Corporate and Securities Alert:
SEC Final Rule: Conflict Minerals Disclosures

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On August 22, 2012, the SEC adopted "conflict minerals" rules that were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). According to the findings of the Dodd-Frank Act, the exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo and adjoining countries is helping to finance extreme levels of violence in that geographic area and contributing to an emergency humanitarian situation.

Summary

Overview

The new rules impose potentially significant and extensive diligence and, in some cases, reporting requirements on companies that file periodic reports with the SEC. The new rules:

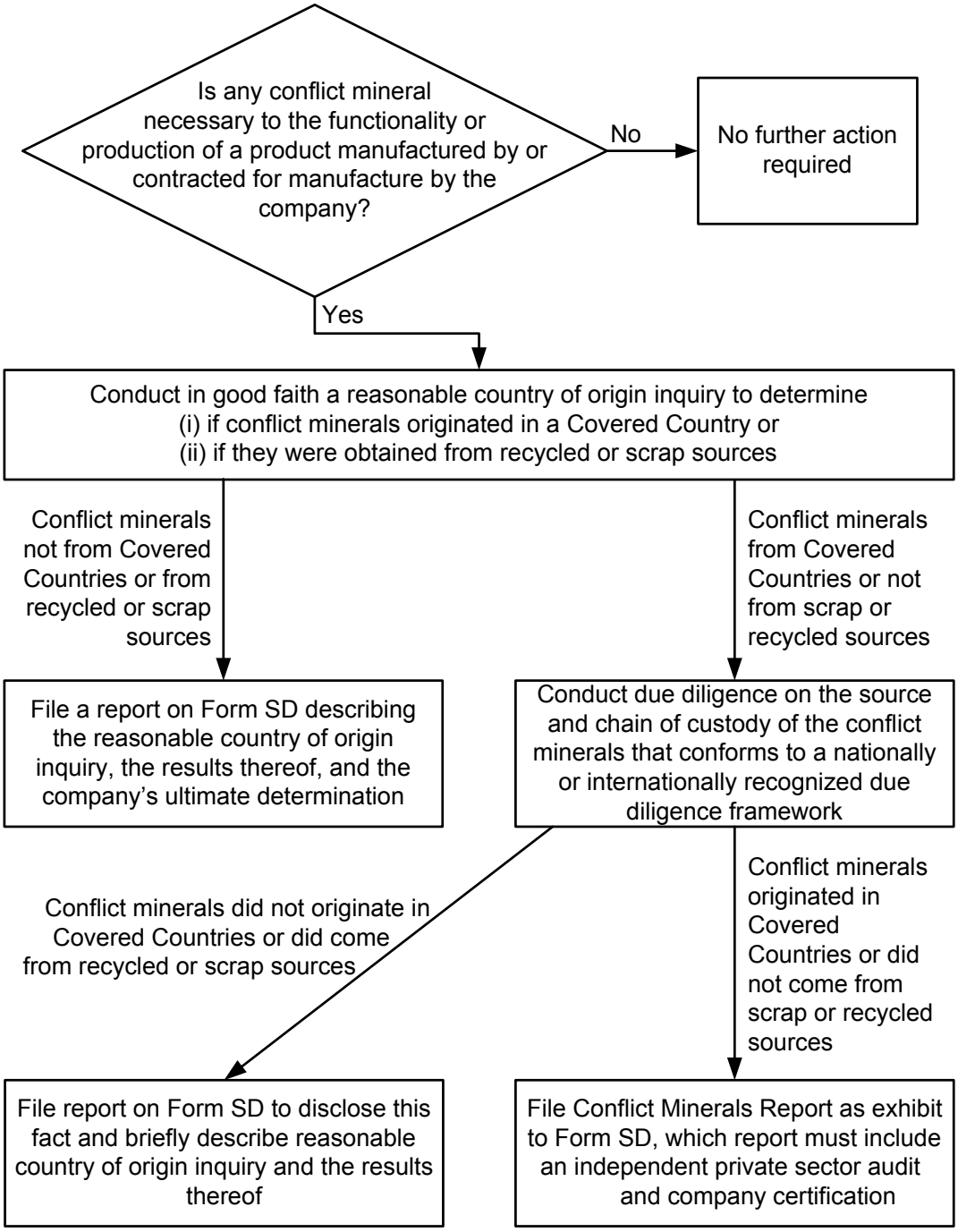
- Require companies for whom conflict minerals are necessary to the functionality or production of a product manufactured by, or contracted for manufacture by, such company to disclose whether such conflict minerals originated in the Democratic Republic of the Congo or in adjoining countries[1] (together referred to in the release as "Covered Countries"), and if so, to disclose the measures the company has taken to diligence the source and chain of custody of such minerals.
- Require that such disclosure of the use of conflict minerals originating in a Covered Country include an independent private sector audit of the measures taken by the company in this regard and a certification of the audit by the company.
- Require certain additional disclosures for those products that have not been found to be "DRC conflict free," including a description of the products, the facilities used to process them, and the country of origin.
- Require reporting companies to conduct this analysis and diligence annually, and if required disclose the results of their efforts on a new Form SD filed with the SEC each year.

