OCTOBER 2012

SEC ISSUES FINAL RULES UNDER DODD-FRANK ACT REGARDING CONFLICT MINERALS

The SEC has issued final rules (the "rules") implementing the conflict minerals disclosure required by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rules apply to issuers that (i) file reports with the SEC under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") and (ii) manufacture or contract to manufacture a product where conflict minerals are necessary to the functionality or production of such product. Such issuers are required to disclose annually on new Form SD whether any of those minerals originated in the Democratic Republic of the Congo or an adjoining country (the "Covered Countries"). Affected issuers must comply with these rules beginning with the year ending December 31, 2013, regardless of an issuer's fiscal year end, with the first reports on Form SD due May 31, 2014.

APPLICATION OF THE RULES: A THREE-STEP PROCESS

The rules implement a three-step process for compliance and disclosure with respect to conflict minerals.

Step One—Applicability. The rules do not apply to all reporting companies. The threshold question for each issuer is to determine whether conflict minerals are necessary to the functionality or production of a product that it manufactured or contracted to manufacture during a given calendar year. If an issuer does not meet this threshold, the issuer is not required to take any action, make any disclosures, or submit any reports under the rules. If, however, an issuer meets this threshold, that issuer moves to step two under the rules.

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Conflict Mineral. The term "conflict mineral" is used to describe certain minerals originating in the Covered Countries, including: (i) columbite-tantalite (tantalum), cassiterite (tin), gold, wolframite (tungsten), or their derivatives[1]; and (ii) any other mineral or its derivatives determined by the U.S. Secretary of State to be financing conflict in the Covered Countries.[2] Because conflict minerals are used in virtually every product containing electronic components, in addition to innumerable other categories of products, the rules will apply to a broad range of issuers. More importantly, the rules do not include a de minimis exception, and even minute or trace amounts of conflict minerals in a product could trigger disclosure obligations under the rules. The rules, however, exempt any conflict minerals that, prior to January 1, 2013, have been smelted or fully refined or are outside the Covered Countries.

Necessary to the Functionality / Production of a Product. The rules do not define the key terms "necessary to the functionality" or "necessary to the production" of a product. Although the SEC has provided limited guidance regarding these terms, the determination of the functionality or production depends on the issuer's particular facts and circumstances. For example, the rules require issuers to consider the following factors, among others, when making a determination of "functionality":

- Whether the conflict mineral is intentionally added to the product or any component of the product and is not a naturally occurring by-product;

- Whether the conflict mineral is necessary to the product's generally expected function, use, or purpose; and

- Whether the primary purpose of the product is ornamentation or decoration, if the conflict mineral is incorporated for purposes of ornamentation, decoration, or embellishment.

Similarly, the rules require issuers to consider the following factors, among others, when making a determination of "production":

- Whether the conflict mineral is intentionally included in the product's production process, other than if it is included in a tool, machine, or equipment used to produce the product (such as computers or power lines);

- Whether the conflict mineral is included in the product; and

- Whether the conflict mineral is necessary to produce the product.

The rules make clear that a conflict mineral must be both contained in the product and necessary to the product's production to be considered "necessary to the production" of a product. For example, if a conflict mineral is used as a catalyst, or in a similar manner in another process that is necessary to produce the product, but is not contained in that product, such conflict mineral would not be considered "necessary to the production" of such product.

Manufacture or Contract to Manufacture. In addition, the rules do not define the key terms "manufacture" or "contract to manufacture." The SEC has provided limited guidance regarding these terms. For example, an issuer that manufactures a product by assembling that product out of materials, substances, or components containing conflict minerals that are not in raw material form—such as certain auto and electronics manufacturers—is covered by the rules. Importantly for some issuers, however, the rules make clear that an issuer that only mines conflict minerals, or services, maintains, or repairs a product containing conflict minerals, will not be treated as "manufacturing" such product unless the issuer also engages in manufacturing.

