CLIENT ALERT

SEC Releases Final Conflict Minerals Rules with Broad Implications for Certain Reporting Companies

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OVERVIEW

On August 22, following a 3-to-2 vote, the U.S. Securities and Exchange Commission (SEC) adopted final rules relating to "conflict minerals," commonly used in everyday products such as electronic equipment, wires and jewelry, that originate in the Democratic Republic of Congo (DRC) or countries that share an internationally recognized border with the DRC ("Covered Countries"). The rules require certain companies to disclose their use of conflict minerals that are "necessary to the functionality or production" of products they manufacture.

Conflict minerals include cassiterite (used to produce tin), columbite-tantalite (from which tantalum is extracted), gold, wolframite (used to produce tungsten), and their derivatives, and any other minerals or their derivatives determined by the Secretary of State to be financing conflict in the Covered Countries. The SEC has anticipated that approximately 1,200 companies will be required to file a Conflicts Minerals Report with the SEC (as described below) under the rules.

The conflict minerals rules were mandated by section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The goal of the final rules is to mitigate the humanitarian crisis in central Africa by cutting off sources of funding for the violent conflict in the region, which has been partially financed by the exploitation and trade of conflict minerals. Companies must comply with the final rules for the calendar year beginning January 1, 2013, regardless of fiscal year end. The first report is due May 31, 2014.

WHO IS COVERED?

Any issuer that files reports with the SEC under Section 13(a) or Section 15(d) of the U.S. Securities Exchange Act of 1934 (the "Exchange Act"), including domestic companies, foreign private issuers and smaller reporting companies, will be subject to reporting requirements, if conflict minerals are "necessary to the functionality or production" of products manufactured or contracted to be manufactured by the issuer.

Manufactured or Contracted to be Manufactured

While the final rules do not define the term "manufacture," they specify that the SEC would not consider an issuer that only services, maintains or repairs a product containing conflict minerals to be "manufacturing" that product. Meanwhile, whether an issuer "contracts to manufacture" a product depends on the degree of influence it exercises on the manufacturing, based on the facts and circumstances of an issuer's business and industry.

Ultimately, a company would not be deemed to have influence over the manufacturing if it merely (1) specifies or negotiates contractual terms with a manufacturer that do not directly relate to the manufacturing of the product, (2) affixes its brand,

marks, logo or label to a generic product manufactured by a third party or (3) services, maintains or repairs a product manufactured by a third party. In a notable departure from the rules as they were proposed in 2010, an issuer that mines or contracts to mine conflict minerals will not be considered to be manufacturing or contracting to manufacture those minerals unless the issuer also engages in actual manufacturing of the end products.

Necessary to the Functionality or Production of a Product

The rules similarly do not define the meaning of "necessary to the functionality" or "necessary to the production of a product," but list a series of factors issuers should consider in making their determinations. A conflict mineral is "necessary to the functionality" of a product if it: (1) is intentionally added to a product and is not a naturally-occurring by-product; (2) is necessary to the product's generally expected function, use or purpose; or (3) is incorporated for ornamentation, decoration or embellishment.

In assessing whether a product is "necessary to the production of a product," factors include whether the conflict mineral is: (1) included in the product's production process; (2) included in the product; and (3) necessary to produce the product. Under the final rules, for a conflict mineral to be considered "necessary to the production" of a product, the mineral must be both contained in the product and necessary to the product's production. A conflict mineral is not "necessary to the production" of a product if it is simply used as a catalyst.

No De Minimis Exception

Due to concerns with the cumulative impact of these products, the SEC rejected requests to include an exception for products that contain de minimis amounts of conflict minerals.

Outside the Supply Chain

The final rules exempt any conflict minerals that are "outside the supply chain" prior to January 31, 2013. Conflict minerals are considered to be "outside the supply chain" if they have been smelted or fully refined or simply do not originate from one of the Covered Countries. The final rules create a special set of procedures if an issuer that previously had not been obligated to provide a specialized disclosure report subsequently obtains control over a company that manufactures or contracts for the manufacturing of products with conflict minerals.

