CIRCUIT COURT DECISIONS, GAO REPORT AND THE IPSA: CHARTING YOUR COURSE

A White Paper by

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A Resource for Companies Affected by

Dodd-Frank Conflict Minerals

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Circuit Court Decision & the IPSA: Now What?

1.0 INTRODUCTION

On August 18, 2015, the three-judge panel of the DC Circuit Court of Appeals reaffirmed an April 2014 decision regarding the Dodd-Frank Conflict Minerals Act (DFCM). It confirmed an earlier decision that the SEC's Conflict Minerals Rule ("Rule") violates First Amendment rights. It was a split decision (2-1), with spirited comments by both the majority and the dissent.

Public issuers subject to DFCM will not be compelled to state they are "not found to be 'DRC Conflict Free'." As published, the Rule required an Independent Private Sector Audit (IPSA) if the public issuer made this conclusion. So, are public issuers off the hook for an IPSA? Maybe yes, and maybe no. Even if they are, there may be good reasons to procure one anyway.

This white paper:

- Reviews the decision, and the most recent conflict minerals report by the Government Accountability Office (GAO);
- Provides enterprise risk management (ERM) considerations regarding conflict minerals programs; and
- Provides information to help public issuers make an informed decision regarding procurement of an IPSA for the 2015 reporting period.

2.0 CIRCUIT COURT DECISION

The Circuit Court decision[1] upheld an earlier decision that stated that the Rule was excessive in that the SEC could not "require" regulated companies to make a particular statement. As originally written, the Rule required companies to implement certain steps, and if those steps included due diligence (as outlined) to then draw one of two conclusions. Companies could conclude that their products were:

- DRC[2] Conflict Free
- Not found to be 'DRC Conflict Free'

For two transition years (ending with 2014), a third conclusion – "DRC Conflict Undeterminable" was also permissible.

The decision[3] cited recent decisions in various other matters, dealing with matters as varied as: compelled speech designed to cure misleading advertising; whether the government is required to prove that its disclosure requirement will accomplish a stated objective; differences between commercial speech, consumer protection, and speech designed to further humanitarian interests. The court also considered the significance of the timing of the disclosure, (e.g. whether it is made at a point of sale or elsewhere), and what constitutes "controversial". The references included an early case involving disclosures related to socially-motivated matters (Nike, Inc. v Kasky (2003)), which affected Sustainability and non-financial reporting in the ensuing years. Between the majority and the dissent, there were quotes from Charles Dickens, George Orwell, Arthur Koestler, and Mark Twain! This made for interesting reading.

The majority cited several flaws in the Rule, including the need to prove a nexus between the measures in the rule and the stated goal, lack of quantifiable benefits, and whether a statutory definition is

[1] Found at http://www.cadc.uscourts.gov/internet/opinions.nsf/7677C9E435244EC985257EA50054F3D4/$file/13-5252-1568402.pdf

[2] "DRC" = Democratic Republic of Congo. "DRC Conflict Free" includes conclusion regarding source of tin, tantalum, tungsten, and gold ("3TG") from DRC and surrounding countries – referred to as "Covered Countries."

[3] Although I have been known to read SEC rules, court decisions, accounting rules, and proposed auditing standards for recreation, I acknowledge that I am not an attorney. I submitted comments on the proposed rule, and have been involved with conflict minerals for several years, both in advisory and assurance roles.

sufficient to convey a meaning or intent. Many of these objections had been raised in the past, but were not subject of this decision.

The dissent also made for interesting reading, touching upon a wide range of topics. The dissent noted that the appellants raised no objection to the obligation to find out which of their products fail to qualify as "DRC Conflict Free" – only the requirement to conclude (and state) that products were "not found to be 'DRC Conflict Free'." The dissent noted that the Rule's reporting requirements were not constrained, in that the issuer can exercise free speech by elaborating on either phrase – or anything else in the Conflict Minerals Report. The dissent expressed belief that the requirements of the SEC Rule resemble the country-of-origin labeling the same court deemed as "commercial speech" – which is subject to different criteria as to what can be required or prohibited - in another decision. The dissent also noted that, although the conflict minerals disclosures are posted on company websites (and not at a direct point of consumer sale), consumers do reference the disclosures when making purchasing decisions. The dissent included a lengthy discussion of the term "controversial", differentiating between whether a topic itself is controversial, or the accuracy of facts and evidence supporting a statement is controversial.

