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August 30, 2012

SEC Adopts Rules Concerning Conflict Minerals Disclosures

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On Wednesday, August 22, 2012, the Securities and Exchange Commission ("SEC") adopted rules requiring companies to publicly disclose their use of conflict minerals that originated in the Democratic Republic of the Congo or an adjoining country. The rules were mandated by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and Section 13(p) of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 1502 directs the SEC to issue rules requiring certain companies to disclose their use of conflict minerals if those minerals are "necessary to the functionality or production of a product" manufactured by those companies.

The scope of the new rules is expansive, both in terms of the number of public companies potentially impacted and the breadth of information required to be diligenced and reported. The time and expense required to comply with the new rules could be quite substantial for those companies required to make disclosure. The disclosures required under the new rules will be filed on a "Conflict Minerals Report" using a new form, Form SD (discussed more fully below). The first reports will be due May 31, 2014 and will cover the calendar year ended December 31, 2013. A copy of the complete Adopting Release can be found here.

Definition of "Conflict Minerals"

For purposes of the new rules, "conflict minerals" are defined as cassiterate, columbite-tantalite (also known as coltan), gold, wolframite and three of their derivatives – tantalum, tin and tungsten. These are minerals commonly known to originate, and in some cases finance armed groups, in the Democratic Republic of Congo and the adjoining countries of Angola, Burundi, the Central African Republic, the Republic of Congo, Rwanda, Sudan, Tanzania, Uganda and Zambia (collectively, the "Covered Countries"). The Secretary of State may also designate additional minerals if it is determined that such minerals are financing conflict in one of the Covered Countries.

The Final Rules

The final rules establish a three-step compliance process.

- **Step One**: A company must determine if it is subject to the new rules based on its use of conflict minerals.
- **Step Two**: A company that is subject to the rules must conduct a country of origin inquiry to determine if the conflict minerals it uses originated in one of the Covered Countries or came from recycled or scrap sources.

- **Step Three**: A company that determines, or has reason to believe, that its conflict minerals originated in a Covered Country and are not from recycled or scrap sources must conduct diligence as to the source and chain of custody and may be required to file a Conflict Minerals Report.

A copy of the flow chart included in the Adopting Release that illustrates the compliance process can be found here.

Step One: Determining if a Company is Subject to the New Rules

A company will be subject to the rules if (1) it files reports with the SEC under Sections 13(a) or 15(d) of the Exchange Act (including domestic companies, foreign private issuers and smaller reporting companies); and (2) conflict minerals are necessary to the functionality or production of a product manufactured by the company or contracted by the company to be manufactured.

The SEC did not specifically define the key terms of "manufacture," "contract to manufacture," "product" or "necessary to the functionality or production of a product," stating that the particular meanings of these concepts would depend on the facts and circumstances of each issuer. However, the SEC did provide some guidance with respect to these concepts:

(1) **"Manufacture"**: The SEC chose not to define "manufacture," stating that it believes the term to be "generally understood." The SEC did note, however, that it does not consider a company to "manufacture" a product if it only services, maintains or repairs the product. The SEC also clarified that a company that assembles products using components that are not raw materials, such as automobile or electronics manufacturers, are considered "manufacturers" of the products for purposes of the rules.

(2) **"Contract to Manufacture"**: The SEC also chose not to define "contract to manufacture" stating that the concept is "intuitive at a basic level" and that attempting to craft a definition that would work across all impacted industries would be unwieldy and overly complicated. The SEC eschewed any bright line test and noted that whether a product is "contracted to be manufactured" by a company depends on facts and circumstances surrounding that company's business and industry and generally will be based on the degree of actual influence the company exercises over the manufacturing of

the product, including its influence over the materials, parts, ingredients or components to be included in the product. However, the SEC noted that a company should *not* be viewed as contracting to manufacture a product if its actions involve no more than the following:

- specifying or negotiating contractual terms 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 like terms, unless the company exercises a degree of influence over the manufacturing of the product in a manner practically equivalent to contracting on terms that directly relate to the manufacturing of the product;
- affixing its brand, marks, logo or label to a generic product manufactured by a third party; or
- servicing, maintaining or repairing a product manufactured by a third party.

Based on the SEC's commentary in the adopting release, retailers that do not exert any direct influence over the manufacturing of the products they sell should not be covered.

(3) **"Necessary" to the Functionality or Production of a Product**: The rules also do not define when a conflict mineral is necessary to the functionality or production of a product. Once again, the ultimate conclusion will depend on the particular facts and circumstances involved. However, the SEC noted that, as a threshold matter, only conflict minerals that are present in the product itself, as opposed to merely used in the production process (for instance, as a catalyst) and not remaining in the final product, would be considered necessary to the functionality or production of the product. Additionally, the SEC identified as a key threshold factor whether the conflict mineral is intentionally added to the product or to the production process (as opposed to appearing as a naturally occurring by-product).

With respect to whether the conflict mineral is necessary to the *functionality* of a product, the SEC noted the following additional significant factors:

- If the conflict mineral is necessary to the product's generally expected function, use or purpose, it is more likely to be necessary to the functionality of the product.

