Securities
Regulation Daily

Wolters Kluwer

February 27, 2017

Conflict Minerals, Oil & Gas and Human Trafficking: An Update on Supply Chain Disclosures for M&A Practitioners

By Mark S. Nelson, J.D.

The latest developments from the Trump Administration and Congress presage at least a potential short-term reversal of the trend in the U.S. for more federally mandated disclosures regarding public companies' supply chains. The president and Congress have already disapproved the SEC's re-written resource extraction issuers rule, and the president is rumored to be mulling an executive order that would direct the Commission to revise or waive the agency's conflict minerals rule. The SEC staff also is separately reviewing its guidance on the conflict minerals rule. Meanwhile, there are some indications that, despite the prospects for near-term rollbacks of some federal disclosure requirements, supply chain disclosures may ultimately take hold in the long-term, including with respect to human trafficking.

This paper reviews the status of the SEC's conflict minerals rule with an eye to how compliance with it can impact M&A due diligence. The paper also explains the impact of the Trump Administration's and Congress's disapproval of the Commission's resource extraction issuers rule. Lastly, the paper explores the long-term trends regarding social or specialized disclosures with a review of federal legislation to require securities disclosures regarding human trafficking and a review of California's supply chain transparency law.

Conflict Minerals

The SEC's conflict minerals rule (See Exchange Act Section 13(p), Rule 13p-1, and Form SD) implementing Dodd-Frank Act Section 1502 can trace its origins back to U.S. policy in the early 2000s responding to an outbreak of violence in Africa's Great Lakes Region, especially with respect to the Democratic Republic of the Congo and adjoining countries ("covered countries"). The rule, adopted by the Commission in 2012 as part of the specialized disclosure regime in Title XV of the Dodd-Frank Act, imposed a new filing requirement on Exchange Act reporting companies regarding their conflict minerals that are necessary to the functionality or production of the products they manufacture or contract to manufacture.

But the status of the Commission's conflict minerals rule is currently in a state of flux. Acting SEC Chairman Michael Piwowar has directed the SEC staff to review the agency's existing guidance on the rule. There also is a possibility that the Trump Administration may issue an executive order invoking Dodd-Frank Act provisions that could require the SEC to revise or waive the conflict minerals rule for up to two years.

Navigating the Conflict Minerals Rule

The conflict minerals rule applies to "person[s] described" in the Dodd-Frank Act, which the Commission explained to mean issuers that file reports under Exchange Act Sections 13(a) or 15(d) and that manufacture or contract to manufacture products which contain conflict minerals necessary to those products' functionality or production. By implication, the rule would not apply to an issuer that is not an Exchange Act reporting company, does not manufacture or contract to manufacture products, or whose products do not contain necessary conflict minerals. The rule also would not apply to an issuer whose products were outside the supply chain before January 31, 2013. For all other issuers subject to the rule, varying levels of compliance are required.

For example, upon completion of a reasonable country of origin inquiry (RCOI), an issuer may be required to file Form SD and disclose its determination and briefly describe the RCOI and the results of the inquiry. In other instances, an issuer may be required to conduct due diligence on its conflict minerals supply chain based on a national or international framework, such as the Organisation for Economic Co-operation and Development's *Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas*. An issuer's due diligence would be described in a conflict minerals report attached as an exhibit to Form SD. In still other instances, an issuer may be required to obtain an independent private sector audit (IPSA) and describe products that have not been found to be DRC conflict free. The Commission included a flow chart in the adopting release that further describes the conflict minerals rule's compliance process.

SEC Guidance Under Review

To help companies comply with the rule, the SEC's Division of Corporation Finance issued guidance after the D.C. Circuit held that the conflict minerals rule's company website disclosure requirement may violate the First Amendment. The case was reheard and the initial ruling affirmed by the appellate panel (the majority did add one new rationale in support of its holding). The case was then remanded to the district court, which as of publication has not issued any further orders. The full D.C. Circuit's decision in a related case about food labels had prompted the panel rehearing in the conflict minerals case (district court opinion; panel opinion 1; panel opinion 2; AMI opinion).

The Division's guidance generally requires issuers to comply with the bulk of the conflict minerals rule, but with some exceptions related to the First Amendment ruling by the appeals court. For one, an issuer would not identify products as "not found to be 'DRC conflict free,'" although the issuer should make other disclosures about facilities used to produce the conflict minerals, country of origin, and efforts to determine the mine or location of origin. Moreover, no issuer would have to use certain descriptive labels (*e.g.*, "DRC conflict free" or "not found to be 'DRC conflict free'"), but an issuer that voluntarily describes its products as "DRC conflict free" would have to obtain an IPSA.

