

## CLIENT ALERT

### D.C. District Court Affirms the SEC's Approach to Regulating Conflict Minerals

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On July 23, 2013, the U.S. District Court for the District of Columbia affirmed the U.S. Securities and Exchange Commission's (SEC) requirement that issuers make filings on a special form, Form SD, by May 31, 2014 to disclose, and thus ultimately to curtail the use of, so-called "conflict minerals" – tin, tungsten, tantalum and gold – sourced from the Democratic Republic of Congo (DRC) and surrounding areas. Congress had directed the SEC to draft a Conflict Minerals Rule (the "Rule") pursuant to Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to help cut off sources of funding for the violent conflict that has plagued the DRC region. By rejecting industry's challenge to the Rule, the District Court has put increased pressure on reporting companies and their suppliers to undertake a sweeping compliance chain overhaul to trace the origins of the minerals in their products.

Shortly after the Rule became effective, a number of industry trade groups challenged it in *National Association of Manufacturers, Chamber of Commerce and the Business Roundtable v. Securities and Exchange Commission*, Civ. No. 13-cv-635 (D.D.C. July 23, 2013). Plaintiffs alleged that various aspects of the Rule were arbitrary and capricious under the Administrative Procedure Act and that the requirement to "publish" the result of a company's due diligence inquiry and Form SD compelled speech in violation of the First Amendment. The District Court rejected each of the Plaintiff's contentions and granted summary judgment in favor of the SEC.

Plaintiffs argued broadly that the SEC failed to analyze the costs and benefits of the Rule properly in violation of its statutory obligation. In rejecting this contention, the Court found that the SEC was only obligated to "consider" the impact that a rule or regulation may have on various economic-related factors and to weigh the costs and benefits of its proposed action "as it relates to efficiency, competition and capital formation." Dodd-Frank did not mandate that the SEC conduct a broader, wide-ranging cost-benefit analysis. The Court emphasized that the resulting benefits "relate to *humanitarian* objectives that Congress concluded would be achieved by the rulemaking, rather than . . . *economic* objectives underlying the Commission's rule."

The Rule was not adopted by the SEC "of its own accord," according to the Court. Rather, the SEC promulgated the Rule "pursuant to express, statutory directive *from Congress*," driven by Congress's determination that the due diligence and disclosure requirements it enacted would help to promote peace and security in the DRC. As a result, the Court agreed with the SEC's decision not to second-guess Congress's judgment as to the benefits of disclosure, but instead to, "promulgate a rule that would promote the benefits Congress identified and would hew closely to that congressional command." The Court emphasized that the SEC had no obligation to assess whether the Rule would actually achieve the humanitarian benefits Congress identified. Instead, the Court found that the SEC's decision to defer to Congress's determination on this point was permissible and not arbitrary, capricious or contrary to law.

## **No De Minimis Exception**

Plaintiffs also challenged the SEC's failure to include a *de minimis exception* from the Rule's coverage. The Court found that the SEC had properly omitted a *de minimis* exception after concluding that it would be contrary to the Rule's purpose, given the focus on "whether the conflict mineral is 'necessary' to a product's functionality or production," rather than "the amount of a conflict mineral contained in the product." In reaching this decision, the SEC also relied on commentators who stated that conflict minerals are often used in products in very limited quantities, as well as the SEC's own understanding "that there are instances in which only a minute amount of conflict minerals is necessary for the functionality or production of a product." The Court agreed that the SEC had exercised its independent, reasonable, judgment in declining to adopt the *de minimis* exception, rather than believing that it 'lacked authority' to create, or was 'precluded from considering,' a *de minimis* exception.

## **Contract to Manufacture**

Plaintiffs also argued that the SEC's extension of the Rule to issuers that "only contract to manufacture" products with necessary conflict minerals, rather than limiting the Rule's coverage to issuers that manufacture such products, was arbitrary and capricious. Once again the Court disagreed, finding that the statute was ambiguous as to whether issuers that "contract to manufacture" should be covered by the Rule. Here, too, the Court concluded that the SEC had exercised its discretion properly in including this category of issuers within the scope of the Rule and was therefore entitled to deference.

## **First Amendment Challenge**

Plaintiffs also mounted a First Amendment challenge to the Rule, arguing that it improperly compelled "burdensome and stigmatizing speech, by compelling companies to state on their websites . . . that certain of their products are 'not DRC conflict free.'" The Court rejected this contention and concluded that Plaintiffs were distorting the nature and extent of the disclosure required. The SEC requires issuers to publish their Form SD and/or their Conflict Minerals Reports on their websites, but not to separately or conspicuously publish on their websites a list of products that have not been found to be 'DRC conflict free,' or to label products such as packaging. The Court concluded that because a company could comply with the disclosure requirements simply by making its conflict minerals disclosure available on the same webpage that housed other required SEC filings, this product-specific disclosure was reasonable and proportionate.

The Court also discounted Plaintiffs' broader challenge that the disclosure scheme was not a reasonable fit to accomplish Congress's objective of promoting peace and security in the DRC. The Court emphasized that judicial review was particularly deferential in areas "at the intersection of national security, foreign policy, and administrative law." Congress believed that it could not "begin to solve the problems of the eastern Congo without addressing where the armed groups are receiving their funding," namely from the "mining of a number of key conflict minerals." The Court concluded that the Rule survived scrutiny by "directly and materially advance[ing] Congress's interest in promoting peace and security in and around the DRC."

## **Implications**

The ruling came as a surprise to many, particularly after the District Court had vacated another rule earlier this month, also issued pursuant to Dodd-Frank, to which plaintiffs had raised challenges that were similarly framed, including arguing that the rule compelled speech in violation of the First Amendment; that the SEC had erroneously read the statute as requiring public

disclosure of the reports; that the SEC was arbitrary and capricious in declining to grant an exemption for countries that prohibit disclosure; and that its cost-benefit analysis was flawed. In *American Petroleum Institute et al., v. SEC*, Civ. No. 12-1668 (D.D.C. July 2, 2013), the District Court had vacated an SEC rule requiring all U.S. and foreign companies registered with the SEC to disclose payments made to foreign governments and the U.S. Federal Government relating to oil, gas and mineral extraction. This rule had been issued pursuant to Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and was designed to increase transparency by allowing investors to know the full extent of a company's exposure when operating in countries where they are subject to "expropriation, political and social turmoil, and reputational risks."

For manufacturers involved with conflict minerals, no matter how tangentially, even if the *National Association of Manufacturers* decision is appealed, it is unlikely to yield a result prior to the May 2014 deadline when issuers must complete their first report. Reporting companies should already have begun to implement the policies and procedures necessary to analyze the origin of the minerals in their supply chains and to solicit information from their suppliers. As companies amass this information, they will need to craft next-step frameworks to guide them in assessing the sufficiency of the assurances they receive. Ultimately, reporting companies must be prepared to make a determination in May, regarding whether their minerals are 'DRC conflict free,' 'not DRC conflict free,' or 'conflict undeterminable.' The *National Association of Manufacturers* decision increases pressure on companies all along the supply chain to frame and execute a meaningful due diligence process.

For more information on the Conflict Mineral Rule please see Crowell & Moring's [Alert](#) of September 13, 2012.

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