- If the primary purpose of a product is ornamentation or decoration, the incorporation of a conflict mineral for purposes of ornamentation, decoration or embellishment is more likely to be considered necessary to the functionality of the product.

With respect to whether the conflict mineral is necessary to the *production* of a product, the SEC noted the following additional guidance:

- Conflict minerals present in a tool or machine used to produce a product but not contained in the final product itself are not considered necessary to the production of the product.
- Conflict minerals present in "indirect" equipment used to produce a product, such as computers or power lines, are not within the "necessary to the production" concept.

Finally, the SEC noted that it will not require companies to report on conflict minerals in materials, prototypes and other demonstration devices because it does not consider those items to be "products" — the concept of a product requires that the item be entered "into the stream of commerce" by offer to "third parties for consideration." Thus, it also does not appear that the SEC intends the rules to apply to companies solely by virtue of their contracting for the manufacturing by a third party of products for their own use or consumption in the ordinary course of business, as opposed to for marketing and resale to others.

(4) **Other Exceptions**: The rules do not consider mining companies to be manufacturing or contracting to manufacture conflict minerals that they mine, unless a company also engages in manufacturing, directly or indirectly through contract. However, the SEC rejected the suggestion it include in the rules a de minimis exception for use of less than a specified threshold amount of conflict minerals.

Step Two: Country of Origin Inquiry

If a company determines that conflict minerals are necessary to the functionality or production of its products as described above, it next must determine whether such conflict minerals originated in any Covered Country, or are from recycled or scrap sources, by conducting, in good faith, a reasonable country of origin inquiry that is reasonably designed

reach this determination. The SEC did not specify the specific steps that a company must take to satisfy this requirement. The SEC stated that the scope of the inquiry will depend on each company's particular facts and circumstances and may vary based on a company's size, products, relationships with suppliers, the available infrastructure at any given time or other factors. However, the final rules do contain some general standards concerning the country of origin inquiry.

A company may satisfy the reasonable country of origin inquiry requirement if it obtains reasonably reliable representations, directly from the facility at which its conflict minerals were processed or indirectly through its immediate suppliers, that those conflict minerals did not originate in any Covered Country or that they came from recycled or scrap sources. A company is not required to obtain representations from all of its suppliers as long as its inquiry is conducted in good faith and otherwise satisfies the requirements of the rules. The SEC noted that a company would have reason to believe representations if the applicable facility received a "conflict-free" designation from a recognized industry group that requires an independent private sector audit or if the applicable facility obtained an independent private sector audit that is made publicly available. A reasonable country of origin inquiry must also take into account any warning signs or other circumstances indicating that the conflict minerals may have originated in a Covered Country or did not come from recycled or scrap sources.

A company's next action will depend on the results of the reasonable country of origin inquiry.

- If (1) the company has determined on the basis of its inquiry that its conflict minerals in fact did not originate in a Covered Country or that they came from recycled or scrap sources, or (2) the company has no reason to believe that its conflict minerals originated in a Covered Country or reasonably believes that they came from recycled or scrap sources, then the company is not required to conduct a further investigation or to file a Conflict Minerals Report. However, the company must disclose its determination in the "Conflicts Mineral Disclosure" section of the new Form SD (discussed more fully below) and also briefly describe its reasonable country of origin inquiry and the results. The company must also disclose this information on its public Web site and provide a link from that Web site to the Form SD.

- If (1) a company has determined on the basis of its reasonable country of origin inquiry that its conflict minerals did originate in a Covered Country, or if it has reason to believe they may have originated in a Covered Country, and (2) the company has determined or has reason to believe the conflict minerals are not, or may not be, from recycled or scrap sources, then the company must conduct due diligence as to the source and chain of custody of such conflict minerals, as described in Step Three below.

Step Three: Source and Chain of Custody Diligence and the Conflicts Minerals Report

A company required to undertake due diligence as to the source and chain of custody of conflict minerals must do so in accordance with a nationally or internationally recognized due diligence framework, if available, for the particular conflict minerals at issue. The SEC stated in its adopting release that the OECD's "Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas" satisfies the rule's criteria and may be used by companies as a framework to satisfy the rule's due diligence requirement. The SEC noted that the final rule does not mandate any particular nationally or internationally recognized due diligence framework, but that the due diligence framework used must have been established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public companies, and be consistent with standards established by the General Accounting Office. If a nationally or internationally recognized due diligence framework does not exist for a necessary conflict mineral, a company must exercise appropriate due diligence in determining the source and chain of custody of the conflict mineral. If a nationally or internationally recognized due diligence framework becomes available for a necessary conflict mineral prior to June 30 of a calendar year, a company must use that framework in the subsequent calendar year.