The scope and impact of the new rules are relevant for many companies in the technology and life science sectors, as the minerals identified by the new rules as "conflict minerals" are commonly found in many of the components used in hardware and consumer electronics products.

1 Adjoining countries are those that share an internationally recognized border with the DRC, which presently includes Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia.

Three-Step Analysis

A useful way to understand the actions required of reporting companies in response to the new rules is to apply the three-step process outlined in the SEC's adopting release. Each step represents a "gate," such that based upon the determination made as a result of that step additional action and reporting will, or will not, be required. Included below is a simplified flow chart depicting the three steps:



The SEC's adopting release contains a more detailed version of this flow chart which can be accessed by visiting: http://www.sec.gov/rules/final/2012/34-67716.pdf#page=33.

New SEC Forms

The new rules create a new form under the Securities Exchange Act of 1934, Form SD. Form SD must be filed by any company that proceeds past the first step in the chart above, i.e., has determined that a conflict mineral is necessary to the functionality or production of a product manufactured by the company or contracted for manufacture by the company. For companies that proceed to the third and final step, Form SD in turn requires the filing of a Conflict Minerals Report as an exhibit to the Form. Companies whose products include conflict minerals will also be required to post the conflict minerals disclosure on their website under a prescribed heading.

Effective Date, Filing Dates, and Phase-in Period

Companies required to file a Form SD must do so annually on a calendar-year basis by May 31st of such year, with each such Form SD covering the twelve-month period ending December 31st of the prior year. The first calendar year for which companies must file a Form SD is 2013, with the first filings due May 31, 2014. Although officer certification of Form SD is not required as it is for Forms 10-K and 10-Q, the new Form must be "filed" as opposed to "furnished."

For the first two calendar years following the effective date of the new rules, and for the first four calendar years for a Smaller Reporting Company, a company required to file a Conflict Minerals Report with its Form SD will not be required to submit an independent private sector audit of the information it provides in the Conflict Minerals Report with respect to those products that it has determined are "DRC conflict undeterminable," meaning that, after exercising due diligence, the company is unable to determine that the minerals in such products are "DRC conflict free." This phase-in provision, however, does not relieve the company of its obligations to conduct the analysis outlined above and file a Form SD or Conflict Minerals Report, in each case as required.

If a company acquires another company (i) for which conflict minerals are necessary to the functionality or production of a product manufactured or contracted for manufacture by such company, and (ii) that was not previously required to disclose information regarding its use of conflict minerals, the acquiror will be permitted to delay its reporting on the products at issue until the end of the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition. Thus, if a company is acquired after April 30 of a given year, the acquiring company's Form SD and, if required, Conflict Minerals Report will not be required to cover the acquired company until the second calendar year following the acquisition.

Key Provisions of the Rule

What are conflict minerals?

The new rules define "conflict minerals" as the following:

- Columbite-tantalite (coltan)
- Casserite
- Gold
- Wolframite

The definition of "conflict minerals" also includes certain derivatives of the above minerals, which are initially limited to the following:

- Tantalum
- Tin
- Tungsten

The U.S. Secretary of State is authorized to expand the list of minerals and derivatives constituting "conflict minerals" upon finding that such minerals and derivatives finance conflict in the Covered Countries.

Companies will not be required to provide information regarding conflict minerals that are "outside of the supply chain" prior to January 31, 2013. Conflict minerals are "outside of the supply chain," (i) in the case of columbite-tantalite, casserite, and wolframite, when they are smelted, (ii) in the case of gold, when it is fully refined, and (iii) in the case of any conflict mineral or derivative that has not been smelted or refined, if it is located outside of a Covered Country.

How do companies determine if conflict minerals are necessary to the functionality or production of a product that they manufacture or contract for manufacture?

Necessary for Functionality or Production. The adopting release does not define the important terms "necessary to the functionality of a product" or "necessary to the production of a product," but it does provide some guidance as to the factors that should be considered when making these determinations. Regarding whether a conflict mineral is "necessary to the functionality" of a product, the adopting release provides that a company should consider

- 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 conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, and whether the primary purpose is ornamentation or decoration.

