Cooley

July 30, 2013

In October of last year, the National Association of Manufacturers, U.S. Chamber of Commerce and Business Roundtable filed a lawsuit asking the court to modify or set aside the SEC's conflict minerals rules, which implement Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. On July 23, 2013, the federal district court for the D.C. Circuit handed the SEC a complete victory by granting the SEC's motion for summary judgment and denying the summary judgment motion of the plaintiffs[1]—a victory the SEC will surely relish, having suffered a recent string of sharp rebukes from courts that vacated a variety of SEC rules. In concluding that the plaintiffs' claims lacked merit, the court found "no problems with the SEC's rulemaking and disagree[d] that the 'conflict minerals' disclosure scheme transgresses the First Amendment." Based on published accounts of the oral argument, where the court is reported to have expressed some skepticism as to whether the federal courts should just defer to Congress and the executive branch on this matter, the outcome in this case should not have come as a complete surprise. The decision stands in sharp contrast, however, to the recent decision of the same federal district court in a case challenging the SEC's contemporaneously adopted resource extraction disclosure rules (implementing Section 1504 of Dodd-Frank), in which the court vacated the rules, characterizing the SEC's statutory interpretations as fundamental miscalculations and its process as an abdication of its statutory responsibility to investors.

With the initial filing of a Form SD due by May 31, 2014, companies that may be subject to the rules—especially those that were wagering on another SEC defeat in the courts—should not delay their compliance efforts any further. Although the plaintiffs will probably appeal the court's order, companies that delay their compliance processes may find, if the appeals court upholds the rules, that they have insufficient time to complete the compliance requirements, particularly in light of the substantial time and energy needed to perform the groundwork necessary for such compliance.

Background

As summarized in our previous *Cooley Alerts* on this topic (**here** and **here**), the final rules implementing Section 1502 were adopted by the SEC in August 2012, governing public company disclosure of the use of "conflict minerals" (gold and the three T's, tin, tungsten and tantalum) originating in the Democratic Republic of the Congo and adjoining countries. Those rules, available **here**, require public companies to assess annually whether any "conflict minerals" are "necessary to the functionality or production of a product" manufactured (or contracted to be manufactured) by the company and potentially to disclose whether the minerals in products originated in the DRC countries and whether the products were found to be DRC conflict free. Section 1502 was enacted for the stated purpose of helping to reduce the exploitation and trade of conflict minerals, which fuel and finance armed groups in the DRC and so help to sustain the violent conflict in the area. Despite the praiseworthy objectives underlying Section 1502, however, the prospective costs and many challenges involved in developing simple and widely available mechanisms to track and trace the origins of conflict minerals fueled significant controversy surrounding the rulemaking. That controversy drove business and trade organizations to contest the rulemaking in court.

The opinion

The plaintiffs' challenge included two separate categories of claims: first, the plaintiffs contended that the adoption of the conflict minerals rules violated the Administrative Procedure Act, arguing that the SEC's process was inadequate and its rulemaking arbitrary and capricious. Second, the plaintiffs contended that both the conflict minerals rules and Section 1502 of Dodd-Frank were unconstitutional because the obligation to post conflict minerals disclosures on issuer websites violated the First Amendment.

APA Claims. The court viewed the "arbitrary and capricious" standard of review under the APA as a narrow one, entitling the SEC's action to a "presumption of regularity"; the court would "not second guess an agency decision or question whether the decision made was the best one." Moreover, because the case involved the SEC's implementation of statutory provisions the court viewed to be ambiguous, the court generally deferred to the SEC's interpretation where it was a "permissible construction of the statute." According to the court, while the plaintiffs might disagree with the SEC's interpretations—and the plaintiffs' views may indeed be equally reasonable—the plaintiffs' disagreement "does not render the SEC's analysis on this point arbitrary or unreasonable," and the court would not "substitute its judgment" for the SEC's.

For example, the plaintiffs invoked an argument that had previously been successful in the court action to strike down the SEC's proxy access rules: that the SEC had failed to "analyze properly the costs and benefits" of the rules. However, here, the court maintained that the SEC was obligated only to "consider" the impact that the rules could have on competition and various other economic factors, and the court was "easily convinced" that the SEC had discharged that responsibility. Moreover, with respect to the plaintiffs' claim that the SEC failed to assess whether the humanitarian goals of the rules—to decrease the conflict and violence in the DRC—would be achieved, the court was likewise not persuaded: "No statutory directive obligated the [SEC] to reevaluate and independently confirm that the [conflict minerals rules] would actually achieve the humanitarian benefits Congress intended. Rather, the SEC appropriately deferred to Congress's determination on this point, and its conclusion was not arbitrary, capricious, or contrary to law—whether because of some statutory directive under the Exchange Act or otherwise."

