

Conflict Minerals: SEC Guidance and Appellate Court Decision

On April 7, 2014, the Division of Corporation Finance of the US Securities and Exchange Commission (“SEC”) updated its frequently asked questions regarding its conflict minerals rule,¹ providing guidance on nine conflict minerals topics. The new FAQs supplement interpretations that the staff issued in 2013² and provide timely direction for public companies that need to file their first specialized disclosure reports on Form SD by June 2, 2014.³

On April 14, 2014, the US Court of Appeals for the District of Columbia Circuit issued an opinion⁴ in the conflict minerals litigation brought by the National Association of Manufacturers, et al. The appellate court upheld many elements of the SEC’s conflict minerals rule, but held that the conflict mineral statute and rule:

violate the First Amendment to the extent the statute and rule require regulated entities 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.’”

The appeals court remanded the case to the district court for further proceedings. In a concurrent order, the appeals court directed that the mandate making its opinion effective be delayed until seven days after the court disposes of any timely rehearing petition. It is possible that this litigation may not be resolved before Form SD is due. Therefore, unless and until the district court or the SEC states otherwise, it would be prudent for companies affected by the conflict minerals rule to continue their

compliance efforts and to familiarize themselves with the recent FAQs.

Independent Private Sector Audit Issues

According to the FAQs, an auditor does **not** have to be a certified public accountant to perform the independent private sector audit (“IPSA”) required by the conflict minerals rule. The IPSA must be conducted in accordance with standards established by the General Accountability Office (“GAO”). The GAO staff has informed the SEC that its Government Auditing Standards (the “Yellow Book”) permit auditors performing the IPSA to follow the provisions for either attestation engagements or performance audits. While only certified public accountants may conduct attestation engagements, the Yellow Book permits performance audits to be conducted by any auditor that meets the applicable requirements set forth in the Yellow Book, even if that auditor is not a certified public accountant.⁵ [FAQ 13]

The FAQs clarify that the IPSA is not required to address the completeness or reasonableness of the due diligence measures performed by the issuer. The FAQs specify that the scope of the IPSA is limited to the objective that is set forth in the conflict minerals rule, which has two distinct parts. The first IPSA objective is to determine that the design of the issuer’s due diligence framework is consistent, in all material respects, with the nationally or internationally recognized due diligence framework used by the issuer. The second IPSA objective is to

determine that the description of the issuer’s due diligence measures contained in the Conflict Minerals Report that is filed as an exhibit to Form SD is consistent with the process that the issuer actually undertook to perform due diligence. [FAQ 17]

Even though the nationally or internationally recognized due diligence framework used by an issuer may include procedures for obtaining information about a conflict mineral’s country of origin, the IPISA does **not** need to address the issuer’s reasonable country of origin inquiry. Under the conflict minerals rule, the reasonable country of origin inquiry is a distinct step that is separate from the source and chain of custody due diligence process; the IPISA requirement relates only to the due diligence process. Therefore, the auditor only needs to opine with respect to the consistency of the portion of the design of the issuer’s due diligence framework beginning **after** the country of origin determination. Similarly, the auditor only must opine on whether the issuer actually performed the due diligence measures described in its Conflict Minerals Report **after** the issuer determined it had reason to believe its conflict minerals may have originated in the Democratic Republic of Congo or an adjoining country (“DRC”). [FAQ 18]

DRC Conflict Undeterminable Issues

If **any** of an issuer’s products are “DRC conflict undeterminable” during the two-year (four-year in the case of smaller reporting companies) temporary transition period (“Transition Period”), the issuer is **not** required to obtain an IPISA of its Conflict Minerals Report. This is the case even if the issuer is able to determine from its source and chain of custody due diligence whether some of the conflict minerals in its other products directly or indirectly financed or benefitted armed groups in the DRC. [FAQ 14]

However, if an issuer does not obtain an IPISA of its Conflict Minerals Report because at least one of its products is “DRC conflict undeterminable,”

it may **not** describe any of its other products as “DRC conflict free” in its Conflict Minerals Report. In order to describe qualifying products in its Conflict Minerals Report as “DRC conflict free,” an issuer must have performed the necessary due diligence, which is defined in the conflict minerals rule as obtaining an IPISA. [FAQ 15]

The FAQs recognize that a product may contain conflict minerals from different sources. If during the Transition Period any portion of the conflict minerals in a product are “DRC conflict undeterminable,” the issuer is precluded from describing that product “DRC conflict free,” even if the product would qualify as “DRC conflict free” but for the “DRC conflict undeterminable” component. On the other hand, both during and after the Transition Period, if an issuer determines that a product contains a conflict mineral that **did** finance or benefit armed groups in the DRC, it must describe that product as “having not been found to be ‘DRC conflict free.’” However, as noted above, the appellate court has held that the requirement to specifically label a product as “having not been found to be ‘DRC conflict free’” violates the First Amendment. [FAQ 16]

