

# Cooley

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On April 14, 2014, a three-judge panel of the D.C. Circuit issued a decision<sup>1</sup> holding that the SEC's final conflict minerals rule violated "the First Amendment to the extent the statute and rule require regulated entities [such as public companies] to report to the Commission and to state on their website that any of their products have 'not been found to be 'DRC conflict free.'"" In October 2012, 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. In July 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. The plaintiffs appealed. Published reports of the oral argument, which occurred in January 2014, indicated that the judges were generally skeptical of the SEC's rulemaking. With the significant First Amendment exception noted above, the D.C. Circuit, somewhat surprisingly, largely upheld the lower court's decision, in many ways sustaining the SEC's rulemaking practices and procedures that have come under fire in recent court battles. As a result, the judgment of the district court was affirmed in part and reversed in part, and the case was remanded to the lower court for further proceedings consistent with the opinion.

It remains to be seen whether the SEC will appeal the decision, request a rehearing (or, as discussed below, participate in a future *en banc* proceeding), or, in the meantime, delay implementation of the rule and/or try to modify it to conform to the decision. The SEC will have 45 days to seek a rehearing on the First Amendment issue. As noted above, however, most aspects of the rule were held valid, and, whether or not there is a rehearing, the SEC could seek to fashion a modified rule that requires companies to make the mandated filing without including a statement as to the conflict-free status of the products. What course the SEC decides to take would likely turn on how central to the rule the SEC views the problematic language. The Court of Appeals has not yet sent the case back to the district court to render a decision on remand and may not do so until after the June 2 deadline for filing Form SD and the related Conflict Minerals Report. Although, technically, the rule thus remains in place as it stood prior to the decision, we anticipate that the SEC would issue some guidance before the June 2 deadline to clarify the reporting obligations. Until more is known, however, companies should continue their efforts to comply with the rule, assuming the current filing deadline remains.

## Background

As summarized in our previous *Cooley Alerts* on this topic ([here](#), [here](#) and [here](#)), the final rules implementing Section 1502 were adopted by the SEC in August 2012. The rules govern 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](#) 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 the 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 resulted in significant controversy surrounding the rulemaking. That controversy drove business and trade organizations to contest the rulemaking in court.

## The opinion

The plaintiffs' challenge included three separate categories of claims: first, the plaintiffs contended that the adoption of the conflict minerals rule violated the Administrative Procedure Act (the "APA"), arguing that the SEC's process was inadequate and its rulemaking arbitrary, capricious and an abuse of discretion. Second, the plaintiffs contended that the conflict minerals rule violated the Securities Exchange Act of 1934 because the SEC did not adequately analyze the costs and benefits of the rule as required by the Act. Third, the plaintiffs contended that the requirement that an issuer describe its products in its report to the SEC and on its website as "DRC conflict free"—or, more to the point, "not been found to be DRC conflict free"—unconstitutionally compelled speech.

**APA Claims.** The Court undertook a de novo review of the claims of violation of the APA. The plaintiffs contended that the SEC was "arbitrary and capricious" in adopting rules that (i) did not include a de minimis exception, (ii) required companies to conduct due diligence and submit a report to the SEC if they had reason to believe that the conflict minerals may have originated in the DRC countries (as opposed to just when they did originate there) , (iii) applied to companies that not only manufacture their own products, but also contract to have products manufactured and (iv) adopted inconsistent phase-in periods. The Court rejected each of these arguments in turn.

First, the Court found that the SEC rejected adoption of a de minimis exception because, "relying on text, context, and policy concerns, [the SEC] inferred that Congress wanted the disclosure regime to work even for those small uses." This interpretation was not, in the Court's view, an arbitrary and capricious action: having "established that conflict minerals are frequently used in minute amounts, the Commission could reasonably decide that a per-issuer exception could 'thwart' the statute's goals by leaving unmonitored small quantities of minerals aggregated over many issuers. Though costly, that decision bears a 'rational connection' to the facts."

Next, with respect to the standard for conducting due diligence and submitting a report to the SEC, the Court found that the plaintiffs had "conflated distinct issues." Because the statute was silent or ambiguous on the circumstances that would require an issuer to perform due diligence before filing a report, the SEC was justified in exercising its reasonable discretion in construing the statute. Indeed, the Court noted that the SEC could have gone further in adopting a more expansive rule here, and it did not.

