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D.C. CIRCUIT COURT OF APPEALS INVALIDATES KEY PART OF CONFLICT MINERALS RULE

On April 14, 2014, the U.S. Court of Appeals for the District of Columbia Circuit issued its long-awaited opinion in the challenge brought by industry groups to the SEC's conflict minerals reporting rule.[1] The court agreed with the SEC that it had not acted arbitrarily or capriciously under the Administrative Procedure Act ("APA") in adopting the conflict minerals rule and that the SEC had properly analyzed the rule's costs and benefits as well as the impact of the rule on competition. Perhaps more importantly, however, the court held that the rule (and the underlying statutory provision) violates the First Amendment rights of public companies by compelling them to make public disclosures regarding the "conflict-free" status of their products. The court's decision leaves much of the SEC's rule intact, and thus creates uncertainty for public companies which have been preparing to file their initial reports under the rule by May 31, 2014.

BACKGROUND

The SEC adopted the conflict minerals rule under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in August 2012.[2] The rules require that public companies annually disclose information about their use of specific minerals (generally, tantalum, tin, tungsten, and gold) originating and financing armed groups in the Democratic Republic of the Congo ("DRC") or an adjoining country. The rules affect thousands of public companies because conflict minerals are used to manufacture a wide array of products, such as smartphones, cameras, computers, microchips, automobiles, tools and heavy machinery. The first reports under the rule, which will cover the year ended December 31, 2013, are due by May 31, 2014.

The National Association of Manufacturers, U.S. Chamber of Commerce and Business Roundtable challenged the SEC's conflict minerals rule in the U.S. District Court for the District of Columbia. Their challenge claimed that (i) the rulemaking was arbitrary and capricious under the APA, (ii) the SEC did not properly analyze the costs and benefits of the rule as required by the Securities Exchange Act of 1934 ("Exchange Act"), and (iii) the rule and Section 1502 of the Dodd-Frank Act compelled burdensome and stigmatizing speech in violation of the First Amendment. On July 23, 2013, the District Court rejected all of plaintiffs' arguments and upheld the rule.[3] Plaintiffs appealed that decision to the U.S. Court of Appeals for the District of Columbia Circuit.

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[1] *National Association of Manufacturers, et. al. v. Securities and Exchange Commission, et. al.* No. 13-5252 (D.C. Cir. Apr. 14, 2014).

[2] *See* Conflict Minerals, Rel. No. 34-67716 (Aug. 22, 2012) ("Adopting Release"). The Adopting Release is available on the SEC's website. For additional information regarding the Adopting Release and interpretive questions regarding the conflicts minerals rulemaking, respectively, see Covington Advisory: SEC Adopts Conflict Minerals Rules, Covington Advisory: Conflict Minerals Rules – Frequently Asked Questions, Covington Advisory: Conflict Mineral Deadline Nears: Update and Frequently Asked Questions.

[3] *National Association of Manufacturers, Chamber of Commerce of the United States of America, and Business Roundtable v. Securities and Exchange Commission,* 956 F. Supp. 2d 43 (D.D.C. Jul. 23, 2013).

THE COURT'S RULING

The DC Circuit affirmed the District Court's ruling with respect to the claims under the APA and Exchange Act, but reversed that ruling with respect to the First Amendment claims.

APA and Exchange Act Claims

With respect to plaintiffs' APA-based claims, the court agreed with the lower court and decided that the four specific aspects of the SEC's rule that were challenged by plaintiffs under the APA represented the exercise of reasonable discretion by the SEC, and were not arbitrary or capricious within the applicable judicial review standards.[4]

With respect to the SEC's obligation to analyze the costs and benefits of the rule in accordance with the Exchange Act, the court also agreed with the lower court and endorsed the SEC's cost-benefit analysis.[5] The court stated that the SEC exhaustively analyzed the rule's costs and the other factors required to be considered by it. On the benefit side, the court rejected plaintiffs' contention that the SEC was obliged to consider, as part of its analysis, whether the rule would achieve the social and humanitarian benefits intended by Congress. Indeed, the court stated that, in light of the clear mandate by Congress, it is difficult to see what the SEC could have done better to analyze the benefits of its rule, noting that the SEC did not have a choice whether or not to adopt a rule. Like the District Court before it, the court agreed that the SEC was not obligated to second guess Congress on the threshold question of whether a disclosure regime would help promote peace and stability in the Congo.