The dissent also noted that the term "DRC Conflict Free" is typically provided in quotations [or, as the author has seen, capitalized], which should provide a reader with a heads-up that the phrase has a specific meaning. The dissent also noted that the SEC was tasked with implementing the statute through a disclosure rule, and had little choice in doing so. The dissent opined that the judiciary should defer to legislative branch's assessments of proactive judgments, and that constitutionality would not turn on a post hoc referendum at a particular point in time[4]. If there are problems with the Rule, then a statutory change would be the obvious solution. "It should be up to the political branches to alter or repeal it, not to the judicial branch to invalidate it." By now, I hope you are racing to the decision to read all 54 pages yourself (the remaining 28 pages are the court's decision from April 2014).

[4] The author – a longtime auditor – invites the reader to envision a world where all regulations were required to be evaluated post hoc for their effectiveness at various points in time, as compared to their original intent.

3.0 GAO REPORT

The Government Accountability Office (GAO) released a report – also on August 18, 2015 – as their annual update related to the SEC Rule. The 2015 GAO Report[5] had three focus areas:

1) Company filings [for the 2013 reporting period]
2) State Department and U. S. Agency for International Development (USAID) Actions
3) Additional Information on Sexual Violence

The report provides background on the rule, GAO's mission, and the involvement and mission of other government entities, including the Department of State and the Department of Commerce. GAO provided objectives, scope and methodology, and stated that the report was done using the performance audit standards.

Company filings: Due to timing of the GAO Report release, there is nothing new for professionals who have been following the SEC conflict minerals submittals. The GAO study looked at submittals for the 2013 reporting period; by the time the GAO report was released, several organizations had published summaries of SEC submittals for the 2014 reporting period.

State and USAID Actions: The Department of State and USAID both reiterated that the strategy and its five key objectives remain relevant. The GAO report listed over 30 actions undertaken towards achieving five objectives:

1) Promote appropriate role for security forces
2) Enhance civilian regulation of CRC minerals trade
3) Protect artisanal miners and local communities
4) Help strengthen regional and international efforts
5) Promote due diligence and responsible trade through public outreach.

The GAO Report also provided status or results attributable to these actions. The achievements included:

- They planned and facilitated demilitarization of two mine sites in South Kivu
- Artisanal miners reported increased capacity to report abuses, and to access legal assistance
- Artisanal mining companies increased technical and organizational capacities
- They assessed the independent mineral chain audit function
- The National Center for Development Support and Public Participation supported civil society capacity to monitor transparency and implementation of an early-warning system.

[5] The report, "SEC CONFLICT MINERALS RULE: Initial Disclosures Indicate Most Companies Were Unable to Determine the Source of Their Conflict Minerals" is available at http://www.gao.gov/products/GAO-15-561

The GAO Report acknowledged that challenges remain.

Sexual Violence: The third focus area was on the rate of sexual violence in Eastern DRC and adjoining countries, and changes since the GAO's 2014 report. The [2015] GAO report stated that three new population-based surveys related to sexual violence in eastern DRC have been published, one of which provides a basis for comparison with results of an earlier survey in the DRC. The GAO had ICF International perform analysis of the data. ICF found there to be a statistically significant decline in rates of sexual violence reported by women in nationwide DRC estimates, and in the province of North Kivu [one of the areas most hard-hit by armed conflict]. The surveys were done in 2007 and 2013-2014; GAO indicated this aligns with "before" and "after" implementation of the SEC conflict minerals rule.

Given the persistent nature of unrest in the region, it would be easy to imagine no progress or deterioration. The author notes that the GAO Report did cite progress. This included actions and tangible results, and regional results that have been found (via independent analysis) to be statistically significant.

4.0 CONTEXT OF THE COURT DECISION

Counsel and other professionals familiar with DFCM, the SEC Rule, and details of the litigation that is at the center of the August 18 Circuit Court decision have written that the decision supports a conclusion that an Independent Private Sector Audit (IPSA) will not be required for the 2015 reporting period. The author does not disagree. There are other aspects of the Rule, however, that could lead to a public issuer requiring an IPSA. Furthermore, a public issuer could conclude that an IPSA would be good for business and for risk management. In this section, the author considers factors relative to an IPSA beyond the Circuit Court decision.

