June 5, 2013

Having assured companies for almost a year that it would be issuing guidance shortly, the SEC's Division of Corporation Finance has finally come through with **a series of compliance and disclosure interpretations** (CDIs)—albeit a surprisingly brief set—that address some of the key issues arising out of the conflict minerals disclosure rules.

As you may recall, in August 2012, the SEC adopted final regulations, mandated by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, governing public company disclosure of the use of "conflict minerals" originating in the Democratic Republic of the Congo and adjoining countries (referred to as the "DRC countries"). Conflict minerals are used in, or in the manufacture of, a wide range of electronic products, as well as in medical devices, airplanes, cars, machine tools, jewelry and a whole host of other products. **Those rules 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 minerals in the products originated in the DRC countries and whether the products were found to be DRC conflict free. Although the deadline for filing the first Form SD is not until May 31, 2014 (covering calendar 2013), preparation of Form SD, and performance of all of the work that is a necessary predicate to it, has required issuers to invest substantial time and energy in advance of that date. Accordingly, the staff's issuance of these CDIs has come not a moment too soon.

Below is a summary of the new CDIs, followed by our observations and commentary:

Companies covered

Voluntary filers included. In the first CDI, the staff makes clear that the conflict minerals rules apply to all issuers that file reports with the SEC under Exchange Act Sections 13(a) or 15(d), even if the issuers are voluntary filers.

Consolidated subsidiaries included. The reporting issuer is responsible for reporting for itself and for all of its consolidated subsidiaries. Therefore, even if the product that contains conflict minerals is not directly manufactured by the issuer, but rather by one of its consolidated subsidiaries, the issuer is still subject to the rule.

Accommodation for newly public issuers. The staff has made an accommodation that allows companies that have just completed an IPO to defer reporting. Under the new CDI, a newly public company may start reporting for the first reporting calendar year that begins no sooner than eight months after the effective date of its IPO registration statement. This accommodation is similar to that afforded to issuers that acquire control over a company that manufactures products with conflict minerals that previously had not been obligated to report on those minerals.

Generic products and components

Generic components subject to rules. In an interpretation that could have broad impact, the staff confirmed that companies are responsible for reporting on conflict minerals contained in generic components used in products they manufacture or contract to have manufactured. According to the new CDI, if a product manufactured by an issuer (or contracted by an issuer to be manufactured) contains a conflict mineral solely because the conflict mineral is in a "generic" component included in the product, the issuer must still conduct a reasonable country-of-origin inquiry regarding the origin of the conflict mineral in the generic component. (Note that, in this example, the issuer has not contracted to manufacture the generic component.) In this regard, the staff refused to

distinguish between the components of a product that an issuer manufactures or contracts to have manufactured and the components it purchases "off the shelf" to include in the product.

Branded generic products not covered. On the other hand, if an issuer sells a generic product that is manufactured by a third party, but the issuer specifies that its logo is to be etched into the product, the issuer is not considered to be "contracting to manufacture" that product. This response by the staff is consistent with the adopting release, which stated that an issuer is not considered to be "contracting to manufacture" a generic product if its actions involve no more than "affixing its brand, marks, logo, or label to a generic product manufactured by a third party."

Packaging

Packaging not covered. While conflict minerals contained in generic components continue to be a trigger, the staff has allayed some concerns regarding conflict minerals contained in packaging and containers. If the issuer manufactures (or contracts to manufacture) a package or container that contains a conflict mineral, and the package or container is used in the display, transport or sale of a product the issuer manufactures (or contracts to manufacture), the conflict mineral would not be considered necessary to the functionality or production of *the product* under the rule, even though the conflict mineral may be necessary to the functionality or production of *the package or container.* For example, even if the container or packaging is necessary to preserve the usability of the product until the time the product is purchased or used, the conflict mineral would not be considered necessary to the functionality or production of the product. Only a conflict mineral that is *contained in the product* would be considered "necessary to the functionality or production" of the product. The packaging or container sold with a product is not considered to be part of the product. Once the consumer starts to use a product, the packaging is generally discarded. If, however, an issuer manufactures and sells packaging or containers independent of the product, then, in that circumstance, the packaging or container would be considered a product.

Equipment

Equipment used to provide services excluded. Issuers that sell services sometimes manufacture (or contract for the manufacture of) equipment they use in providing the service they sell. The new CDIs indicate that issuers need not file reports on Form SD regarding the conflict minerals in the equipment that they manufacture or contract to have manufactured so long as the following applies:

- the equipment is used for the service provided by the issuer; and
- the equipment is retained by the service provider, is required to be returned to the service provider or is intended to be abandoned by the customer following the terms of the service.

Item 1.01(a) of Form SD requires issuers to report only on conflict minerals that are necessary to the functionality or production of "products" they manufacture or contract to have manufactured, and the staff does not interpret equipment used to provide services to be "products" under the rule. For example, issuers that operate cruise lines are not required to file reports regarding the conflict minerals in the cruise ships they manufacture or contract to have manufactured.

Equipment used and resold excluded. Issuers may, from time to time, seek to resell tools, machinery or other equipment that they manufacture (or contract to have manufactured) for use in the manufacture of their products. This equipment may contain conflict minerals. The staff concluded that, if the issuer, after using the equipment, subsequently sells it, the issuer is not required to report regarding the conflict minerals in the equipment because the equipment is not a product of that issuer. In addition, the staff will not view the later entry of the equipment into the stream of commerce as transforming the equipment into products of that issuer.

