the requirement, explained below, to obtain an independent private-sector audit of its Conflict Minerals Report.

The SEC has provided a flowchart summarizing the provisions of the annual disclosure rules. It is available at http://www.morganlewis.com/pubs/ConflictMineralsChart_sept2012.pdf.

Three-Step Analytical Process

The Final Rules provide the following three-step analytical process registrants must follow to comply with the conflict minerals disclosure requirements.

Step One

A registrant will first need to determine whether any conflict minerals are "necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured." This analysis requires considering components of a product as well as the product itself.

Although the SEC did not define the phrase "necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured" in the Final Rules, it did provide guidance in the Adopting Release as to the meaning of the terms "contract to manufacture," "necessary to the functionality," and "necessary to the production." This guidance includes the following:

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- **"Contract to manufacture."** Whether a registrant will be considered to "contract to manufacture" a product depends on the degree of influence the registrant exercises over the materials, parts, ingredients, or components to be included in the product that contains conflict minerals.
  - A registrant will not be considered to "contract to manufacture" a product if the registrant **only**
    - specifies or negotiates contractual terms with a manufacturer 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 similar terms relating to the product, unless the actions it takes are "practically equivalent to contracting on terms that directly relate to the manufacturing of the product";
    - affixes its brand, mark, logo, or label to a generic product manufactured by a third party; or
    - services, maintains, or repairs a product manufactured by a third party.
  - With respect to influence over the manufacturing of a product, the Adopting Release provides the following:
    - If the registrant specifies that a particular conflict mineral must be included in a product, the registrant may be viewed as exerting "substantial" influence on the overall manufacturing of the product.
    - If a registrant merely specifies to a manufacturer that, for example, a cell phone it will purchase from that manufacturer to sell at retail must be able to function on a certain network, the registrant would not be regarded as exerting sufficient influence to be considered to "contract to manufacture" the phone for purposes of the Final Rules.
- **"Necessary to the functionality."** A conflict mineral may only be considered "necessary to the functionality" of a product if the conflict mineral is, in fact, contained in the product.
  - Once that threshold requirement is met, the SEC has explained that the conflict mineral would be considered "necessary to the functionality" of the product if any of the following applies:
    - The conflict mineral is intentionally added to the product and is not a naturally occurring by-product.
    - The conflict mineral is necessary to any of the product's generally expected functions, uses, or purposes.
    - The primary purpose of the product is ornamentation or decoration, and the conflict mineral is incorporated for purposes of ornamentation, decoration, or embellishment.
  - A registrant must consider any conflict mineral contained in its product, even if that conflict mineral is only in the product because it was included as part of a component of the product that was originally manufactured by a third party.
  - A conflict mineral that is "necessary to the functionality" of a product is also "necessary to the functionality" of any subsequent product that incorporates the product as a component.
- **"Necessary to the production."** A conflict mineral is "necessary to the production" of a product if the conflict mineral is intentionally included in the production process of the product, other than in tools, machines, or equipment used to produce the product (such as computers or power lines).
  - The SEC does not believe that "a conflict mineral is 'necessary to the production' of a product if the conflict mineral is used as a catalyst, or in a similar manner in another process, that is necessary to produce the product but is not contained in that product." If a conflict mineral is used as a catalyst and is not completely washed away, however, the Adopting Release states that the product will be considered to contain "a necessary conflict mineral that is necessary to its production and is subject to the [F]inal [R]ules," even if only "trace amounts" of the conflict mineral are contained in the product.
  - Conflict minerals contained in materials, prototypes, and other demonstration devices are not covered by the Final Rules because the SEC does not regard those types of devices as "products."

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If a registrant determines that no conflict minerals are "necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured," the registrant will not need to do anything else under the Final Rules.

Step Two

If the registrant determines that any conflict minerals are "necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured," it must then conduct, in good faith, a "reasonable country of origin inquiry regarding the origin of its conflict minerals." The Final Rules provide that a "reasonable country of origin inquiry" is an inquiry conducted in good faith regarding the origin of conflict minerals that is reasonably designed to determine whether any of the conflict minerals originated in the DRC or are from recycled or scrap sources.

The Adopting Release notes the following:

- A registrant's policies with respect to the sourcing of conflict minerals will generally form a part of the "reasonable country of origin inquiry."
- The "reasonable country of origin inquiry" standard would be met if a registrant both (i) seeks and obtains reasonably reliable representations from the facility at which the conflict minerals were processed, or from the registrant's immediate suppliers, indicating the facility at which the conflict minerals were processed and demonstrating that those conflict minerals either did not originate in the DRC or came from recycled or scrap sources; and (ii) has a reason to believe that these representations are true, given the facts and circumstances surrounding those representations and taking into account warning signs or other circumstances indicating that its conflict minerals may have originated in the DRC or may not have come from recycled or scrap sources.
- A registrant would have reason to believe that representations were true if a processing facility either had received a "conflict free" designation by a recognized industry group that requires an independent private-sector audit, or if an individual processing facility, while not part of an industry group's "conflict free" designation process, had obtained an independent private-sector audit that was made publicly available. A product is "DRC conflict free" if the product does not contain conflict minerals necessary to the functionality or production of that product that directly or indirectly finance or benefit an armed group in the DRC.