Similarly, with regard to the provisions describing companies covered by the rules, the Court held that the provision was "silent on the obligations of issuers that only contract for their goods to be manufactured. Standing alone, that silence allows the Commission to use its delegated authority in determining the rule's scope, just as with the due diligence provision." Internal inconsistencies in the rule gave rise only to ambiguity, and the SEC's interpretation was reasonable "because it reconciles otherwise confusing and conflicting provisions 'into an harmonious whole.'"

Finally, as to the variation in phase-in periods, according to the Court, there was "trickledown logic" underlying the SEC's approach, given that larger companies may have more leverage in obtaining the necessary information.

**Exchange Act claims.** The Court made short shrift of the plaintiffs' claim of Exchange Act violations as a result of an inadequate cost-benefit analysis. There was no dispute as to the adequacy of the SEC's cost-side analysis. Rather, the plaintiffs argued that, on the benefit side, the SEC "failed to determine whether the final rule would actually achieve its intended purpose." The Court replied that it was "difficult to see what the Commission could have done better." The SEC was not required "to measure the immeasurable." The statute required the SEC to promulgate a disclosure rule despite the lack of data, and the SEC relied on the determination of Congress that the costs of the rule "were necessary and appropriate in furthering the goals of peace and security in the Congo." Had the SEC "second-guessed Congress on that issue, then it would have been in an impossible position."

**First Amendment claims.** Finally, the plaintiffs challenged as unconstitutional under the First Amendment the requirement that an issuer describe its products as "not been found to be DRC conflict free" in the report it files with the SEC and posts on its website. Applying a "rational basis" standard, the lower court rejected that claim. The SEC argued that the "rational basis" standard was "appropriate because the conflict free label discloses purely factual non-ideological information." In a de novo review, the Court

disagreed: rational basis review applies to disclosures of "purely factual and uncontroversial information," and is "limited to cases in which disclosure requirements are 'reasonably related to the State's interest in preventing deception of consumers.'" Here, all parties acknowledged that consumer deception was not an issue. Moreover, the Court ruled, disclosure is not immunized from review just because it is factual if it also has an ideological overlay:

At all events, it is far from clear that the description at issue—whether a product is "conflict free"—is factual and nonideological. Products and minerals do not fight conflicts. The label "conflict free" is a metaphor that conveys moral responsibility for the Congo war. It requires an issuer to tell consumers that its products are ethically tainted, even if they only indirectly finance armed groups. An issuer, including an issuer who condemns the atrocities of the Congo war in the strongest terms, may disagree with that assessment of its moral responsibility. And it may convey that "message" through "silence." ... By compelling an issuer to confess blood on its hands, the statute interferes with that exercise of the freedom of speech under the First Amendment.

The Court did not need to further address the question of the applicable standard of review because it found that the SEC's rule did not survive under even the intermediate standard. Under that standard, among other things, the SEC was required to show that the restriction was narrowly tailored by presenting evidence that less restrictive means would have failed. Here, however, the SEC "has provided no such evidence." According to the Court, the SEC failed to explain why various alternative approaches suggested by the plaintiffs would be any less effective than the SEC's approach and, therefore, the Court could not agree that the restriction was narrowly tailored. The Court noted that its holding implicates Dodd-Frank itself only "to the extent that it imposes that description requirement. If the description is purely a result of the Commission's rule, then our First Amendment holding leaves the statute itself unaffected."

Interestingly, in his concurring opinion, Judge Srinivasan advocated that the Court "issue forthwith" the first three parts of the Court's opinion (upholding the lower court opinion and the rule) and hold in abeyance the First Amendment portion of the opinion pending a potentially dispositive decision from the same court sitting en banc on the same legal issue -- the applicable standard of review for compelled commercial speech disclosures where deception of consumers is not an issue. (Oral arguments in that case are scheduled for May 19.) The majority failed to see the merits of that approach, suggesting instead that issuance of the opinion would permit the "parties in this case to participate in the court's en banc consideration of this important First Amendment Question" perhaps, consistent with past precedent, by consolidating the cases so that all parties could participate in the *en banc* proceeding. That might be an offer the SEC just can't refuse.

## NOTES

1. *National Association of Manufacturers, et al., v. Securities and Exchange Commission, et al.*, 13-5252 (D.C. Cir. April 14, 2014). [USCADC Opinions released on April 14, 2014.](#)

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## 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

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