REPORTING OBLIGATIONS UNDER THE RULES: THE THREE STEP TEST

Step 1: Does the Issuer Fall Under the Baseline Definition?

An issuer must first determine whether it is a "covered person," meaning one for whom "conflict minerals are necessary to the functionality or production of a product manufactured by such person". If not, the issuer is not required to take any action, make any disclosures, or submit any reports under the final rules. If, however, an issuer meets this definition, it must move on to the second step.

Step 2: Determining Whether Conflict Minerals Originated in the DRC or Other Covered Countries

Under the final rules, a company that uses any of the designated minerals would be required to conduct a 'country of origin' inquiry, performed in good faith and reasonably designed to determine whether any of the minerals in use by the company originated in the Covered Countries or are from scrap or recycled sources.

If a company determines that its conflict minerals did not originate in the Covered Countries or are from recycled or scrap sources or if the company has no reason to believe that the mineral may have originated in the covered countries and may not be from scrap or recycled sources, then the inquiry ends. The company must file a specialized form (Form SD, discussed below), disclosing its determination and briefly describing the inquiry it used.

The company is required to make its description publicly available on its website and provide the internet address of that site in the Form SD but would not be required to retain the business records it used to support its country of origin conclusion.

Step 3: Due Diligence on the Source and Chain of Custody of Conflict Minerals

If, however, based on the reasonable country of origin inquiry, the issuer knows, or has reason to believe, that it has conflict minerals that originated in the Covered Countries and they did not come from recycled material or scrap, the company must perform additional diligence on the source and chain of custody of its conflict minerals. The due diligence must conform to a nationally or internationally recognized due diligence framework, such as the guidance approved by the Organization for Economic Co-operation and Development (OECD).

Content of Conflict Minerals Report: Are the Company's Minerals DRC Conflict Free?

As a result of the company's due diligence, the company must determine whether its minerals fall into one of three categories: (1) "DRC conflict free;" (2) "not DRC conflict free;" and (3) "DRC conflict undeterminable" (discussed in detail below). The extent of the company's reporting obligations will hinge directly upon the category into which the minerals fall. The company must then prepare a Conflict Minerals Report (describing its due diligence measures and its results) and may be required to have it audited by an independent private sector auditing firm. The final rules specify that the audit's objective is to express a conclusion as to whether the design and the company's description of the due diligence measures it performed conform to the criteria set forth in the nationally or internationally recognized framework.

The Conflict Minerals Report must then be filed as an exhibit to Form SD. The Company is also required to make the Conflict Minerals Report publicly available on its website and to provide the internet address of that site in Form SD.

DRC Conflict Free

If, after due diligence, a company determines that its products are "DRC conflict free," specifically, that while the conflict minerals the company utilizes may originate from Covered Countries, they do not directly or indirectly finance or benefit armed groups in the Covered Countries, then the company must have its Conflict Minerals Report audited by an independent private sector auditor. The company must also certify that it obtained the audit, include the audit report as part of the Conflict Minerals Report, and disclose the auditor.

Not DRC Conflict Free

On the other hand, any issuer that manufactures products or contracts for products to be manufactured that have not been found to be "DRC conflict free," must, in its Conflicts Minerals Report, provide a description of: those products which are not DRC conflict free; the facilities used to process the necessary conflict minerals in those products; the country of origin of the necessary conflict minerals in those products; and the efforts to determine the mine or location of origin with the greatest possible specificity.