In determining whether a conflict mineral is "necessary to the production" of a product, a company should consider

- whether the conflict mineral is intentionally included in the product's production process, other than if it is included in a tool, a machine, or in equipment used to produce the product;
- whether the conflict mineral is included in the product; and
- whether the conflict mineral is necessary to produce the product.

Although the adopting release does not specify that any one of these factors is determinative, it does make clear that a product must actually contain the conflict mineral at issue, in addition to being necessary to its production, in order for it to be necessary to the production of the product. For example, if a conflict mineral was used as a catalyst in the production process, but was not actually included in the product, it would not be necessary to the production of the product. However, there is no *de minimis* exception in the new rules, so even if only traces of the conflict mineral appear in the final product, these small amounts are not carved out by the new rules.

Manufactured By or Contracted for Manufacture By the Company. Similar to the key terms relating to functionality and production, the adopting release does not define the term "contract to manufacture." This concept is especially important for technology and life science companies as they very frequently outsource

the manufacture of their products to contract manufacturers or other businesses specializing in manufacturing processes. Thus, whether these companies are required to file Form SD will turn on the level of control they impose on the production of the product.

The adopting release provides that a company will be considered to "contract to manufacture" a product to the extent the company exercises influence over the materials, parts, ingredients, or components to be included in the product. A company will not be considered to "contract to manufacture" a product if it does no more than the following:

- specify or negotiate contractual terms with a manufacturer that do not directly relate to the manufacturing of the product (for example, contractual terms relating to training or technical support, price, insurance, indemnity, intellectual property rights, dispute resolution, or other like terms);
- affixing its brand, marks, logo, or label to a generic product manufactured by a third party; or
- service, maintain, or repair a product manufactured by a third party.

It appears that as a result of the inclusion of the "contract to manufacture" concept in the new rules, both the company developing, marketing and selling the product, as well as any independent company that manufactures the product, will be subject to the new rules if they are SEC reporting companies. Presumably the two companies will want to ensure that their treatment of the products-in-common is consistent.

What is a reasonable country of origin inquiry?

If the conflict minerals used in a company's products are necessary to the functionality or production of a product that it manufactures or contracts for manufacture, the company must conduct in good faith a reasonable country of origin inquiry for each such conflict mineral. The country of origin inquiry must be reasonably designed to determine whether any of the conflict minerals (i) originated in a Covered Country or (ii) are from recycled or scrap sources.

While not prescribing steps required to satisfy these standards, the adopting release notes that a company may do so if it seeks and obtains reasonable country of origin representations indicating the facility at which its conflict minerals were processed and demonstrating that those conflict minerals did not originate in Covered Countries or did come from recycled or scrap sources. If it intends to rely on these representations, the company must have a reason to believe they are true and must take into account any warning signs to the contrary. A company would have reason to believe representations from a processing facility were true if the facility received a "conflict-free" designation by a recognized industry group that requires an independent private sector audit of the smelter, or if an individual processing facility obtained an independent private sector audit that is made publicly available, even if the processing facility is not part of the industry group's "conflict-free" designation process,. The adopting release notes that a company's policies with respect to the sourcing of conflict minerals will generally form a part of its reasonable country of origin inquiry, and would generally be required to be disclosed in the company's Form SD.

If, upon completion of the reasonable country of origin inquiry the company determines that any of the following are true:

- the conflict minerals did not originate in a Covered Country;
- the conflict minerals did come from recycled or scrap sources;
- the company has no reason to believe that the conflict minerals may have originated from a Covered Country; or
- the company reasonably believes that the conflict minerals did come from recycled or scrap sources;

then the company must disclose this determination on Form SD, describe the reasonable country of origin inquiry it conducted in order to reach such determination, and the results thereof. As indicated in the flow chart, companies making this determination are not required to file a Conflict Minerals Report.

Alternatively, if any of the following are true:

- the company knows that the conflict minerals originated in a Covered Country and are not from recycled or scrap sources, or
- the company has reason to believe that the conflict minerals may have originated in a Covered Country and has reason to believe that they may not be from recycled or scrap sources

then the company must conduct due diligence on the source and chain of custody of the conflict minerals that conforms to a nationally or internationally recognized due diligence framework, if such a framework is available for the conflict mineral.

If, as a result of such due diligence, the company determines that the conflict minerals did not originate from a Covered Country, or if it determines that the conflict minerals are from recycled or scrap sources, then the company must describe on Form SD the company's reasonable country of origin inquiry, the due diligence efforts it undertook, and the results of both. If the company determines otherwise, it must file a Conflict Minerals Report as an exhibit to Form SD. A company will not be allowed to determine that conflict minerals did not originate from a Covered Country, or that they did originate from recycled or scrap sources, if it is unable to determine the source of the minerals.