However, M&A practitioners should be alert to the possibility that this guidance may change in the coming weeks. Acting Chairman Piwowar directed SEC staff to reconsider the Division's prior guidance (See related Stay and Small Entity Compliance Guide). Piwowar also issued a statement asking for public comments on the existing guidance, in part based on his own visit to Africa, which

he said had highlighted for him the conflict minerals rule's "unintended consequences," such as a *de facto* boycott of the region's minerals. He also said a "withdrawal" from parts of Africa due to the rule could implicate U.S. national security interests. Media outlets have widely reported that the Trump Administration may direct the SEC to revise or waive the conflict minerals rule.

M&A Practice

Although the conflict minerals rule contained in Exchange Act Rule 13p-1 is deceptively simple, the application of that rule as described in Form SD and the Commission's adopting release is more complex. Still, there are only a few explicit references in the adopting release, the conflict minerals rule, or Form SD to M&A transactions. Here are some M&A-related features of the Commission's final conflict minerals rule that may help to inform M&A due diligence:

- ***Acquisitions and the Reporting Delay***

  The most direct mention of M&A activity is set forth in Instruction (3) to Item 1.01 of Form SD. Accordingly, a registrant that acquires or obtains control over a company that manufactures or contracts to manufacture products with conflict minerals necessary to the functionality or production of those products, and which was not previously required to file a Form SD, can delay its report on the acquired company's products. Specifically, the acquirer can wait to file any required specialized disclosure under Rule 13p-1 until the end of the first reporting calendar year beginning no earlier than eight months after the acquisition's effective date.

  The Commission explained in the adopting release that the delay was included in the final rule and Form SD in response to comments. The Commission also said it was concerned that setting an earlier date could have resulted in an acquirer having too little time to establish its systems for reporting on conflict minerals.

- ***Reporting Deadline (non-M&A context)***

  According to General Instruction B. of Form SD, reports required by the conflict minerals rule are due for the prior calendar year on May 31 of each year (or the next business day if there is an intervening weekend or holiday on which the SEC is closed for business).

- ***Applicability of Rule***

  The conflict minerals rule applies to companies that file reports under Exchange Act Sections 13(a) or 15(d). That means the rule applies broadly to domestic companies, foreign private issuers, and smaller reporting companies. A "smaller reporting company" is a company that, among other things, has public float of less than $75 million (See Securities Act Rule 405; Exchange Act Rule 12b-2; and Item 10(f) of Regulation S-K). But the conflict minerals rule does not apply to registered investment companies that file reports under Investment Company Act Rule 30d-1.

  The adopting release further explained that the inclusion of foreign private issuers was unlikely to imply the conflict minerals rule has extraterritorial reach because the rule would apply only to

those foreign private issuers that enter U.S. securities markets. Moreover, the Commission chose not to exempt foreign private issuers in order to give effect to Congressional intent and to avoid a scenario in which some foreign firms may obtain a competitive advantage that could reduce domestic firms' ability to comply with the rule and also could more generally lessen conflict minerals transparency.

- ***Industries Impacted by Rule***

  The Commission's adopting release cited the earlier proposal for the notion that many industries are impacted by conflict minerals owing to the ubiquity of conflict mineral derivatives in modern products. Overall, conflict minerals may appear in products that span the technology, consumer, industrial and materials, and healthcare sectors. Industry sectors specifically mentioned by the Commission include: Electronics; Communications; Aerospace; and Jewelry. These are just a few examples and many other sectors can be found by consulting the Standard Industrial Classification Codes.

- ***"Outside the Supply Chain"***

  The conflict minerals rule does not apply to conflict minerals outside the supply chain before January 31, 2013. The adopting release cited public comments explaining how smelting and refining impact conflict minerals. As a result, columbite-tantalite, cassiterite, and wolframite are "outside the supply chain" after they have been smelted, whereas gold is "outside the supply chain" after it is refined. In the case of columbite-tantalite, cassiterite, and wolframite, smelting means conversion of ore into its metal derivatives; refining of gold means the removal of impurities. "Outside the supply chain" also refers to conflict minerals (and their derivatives) that have not been smelted or fully refined and are located outside of covered countries.