The Adopting Release also states that the "reasonable country of origin inquiry" is consistent with the supplier engagement approach in the Organisation for Economic Co-operation and Development (the OECD) guidance to determine if due diligence under the OECD guidance is necessary. Among other things, this approach includes contacting suppliers to explain the registrant's possible need to undertake due diligence. The OECD's final draft report, "Downstream Implementation of the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas – Cycle 2 Interim Progress Report on the Supplement on Tin, Tantalum and Tungsten," is available at http://www.oecd.org/investment/guidelinesformultinationalenterprises/Downstream%20cycle%202%20report%20-%20Edited%20Final%20-%201%20June.pdf.

If, based on this inquiry, the registrant determines or reasonably believes that its conflict minerals did not come from the DRC or that its conflict minerals are from recycled or scrap sources, it does not need to conduct due diligence on the source and chain of custody of the conflict minerals or prepare a Conflicts Minerals Report. However, it must do the following:

- File with the SEC a specialized disclosure report on Form SD in which it (i) discloses under the heading "Conflict Minerals Disclosure" its determination; and (ii) describes the results of the inquiry and the "reasonable country of origin inquiry" it conducted in reaching its determination to demonstrate its basis for concluding that it is not required to file a Conflict Minerals Report.
- Disclose this information on its publicly available website.

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- Provide a link under the heading "Conflict Minerals Disclosure" in its Form SD to the information posted on its website.

Step Three

If, based on the "reasonable country of origin inquiry," the registrant knows or has reason to believe that its conflict minerals originated in the DRC and are not from recycled or scrap sources, it must exercise due diligence on the source and chain of custody of the conflict minerals to determine whether such conflict minerals are "DRC conflict free," as defined above. The due diligence must be conducted in a manner that conforms to a nationally or internationally recognized due diligence framework, if one is available.

The OECD has provided due diligence guidance with respect to tantalum, tin, and tungsten (available at http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/46740847.pdf) and with respect to gold, including recycled or scrap gold (available at http://www.oecd.org/corporate/guidelinesformultinationalenterprises/FINAL%20Supplement%20on%20Gold.pdf).

If, as a result of the due diligence, the registrant **determines that it is not required to submit a Conflict Minerals Report** due to its determination that its conflict minerals did not originate in the DRC or that its conflict minerals came from recycled or scrap sources, the registrant must do the following:

- File with the SEC a specialized disclosure report on Form SD in which it (i) discloses under the heading "Conflict Minerals Disclosure" its determination; and (ii) describes the reasonable country of origin inquiry and the due diligence efforts it undertook to demonstrate the basis for concluding that it is not required to submit a Conflict Minerals Report.
- Disclose this information on its publicly available website.
- Provide a link under the heading "Conflict Minerals Disclosure" in its Form SD to the information on its website.

If, as a result of the due diligence, the registrant **determines that it is required to submit a Conflict Minerals Report** because it cannot determine that its conflict minerals did not originate in the DRC or that its conflict minerals came from recycled or scrap sources, the registrant must do the following:

- File a Conflict Minerals Report as an exhibit to a Form SD that it files with the SEC.
- Provide the Conflict Minerals Report on its publicly available website.
- Disclose in its Form SD under the heading "Conflict Minerals Disclosure" that it has included the Conflict Minerals Report on its website and provide a link to the Conflict Minerals Report on its website.

Contents of a Conflict Minerals Report

In its Conflict Minerals Report, a registrant must describe all of its products "that have not been found to be 'DRC conflict free.'" In addition, among other things, a registrant must describe its due diligence process on the source and chain of custody of the conflict minerals.

- For products that have not been found to be "DRC conflict free," the registrant's Conflict Minerals Report must also:
  - Describe (i) any products that it manufactures or contracts to manufacture that have not been found to be "DRC conflict free"; (ii) the facilities (that is, smelters or refineries) used to process the conflict minerals in those products; (iii) the country of origin of the conflict minerals in those products; and (iv) the efforts to determine the mine or location of origin with the greatest possible specificity.
  - Include a statement that the registrant obtained an independent private-sector audit of its Conflict Minerals Report, identify the entity that conducted such audit, and attach that audit report.