The disclosure required after completion of the required due diligence exercise depends on the results of the due diligence:

(1) **No Conflict Minerals Report**: If, after its due diligence exercise, a company determines that conflict minerals necessary to the functionality or production of its products did not originate in a Covered Country or came from recycled or scrap sources, the company does not need to file a Conflicts Mineral Report. Like those companies who could end their inquiry after Step Two above, these companies must disclose in Form SD their

determination, must briefly describe the country of origin inquiry and due diligence exercise undertaken and the results of those efforts. These companies are also required to include this information on their public Web sites and link to their Forms SD.

(2) **DRC Conflict Free**: If a company determines that conflict minerals necessary to the functionality or production of its products are not from recycled or scrap sources and may have originated from a Covered Country but did not finance or benefit armed groups, the company must file a Conflict Minerals Report as an exhibit to Form SD. The Form SD must disclose that a Report is provided as an exhibit and provide a link to the company's Web site, where the Report must also be posted. The following must be included in the Report:

- a description of the measures taken by the company to exercise due diligence on the source and chain of custody of the conflict minerals;
- a statement that the company obtained an independent private sector audit of the report, which statement serves as certification of the audit as required by Section 13(p) of the Exchange Act; and
- the identity of the auditor and a copy of the audit report prepared by the independent private sector auditor.

(3) **Not Been Found to be DRC Conflict Free**: If a company's products have not been found to be "DRC conflict free," then, in addition to the requirements above under "DRC Conflict Free" above, the company must provide the following information in its Report:

- The products manufactured or contracted to be manufactured that have not been found to be "DRC conflict free;"
- The facilities used to process the conflict minerals in those products *(i.e.*, the smelter or refinery through which the minerals passed);
- The country of origin of the conflict minerals in those products; and
- The efforts to determine the mine or location of origin with the greatest possible specificity.

(4) **DRC Conflict Undeterminable**: For calendar years 2013 and 2014 only (or calendar years 2013 - 2016 for smaller reporting companies), if a company is unable to determine whether its necessary conflict minerals originated in a Covered Country, come

from recycled or scrap sources, or directly or indirectly financed or benefited armed groups in the Covered Countries, it may describe products containing such conflict minerals as "DRC conflict undeterminable." In that case, the company must describe the following in its Conflict Minerals Report:

- Its products manufactured or contracted to be manufactured that are "DRC conflict undeterminable;"
- The facilities used to process the conflict minerals in those products, if known;
- The country of origin of the conflict minerals in those products, if known;
- The efforts to determine the mine or location of origin with the greatest possible specificity; and
- The steps it has taken or will take, if any, since the end of the period covered in its most recent Conflict Minerals Report to mitigate the risk that its necessary conflict minerals benefit armed groups, including any steps to improve due diligence.

For those products that are "DRC conflict undeterminable," the company is not required to obtain an independent private sector audit of the Conflict Minerals Report regarding the conflict minerals in those products.

There are special rules concerning the due diligence exercise and Conflict Minerals Reports for minerals from recycled or scrap sources. If a company knows or reasonably believes that conflict minerals come from recycled or scrap sources, no due diligence exercise is required and no Conflict Minerals Report must be filed. The rules also expressly permit companies to describe their products containing conflict minerals from recycled or scrap sources as "DRC conflict free." If a company cannot reasonably conclude after its country of origin inquiry that its conflict minerals are from recycled or scrap materials, then its due diligence inquiry will focus on determining whether the minerals are from recycled or scrap sources and must utilize a nationally or internationally recognized due diligence framework for making such a determination. The SEC noted in the adopting release that the OECD Gold Supplement appears to be the only such framework currently existing. Where no such nationally or internationally recognized due diligence framework exists for any other particular conflict mineral from recycled or scrap sources, the company must simply describe the due diligence efforts it undertook to determine that its conflict minerals were from recycled or scrap

sources and the final rules do not require an independent private sector audit regarding those conflict minerals.

New Form SD

All conflict minerals disclosures required under the new rules must be provided using new Form SD. This is a significant change from the proposed rules, which would have required the disclosures to be made in the Form 10-K. Thus, the disclosure will not be automatically incorporated into registration statements filed under the Securities Act of 1933 and will not be covered by executive officer certifications required in connection with the Form 10-K.

All required disclosures must be provided on a calendar-year basis, regardless of a particular company's fiscal year, and must cover the calendar year in which the manufacture of a product containing conflict minerals necessary to the functionality or production of that product is completed. Form SD must be filed annually by May 31 and will cover the prior calendar year. In a significant change from the proposed rules, the final rules specify that the Conflict Minerals Report and the disclosure in the body of Form SD be "filed," rather than "furnished." Thus, the disclosures in the Form SD could expose a company to liability under Section 18 of the Exchange Act for false or misleading statements, unless the company can establish that it acted in good faith and had no knowledge that the statement was false or misleading.

Conclusion

The new rules adopted by the SEC concerning conflict minerals disclosure are very detailed, dense and complex. Public companies will need to review them carefully, determine whether they fall within the purview of the rules and, if so, craft protocols for complying with the origin inquiry and due diligence exercises required by the rules. Members of Schiff Hardin's Public Companies Group stand ready to assist and advise you as you evaluate necessary actions under the rules.

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