SIMPSON THACHER MEMORANDUM

Court of Appeals Invalidates Part of SEC's Conflict Minerals Rule; SEC to Implement the Remainder of the Rule

April 30, 2014

On April 14, 2014, in *National Association of Manufacturers* v. *Securities and Exchange Commission*, the United States Court of Appeals for the District of Columbia Circuit partially invalidated the final rule of the Securities and Exchange Commission ("SEC") requiring public companies to investigate and disclose the origin of certain minerals found in the war-ridden Congo region ("conflict minerals").[1] While upholding most aspects of the rule, the Court concluded that the rule and the statutory provisions on which it is based violate the First Amendment "to the extent the statute and rule require regulated entities 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.'"[2] ***On April 29, 2014, amid uncertainty regarding the impact of the Court's decision on issuers' obligations under the rule, the Director of the SEC's Division of Corporation Finance announced that the SEC expects issuers to comply with those aspects of the rule that were upheld by the Court.***

I. BACKGROUND: THE CONFLICT MINERALS RULE

The SEC's final rule, adopted pursuant to Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), applies to issuers who file reports with the SEC under sections 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), and who manufacture or contract to manufacture products that contain conflict minerals (in any amount).

Each issuer that concludes that it is subject to the rule must conduct a "reasonable country of origin inquiry" to determine whether its conflict minerals originated in the Democratic Republic of the Congo ("DRC") or an adjoining country (collectively, the "covered countries").[3] If,

---

[1] *See* 2014 WL 1408274 (D.C. Cir. Apr. 14, 2014). The conflict minerals are cassiterite, columbite-tantalite, gold, wolframite, and their derivatives, tin, tantalum and tungsten.

[2] *Id*. at *11. "A product is 'DRC conflict free' if its necessary conflict minerals did not 'directly or indirectly finance or benefit armed groups'" in the Democratic Republic of the Congo or an adjoining country. *Id*. at *1 (citing 15 § U.S.C. 78m(p)(1)(A)).

[3] The term "adjoining country" is defined in the Dodd-Frank Act as a country that shares 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.

following the reasonable country of origin inquiry, an issuer knows that its conflict minerals originated in the covered countries or "has reason to believe" that those minerals "may have originated" in the covered countries, it must "exercise due diligence on the source and chain of custody of its conflict minerals." If an issuer's due diligence gives the issuer reason to believe that its conflict minerals originated in the covered countries, it must file a conflict minerals report with the SEC as an exhibit to its Form SD, describing its due diligence efforts (including a private sector audit) and those products that have "not been found to be 'DRC conflict free'" and providing details regarding the origin of the conflict minerals used in its products.

For the first two years (or four years, for smaller issuers) that the rule is in effect, issuers who cannot ascertain whether their conflict minerals originated in the covered countries or benefitted armed groups can describe their products as "DRC conflict undeterminable," rather than "DRC conflict free" or not "DRC conflict free." Issuers availing themselves of this phase-in provision are still subject to the rule's due diligence and filing requirements, but are not obligated to obtain a private sector audit.

II. THE LEGAL CHALLENGES TO THE RULE AND THE DISTRICT COURT'S FINDING

The National Association of Manufacturers (the "Association"), along with other business groups, brought an action against the SEC, claiming that its conflict minerals rule violated:

1. the Administrative Procedure Act, under which a court must set aside agency action found to be, among other things, "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," or "in excess of statutory jurisdiction [or] authority"[4];
2. provisions of the Exchange Act that (a) prohibit the SEC from adopting any rule that "would impose a burden on competition not necessary or appropriate in furtherance of the purposes of" the securities laws[5], and (b) require that in its rulemaking, the SEC "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation"[6]; and
3. the free speech clause of the First Amendment.

The district court rejected all of the Association's claims and entered summary judgment for the SEC.