- ***Record Retention***

  The Commission's final conflict minerals rule discarded a proposed requirement that issuers keep reviewable business records of their determinations that their conflict minerals did not originate in covered countries following a RCOI. The Commission explained that since the Dodd-Frank Act provision did not impose this requirement, neither should the Commission. But the Commission also noted that an issuer may benefit from keeping these records, such as by aiding its compliance with a national or international due diligence framework.

- ***Liability—Filed, not Furnished***

  Unlike its proposal, the Commission's adopting release required that conflict minerals information be filed, not just furnished, to the Commission. This development created a potential liability risk under Exchange Act Section 18. In reaching this conclusion, the Commission said it resolved an ambiguity in the statute between "submit[ting]" a report to the Commission and the use of "file" in the definition of "person described."

Section 18 provides that a person who files a report that contains a false or misleading statement can be liable for damages to any person who (without knowledge the statement was false or misleading) relied on the statement in buying or selling a security whose price was affected by the statement. The conflict minerals release further explained that Section 18 is not a strict liability law and a person sued under Section 18 can avoid liability if she proves she acted in good faith without knowledge the statement was false or misleading.

But a footnote to the Commission's discussion warns that other liability risks may arise under the federal securities laws for conflict minerals disclosures. Specifically, the Commission suggested liability may attach under Exchange Act Sections 13(a), 13(p), 15(d), and 10(b) and Rule 10b-5.

Evolution of a Securities Disclosure Requirement

While Dodd-Frank Act Section 1502 may have seemed to appear from nowhere in the 2010 financial reform law enacted in the aftermath of the Great Recession, the idea that the federal government could regulate companies' ties to the conflict minerals trade took root before the Great Recession. One of the first attempts by the U.S. to deal with the DRC involved enactment of a law focused on geopolitical goals such as stability in Africa's Great Lakes Region, halting "mass rapes" perpetrated by armed groups, and fighting terrorism. The law, which cited a 2002 U.S. national security strategy on Africa, also provided for bilateral aid to the DRC and for other U.S.-led multilateral actions in support of the DRC.

Former President Barack Obama (then a Democratic Senator from Illinois) introduced the legislation, which drew 12 co-sponsors, including equal numbers of Democrats and Republicans among its sponsor and original three co-sponsors (Pub L. No. 109-456). The Obama bill became law in December 2006, one year before the Fed launched the Term Auction Facility, one of its first special lending programs, to address the early signs of a flagging economy, and four years before President Obama signed the Dodd-Frank Act into law with its specialized disclosure provisions.

A 2008 bill offered by Sen. Sam Brownback (R-Kan) (currently governor of Kansas) would have imposed import restrictions on products that contained columbite-tantalite or cassiterite (S. 3058). But it would be a pair of bills yet to be introduced that would contain elements of the Dodd-Frank Act conflict minerals provision. In 2009, then-Rep. Jim McDermott (D-Wash) introduced the Conflict Minerals Trade Act (H.R. 4128) while Sen. Brownback introduced the Congo Conflict Minerals Act (S. 891), a more detailed update to S. 3058. The chief difference between these bills was that the House version placed greater emphasis on federal government involvement in promoting a solution to problems in the eastern DRC, while the Senate bill included new Exchange Act disclosures for public companies.

According to the 2009 House and Senate bills, the conflict minerals trade enables armed groups and results in human rights abuses. The preamble to both bills said "Sexual violence and rape" are "pervasive tools of combat." The lengthy recitations of the problem in the earlier versions of the conflict minerals law were distilled into a terser statement of Congress in the Dodd-Frank Act: the conflict minerals trade fuels "extreme levels of violence" in the eastern DRC which often involves "sexual- and gender-based violence" that contributes to an "emergency humanitarian situation" that further justifies placing a disclosure burden on public companies via the securities laws.

Much as Section 1502 does, the two precursor bills provided for exemptions and termination of the federal government's involvement in dealing with the conflict minerals trade in the DRC. The House bill used national security language akin to the language used in Section 1502 to let the president exempt items from being included on a list of potential conflict goods for two years upon stating the reasons for the exemption. By contrast, the Senate bill would have granted authority to the Commission (no mention of the president) to revise or waive disclosure requirements if doing so is necessary to protect investors and in the public interest. Thus, Section 1502 is an amalgam of the draft House and Senate bills.

Section 1502 also contains language similar to the House and Senate bills that allows the president to terminate the conflict minerals rule. But those bills would have added a basis for termination not included in the Dodd-Frank Act: the existence of an effective regional framework to deal with the negative impact of the conflict minerals trade. Moreover, the House bill would have imposed a penalty for introducing goods with conflict minerals into the U.S. by reference to the Tariff Act of 1930.

