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DC Circuit Court of Appeals Upholds Conflict Minerals Disclosure Rules, But Strikes Down Requirement That Companies Label Their Products

Last week, the US Court of Appeals for the District of Columbia ("DC Circuit") issued its long-awaited opinion relating to legal challenges to the Securities and Exchange Commission's ("SEC") conflict minerals disclosure rules. The DC Circuit upheld all of the challenged aspects of the SEC's final disclosure rules, but struck down on free speech grounds the SEC mandate that reporting companies describe certain products in their SEC filings (and on their websites) as being "not Democratic Republic of the Congo conflict free." A copy of the decision is available here.[1] The decision is important to the extent that it upholds the government's ability to require public companies to disclose information relating to social responsibility and human rights, even though that information may not be financially material to a company's operations. This decision, however, also limits the government's ability to force public companies to characterize certain of their corporate activities in negative ways.

What the SEC Conflict Minerals Rules Require

The SEC's conflict minerals rules (the "Rules") implement Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") by requiring SEC-reporting issuers (companies filing under Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) to disclose information annually about their use of specified "conflict minerals" originating in the Democratic Republic of the Congo ("DRC") and certain adjoining countries. The "conflict minerals" are especially important to the electronics industry and include gold, columbite-tantalite (coltan), cassiterite and wolframite (including their derivatives, tantalum, tin and tungsten).

The Rules provide for a three-step compliance framework. First, an SEC-reporting company must determine whether conflict minerals are necessary to the functionality or production of a product the company manufactures or contracts to manufacture. If the company determines that conflict minerals are necessary to the functionality or production of a product the company manufactures or contracts to manufacture, then it must conduct a good faith "reasonable country of origin inquiry" designed to determine whether the conflict minerals originated in the DRC or adjoining countries, or are from recycled or scrap sources. If a company determines that its conflict minerals originated in the DRC or adjoining countries and are not from recycled or scrap sources (or has reason to believe that its

Colin Diamond
Partner, New York
+ 1 212 819 8754
cdiamond@whitecase.com

David Johansen
Partner, New York
+ 1 212 819 8509
djohansen@whitecase.com

Owen Pell
Partner, New York
+ 1 212 819 8891
opell@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

1 See http://www.cadc.uscourts.gov/internet/opinions.nsf/D3B5DAF947A03F2785257CBA0053AEF8/%24file/13-5252-1488184.pdf.

conflict minerals may have originated in the DRC or adjoining countries, and may not be from recycled or scrap sources), then it must conduct a due diligence review on the source and chain of custody of its conflict minerals and, along with a newly created Form SD filing, file a Conflict Minerals Report indicating whether or not its products are "DRC conflict free." Subject to a two-year phase-in period (four years for smaller companies), companies subject to the Rules are required to obtain an independent private sector audit of the Conflict Minerals Report. The conflict minerals disclosures are due by May 31 of each year beginning in 2014 for the preceding calendar year (June 2, 2014, because May 31, 2014 is a Saturday).

The DC Circuit's Ruling

The National Association of Manufacturers and certain industry groups (the "Plaintiffs") challenged the Rules under (i) the Administrative Procedure Act ("APA"), (ii) the Exchange Act and (iii) the First Amendment to the US Constitution. The district court rejected all of the Plaintiffs' arguments. The Plaintiffs appealed. The DC Circuit affirmed the district court's ruling with respect to the objections raised under the APA and Exchange Act, but reversed the ruling with respect to the claim made on First Amendment grounds.

APA and Exchange Act Claims

Plaintiffs argued that four facets of the Rules violated the APA because they exceeded the SEC's rulemaking authority under Section 1502 of the Dodd-Frank Act or were otherwise arbitrary and capricious. Specifically, the Plaintiffs challenged (i) the SEC's failure to create a *de minimis* exception, which would exclude from the Rules issuers using very small amounts of conflict minerals; (ii) the SEC's decision to apply the Rules to situations in which conflict minerals "may have originated" in covered countries as going beyond the Dodd-Frank Act requirement for reporting that conflict minerals "did originate" in covered countries; (iii) the SEC's decision to apply the Rules to issuers that not only manufacture their own products using conflict minerals, but also to those that contract to manufacture products; and (iv) the shorter phase-in period for large issuers (two years) as opposed to small issuers (four years). The DC Circuit rejected all these challenges, holding that the SEC had reasonably exercised its discretion in construing the Dodd-Frank Act, and had used the authority delegated to it under the Dodd-Frank Act to fill in gaps where the Act was silent or ambiguous. The DC Circuit also found that the SEC's decisions were not arbitrary or capricious, as the SEC's explanations were rational and bore a reasonable connection to the facts upon which they acted.