Whether an issuer "contracts to manufacture" a product will depend on the degree of influence the issuer exercises over the materials, parts, ingredients, or components to be included in any product that contains conflict minerals or their derivatives. In response to comments on the proposed rule, the rules clarify that an issuer will not be viewed as "contracting to manufacture" a product if such issuer is involved only in:

- Specifying or negotiating contractual terms with a manufacturer 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 other similar terms or conditions concerning the product, unless the issuer specifies or negotiates taking these actions so as to exercise a degree of influence over the manufacturing of the product that is 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.

For example, an issuer that specifies to a manufacturer only general requirements of a product that it will purchase from that manufacturer to sell at retail, such as when an issuer offers a generic product under its own brand name or a separate brand name without additional involvement by the issuer, does not exert sufficient influence to "contract to manufacture" such product for purposes of the rules.

Step Two—Reasonable Country of Origin Inquiry. If an issuer determines that conflict minerals are necessary to the functionality or production of a product that it manufactures or contracts to manufacture, it must then conduct a reasonable inquiry to determine whether any of its conflict minerals originated in the Covered Countries or are from recycled or scrap sources. The rules do not prescribe the actions required for this reasonable inquiry, and the required inquiry will ultimately depend on each issuer's facts and circumstances, such as the issuer's size, products, relationships with suppliers, or other factors. The rules provide that the SEC will view an issuer as satisfying the reasonable inquiry standard if it seeks and obtains reasonably reliable representations, either directly from a facility at which its conflict minerals were processed or indirectly through the issuer's immediate suppliers, indicating that conflict minerals used at such facility did not originate in the Covered Countries or came from recycled or scrap sources. The issuer is not required to receive representations from all of its suppliers, through contract clauses or otherwise, but it must be able to demonstrate that the inquiry was reasonably designed to determine whether the issuer's conflict minerals originated in the Covered Countries or came from recycled or scrap sources, and that the inquiry was performed in good faith.

An issuer that determines that its conflict minerals did not originate in the Covered Countries or came from recycled or scrap sources must disclose this determination in its annual Form SD filing, along with a brief description of the inquiry it undertook, and provide a link to its web site where the disclosure is publicly available. However, if, based on its reasonable inquiry, the issuer (i) knows or has reason to believe that it has necessary conflict minerals that originated or may have originated in the Covered Countries and did not come from recycled or scrap sources or (ii) cannot determine the source of its conflict minerals, such issuer must move to step three and exercise due diligence on the source and chain of custody of its conflict minerals.

Step Three—Supply Chain Diligence and Conflict Minerals Report; Third-Party Audit. ***Supply Chain Due Diligence and Conflict Minerals Report.*** The purpose of the supply chain due diligence required by the rules is to allow the issuer to produce a Conflict Minerals Report. An issuer required to provide a Conflict Minerals Report will provide that report as an exhibit to its Form SD. An issuer is not required to submit a Conflict Minerals Report, however, if the due diligence investigation determines that its conflict minerals did not originate in the Covered Countries or came from recycled or scrap sources. In such cases, the issuer would still be required to submit a specialized disclosure report disclosing its determination and briefly describing its inquiry and its due diligence efforts and the results thereof.

The rules require issuers to use a nationally or internationally recognized due diligence framework when conducting the due diligence review, such as the Organisation for Economic Co-operation and Development's "Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas," if such a framework is available for the specific conflict mineral. The resulting Conflict Minerals Report must provide:

- A description of the products manufactured or contracted to be manufactured by the issuer that "have not been found to be 'DRC conflict free'";
- The facilities used to process the conflict minerals;
- The country of origin of the conflict minerals; and
- The issuer's efforts to determine the mine or location of origin with the greatest possible specificity.