Revision, Waiver, Termination

Dodd-Frank Act Section 1502 provides for the sunset of the conflict minerals rule via two routes. In one scenario, the president can direct the Commission to revise or waive the rule for up to two years if he determines this action is in the U.S.'s national security interest and states the reasons for that determination. National security strategy has been a key part of American aid to the DRC since the early 2000s, and was at the core of legislation sponsored by former President (then-Senator) Obama which became law in 2006.

The president also can terminate the conflict minerals rule by determining and certifying to Congress "that no armed groups continue to be directly involved and benefitting from commercial activity involving conflict minerals." The president could, assuming he can make the required finding, seek to terminate the conflict minerals rule, since the mandatory five years and one day waiting period from the Dodd-Frank Act's enactment date has passed.

An unauthenticated draft presidential memorandum reviewed by Wolters Kluwer suggested the Trump Administration may invoke the revise-or-waive provision, and not the termination provision, to direct the SEC to put the conflict minerals rule on hold for two years. As of publication, the Trump Administration had not issued such an executive order.

Resource Extraction Issuers Rule Disapproved

President Trump signed a joint Congressional resolution that disapproves the SEC's resource extraction issuers rule. The Commission adopted the Dodd-Frank Act-mandated rule for the second time last summer, which, under the timing provisions of the Congressional Review Act, made the rule eligible for a second look by lawmakers.

This was the first time Trump signed CRA legislation, according to a transcript of the signing ceremony published by the White House which suggested more CRA disapprovals are planned. Trump

had earlier pledged to "dismantle" the Dodd-Frank Act, although the resolution on the resource extraction issuers rule does not repeal the corresponding Dodd-Frank Act statutory provision.

The Republican-led effort to push the joint resolution through Congress emphasized the costs of the rule to businesses and the impact of foreign competition on U.S. firms. Democrats had emphasized the rule's anti-corruption goals.

What was Disapproved—Basic Rule Mechanics

The SEC's latest version of the resource extraction issuers rule that implemented Dodd-Frank Act Section 1504 was the product of a re-write following protracted court battles. Legislation to repeal the rule passed Congress just as the White House was unveiling a series of executive orders and other memoranda directing reviews of the Department of Labor's fiduciary standard rule and a wide-ranging review of U.S. financial system regulations.

The revised resource extraction issuers rule applied broadly to payments that are "not de minimis," meaning one or a series of related payments of at least $100,000. The rule included exemptions for acquired companies and for exploratory activities, and it reiterated that the Commission could grant other case-by-case exemptions. The rule became effective September 26, 2016, and compliance was set to begin for fiscal years ending on or after September 30, 2018. Issuers subject to the rule would have used Form SD, which accommodates disclosures made under both the conflict minerals and resource extraction issuers rules.

Will SEC try Again?

The bill that was incorporated into the Dodd-Frank Act resource extraction issuers provision resulted from the efforts of former Sen. Richard Lugar (R-Ind) and Sen. Ben Cardin (D-Md). The namesake Cardin-Lugar amendment advocated disclosure under the federal securities laws by public companies of payments they make to the U.S. or foreign governments for the purpose of commercially developing oil, natural gas, or minerals in order to establish a public record that citizens in resource-rich countries could use to hold their government leaders accountable for the allocation of natural resources.

But the CRA disapproval of the SEC's resource extraction issuers rule dims the chances that the Commission will adopt a substantially similar rule in the future. The CRA prohibits a federal agency from reissuing a disapproved rule in substantially the same form without specific, new Congressional authority.

As a result, the near-term prospects for major SEC rulemaking generally, and specifically resource extraction issuers, is unclear. The Commission has just two members, Acting Chairman Piwowar (a Republican) and Commissioner Kara Stein (a Democrat). The SEC's rules of practice impose special quorum requirements when the Commission has three or fewer members such that rulemaking would likely require unanimity by Piwowar and Stein.

President Trump nominated deal lawyer Jay Clayton to be chairman, but the Senate Banking Committee has yet to schedule a confirmation hearing. Even if Clayton is confirmed, it will take some time for him to establish the SEC's policy direction and there will still be two vacancies on the

Commission. Former President Obama re-nominated his two picks for the CFTC, but did not do the same for his two SEC nominees, Lisa Fairfax and Hester Peirce.

