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Disclosure

SEC Division Issues Broad Guidance On Conflicts Rule; Future Still Uncertain

By Yin Wilczek

April 30 — The Securities and Exchange Commission Division of Corporation Finance late April 29 issued guidance on the agency's conflict minerals requirements that caught some by surprise because of the broadness of its scope.

The guidance—in the form of a statement from division director Keith Higgins—said that companies and foreign private issuers, in filing their first conflict minerals disclosures by June 2, do not have to describe their products as "DRC conflict free," "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable."

The guidance followed testimony by SEC Chairman Mary Jo White that same day in which White told the House Financial Services Committee that the SEC will press ahead with implementing parts of the rule that were not invalidated by the U.S. Court of Appeals for the District of Columbia Circuit (83 SLD, 4/30/14).

However, while the guidance resolves certain short-term questions, there still is much uncertainty about the parameters of the regime in the longer term. Corp Fin acknowledged this, warning in its guidance that things may change due to "any further action that may be taken either by the Commission or a court."

Mandate by Dodd-Frank

The rule requires companies and foreign private issuers in the U.S. to report their use of so-called "conflict minerals"—gold, tantalum, tin and tungsten from the Democratic Republic of Congo and adjacent countries—if those minerals are "necessary" to a product made by the companies.

The rule was mandated by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Its requirements will impact some 6,000 SEC-reporting issuers and perhaps as many as 300,000 of their suppliers.

The first disclosures on a new Form SD—covering the reporting period of Jan. 1 to Dec. 31, 2013—must be submitted to the commission by May 31 (or June 2, given that May 31 is a Saturday).

On April 14, a divided D.C. Circuit—in response to a legal challenge by industry petitioners—concluded that the statute and the SEC rule violated the First Amendment to the extent that they require issuers to report to the commission and to state on their website that any of their products have not been found to be "DRC conflict free" (72 SLD, 4/15/14).

No 'Punchline.'

During an April 30 Practising Law Institute conference on the disclosure requirements, Brian Breheny, a Washington-based partner at Skadden Arps Slate Meagher & Flom LLP and a former Corp Fin deputy director, said the guidance went beyond the concerns voiced by the D.C. Circuit by saying issuers need not characterize their products, even those that are conflict-minerals free or undeterminable. The disclosures will now lack a "final punchline," he said.

"Certain companies are about to publicly disclose a telltale novel of conflict minerals, and then they're just going to leave out the ending, they're just going to leave you" to determine whether their products contain or lack conflict minerals, Breheny told the audience. "It's like a cliffhanger."

At the same event, Joseph Hall, a New York-based Davis Polk & Wardwell LLP partner, suggested that the SEC is tiptoeing

around the disclosure issue because of the First Amendment implications.

“I think the SEC is always worried when somebody raises a First Amendment challenge in the D.C. Circuit because one day the D.C. Circuit is going to realize that the securities laws do nothing but compel” and restrain speech, Hall said. “When the appellate judges and their law clerks start to think about that, I think we're going to have bigger problems down the line.”

Request for Stay?

Hall added that the Corp Fin guidance likely will “undercut” any petition to the D.C. Circuit to stay the rule by the Business Roundtable, the U.S. Chamber of Commerce and the National Association of Manufacturers, the industry groups that challenged the regulation.

In requesting a stay, the groups presumably will argue that they will suffer irreparable First Amendment harm should a stay not be granted, Hall said. However, the guidance states that companies will not have to do the “one thing” the court said violated the First Amendment, he added. “So they've lost the main ground that they could have used to say that the law needed to be stayed.”

The industry groups did not respond to Bloomberg BNA's question as to whether they will seek a stay. According to the court's docket, no petition had been filed as of the afternoon of April 30.

The SEC, for its part, has not stated whether it will ask for review of the D.C. Circuit's ruling.

In the wake of the decision, former and current SEC officials suggested that while the D.C. Circuit invalidated portions of the agency's conflict minerals regulation, the court also issued a very favorable judgment on the commission's need to perform cost-benefit analysis in its rulemaking. The SEC might not want to risk having that part of the decision overturned on review, they said (82 SLD, 4/29/14).

Corp Fin staff views the decision as a “win” for the commission, Breheny said. “They are happy” that the Administrative Procedure Act portions of the challenge were rejected by the court.

What Lies Ahead

In any case, given the possibility of further action from the commission or the courts, companies should stay abreast of any developments that could impact their disclosure requirements, said Michael Hermsen, a partner in Mayer Brown LLP's Chicago office.

“For companies that are subject to the new Form SD requirements, it will be very important to monitor the situation to see if any further changes are made or guidance issued that could impact their first filings,” Hermsen told Bloomberg BNA.

Looking even further ahead, Hall said it is unlikely that the district court will throw out the entire rule on remand. That path was suggested by two of the SEC's Republican commissioners in a joint April 28 statement urging the agency to stay the rule (82 SLD, 4/29/14).

“I think it's much more likely that the district court tells the SEC to go back and rewrite the rule,” Hall told the PLI audience. “That will throw us into another public notice and comment period, so I think it's ultimately going to be several months, and maybe several court challenges, before we actually know what's going to be required for next year.”

NGO Scrutiny

Meanwhile, non-governmental organizations and other activist groups that lobbied Congress to enact Section 1502 are gearing up to monitor companies' first disclosures.

The characterization of the products is an important issue, and the SEC should ask for panel rehearing or en banc review of the D.C. Circuit's decision, said Sasha Lezhnev, a senior policy analyst at the Enough Project.

However, “that particular part will get resolved, one way or another, by the judicial system”—whether through the D.C. Circuit or the district court, over the coming months, Lezhnev said in an interview. “So we'll just wait on that, and then see where that goes in terms of reporting in future years.”

In the meantime, the initial filings will yield plenty of information by which to assess companies' efforts regarding conflict

minerals, Lezhnev said. “There will be a lot of information in those reports about their due diligence or lack thereof, and we understand that a lot of companies will be supplementing those reports with information on their websites,” he added. “So we will be scrutinizing the websites, and also talking to some of the leading companies.”

Similarly, Global Witness representative Carly Oboth said her organization will closely monitor companies' due diligence efforts.

“The most important thing is for companies to undertake comprehensive due diligence on their supply chains, which includes assessing risk, creating a plan to mitigate that risk and reporting on their efforts to do so, as prescribed by the OECD Due Diligence Framework,” Oboth told Bloomberg BNA in an interview. “We will be closely analyzing the quality of companies' conflict minerals reports after they are filed.”

Oboth further encouraged companies to have their conflict minerals reports audited, “which will lend greater credibility” to their efforts.

The Corp Fin guidance said that “[p]ending further action,” an independent private sector audit is not required unless a company voluntarily describes its product as “DRC conflict free” in its conflict minerals report.

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For More Information

The guidance is available at http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541681994#.U2F411dWhwQ.