Decision in Context

The Circuit Court decision means that a public issuer cannot be compelled to state as a conclusion [assuming the data and information gathered relevant to the reporting period] that the company manufactures, or contracts to manufacture, products that are "not found to be 'DRC Conflict Free'." This term is one of three provided in the SEC Rule; each of these terms (which are often referred to as "the magic words") is considered below.

"Not found to be 'DRC Conflict Free'": Making this conclusion would trigger an IPSA, so readers of the SEC filing could have a better understanding and some assurance over the procedures that the public issuer was following. Remember, the SEC Rule is a disclosure; it is not a ban. The description of due diligence measures, and some assurance over the issuer's statements about it, would provide a user of the Conflict Minerals Report some insight regarding what the issuer has been doing to achieve a more positive outcome.

"DRC Conflict Undeterminable": The SEC acknowledged that it would take time to develop systems that would enable public issuers to obtain supportable information about 3TG in their supply chain. The Rule provided for two transition years, when companies could conclude that their products were "DRC Conflict Undeterminable." If they did so, no IPSA would be required. The transition years ended with 2014. Since the SEC only intended this term to be used for two years (and that time period is over), there has been relatively little discussion over this term. Companies could elect to express the intent of this conclusion in their 2015 filings, and rationalize that in so doing, they would not need an IPSA.

"DRC Conflict Free": If a public issuer elects to conclude that at least one product they manufacture, or contract to manufacture, is "DRC Conflict Free," then they must obtain and submit an IPSA. The author

has seen no dispute of this statement. This applied from the outset of the Rule. For the 2013 reporting period, only four companies had sufficient basis to make such a conclusion, and opted to procure and IPSA, and submit this in their SEC filing. For the 2014 reporting period, six companies did submit reports. The Rule anticipated that the systems of obtaining reliable information would develop sufficiently by 2015 to enable many companies to make this conclusion in their SEC filing.

SEC Commissioner Keith Higgins offered personal remarks to the American Bar Association's Business Law Section meeting in Chicago in September 2014[6]. He noted that some companies had provided conclusions that were very close to the conflict free magic words, or that implied conflict free. He cautioned that companies should not give the appearance of being conflict free without also providing an IPSA.

[6] See http://www.bna.com/sec-official-offers-n17179895108/

5.0 ENTERPRISE RISK CONSIDERATIONS

Risk management involves assessment of risk, consideration of additional practices to mitigate risk, and implementation of additional controls where practical to reduce risks.

The Circuit Court decision, and the litigation that spawned it, are all about the Rule – in particular, about specific words that must, may, or need not be included in the Conflict Minerals Report submitted to the SEC. The CMR is but one element of information and communications that an issuer generates relative to conflict minerals.

5.1 Information and Communications

The COSO Internal Controls framework includes information and communications as an element of internal controls. The COSO Enterprise Risk Management (ERM) framework includes information and communications as an element of enterprise risk management. Communications is an element of every management system published by the International Standards Organization (ISO). This section summarizes information and communications channels, and considers scenarios and possible impacts and likelihood.

SEC: The public issuer's conflict minerals filings to the SEC consist of a Form SD, and, if applicable, a Conflict Minerals Report (CMR), and, embedded within the CMR (also if applicable) the IPSA. These are all annual filings for affected companies. The Rule does not include provisions for updates, adjustments, corrections of errors, etc. specific to the conflict minerals filings.

Customer: Companies affected by the Rule compile information about conflict minerals in their products. They communicate this information externally, notably to customers. The standard mechanism for customer communication is via the Conflict Minerals Reporting Template (CMRT), developed, maintained, and upgraded by the Conflict Free Sourcing Initiative. This may be directly to the customer, or to a third-party vendor they have retained. Customers may request information in addition to the CMRT, in order to gain confidence over the quality of the supplier's procedures. Customers may ask how the supplier confirmed applicable products, gathered information, reviewed information provided by suppliers, identified or confirmed smelters, or how they drew their conclusions. Companies would ideally have all this information documented. However, some of this is likely to be contained in business process documents, which are typically controlled and company confidential. If released – in whole or in part – companies should have procedures to limit distribution to entities who

need to know; inclusion of a third party vendor poses some risk of broader distribution of this information.