DRC Conflict Undeterminable

For a temporary period, a company may describe its products as "DRC conflict undeterminable" if it is unable to determine that its minerals meet the statutory definition of "DRC conflict free" for either of two reasons: (1) if after the exercise of due diligence the company is unable to determine whether the minerals in its products financed or benefited armed groups in the Covered Countries; or (2) if after an initial determination that its minerals may have originated in the Covered Countries, the company failed to clarify the conflict minerals' country of origin, whether the conflict minerals financed or benefited armed groups in those countries, or whether the conflict minerals came from recycled or scrap sources. This is a significant departure from the proposed rules which would have required companies that were unsure if its conflict minerals met the criterion above to label those conflict minerals "not DRC conflict free."

This temporary accommodation will be available to all issuers for the first two years of reporting under the final rules. The final rules extend that period for smaller reporting companies for an additional two years, providing a temporary four-year provision for smaller reporting companies.

During the transition period, companies with products that may be described as "DRC conflict undeterminable" are not required to have their Conflict Minerals Report audited. Such issuers, however, must still file a Conflict Minerals Report, including a description of those products, the facilities used to process the necessary conflict minerals in those products, if known, the country of origin of the necessary conflict minerals in those products, if known, and the efforts to determine the mine or location of origin with the greatest possible specificity. Additionally, these companies must describe their due diligence, and must describe the steps they have taken or will take to mitigate the risk that their conflict minerals benefit armed groups, including any steps to improve their due diligence.

Special Due Diligence for Recycled or Scrap Material

The SEC determined that a company that uses conflict minerals from recycled or scrap sources may describe its products as "DRC conflict free." Despite the fact that the scrap may have originated from Conflict Minerals, the Commission did not feel that, once reconstituted, these minerals were continuing to contribute to the ongoing conflict in the DRC.

The final rules require a company with conflict minerals from recycled or scrap sources only to perform due diligence if, following its reasonable country of origin inquiry, it has reason to believe that the conflict minerals that it thought were from recycled or scrap sources were in fact mined. Under these circumstances, whether the due diligence the company performs is required to conform to a nationally or internationally recognized due diligence framework will depend upon which mineral is in question.

If after its inquiry, the company cannot conclude that the gold contained in its products is from recycled or scrap sources, then it is required to undertake due diligence in accordance with the OECD Due Diligence Guidance, and obtain an audit of its Conflict

Minerals Report. Gold is specified because currently, it is the only conflict mineral with a nationally or internationally recognized due diligence framework for determining whether it is recycled or scrap, which is part of the OECD Due Diligence Guidance.

For the other three minerals, cassiterite, columbite-tantalite and wolframite, if after its inquiry, a company cannot reasonably conclude that its minerals came from recycled or scrap sources, the company will have to perform its due diligence without the benefit of a nationally or internationally recognized framework. In this case, until a widely recognized due diligence framework is developed, the company must describe the due diligence measures it exercised in determining that its conflict minerals were from recycled or scrap sources in its Conflict Minerals Report. In this case, the company is not required to obtain an independent private sector audit regarding these conflict minerals.

SEPARATE REPORTING REQUIREMENT AND IMPLICATIONS

The final rules require an issuer to provide the conflict minerals disclosures that would have been in the body of the annual report in the body of a new specialized disclosure report on a new form, Form SD. An issuer required to provide a Conflict Minerals Report will provide that report as an exhibit to the specialized disclosure report, instead of as an exhibit to its annual report on Form 10-K, Form 20-F, or Form 40-F, as had been proposed. However, because the form is separate from a company's Form 10-K or 20-F, it will not be covered by those forms' CEO and CFO certifications, or automatically incorporated into a company's shelf registration statement.

In order to reduce the burdens on the supply chain, the final rules require that the conflict minerals information in the specialized disclosure report and/or in the Conflict Minerals Report cover the calendar year from January 1 to December 31 regardless of the issuer's fiscal year end, and the specialized disclosure report covering the prior year must be provided each year by May 31. Further, in a change from the proposed rules, the final rules require Form SD, including the conflict minerals information therein and any Conflict Minerals Report submitted as an exhibit to the form, to be "filed" under the Exchange Act as opposed to "furnished" and thereby subject to potential Exchange Act Section 18 liability.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.