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Form SD – Specialized Disclosure for Conflict Minerals

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or Act) focuses mostly on the financial services sector. However, there are a number of secondary provisions in the Act that may impact the corporate governance and compliance programs of any non-financial publicly held company.

One of these secondary provisions is Section 1502 of the Act, which deals with the use of certain minerals extracted by, and imported from, certain geographic locations. Section 1502 of the Dodd-Frank Act intends to curb the violence and exploitation in the Democratic Republic of the Congo (DRC) and the neighboring countries (covered countries)[1] by requiring issuers to disclose any use of minerals derived from this region.

This article will discuss the provisions of Section 1502 of the Dodd-Frank Act and will focus on reporting and disclosure requirements for publicly held companies under the new SEC promulgation (www.sec.gov/rules/final/2012/34-67716.pdf).

SECTION 1502 OF THE ACT

The goal of Section 1502 of the Dodd-Frank Act is to promote peace and security in the DRC and covered countries. Congress and the Securities and Exchange Commission (SEC) both recognize that the implementation of this Act may provide a significant advantage to foreign companies that are not registered for filing in the United States and do not have to comply with this Act, but are competing with their U.S. counterparts.

The requirement of the Act affects most electronics, aerospace, communication, automotive, jewelry, healthcare devices, and industrial machinery. Even some private companies may be affected if they are part of the supply chain for these conflict minerals to registrants.

CONFLICT MINERALS

Section 1502(e)(4) of the Act defines "conflict minerals" as tin, tantalum, tungsten and gold; these metals are also collectively referred to as "3TG." However, the U.S. Secretary of State is authorized to expand the list of minerals and derivatives constituting conflict minerals upon finding that such minerals and their derivatives finance the conflict in the DRC and covered countries.

SEC PROMULGATION

Section 1502 amended the Securities and Exchange Act of 1934 by adding new Section 13(p), which requires the SEC to promulgate disclosure and reporting rules regarding the use of conflict minerals. On Aug. 22, 2012, the SEC after several delays and postponements adopted a conflict minerals rule (Section

1502 of the Dodd-Frank Act) by a two-one vote.

The SEC rule applies to all issuers that file under Section 13(a) or Section 15(d) of the Securities and Exchange Act of 1934. The issuers are all publicly held corporations (other than registered investment companies), including domestic companies, foreign private issuers, small reporting companies and voluntary filers (including debt-only filers).

The Exchange Act Section 13(p)(1)(A)(ii) requires that issuers file a Conflict Minerals Report for products that they manufacture or contract to be manufactured. The rule does not consider an issuer engaged in extracting and mining of conflict minerals within its scope unless the issuer is engaged in manufacturing in addition to extracting and mining. The final rule excludes the conflict minerals used for purposes of ornamentation and decoration. The rule generally applies to manufacturers and excludes the mining industry.

The following is a summary of the SEC rule and its requirements. First, the issuers should determine whether 3TG is within the products they manufacture. If not, no disclosure or audit is required.

Second, if 3TG is in the products that they manufacture, issuers need to conduct a reasonable country of origin inquiry (RCOI). If it is determined that 3TG is sourced outside the DRC and the covered countries, the issuers are conflict free, but they are still required to file Form SD (Specialized Disclosure for Conflict Minerals).

Third, if based on the result of RCOI, the issuers determine that 3TG is sourced within the DRC or the covered countries, they need to not only file Form SD, but also a Conflict Mineral Report and an audit report. An independent private auditor must conduct the audit, and the independent qualification of the auditor is based on Rule 2-01 of Regulation S-X (17 CFR 210.2.01).

FORM SD

The SEC requires issuers to comply with the conflict minerals rule beginning with the calendar year ended Dec. 31, 2013. All issuers must report on a calendar year base for conflict minerals reporting purposes (even if their fiscal year is not a calendar year). The issuers should disclose their conflict minerals on the new specialized disclosure form (Form SD) by May 31, 2014. However, the SEC does not require that the issuer's chief executive officer and chief financial officer certify the Form SD, but nevertheless the filing is subject to liability under Section 18 of the Securities and Exchange Act of 1934.

The SEC believes that a separate filing event for Form SD will remove the conflict mineral information from the scope of the certification requirement of principal executives and financial officers under Section 302 and 906 of the Sarbanes-Oxley Act, and at the same time reduces the burden of annual filing and reporting for issuers.

The final rule's filing requirements differ from those published in the proposed rule. Under the proposed rule, the issuers needed to provide disclosures about conflict minerals on Forms 10-K, 20-F (foreign issuers) and Form 40-F (a Canadian issuer that files under the Multijurisdictional Disclosure System), along with the Conflict Mineral Reports

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as an exhibit to their annual reports. However, the final rule only requires the issuers to file the information in the Specialized Disclosure Form (Form SD). Furthermore, the issuers are required to post conflict mineral disclosure reports on their websites until the subsequent annual report is filed.

For the first two calendar years following the effective date of the new rule, and for the first four calendar years for a smaller reporting company (a public company with a public float of $75 million or less), an issuer, which is required to file a Conflict Minerals Report with its Form SD, will not be required to submit an independent private sector audit of the information it provides in the Conflict Minerals Report with respect to those products that it has not been able to determine if they are "conflict minerals free" after conducting its initial due diligence.