Company Website: It is standard fare for companies to post their conflict minerals policy on their website. Regulated public issuers may post their SEC submittals on their website. Companies may post information on their websites that go beyond the content of SEC submittals, since this avenue of communication is not enforceable by the SEC – at least in theory. Companies may post goals for responsible sourcing, or for becoming conflict free that seek to inspire confidence in customers or the general public. Companies may include information on conflict minerals in their Sustainability reports.

5.2 Impact

What scenarios could occur that could have an impact on organizations, as a result of information and communications described above?

SEC enforcement or attention: Since publication of the Rule, regulated companies have been especially interested in what SEC might enforce with regard to the Conflict Minerals Rule. At this writing, the SEC has not brought any enforcement related to conflict minerals, nor have they published official guidance of what would constitute grounds for SEC enforcement. This is hardly surprising, given the unusual driver for this Rule, aspects of the Rule, and the ongoing litigation associated with the Rule. As noted above, SEC Commissioner Keith Higgins cautioned against making statements that are functionally equivalent to "DRC Conflict Free" in SEC filings without procuring and submitting an IPSA. Consider other ways that a public issuer's SEC filings could come to the attention of the SEC, such as the scenario described on this page. SEC may connect the dots and suspect that Acme Components submitted an incorrect, misleading, or false submittal. SEC may opt to use their authority to enforce provisions of the Rule.

Shareholders: Companies must submit a Form 8-K to the SEC upon an unscheduled material event or corporate change at a company that could be of importance to the shareholders or the SEC. A firm 8-K is often called a "current report." Publicly-traded companies include 8-Ks on their websites; they often consist of notifications in changes of executive leadership; notices of acquisition; resignation or changes in directors; or purchase or sale of stock by executives. The goal of the 8-K is to provide information to investors that cannot wait until the next regularly-scheduled reporting period. The Rule, the Form SD and the Conflict Minerals Report are, by all accounts, unusual. Could a shareholder (including pension funds, activist investors, etc.) look to a company to submit an 8-K filing when they transition from having no conclusions about their DRC Conflict Free status to achieving it? Could a shareholder submit proxy filings requesting that the company state their conclusion?

Inconsistent communications: If a company's communications regarding the conflict minerals conclusions of their products are inconsistent via different communications channels, this could get the attention of stakeholders, and it could have an impact. This is regardless of whether there is legal basis for the different types of reports. See the scenario described.

Acme Components sells to Beta Products.

Acme's CMRT to Beta includes only smelters on the CFSI's Conflict Free Smelter (CFS) List.

Beta receives similarly positive CMRTs from their other suppliers, and indicates in their SEC filings that they are DRC Conflict Free.

Acme elects not to make this conclusion, and does not provide an IPSA. However, Acme lists Beta Products as a key customer on their website. Acme's 10-K filing with the SEC indicates that Beta is among their top three customers, and it could be a material financial impact if it were to lose Beta as a customer.

Loss of sales: A company that does not provide communications, including suitable support, for manufacturing conflict free products could find that customers prioritize purchases from other suppliers who have concluded they are DRC Conflict Free.

Analysts and NGOs: Shortly after the deadline for submitting SEC submittals, accounting firms, law firms, consulting firms, NGOs, and academia have done analysis of the conflict minerals findings. For "Year One Filings" (those submitted to SEC by June 2, 2014), the parameters were fairly simple, and relatively standard across the analyses: how many pages were the filings; who signed the filings; did they explicitly mention the OECD Due Diligence Guidelines; etc. For "Year Two Filings" (those submitted to SEC by June 1, 2015), the criteria for analysis was more varied, and more in depth. At least one survey included points for public issuers that obtained an IPSA[7]. The expectations of NGOs and analysts is likely to continue to rise. If company communications lag behind the expectations of these key stakeholders, their ratings could dip, or they could be noted as examples of industry laggards in future NGO analyses.