What is a Conflict Minerals Report?

A Conflict Minerals Report is an exhibit to new Form SD that must be filed in the situations described above. This report must describe the efforts the company has undertaken to conduct due diligence on the source and chain of custody of the conflict minerals and must:

a. conform to a nationally or internationally recognized due diligence framework;

b. include an independent private sector audit of the Conflict Minerals Report that is conducted pursuant to standards that are to be provided by the Comptroller General of the United States; and

c. include a company certification of such audit.

At present, the only nationally or internationally recognized due diligence framework available is the due diligence guidance approved by the Organisation for Economic Co-operation and Development ("OECD"). [http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/46740847.pdf]

It is not clear which existing or new organizations will perform the independent private sector audit, although the adopting release does indicate that the performance of the audit by the company's independent public accountant would not impair the independent public accountant's independence. The SEC may determine that a company's independent private sector audit or any of the company's due diligence processes are unreliable, and that any Conflict Minerals Report founded on such unreliable sources would not meet the requirements of the new rules.

For any products not found to be "DRC conflict free," a description of the products, the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and the measures taken to determine the mine or location of origin with the greatest possible specificity must be included in the Conflict Minerals Report. For a product to be "DRC conflict free," the company must have determined that it does not contain minerals that directly or indirectly benefit armed groups in the Covered Countries.

How are Recycled or Scrap Materials Handled?

As indicated above, if a company that uses conflict minerals has determined that these minerals did come from recycled or scrap sources, or if the company reasonably believes that the conflict minerals did come from recycled or scrap sources, then that company would be required to file a Form SD describing this conclusion but would not be required to file a Conflict Mineral Report. However, if the company thinks that the conflict minerals came from recycled or scrap sources but has reason to believe that they may not have come from such sources, then the company must complete its due diligence and file a Conflict Minerals Report.

Conflict minerals are deemed derived from recycled or scrap sources if they are from recycled metals, which are reclaimed end-user or post-consumer products, or from scrap processed metals created during product manufacturing. Recycled metal includes excess, obsolete, defective, and scrap metal materials, and minerals that are partially processed, unprocessed, or a bi-product of another ore will not be considered "recycled metal."

If a company must perform due diligence on minerals to determine if they are from scrap or recycled sources, it must use a nationally or internationally recognized due diligence framework for this due diligence effort. At present, the gold supplement for the OECD's due diligence framework is the only nationally or internationally recognized due diligence framework for any conflict mineral from recycled or scrap sources. These OECD guidelines can be accessed here [http://www.oecd.org/corporate/guidelinesformultinationalenterprises/FINAL%20Supplement%20on%20Gold.pdf]. If a nationally or internationally recognized due diligence framework is not available, a company will still be required to exercise due diligence in determining whether the conflict minerals are from recycled or scrap sources. In addition, as such frameworks become available, companies will be required to use them to conduct their due diligence.

Implications for Technology and Life Sciences Companies

For those companies that do not use conflict minerals in products they manufacture, or that are manufactured for them, the new rules will be of limited significance. However, even these companies must do the initial evaluation required to determine if conflict minerals are so used and their products are so manufactured. For those

companies who do use conflicts minerals in products so manufactured, the implications of the rule are, potentially, quite significant.

We anticipate that between now and the initial filing date of Forms SD, May 31, 2014, reporting companies and their component and raw material vendors, their contract manufacturers and their advisors will devote substantial amounts of time to determining of the most efficient and effective means of complying with the new rules. As starting points, we recommend the following initial steps:

- Companies should conduct a preliminary analysis of their use of conflict minerals and the extent to which such conflict minerals are "necessary to the functionality or production" of their products. If a company determines that conflict minerals are necessary to the functionality or production of its products, it should also begin the analysis of whether the products are manufactured by or for it in accordance with the provisions of the new rules.

- To the extent conflict minerals are necessary to the functionality or production of products manufactured or contracted to be manufactured by the company, it should begin to develop the steps that the company will undertake to complete a country of origin assessment.

- Companies should begin to establish policies for the use and sourcing of conflict minerals so as to gain assurance that in the future conflict minerals are not acquired from Covered Countries or, if they are so acquired, that the company can determine that they are DRC conflict free. Elements that should be considered include supplier screening mechanisms, supplier agreement certifications or other provisions, supplier audits, diligence policies, new internal accountability structures, and training of employees, contractors, and suppliers.

For more information on these or related matters, please contact your Fenwick securities team or the author.

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