Plaintiffs also argued that the SEC violated the Exchange Act because it failed to engage in an adequate cost-benefit analysis of the Rules. The DC Circuit rejected this, stating that an agency is not required to "measure the immeasurable," especially when the benefits of the rules would occur on the other side of the world against the backdrop of a complex conflict. The DC Circuit also signaled that the potential humanitarian benefits of the Rules cannot be compared to the Rules' economic costs—which could set an important precedent for future rules like these.

First Amendment Claim: Compelled Speech

The DC Circuit, however, upheld Plaintiffs' First Amendment claim, holding that the SEC could not compel issuers to describe their products as not "DRC conflict free." The DC Circuit recognized that "[t]he label 'conflict-free' is a metaphor that conveys moral responsibility for the Congo war" and "requires an issuer to tell consumers that its products are ethically tainted, even if they only indirectly finance armed groups." Thus, by impairing an issuer's ability to exercise its free speech (including by remaining silent about how its products may be linked to the DRC) and "[b]y compelling an issuer to confess blood on its hands, the statute interferes with [an issuer's] exercise of the [sic] freedom of speech under the First Amendment."

Under the heightened standard of scrutiny that the DC Circuit applied to the "conflict-free" label, the disclosure requirement in the Rules was not sufficiently "narrowly tailored" to survive scrutiny. The SEC presented no evidence that less restrictive means would be less effective in achieving the government's interest in promoting peace in the Congo. The DC Circuit reasoned that if issuers could determine the conflict status of their products based on their own due diligence efforts, the SEC would be in a position to make a similar determination on the basis of the information submitted to it in such issuers' reports. While the DC Circuit concluded that the "conflict-free" label did not pass constitutional muster, it also clarified that its holding was that the Rules violate the First Amendment only to the extent that they impose that particular designation requirement on issuers. The DC Circuit sent the case back to the lower court for further proceedings based on its ruling.[2]

2 This case is one of several recent challenges by industry groups to human rights-related reporting obligations. In 2013, a lower federal court in Washington, DC struck down the SEC's resource extraction disclosure rules adopted under Section 1504 of the Dodd-Frank Act. The court held that the rules, which would have required listed oil, gas and mining companies to publish what they pay to governments of countries in which they operate, went beyond the SEC's statutory mandate, and that the SEC acted in an "arbitrary and capricious" manner by not adopting an exemption to account for foreign secrecy laws. The court remanded the matter to the SEC for reconsideration and restatement. The SEC has yet to issue a revised rule. See *Am. Petroleum Inst. v. SEC*, 953 F. Supp. 2d 5 (D.D.C. 2013).

What Companies Should Be Doing Now

Since the DC Circuit did not overturn the Rules entirely, it is possible that the SEC will require issuers to comply with all aspects of the Rules other than the designation requirement. Therefore, unless the SEC decides to suspend the initial reporting obligation (or a party to the case seeks a stay of the Rules pending further proceedings or the SEC offers additional guidance), issuers subject to the Rules should continue their diligence and disclosure efforts and should be prepared to file a Form SD and, if required, a Conflict Minerals Report by June 2, 2014. It is also significant that, although the DC Circuit took issue with the morally charged designation requirement, the DC Circuit otherwise validated the Rules' substantive requirement that issuers engage in diligence efforts regarding conflict minerals. Thus, the conflict minerals reporting regime appears to be here to stay, although it remains to be seen whether and how the SEC will attempt to restructure the designation requirement in any meaningful way.

Finally, issuers should note that similar measures are now underway in other jurisdictions. The European Commission recently announced a proposed self-certification scheme, which would require EU importers of conflict minerals to monitor their conduct in line with OECD Due Diligence Guidelines for Responsible Supply Chains. The Guidelines emphasize the need for issuers to adopt strong internal management systems and to identify and disclose supply chain risks.[3] It is important to note that these recommendations are, for now, non-binding, and that this proposal represents a significant step back from earlier recommendations that the Commission adopt legally binding due diligence obligations. Measures similar to Dodd-Frank Act Section 1502 also are being considered in the Canadian House of Commons.[4]

3 European Commission, Press Release, No. IP/14/218 05/03/2014, "EU proposes responsible trading strategy for minerals from conflict zones" (March 5, 2014), *available at* http://europa.eu/rapid/press-release_IP-14-218_en.htm. The OECD Guidelines are *available at* http://www.oecd.org/daf/inv/mne/GuidanceEdition2.pdf.

4 See http://www.theglobeandmail.com/technology/tech-news/ndp-to-introduce-federal-bill-on-conflict-minerals/article10319230/.