Information "leakage": Customers, their data management vendors, NGOs, and other stakeholders continue to request information regarding companies' conflict minerals programs. This includes information over and above standard disclosures (the SEC filings and the CMRT). Some of these requests are standard – such as those from NGOs for their surveys. Others may be company-specific, and may arise from stakeholders' questions about content provided (or omitted) from the CMR. Suppose, for example, that a customer requests "evidence" of a supplier's data quality control practices. These practices are typically embodied in a company's operating procedures. While they may not rank with the latest engineering or technology advancement in terms of intellectual property that can provide long-term value, they are nonetheless controlled company documents. The subject of the request could be embedded within a document of broader scope, such as a supply chain risk

[7] Insert reference(s) here. Assent/ Tulane study for one. Check the Sustainalytics study for another.

management plan. There are risks that a conflict minerals team member, or a data management vendor, could release company-controlled information. This could be obtained by a competitor, and could provide hints as to other aspects of company strategy or operations.

Inefficiencies/ Ineffectiveness: The level of communications to customers and other stakeholders could increase, including a more diverse array of what stakeholders are requesting. As companies' conflict minerals programs have evolved, many have added more rigor to their escalation processes[8] for customers who provide incomplete or unsatisfactory responses. Automated data management systems may generate standard responses; however, additional requests require customized effort. This equates to staff time and resources, additional costs (if vendors handle these responses). Ideally, companies would have an internal control process for generating non-routine communications; this may involve input from company management in Legal, Compliance, Operations, or Sales. Also, these requests tend to have short timeframes, resulting in the proverbial fire drill – and distracting many resources from their primary job activity. The IPSA includes procedures that cover many – if not most – of the matters included in customer requests. A company that has procured an IPSA may direct customers to their latest Conflict Minerals Report (which includes the IPSA) to get assurance on their questions – and more. This provides a more consistent, efficient, and effective mechanism for public issuers to respond to customer requests.

5.3 Likelihood

The examples above provide scenarios where an occurrence could have an adverse impact on the company. Risk assessment also considers likelihood. A risk manager could assess the likelihood that any or all of the scenarios above (or others that come to mind) could occur. They should also consider the likelihood that the occurrence will happen to them. Factors that could affect likelihood could include, but need not be limited to:

- Visibility of the company's consumer-facing brands
- The extent to which the company sells to consumer-facing brands
- The stated conflict minerals policies, commitments, or goals of customers
- Forward-looking statements in SEC filings of customers
- The company's perceived performance on conflict minerals reporting relative to industry peers, or relative to companies of similar market capitalization
- The company's compliance history in similar areas (social issues in supply chain management, SEC disclosures, etc.)

[8] An escalation process is a component of the OECD Guidelines step INSERT NUMBER. The OECD Guidelines are the only due diligence framework referenced in the Rule. They can be found a INSERT URL HERE.

6.0 IPSAs AND ENTERPRISE RISK MANAGEMENT

An Independent Private Sector Audit (IPSA) can provide value to a public issuer affected by Dodd-Frank Conflict Minerals, who must submit a Conflict Minerals Report to the SEC. The benefits extend across all four categories of risk of the COSO Enterprise Risk Management framework.

Compliance: If the company concludes that at least one product they manufactured is "DRC Conflict Free", then the IPSA is a compliance requirement. An IPSA can enable the company to make such a conclusion, or to make conclusions that are similarly worded, and reduce one risk of SEC enforcement. An IPSA can also help companies demonstrate compliance with provisions of customer contracts.

Operations: The IPSA could identify improvement opportunities in the company's design or implementation of the portions of the conflict minerals program that are in scope for the audit. This may occur by what the client learns during audit planning, from auditor observations during field procedures, or other means. An IPSA can also improve communications with customers for information on various aspects of a company's conflict minerals programs. If the subject of the inquiry was included in the IPSA, then the company can simply refer the inquiring party to the IPSA. This reduces effort required and ensures a consistent response to these inquiries.

Reporting (Financial, Non-Financial): The SEC established the objectives of the IPSA after going through two public comment periods, and considering dozens of comments[9] from stakeholders familiar with the issue. It is a standard set of objectives, using a standard auditing framework (the Generally Accepted Government Auditing Standards). If any audit is to be performed on a public issuer's conflict minerals program, it makes sense to conduct an audit that the SEC designed to provide assurance to users of the CMR.

