

Client Alert

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U.S. Court of Appeals for the District of Columbia Circuit Holds That Portion of Conflict Minerals Rule Violates First Amendment

On April 14, 2014, the United States Court of Appeals for the District of Columbia issued its decision in the pending court challenge to the conflict minerals rule. The rule was promulgated in 2012 by the Securities and Exchange Commission (SEC) in response to Dodd-Frank Act mandates. After the district court upheld the rule, the National Association of Manufacturers (NAM) appealed. While the court sustained the conflict minerals rule against challenges brought under the Administrative Procedure Act and the Securities Exchange Act of 1934, it held that certain aspects of the rule, and, conditionally, certain aspects of the Dodd-Frank Act, violate the First Amendment. Judge Randolph delivered the opinion of the Court, which concluded that the government failed to demonstrate that the rule is narrowly tailored to achieve its goal. While the Court did not provide express guidance on the reports some companies must file with the SEC beginning on May 31, 2014, it held that the rule's requirement, that reporting companies list "products" that "have not been found to be DRC conflict free," is unconstitutional.

The conflict minerals rule aims to reduce the source of funding for armed groups that are committing human rights abuses and contributing to the conflict in the eastern Democratic Republic of Congo (DRC). To accomplish this, the rule generally requires covered companies to: (1) determine whether products that they manufacture or contract to have manufactured include tungsten, tantalum, tin or gold (collectively, "conflict minerals") that are necessary to the functionality or production of its products; (2) conduct a reasonable country of origin inquiry to determine whether any of its conflict minerals originate in the DRC or adjoining countries (i.e., Angola, Burundi, the Central African Republic, Congo, Rwanda, South Sudan, Uganda, the United Republic of Tanzania, or Zambia) and did not come from recycled or scrap sources; (3) file a Specialized Disclosure (Form-SD) with the SEC; and, if necessary, (4) conduct due diligence on the source and chain of custody of its necessary conflict minerals and file a conflict minerals report as an exhibit to its Form-SD filing. Subject to certain exceptions, the conflict minerals report must also include an independent private sector audit (IPSA) report.

In its First Amendment argument, NAM only challenged the requirement that an issuer describe its products as not "DRC conflict free" in its report and on its website. A critical question with any First Amendment challenge is which level of judicial review applies. The SEC argued that because the disclosures are purely factual and non-ideological, rational basis review applies. The court disagreed, stating that the controlling precedent limits rational basis review to cases in which purely factual disclosure requirements are reasonably related to the State's interest in preventing consumer deception. Simply put, compelled speech is not immune from scrutiny merely because it is rooted in fact. As the court indicated, the SEC admitted that the rule was not related to a consumer deception interest.

Although the court concluded that rational basis review does not apply, it declined to state what level of review does apply. In short, the court concluded it did not need to make a level of review determination: since the rule does not satisfy the precedential “*Central Hudson*” intermediate scrutiny standard, it would not pass under a strict scrutiny standard. The *Central Hudson* test requires that the government show a substantial government interest that is directly and materially advanced by the restriction, and that the restriction is narrowly tailored. The court determined that the government presented no evidence that less restrictive means would cause the rule to fail to meet its objectives. As such, the court held certain provisions of both the rule and conditionally, the statute, unconstitutional, and remanded the case for further proceedings.

The immediate and long-term implications of the decision are unclear. While some issuers may view this as a “win,” the court did not strike down the entire rule and indeed rejected several of NAM’s arguments targeted at setting the entire rule aside. The court’s holding was narrow. It applied only to the requirement that companies label their products “not DRC conflict free;” additionally, in a footnote, the court included a caveat that the corresponding Dodd-Frank provision is itself unconstitutional only to the extent it imposes this labeling requirement. Thus, if the labeling requirement is purely a result of the SEC’s rule, then the court’s holding leaves the statute unaffected. Furthermore, the court expressly left open the opportunity for the SEC to impose different or less restrictive labeling requirements, or for the SEC to create its own public list of products containing DRC conflict minerals, based on the required due diligence processes.

Several points in Judge Srinivasan’s concurring opinion highlight the complexity of the analysis. In his opinion, the court should not have ruled on the First Amendment issue because the D.C. Circuit is conducting an en banc review of another case, *American Meat Institute v. United States Department of Agriculture*, that could change the conclusion that rational basis review only applies to compelled speech with an interest tied to preventing consumer deception. As he explains, a critical step in the majority’s First Amendment analysis is that the relaxed, rational basis standard of review did not apply to the conflicts mineral rule, because the rule was not related to a consumer protection interest. Judge Srinivasan asserts that the validity of this principle is being reviewed in the pending *American Meat* case. Judge Srinivasan argues that if the *en banc* court decides that “mandatory disclosure” obligations can properly proceed, even if they service interests aside from addressing consumer deception, the present case would need to be reconsidered afresh.

Consequently the conflict minerals rule is still in limbo. It is possible that the SEC will await a possible favorable decision from the *en banc* court, and then argue to the district court on remand that a rational basis review applies and the rule should survive. It is also possible that NAM will move quickly to seek to enjoin enforcement of the entire rule at the District Court. However, as Judge Srinivasan asserted in his concurring opinion, the Dodd Frank Act “contains no mandate to use any magic words when categorizing those products.” If the courts ultimately agree that the Dodd Frank Act does not compel speech, the D.C. Circuit’s caveat would apply and the NAM decision would not invalidate the statute itself.

Clarification from the SEC about interim responsibilities would be welcomed by the issuer community. In the meantime, issuers should consult with counsel concerning their responsibilities under the conflict minerals rule.

Compliance Guidance: Updated FAQs

Prior to the court's decision, the SEC published updated conflict minerals FAQs on its website. The updates focused particular attention on the rule's IPSA requirement. An IPSA of the Conflicts Minerals Report is required if the minerals used in an issuer's products may have originated in one of the covered countries, but did not finance or benefit armed groups, or if the minerals are classified as Not Been Found to Be DRC Conflict Free. The IPSA evaluates the issuer's due diligence framework and measures. The FAQs and responses are available at: <http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm>.

Contact Information

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