Even assuming the Commission did issue another rule that overcame the CRA's limits, Congress may step in before that could happen to resolve the matter via legislation that would repeal or replace parts of the Dodd-Frank Act. Specifically, Section 455 of the Financial CHOICE Act (H.R. 5983; House Rep. No. 114-883), as first introduced in the last Congress, would repeal the Dodd-Frank Act's resource extraction issuer provision (along with the conflict minerals and mine safety provisions). It is expected that the CHOICE Act's sponsor, Rep. Jeb Hensarling (R-Texas), Chairman of the House Financial Services Committee, will re-introduce the bill this year.

Is Human Trafficking the Next Disclosure Frontier?

While the debate will likely continue over whether the federal securities laws are the proper locus for disclosures about social or specialized topics, Congress, via the Dodd-Frank Act, has taken the first steps in the direction of requiring public companies to make these types of disclosures. The introduction in the last Congress of bills dealing with human trafficking suggests an ongoing legislative interest in specialized disclosures, even if the immediate trend in Congress may lean towards repeal of existing specialized disclosure requirements.

Bills in the 114th Congress

A bill introduced in the last Congress by Rep. Carolyn Maloney (D-NY) would create a new specialized disclosure obligation under the federal securities laws for many companies. The Business Supply Chain Transparency on Trafficking and Slavery Act of 2015 (H.R. 3226) calls on firms to disclose if their supply chains involve labor that may be the product of human rights abuses. Representative Maloney initially offered her bill in 2011 (H.R. 2759).

"This legislation simply requires businesses to publicly disclose what actions they have voluntarily undertaken to remove labor abuses from their supply chains," said Rep. Maloney. "It is a good first step we can take to improve reporting and transparency so that we can enforce existing laws against labor abuses and allow consumers to make more informed decisions." In floor remarks, Rep. Maloney said her bill responds to the problem of human trafficking by emphasizing market-based solutions over prescriptive government action.

The bill would amend the Exchange Act to require businesses with more than $100 million in global gross receipts to report annually to the SEC about their policies to prevent slavery and human trafficking from entering into their supply chains. According to the bill's authors, it will enhance consumer choice, increase companies' accountability for supply chain practices, and foster competition to adopt better practices for handling human rights issues.

A summary of the bill also noted that disclosures would have to be "prominently posted" on both the SEC's and companies' websites. The posting of these types of disclosures on company websites is already subject to an ongoing legal challenge over whether similar requirements for conflict minerals supply chains violate the First Amendment.

The latest version of the Maloney bill was partially inspired by a recent State Department report urging businesses to do more regarding human rights. Senator Richard Blumenthal (D-Conn) introduced a similar bill (S. 1968).

California Disclosure Law

The federal government is not the only actor when it comes to human trafficking disclosures. The California Transparency in Supply Chains Act took effect on January 1, 2012, and requires subject companies to disclose how they have addressed five topics. Proposed federal laws for dealing with business labor supply chains are similar in scope to California's law, especially regarding the size of companies that must comply with the law and the law's requirement that companies post required documentation on their websites.

Specifically, the California law applies to "every retail seller and manufacturer" that does business in California and has global gross receipts of more than $100 million. These companies must disclose their efforts to end slavery and human trafficking in their direct supply chains for the tangible goods they offer for sale.

Companies also are directed to focus on five areas lawmakers identified as comprising the minimum required disclosure. As a result, each subject company must disclose:

- How it verifies supply chains to deal with human trafficking and slavery (including by indicating if it did not use a third party to do the verification);
- How it audits suppliers to evaluate suppliers' compliance with company standards (the company must state if the audit was not independent and unannounced);
- How it mandates certification by direct suppliers that materials incorporated into a product meet the laws on slavery and human trafficking in countries where they do business;
- How the company maintains internal accountability standards and procedures regarding employees and contractors that do not satisfy company standards; and
- How the company trains managers and employees with direct supply chain responsibilities to mitigate the risks of human trafficking and slavery in product supply chains.

A company subject to the law must provide a "conspicuous and easily understood" hyperlink to a location on its website's homepage where others can read its required disclosures. A company that has no website must provide the information in response to a written consumer request within 30 days. If a company violates the law, the sole remedy is an action by the California Attorney General for injunctive relief, but remedies under other state or federal laws may be available.

The California Attorney General's website provides additional information about human trafficking enforcement. The website also publishes a guide and other resources for businesses regarding the California Transparency in Supply Chains Act.