Recycled or Scrap Sources Issues

The FAQs emphasize that if **any** conflict minerals in an issuer’s products came from recycled or scrap sources, the issuer must include the required disclosures for those conflict minerals in the body of its report on Form SD. The issuer would also have to file a Conflict Minerals Report as an exhibit to its Form SD describing the due diligence that it performed and any other required disclosures with respect to its conflict minerals that are not from recycled or scrap sources. However, the Conflict Minerals Report would not need to include the disclosures for the conflict minerals that are derived from recycled or scrap sources. The FAQs state that the IPISA is only required for the Conflict Minerals Report, not for the

disclosures contained in the body of its Form SD. Therefore, the IPISA would not need to cover the required disclosures regarding conflict minerals from scrap or recycled sources that are contained in the body of the Form SD itself (as opposed to the Conflict Minerals Report exhibit). [FAQ 19]

Due Diligence Issues

The FAQs specify that although the conflict minerals due diligence must apply to conflict minerals in products manufactured during the calendar year, there is no requirement that such due diligence measures be conducted constantly throughout that calendar year. The FAQs also allow such due diligence measures to begin before or extend beyond the calendar year. [FAQ 20]

An issuer is not required to include a full description of the design of its due diligence in its Conflict Minerals Report. However, the description of the due diligence measures undertaken must be sufficiently detailed for the auditor to be able to form an opinion or conclusion about whether such description is consistent with the process the issuer actually performed. [FAQ 21]

Practical Considerations

Although the appellate court has found that a portion of the conflict minerals rule violates the First Amendment, it has upheld other features of the rule and has remanded the litigation to the district court for further proceedings. The ultimate litigation may not be resolved until after the June 2, 2014 due date for the first reports on Form SD. Therefore, companies required to file such reports should continue their compliance preparations while monitoring any response from the SEC.

When performing source and chain of custody due diligence, SEC reporting companies that use conflict minerals that are necessary for the functionality of products they manufacture or

contract to manufacture should pay particular attention to whether they can legitimately conclude that any of the conflict minerals they used during 2013 (which is part of the Transition Period for all such companies) are “DRC conflict undeterminable.” If they can, then they will not need to incur the expense of an IPISA—or factor the time for such audit into their calendars for the preparation of the filings on Form SD that are due by June 2, 2014. On the other hand, companies relying on this temporary rule will not be able to reap any marketing benefits from being able to report that they have “DRC conflict free” products.

To the extent that an issuer requires an IPISA for its upcoming Form SD filing and is using an auditor that is not a certified public accountant, it should confirm that its auditor meets the applicable requirements under the Yellow Book for performance audits.

When an IPISA is required, the issuer and the auditor each needs to understand the required scope of the audit so that the auditor’s time (and the issuer’s associated cost) is focused on responding to the audit’s mandatory objectives. Additionally, the issuer needs to draft its Conflict Minerals Report with sufficient information for the auditor to be able to assess whether the issuer implemented the process it described.

On an ongoing basis, SEC reporting companies that are subject to the conflict minerals rule should implement due diligence procedures that apply to entire calendar years, recognizing that such measures can be performed at times that make sense for it to achieve this purpose.

Issuers that determine that relevant conflict minerals derive from scrap or recycled sources should be sure to include the required disclosures for such minerals in the body of their Form SD, even if they are preparing a Conflict Minerals Report with respect to other conflict minerals.

*If you have any questions about the SEC's conflict minerals rule and the upcoming Form SD requirement, please contact the author of this Legal Update, **Laura D. Richman**, at +1 312 701 7304, or any of the lawyers listed, or any other member of our Corporate & Securities practice.*

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Endnotes

¹ Available at

<http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm#q13>.

² For more information on the staff's initial conflict minerals

FAQs, see our June 5, 2013 Legal Update, "Securities and Exchange Commission Provides Guidance on Conflict Minerals and Resource Extraction Payments Disclosure," available at http://www.mayerbrown.com/files/Publication/583aae6d-7f47-4138-a4fc-be72d92650a4/Presentation/PublicationAttachment/0418c673-ab94-40c9-8aa1-c95203e98756/UPDATE-Corp_Conflict_Minerals_0613_V4.pdf.

³ For a discussion of steps to take to get ready for the upcoming conflict minerals disclosure requirement, see our March 24, 2014 Legal Update “Conflict Minerals Disclosures: Time for Final Preparations,” available at http://www.mayerbrown.com/files/Publication/5c560539-cf0c-4808-9b5e-3152016769df/Presentation/PublicationAttachment/1860bd0c-c024-42ac-ad89a09fcbddd4f8/Conflict_Minerals_Disclosures_032114.pdf. For a detailed analysis of the conflict minerals disclosure requirements, see our September 5, 2012 Legal Update, “US Securities and Exchange Commission Adopts Final Conflict Minerals Disclosure Rule,” available at http://www.mayerbrown.com/files/Publication/obd3401f-837a-41d0-b8d4-e8a34e2dedee/Presentation/PublicationAttachment/b4cbf266-ca65-4691-a832-a687c361bd55/UPDATE-Corporate_US_SEC_Conflict_Minerals_Rule_0912_V3.pdf.

⁴ Available at [http://www.cadc.uscourts.gov/internet/opinions.nsf/D3B5DAF947A03F2785257CBA0053AEF8/\\$file/13-5252-1488184.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/D3B5DAF947A03F2785257CBA0053AEF8/$file/13-5252-1488184.pdf).

⁵ The Yellow Book is available at www.gao.gov/yellowbook.

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