Similarly, the plaintiffs contended that the SEC's failure to implement a *de minimis* exemption was the arbitrary product of improper statutory interpretation and insufficient consideration of the various *de minimis* proposals submitted during the rulemaking process. However, the court concluded that the SEC's interpretation of Section 1502 on the issue of the *de minimis* exception was permissible. The SEC had concluded that adopting a *de minimis* exception would "undermine the impact" of the rules after it had "weighed and evaluated feedback from commentators and stakeholders on both sides of the issue." Although the court acknowledged that the SEC's "explanation arguably could have been more thorough in some respects," on balance, the court could not "say that the [SEC's] determination was unreasonable or devoid of a 'rational connection' in violation of the APA…."

First Amendment Claims. In these claims, the plaintiffs argued that Dodd-Frank Section 1502 and the SEC rules improperly compel companies to make public disclosures on their own websites of "burdensome and stigmatizing speech"—*i.e.,* in effect, that issuers' products could be contributing to violence in the DRC—in violation of the First Amendment. In light of the commercial nature of the disclosures at issue, the court applied a standard of "intermediate scrutiny," under which "the government must establish that disclosures 'directly and materially advance[]' a 'substantial' government interest."

First, the plaintiffs argued that, with respect to Congress's interest in promoting peace and security in the DRC, "[i]t is difficult to think of a *less* direct way to benefit the DRC than imposing this disclosure requirement on U.S. public companies." Second, the plaintiffs contended that the disclosure scheme—requiring issuers to accept a "scarlet letter"—was not "a reasonable fit to accomplish Congress's objective in promoting peace and security in the DRC." However, the court was not persuaded by either argument. In light of the foreign relations context in which Congress enacted Section 1502, where "judicial review is particularly deferential," the court viewed Congress's passage of Section 1502 to be rooted in its "informed judgment" that requiring the conflict minerals disclosure was "a reasonable step" in promoting peace and security in the DRC. Accordingly, the court held that the plaintiffs' First Amendment claims failed.

Observations and commentary

Companies that may be subject to the rules but have not commenced the compliance process should now consider accelerating their efforts to achieve compliance on a timely basis. The following are just some of the key steps companies will need to undertake in the early stages of the compliance process:

- Assemble an internal working group with representatives from legal, finance, manufacturing, supply management and any other relevant areas;
- Bring in outside help as needed from auditors, outside counsel and third-party consultants;
- Establish a compliance program that includes internal controls in connection with the mineral supply chain management;
- Consult with others in the industry, as well as industry organizations and trade groups, such as the EICC-GeSI, to benefit from historical learning and group initiatives;
- Identify and catalogue any of the company's products that contain conflict minerals;
- Analyze whether those minerals are "necessary to the functionality or production of a product" manufactured (or contracted to be manufactured) by the company;
- If the answer is yes, identify and catalogue the first tier immediate suppliers that provide the parts or components that contain the necessary conflict minerals;
- Begin the process of supplier engagement by making initial contact with appropriate supplier personnel to advise them that the company will be requesting their assistance in this effort;
- Determine whether any of the necessary conflict minerals were outside the supply chain before January 31, 2013;
- Adopt a supply chain policy;
- Consider whether to include supply chain provisions in agreements with suppliers;
- Develop questionnaires and certifications to be submitted to first tier suppliers to determine the country of origin of the necessary conflict minerals and begin that process, keeping a careful record of responses;
- Follow up regularly, as necessary;
- Become familiar with the OECD due diligence framework that will be used to structure the due diligence process required in the event that conflict minerals are known or reasonably believed to have originated in the DRC countries (and are known or reasonably believed not to be from recycled or scrap sources);
- Become familiar with Form SD and the disclosures that will be required in a Conflict Minerals Report; and
- At each step along the way, fully document the company's process and the analysis underlying any decisions made; that documentation will be useful in the event that an audit is required as part of Step Three of the compliance process or the company is otherwise challenged on its compliance process.

If you have any questions about this *Cooley Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

NOTES

1. ***National Association of Manufacturers, Chamber of Commerce of the United States of America and Business Roundtable v. Securities and Exchange Commission, Amnesty International USA, and Amnesty International Ltd.,* No. 13-cv-635 (D.D.C. July 23, 2013).**

accordance with our AI Principles, may be considered Attorney Advertising and is subject to our legal notices.

Key Contacts

Kenneth Guernsey San Francisco	kguernsey@cooley.com +1 415 693 2091
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Sam Livermore San Francisco	slivermore@cooley.com +1 415 693 2113
Darren DeStefano Reston	ddestefano@cooley.com +1 703 456 8034