If an issuer acquires another company that conflict minerals are necessary to the functionality or production of its product, and the company was not previously required to disclose information regarding its use of conflict minerals, the issuer can delay its reporting until the end of the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition. Thus, if an acquisition occurs after April 30 of a given year, the issuer's Form SD for that particular acquisition will not be due until the second calendar year following the acquisition.

CONFLICT MINERALS REPORT

The SEC rule requires that if the issuer has determined that the conflict minerals are present in its products, and they are not from scrap or recycled sources and are sourced either from the DRC or covered countries or their source is undeterminable, it must provide a Conflict Minerals Report.

The report should encompass a description of the due diligence that the issuer has performed. It should also disclose the products that contain 3TG and may have financed or benefited the armed groups in DRC or the covered countries. There may be additional product-level disclosures required as well, such as a description of the country of origin of these minerals and the efforts that issuers have taken to determine the mine or the country of their origin.

INDEPENDENT AUDITOR REPORT

If the issuer determines that conflict minerals are present in the products that it manufactures, or contracts to be manufactured, it must provide an audit report by an independent private auditor (a CPA). The CPA must conduct the audit, and the independent qualification of the auditor is based on Rule 2-01 of Regulation S-X (17 CFR 210.2.01).

The SEC rule limits the scope of the audit only to the sections of the Conflict Mineral Report that discusses the design of the issuer's due diligence framework and processes. The auditor is not required to express an opinion or conclusion as to whether the issuer's processes were effective or if conflict minerals used in manufacturing of its products (or contract for manufacture products) are "DRC conflict free." The engagement to perform the audit of the Conflict Minerals Report is a "non-audit service" subject to pre-approval requirements of Rule 2-01 of Regulation S-X and is classified as "All Other Fees" in the issuer's proxy statement.

AICPA CONFLICT MINERALS TASK FORCE

The American Institute of CPAs (AICPA) formed a Conflict Minerals Task Force in October 2012, and it includes representatives from the accounting profession and the Government Accountability Office (GAO). The goal of the task force is to review SEC rule requirements and provide practical guidance on addressing the audit provisions of the rule.

The task force also interacts with the SEC and with industry bodies, such as the Electronic Industry Citizenship Coalition (EICC). Its current areas of focus include developing sample Conflict Minerals Audit Reports, application of independence requirements for auditors, and developing guidance focused on the audit objectives and scope.

XBRL FILING REQUIREMENT

The SEC requires that Form SD and its exhibits be tagged by eXtensible Business Reporting Language (XBRL) interactive data format. The 2013 draft of Form SD XBRL taxonomy is available on the SEC's website at www.sec.gov/info/edgar/edgartaxonomies_d.shtml.

SUPPLY CHAIN RISKS

Form SD, conflict mineral disclosures and the potential business impact of such disclosures have made supply chains a potentially more risk area than before. When there is a problem with the supply chain, whether it is related to conflict minerals or any other issues, it quickly becomes the problem of the issuer rather than the supplier.

It is important for issuers to identify the conflict minerals risk to the supply chain as early as possible. Management should have a plan to react quickly, and be able to sidestep the problem, if needed. Most importantly, management should have a plan for the possible shutdown of the supply chain and being able to bounce back quickly from any disruptions.

There must be controls in place for the issuer to track and monitor the supply chains governance structure and policies. It is equally important to work closely with the supply chain organization to instill a trust-based relationship.

LATEST DEVELOPMENT

The SEC originally estimated that it would cost issuers about $71 million to implement the rule, but it increased its estimate to $4 billion for the final rule, based on the input that it received from its constituents (Colleen Cunninghum, www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2012/CorpFin/ConflictMinerals).

A legal challenge was filed with the Court of Appeals regarding the legality of the provisions of the Dodd-Frank Act and conflict minerals. However, on July 23, 2013, the federal court upheld the SEC's controversial conflict minerals promulgation. In a 63-page ruling, Judge Robert Wilkins of the United States District Court for the District of Columbia wrote that the plaintiff's claims "lack merit" (www.complianceweek.com/court-rejects-legal-challenge-to-secs-conflict-minerals-rule/article/304305/).

QUESTIONS TO CONSIDER

During the comment period for the proposed rule, many constituents noted that their supply chains run deep, and it may be extremely difficult in some cases to trace the minerals all the way back to the point of extraction. To prepare for the new reporting requirements and disclosures, issuers need to think about their supply chains.

How deep do the supply chains run? Can their suppliers provide the appropriate certifications regarding the use and origin of conflict minerals? Do contracts with suppliers provide for the ability to obtain such certifications? What are the legal implications if the contracts conflict with the SEC rule? What are the issuers' sourcing policies? Do they conflict with the SEC rule? Do they need to be revised to accommodate the SEC rule?

The Conflict Minerals Report requires transparency with regard to such policies. Its implementation could be a very time consuming and expensive process.

FOOTNOTE

1. The term "covered country" is defined in Section 1502(e)(1) of the 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.

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