Definition of mining

"Mining" broadly defined. Instruction 1 to Item 1.01 of Form SD states that an issuer that mines conflict minerals would not be considered to be manufacturing those minerals for purposes of the rule. The staff confirmed that this Instruction is broad enough to exclude from the rule all of the activities customarily associated with mining. These activities might include, for example, in addition to mining the ore, transporting the mined ore to a processing facility, crushing and milling the ore, mixing crushed/milled ore with cyanide solution, floating cyanide mixture through a leaching circuit, extracting gold from a leached circuit, melting leached gold (often referred to as smelting) into ingots or bars and transporting the gold bars to a refinery for the refining process.

Form SD

Product description not specified. Item 1.01(c)(2) of Form SD requires an issuer that manufactures products (or contracts for their manufacture) to provide a description of those products if they have not been found to be "DRC conflict free" or if they are "DRC conflict undeterminable." The staff is not prescribing any particular type of product description (*e.g.*, identifying products by model number). Because the issuer is in the best position to know its products and to describe them in terms commonly understood within its industry, the issuer may describe its products based on its own facts and circumstances. However, the description in the Conflict Minerals Report filed with Form SD must state clearly that the products "have not been found to be 'DRC conflict free'" or are "DRC conflict undeterminable," as applicable.

Products that are "DRC conflict free" still require audit. Even though an issuer's products contain conflict minerals from the DRC countries, the issuer may still determine that the products are "DRC conflict free" if they do not directly or indirectly benefit or finance armed groups in the DRC countries. (For example, this determination may result where the minerals have been processed at a smelter in the DRC that has been validated under the EICC-GeSI "conflict-free smelter" (CFS) program.) Nevertheless, the staff maintains that the issuer is still required to file a Form SD with a Conflict Minerals Report and to obtain an independent private sector audit of the report, even if the minerals from the DRC countries are found to be DRC conflict free. The issuer, however, is not required to disclose the products containing those conflict minerals in its report or to provide certain other disclosures specified in Item 1.01(c)(2) of Form SD because those products are "DRC conflict free."

Late filing of Form SD has no impact on S-3 eligibility. The failure to timely file a Form SD regarding conflict minerals would not cause an issuer to lose eligibility to use Form S-3. In determining eligibility for use of Form S-3, the staff takes the position that the requirement that issuers have filed in a timely manner all reports and materials required to be filed during the prior 12 calendar months refers only to Section 13(a) or 15(d) reports (such as Forms 10-K and 10-Q) and Section 14(a) and 14(c) materials (such as proxy statements and other soliciting material). Form SD is required to be filed under Section 13(p) and, "[t]herefore, the filing of Form SD regarding conflict minerals does not impact an issuer's eligibility to use Form S-3."

Observations and commentary

- The staff has taken some useful, albeit relatively modest, steps toward clarifying the elaborate conflict minerals rules. For example, the staff's confirmation that most packaging of products is excluded from the rules is certainly welcome, as is the interpretation excluding from the rules equipment used to provide a service, such as airplanes used to provide airline flights. The accommodation granted to newly public companies will also be greeted with some measure of relief, allowing newly public companies to avoid becoming immediately subject to the rules with potentially little or no time to conduct the due diligence necessary.
- Although the staff's position that conflict minerals contained in generic components will trigger application of the rules was entirely predictable (and consistent with language in the adopting release), it will nevertheless be a major disappointment to many companies that had believed, or hoped, that the staff would provide an exception where the only conflict minerals contained in the product were those used in off-the-shelf components. Some issuers had anticipated that the staff might extend to generic components the logic of the degree-of-influence test used to determine whether an issuer has contracted to have a product

manufactured: if the issuer does not exhibit "some actual influence" over the manufacture of the product, it is not considered to have "contracted to manufacture" the product, thus skirting the ambit of the rules. Since no influence was exercised over the manufacture of the generic component, so the optimistic analysis went, perhaps the staff might extend its reasoning to those off-the-shelf components. However, as noted above, the staff declined to do so and, indeed, emphasized that "there is no distinction between the components of a product that an issuer directly manufactures or contracts to manufacture and the 'generic' ones it purchases to include in a product."

- As noted above, the staff concluded that issuers manufacturing products that use conflict minerals from the DRC countries must file a Form SD with a Conflict Minerals Report and must obtain an independent private sector audit of the report, even if the minerals are determined to be "DRC conflict free." Because an audit is not required for conflict minerals sourced outside the DRC countries, the staff's position in this CDI could induce those seeking to reduce cost, time and effort to source outside the DRC countries, with the result that issuers are discouraged from using minerals processed at CFS-validated smelters in the DRC countries. (Even if the staff believed that an audit was mandated by the statute, it might have interpreted the statutory requirement more broadly to be satisfied by the audit conducted by the CFS program.) Ironically, by not neutralizing the burdens associated with use of DRC conflict free minerals from the DRC countries, the position of the staff may have the effect of exacerbating a potential de facto boycott of minerals from the DRC, further impoverishing artisanal miners who work there. Had the staff instead taken the opposite position, it may have helped to preserve access to international markets for these miners, while, at the same time, driving support for further development of beneficial validated smelter programs, like the CFS program, in the DRC countries.

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

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