III. THE DECISION OF THE COURT OF APPEALS

The Court of Appeals affirmed the district court's decision with regard to the Association's Administrative Procedure Act and Exchange Act arguments, but found that the SEC's conflict

[4] 5 U.S.C. § 706(2).

[5] 15 U.S.C. § 78w(a)(2).

[6] 15 U.S.C. § 78c(f).

minerals rule and the statute on which it is based unconstitutionally compel speech insofar as they require issuers to describe their products as not "DRC conflict free" in the reports they file with the SEC and on their websites.[7] According to the Court:

> 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.[8]

The Court opined that the SEC failed to provide evidence that less restrictive means of achieving the government's goals would be ineffective. The Court agreed with the Association, which had suggested that "rather than the 'conflict free' description the statute and rule require, issuers could use their own language to describe their products, or the government could compile its own list of products that it believes are affiliated with the Congo war, based on information the issuers submit to the Commission."[9] Having found that the SEC did not establish a "reasonable fit" between its means and ends, the Court concluded that the descriptive disclosure required by the SEC's rule violated the First Amendment and thus reversed in part and remanded the district court's decision.

IV. IMPLICATION OF THE COURT'S DECISION

The Court of Appeals did not invalidate the SEC's conflict minerals rule in its entirety, nor did it stay this year's June 2nd deadline for filing conflict minerals disclosure reports on Form SD. As a result, in the days and weeks following the Court's decision, there was much speculation regarding the extent to which issuers would be required to comply with the rule as the legal proceedings continue, particularly since the SEC had remained silent on the issue. On April 29, 2014, however, Keith F. Higgins, the Director of the SEC's Division of Corporation Finance,

---

[7] In a footnote, the Court clarified that it was holding that Section 1502 of the Dodd-Frank Act violates the First Amendment "to the extent that it imposes" the requirement that an issuer use the descriptor "not been found to be 'DRC conflict free.'" According to the Court, "[i]f the description is purely a result of the Commission's rule, then our First Amendment holding leaves the statute itself unaffected." *National Association of Manufacturers*, 2014 WL 1408274, at *11 n.14.

[8] *Id.*, at *9 (internal citations omitted).

[9] *Id.* at *11.

issued a statement notifying issuers that the SEC is implementing the portions of the rule that were not invalidated by the Court. [10]

In light of Higgins' statement, issuers must continue to fulfill their obligations pursuant to the SEC's conflict minerals rule and prepare their Forms SD in compliance with the rule, with the exception of the specific provisions struck down by the Court. Specifically, according to Higgins' statement:

> No company is required to describe its products as "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable." If a company voluntarily elects to describe any of its products as "DRC conflict free" in its Conflict Minerals Report, it would be permitted to do so provided it had obtained an independent private sector audit (IPSA) as required by the rule. Pending further action, an IPSA will not be required unless a company voluntarily elects to describe a product as "DRC conflict free" in its Conflict Minerals Report.

According to Higgins' statement, the Division of Corporation Finance will consider the need to provide further guidance to companies on their compliance obligations in advance of the Form SD filing deadline.

* * *

If you have any questions or would like additional information, please do not hesitate to contact Yafit Cohn at (212) 455-3815 or yafit.cohn@stblaw.com, Arjun Koshal at (212) 455-3379 or akoshal@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

[10] *See* Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule (Apr. 29, 2014). Higgins' announcement comes one day after the release of an unusual public statement by SEC Commissioners Daniel M. Gallagher and Michael S. Piwowar, in which the Commissioners offered their opinion that "the entirety of the rule should be stayed, and no further regulatory obligations should be imposed, pending the outcome of this litigation," since, in their opinion, the district court could and should invalidate the entire rule. These Commissioners expressed their view that given the current uncertainty surrounding the validity of the SEC's rule, "the wisest course of action would be for the Commission to stay the effectiveness of the entire rule until the litigation has concluded," so as to avoid wasting the SEC's time and resources and shareholders' money.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000