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- For products that are "DRC conflict undeterminable":
  - A registrant may use the term "DRC conflict undeterminable" during the Transition Period if it cannot determine if any of following are true:
    - The conflict minerals did not originate in the DRC.
    - The conflict minerals that originated in the DRC directly or indirectly financed or benefited an armed group.
    - The conflict minerals came from recycled or scrap sources.
  - During the Transition Period, when a registrant uses the term "DRC conflict undeterminable" with respect to particular products, it must also do the following:
    - Describe (i) the products that it manufactures or contracts to manufacture that it identifies as "DRC conflict indeterminable"; (ii) the facilities (that is, smelters or refineries) used to process the conflict minerals in those products (if known); (iii) the country of origin of the conflict minerals in those products (if known); and (iv) the efforts to determine the mines or locations of origin with the greatest possible specificity.
    - Describe the steps it has taken since the end of the period covered by its Conflict Minerals Report (or those steps that it plans to take in the future) to mitigate the risk that its conflict minerals benefit armed groups, including any steps to improve its due diligence.
  - A registrant that reports during the Transition Period that its products are "DRC conflict undeterminable" is not required to obtain an independent private-sector audit of its Conflict Minerals Report.

Additional Clarifications or Changes in the Final Rules

The Final Rules contain the following clarifications or changes from the proposed rules:

- Disclosures are required about those conflict minerals that are necessary to the functionality or production of a product with respect to which the registrant or its contract manufacturer completed the manufacturing process in the calendar year covered by the report.
- With respect to the independent private-sector audit of the Conflict Minerals Report:
  - The audit must be based on the auditing standards included in the Government Auditing Standards issued by the Government Accountability Office (the GAO) (commonly referred to as the Yellow Book) unless the GAO provides otherwise.
  - The entity performing such audit must comply with any independence standards established by the GAO and can be the registrant's independent auditor, which would be regarded as providing a "non-audit service" subject to the pre-approval requirements of Rule 2-01(c)(7) of Regulation S-X and the fee disclosure in the "All Other Fees" category required by Item 9(e)(4) of Schedule 14A.
  - The objective of the audit is to express an opinion or conclusion on whether the design of the registrant's due diligence measures as described in, and with respect to the period covered by, the Conflict Minerals Report is in conformity with, in all material respects, the criteria set forth in the nationally or internationally recognized due diligence framework used by the registrant and whether the registrant's description of its due diligence measures in the Conflict Minerals Report is consistent with the due diligence process that the registrant undertook.
- A registrant is not required by the Final Rules to maintain reviewable business records supporting its reasonable country of origin conclusion.
- A registrant must make available its Conflict Minerals Disclosure or its Conflict Minerals Report on its website for one year.

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- A registrant that obtains control over a company that manufactures or contracts the manufacture of products that contain conflict minerals and that had not previously been subject to the conflict minerals reporting rules may delay reporting on the products manufactured by the acquired company until the report for the first calendar year beginning no sooner than eight months after the effective date of the acquisition.

Costs and Benefits of the Final Rules

The Adopting Release notes that the SEC believes that the initial cost of compliance with the Final Rules is approximately $3 billion to $4 billion, and the annual cost of ongoing compliance will be between $207 million and $609 million. In addition, the SEC acknowledges in the Adopting Release that the Final Rules could adversely affect the competitive position of registrants because companies not subject to the disclosure requirements will not need to incur those costs. The SEC was unable to compare those costs to the benefits of the Final Rules.

The Adopting Release further explains that Section 1502 of Dodd-Frank is intended to achieve compelling social benefits, which the SEC has been unable to "readily quantify with any precision," both because it does not have the data to quantify the benefits and because it is not able to assess how effective the Final Rules will be in achieving those benefits. The two commissioners who voted against the adoption of the Final Rules noted their concerns that the new requirements could do more harm than good in the DRC.

Next Steps

Given the new requirements under the Final Rules, a registrant should start now to take the following steps:

- Determine whether the registrant manufactures or contracts to manufacture any products, including components, containing tin, tantalum, tungsten, or gold.
- For those products containing conflict minerals, do the following:
  - Determine whether any of those minerals are necessary to the functionality or production of the products.
  - Determine whether any of those minerals are from recycled or scrap sources.
  - Determine whether any of those minerals might meet the exclusion for "outside the supply chain" prior to January 31, 2013.
- Review the OECD guidance and any other applicable nationally or internationally recognized due diligence framework to determine appropriate steps to take to comply with the "reasonable country of origin inquiry" and due diligence requirements, including inquiries to be made to suppliers.
- Examine the supply contracts for tin, tantalum, tungsten, and gold and for the manufacturing of products containing those minerals to determine whether the contractual terms can be revised to include representations with respect to the origin of the minerals.

Contacts

If you have any questions or would like more information on the issues discussed in this White Paper, please contact any of the following Morgan Lewis attorneys:

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