Products are considered "DRC conflict free" if they "do not contain minerals that directly or indirectly finance or benefit armed groups" in the Covered Countries. For the 2013 and 2014 annual reporting periods, however, the rules allow issuers, in certain circumstances,[3] to describe their products as "DRC conflict undeterminable" if they are unable to determine that their minerals meet the statutory definition of "DRC conflict free." In addition, because the term "facilities used to process the conflict minerals" refers to, with the exception of gold (which is not refined), the smelter or refinery through which the issuer's minerals pass, the due diligence inquiry will be very difficult as a practical matter. Some industry groups, such as the Electronic Industry Citizenship Coalition and the Global e-Sustainability Initiative, have developed assessment programs to help issuers identify conflict-free smelters and refineries.

Third-Party Audit. Finally, the rules require that the issuer must also certify that it obtained an independent private sector audit of its Conflict Minerals Report and include that certification in the Conflict Minerals Report. The rules require that the audit's objective is to express an opinion or conclusion as to whether (i) the design of the issuer's due diligence measures as set forth in the Conflict Minerals Report, with respect to the period covered by the report, is in conformity with, in all material respects, the criteria set forth in the nationally or internationally recognized due diligence framework used by the issuer and (ii) whether the issuer's description of the due diligence measures it performed as set forth in the Conflict Minerals Report, with respect to the period covered by the report, is consistent with the due diligence process that the issuer undertook.

The rules state that the applicable audit standards are to be established by the U.S. Government Accountability Office ("GAO") and note that the GAO has informed the SEC that its existing Government Auditing Standards, such as the standards for Attestation Engagements or the standards for Performance Audits, will be applicable to audits of the Conflict Minerals Report. In addition, entities performing the independent private sector audit of the Conflict Minerals Report must comply with any independence standards established by the GAO.

CONCLUSION

The conflict minerals disclosure regime imposed by the rules represents a new burden on issuers. At a minimum, the reasonable inquiry standard established by the rules will require affected issuers to implement disclosure controls and procedures throughout the supply chains of each product affected by the rules, beginning on January 1, 2013. More importantly, because an affected issuer's Form SD and Conflict Minerals Report will be "filed" as opposed to "furnished" under the Exchange Act, these disclosures will be subject to the same liability and certification requirements that apply to the other portions of the periodic and current reports that are filed with the SEC.

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ENDNOTES

1 Cassiterite is the metal ore that is most commonly used to produce tin, which is used in alloys, tin plating, and solders for joining pipes and electronic circuits. Columbite-tantalite is the metal ore from which tantalum is extracted. Tantalum is used in electronic components, including mobile telephones, computers, videogame consoles, and digital cameras and as an alloy for making carbide tools and jet engine components. Gold is used in jewelry and in electronic, communications, and aerospace equipment. Wolframite is the metal ore that is used to produce tungsten, which is used for metal wires, electrodes, and contacts in lighting, electronic, electrical, heating, and welding applications.

2 As of the date of this *Commentary*, the U.S. Secretary of State has not determined that any additional minerals, or their derivatives, constitute conflict minerals for purposes of the rules, although additional minerals may be added at a later date.

3 This exception applies for issuers who are unable to determine that their minerals meet the statutory definition of "DRC conflict free" for either of two reasons: (i) they proceeded to step three based upon the conclusion, after their reasonable inquiry, that they had conflict minerals that originated in the Covered Countries and, after the exercise of due diligence, they are unable to determine if their conflict minerals financed or benefited armed groups in the Covered Countries; or (ii) they proceeded to step three based upon the conclusion, after their reasonable inquiry, that they had a reason to believe that their necessary conflict minerals may have originated in the Covered Countries and may not have come from recycled or scrap sources, and the information they gathered as a result of their subsequently required exercise of due diligence failed to clarify the conflict minerals' country of origin, whether the conflict minerals financed or benefited armed groups in those countries, or whether the conflict minerals came from recycled or scrap sources. The rules extend this period to the 2015 and 2016 annual reporting periods for smaller reporting companies.

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