Business Strategy: Conflict minerals is one of many issues that demonstrates how companies manage social issues in their supply chain. It has evolved into a statute, and a regulatory requirement. The European Union appears to be on track to issue conflict minerals regulations and there are early

[9] Douglas Hileman has been involved with Dodd-Frank Conflict Minerals since submitting comments on the proposed SEC rule. He has helped clients in several aspects of DFCM compliance preparedness, and has published numerous articles for the business community. He launched www.DFCMAudit.com as a resource for filers and their suppliers. He has developed a Dodd-Frank Conflict Minerals training course, ideal for companies who seek a more efficient, effective program. He has worked on dozens of financial audit teams, an audit to terms of an SEC consent decree, internal audit engagements, management systems audits, and other specialty audits – unique qualifications for an IPSA Auditor. His firm has a network of resources nationwide with IPSA and conflict minerals credentials.

indications that they will differ from the SEC conflict minerals rule in several key ways. Canada is also considering a conflict minerals rule. Human trafficking and forced labor in supply chains is a growing concern. It is now subject to regulatory requirements in California and is being seriously considered in many other jurisdictions. An IPSA can serve as one cost-effective, efficient mechanism to position a company as a business of social integrity.

To IPSA, or not to IPSA: That is the question for the 2015 reporting year. Of course, you should look to Legal for guidance regarding the Circuit Court decision, the Rule itself, and other legal and regulatory requirements (customer contracts, etc.) that establish requirements – or lack those requirements, providing flexibility. Also consider risks as they might accrue to R&D, Sales, Compliance, Investor Relations, HR, or Risk Management. If your company elects to procure an IPSA, engage an IPSA auditor that has experience with the Rule, suitable auditor credentials, an understanding of risk management, and a commitment to your success across the enterprise. Recognize the value that an IPSA can bring to your company, and leverage it in your company's relationships with customers, NGOs, shareholders, and other stakeholders.

Looking Ahead: The 2015 SEC filings will shape how many key stakeholders view public issuers' conflict minerals programs. Users of information submitted to the SEC typically want some type of assurance that the information is complete, accurate, and supportable. If a public issuer elects not to procure an IPSA for the 2015 reporting period, this will be a gap – a permanent gap - in assurance for users of the CMR. The issuer may face options of preparing for an IPSA for the 2016 reporting period, answering a series of questions from customers, loss of ratings points from NGOs and other analysts, loss of sales, or proxy filings. Could the public issuer procure a "late IPSA" and submit a revised 2015 Conflict Minerals Report in July or August of 2016? The author defers to counsel for legal analysis of this scenario. From a risk management perspective, an IPSA in 2015 can be a wise investment.

Douglas Hileman, CRMA, CPEA, P.E. has led his own firm for over seven years. He draws from over 35 years of experience in many aspects of operations, compliance, business strategy, enterprise risk management, non-financial reporting, audit readiness, and auditing. He worked at PricewaterhouseCoopers for six years, where he supported financial audits, internal audits, and other engagements involving governance, risk management, compliance. He also has nine years of experience in industry.

Douglas commented on the draft SEC Rule for conflict minerals. He has worked with clients in Advisory and Assurance roles for conflict minerals. As an advisor, he helped incorporate elements of other compliance and risk management frameworks into conflict minerals programs, anticipating inquiries from customers and senior management. His firm conducted one of the first four Independent Private Sector Audits (IPSAs), submitted for the 2013 reporting period. His firm was one of only three firms based in the U.S. to conduct IPSAs for the 2014 reporting period.

He is active in the Institute of Internal Auditors. He holds credentials as a Certified Risk Management Assurance professional (CRMA), Certified Professional Environmental/ Health & Safety Auditor (CPEA, Management Systems focus), Professional Engineer (chemical), and a Qualified Environmental Professional. He has taught “Incorporating Sustainability into Financial Reporting” at UCLA Extension. His firm serves clients nationwide from Los Angeles.

See www.DFCMAudit.com for more resources on IPSAs and related aspects of conflict minerals.

See www.douglashileman.com for more resources on environmental, safety, non-financial reporting, compliance, and risk management.

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