First Amendment Claims

With respect to the plaintiffs' First Amendment claims, however, the court disagreed with the lower court, holding that the SEC's rule violates the First Amendment's prohibition against compelled speech. The court said that the "label 'conflict free' is a metaphor that conveys moral responsibility for the Congo war..." and that the rule "requires an issuer to tell consumers that its products are ethically tainted." The obligation to make these statements, the court said, interferes with the exercise of freedom of speech.

In reaching its decision, the court used the "intermediate scrutiny" standard of review articulated by the Supreme Court in the *Central Hudson* case.[6] This standard requires that the government show a substantial government interest that is directly and materially advanced by the speech restriction, and that the restriction be narrowly tailored. Applying this standard to the rule's central requirement that issuers make public disclosures, in reports filed with the SEC and on their websites, regarding

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[4] The challenged aspects of the rule were (i) the absence of a *de minimis* exception, (ii) the scope of the reasonable country of origin inquiry, (iii) the inclusion of companies that "contract to manufacture" products containing conflict minerals, and (iv) different phase-in periods for smaller reporting companies and other companies.

[5] The two Exchange Act provisions obligating the SEC to analyze the costs and benefits of its proposed rules are (i) Section 23(a)(2) (15 U.S.C. §78w(a)(2)), which prohibits the adoption of a rule "which would impose a burden on competition not necessary or appropriate" to advance the purposes of securities laws, and (ii) Section 3(f) (15 U.S.C. §78(c)(f)), which requires the SEC in the context of rulemaking to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

[6] *Cent. Hudson Gas & Elec. Corp. vs. Pub. Serv. Comm'n*, 447 U.S. 557 (1980). The court rejected the SEC's argument that the appropriate judicial standard is the less rigorous "rational basis" standard of review, but did not reach the issue of whether strict scrutiny applies because it concluded that the intermediate scrutiny standard was not met.

any products that have "not been found to be DRC conflict free," the court concluded that the rule's disclosure requirement was not sufficiently "narrowly tailored" to survive First Amendment scrutiny.[7]

The court also rejected arguments that a lesser judicial review standard should apply to the SEC's conflict mineral rule in light of the government's substantial power to regulate the securities markets.[8] If the lesser review standard applied, the court wondered, it might open the door to Congress or the SEC requiring issuers to disclose information such as the labor conditions at their factories abroad or the political ideologies of their board members, which the court characterized as "obviously repugnant" to the First Amendment.

Finally, with respect to Section 1502 of the Dodd-Frank Act, the court noted that the underlying statutory provision would only violate the First Amendment to the extent that the statute itself imposes a requirement on issuers to use the label "not been found to be 'DRC conflict free.'" Given the use of the defined term "DRC conflict free" in Section 1502, however, the SEC's discretion to adopt an approach that does not use this term may have limits.

PROCEDURAL STATUS AND NEXT STEPS

The court remanded the case to the District Court for further proceedings consistent with its decision. Before the District Court can take action, the SEC will have 45 days to decide whether to petition for rehearing or rehearing en banc. If it does not seek rehearing, then the case will be remanded to the District Court seven days after the deadline for a rehearing petition. Consequently it may be more than 45 days (and potentially up to 52 days) before the District Court has an opportunity to hear the case, which means that the District Court may not have an opportunity to hear the case before the May 31 deadline for the first reports under the rule.

Presumably, the District Court will vacate the rule to the extent that the rule and the statute require issuers to make public disclosures regarding their products that have "not been found to be DRC conflict free." Even if the District Court does this, however, the ruling appears to leave untouched other aspects of the rule, including the requirement that companies prepare and submit a conflict mineral report with the SEC, including a description of the due diligence measures taken with respect to conflict minerals and an independent private sector audit of such report. Of course, the "DRC conflict free" determination is a central element of the SEC's rule and the statute, so it is unclear whether the SEC would seek to enforce the remaining aspects of the rule without modifying the rule.

We expect the SEC to make a public announcement of its intentions with respect to the conflict minerals rule, and next steps, well before the May 31, 2014 deadline for the initial filing of reports under the rule. In the meantime, until there is further action by the District Court or the SEC, the May 31, 2014 deadline for initial reports under the rule remains in effect, and we advise public companies to continue to prepare for such filing.

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[7] On this issue, the court mentioned two less restrictive alternatives suggested by the plaintiffs, (i) a rule permitting issuers to use their own language, rather than the "DRC conflict free" label, to describe their products, and (ii) a system whereby the government compiles its own list of products that it believes are affiliated with hostilities in the Congo, based on information provided to the SEC by issuers.

[8] Intervenor Amnesty International cited the court's opinion in *SEC v. Wall Street Publishing Institute, Inc.*, 851 F.2d 365 (D.C. Cir. 1988) in support of this argument.

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