D.C. Circuit Rejects Effort to Invalidate SEC Conflict Minerals Rules While Limiting Disclosure Requirement on First Amendment Grounds

On April 14, 2014, in *National Association of Manufacturers* v. *Securities and Exchange Commission*, the U.S. Court of Appeals for the D.C. Circuit rejected an effort to invalidate the rules adopted by the SEC requiring public reporting companies to investigate and report on whether their products contain "conflict minerals" originating in the Democratic Republic of the Congo ("DCR").[1] While allowing the regulatory framework adopted by the SEC, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2] to remain in force, the court held that the provision in the rule requiring public companies to report to the SEC, and on their websites, that any of their products have "not been found to be DRC conflict free" violated the free speech guarantee of the First Amendment.[3] The appellate court dismissed all other challenges by plaintiff-appellants and remanded to the district court for further proceedings. The opinion was authored by Senior Circuit Judge Randolph, with Judge Srinivasan concurring in part.

I. Background and Procedural History

This dispute concerns Congress's effort to prevent armed groups from profiting from the mining operations used to fund the ongoing war and humanitarian crisis in the DCR by increasing the accountability of the parties involved in the supply chain of products containing minerals from the region. In 2010, Congress enacted Section 1502 of Dodd-Frank, which directed the SEC to promulgate rules requiring public reporting companies to investigate whether their products contain conflict minerals and detail the results of their investigations.[4] The disclosure regime requires annual reporting of whether the conflict minerals originated in the DRC, or specified adjoining countries; and if so, the company must submit a report to the SEC describing the due diligence measures taken to establish the "source and chain of custody" of the minerals, including a "private sector audit" of the report.[5] The report must also list "the products manufactured or contracted to be manufactured that are not DRC conflict free"—meaning the conflict minerals "directly or indirectly finance[d] or benefit[ted] armed groups" in the covered countries.[6] In late 2010, the SEC proposed rules for implementing Section 1502 and solicited extensive comments.[7] The final rule became effective November 13, 2012.[8]

The National Association of Manufacturers[9] challenged the final rule on a number of grounds, including that the rule does not contain a *de minimis* exception and therefore applies to even those products containing a

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[1] For an overview of the SEC conflict minerals rule see our Firm memorandum, *SEC Required Conflict Mineral Disclosure* (September 25, 2012), available at http://cgrnysps1/Firm%20Memos/SEC%20Required%20Conflict%20Minerals%20Disclosure%20and%20Report%20Compliance.pdf

[2] Pub. L. No. 111-203, 124 Stat. 1376 (relevant parts codified at 15 U.S.C. §§ 78m(p), 78m note ('Conflict Minerals')).

[3] No. 1:13-cv-00635, slip op. at 23 (D.C. Cir. Apr. 14, 2014) [hereinafter "Slip Op."], *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/D3B5DAF947A03F2785257CBA0053AEF8/$file/13-5252-1488184.pdf.

[4] Slip Op. at 3-4.

[5] *Id.* at 4 (quoting 15 U.S.C. § 78m(p)(1)(A)).

[6] 15 U.S.C. § 78m(p)(1)(A).

[7] 75 Fed. Reg. 80,948 (Dec. 23, 2010).

[8] Slip Op. at 4.

[9] [Hereinafter "the Association"].

very small amount of conflict minerals. Also, the SEC interpreted the statute to apply not only to "issuers that manufacture their own products, but also to those that only contract to manufacture."[10] The final rule contains a temporary "phase-in" period (two years for large issuers, and four for small), allowing issuers to describe products as "DRC conflict undeterminable," and as such, the issuer does not need to conduct an audit.[11] Lastly, while the SEC provided detailed cost estimates for the rule, it was "unable to readily quantify" the benefits the rule would achieve including "reducing violence" and "promoting peace and stability in the Congo."[12]

The Association initially raised a petition for review in the D.C. Circuit, and then moved to transfer the case to the D.C. District Court.[13] The motion was granted and the district court rejected all of the Association's claims and granted summary judgment for the SEC and intervenor Amnesty International.[14]

II. The First Amendment Aspect of the Court's Decision

The D.C. Circuit reviewed the district court's consideration of the Association's First Amendment challenge *de novo*.[15] The Court stated that the description at issue, whether a product is "conflict free," is "a metaphor that that conveys moral responsibility for the Congo war" and "requires an issuer to tell consumers that its products are ethically tainted, even if they only indirectly finance armed groups."[16] Therefore, by "compelling an issuer to confess blood on its hands," the Court determined that the statute interfered with the exercise of freedom of speech under the First Amendment.[17] The Court did not decide whether to use the intermediate standard for commercial speech outlined in *Central Hudson*[18] or strict scrutiny, because the disclosure requirement failed the lesser, *Central Hudson*, standard.[19]

One prong of the *Central Hudson* test requires that the speech restriction is narrowly tailored to the government interest advocated.[20] The decision mentioned two less restrictive alternatives to the DRC conflict disclosure requirement that the court found "intuitive": (1) that the issuers use their own language to describe their products or (2) that the government compile a centralized list of products, based on the entities' due diligence reports.[21] The SEC failed to explain or provide any evidence that these methods would be less effective than the disclosure requirement, prompting the Court to conclude that the rule was not narrowly tailored. The D.C. Circuit held that the requirement for a public company to report to the SEC, and on its website, that its products have "not been found to be DRC conflict free" is a violation of the free speech guarantee of the First

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[10] *Id.* at 12.

[11] *Id*. at 14.

[12] *Id.* at 6-7 (quoting 77 Fed. Reg. 56,350).

[13] *See* Per Curiam Order, *Nat'l Ass'n of Mfrs.* v. *SEC*, No. 12-1422 (D.C. Cir. May 2, 2013).

[14] *Nat'l Ass'n of Mfrs.* v. *SEC*, F.Supp. 2d 43, 26 (D.D.C. 2013).

[15] Slip Op. at 18.

[16] *Id.* at 20.

[17] *Id.*

[18] *Central Hudson Gas & Electric Corp.* v. *Public Service Commission*, 447 U.S. 557 (1980).

[19] *Id.* at 21.

[20] *Id*. The other portion of the test requires the government to show a substantial government interest that is directly and materially advanced by the restriction. 477 U.S. at 565.

[21] Slip Op. at 22.

Amendment.[22] The Court did not determine whether this specific descriptive phrase was the result of the SEC's rulemaking or the statute itself, but noted that if it was "purely a result of the Commission's rule," the statute would be unaffected.[23]

The Court affirmed the district court opinion concerning the Association's challenges under the Administrative Procedure Act and the Exchange Act, leaving the lack of a *de minimis* exception; the broad application to manufacturers and contractors; the temporary phase-in period; and the SEC's cost-benefit analysis intact.[24] The case was remanded for further proceedings in the D.C. District Court.

III. Significance of the Decision

The D.C. Circuit's decision sends a message to Congress that disclosure requirements may be considered impermissible freedom of speech restrictions, even in the context of securities regulations, requiring an intermediate, if not strict, level of scrutiny. However, most of the SEC's disclosure rule survived the Association's challenge and the Court did not stay the rule's implementation. As a result, barring judicial or regulatory action delaying implementation of the rule, public companies will have to comply with all other parts of the rule and file their first reports under the rule by the May 31, 2014 deadline.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Tara Curtin at 212.701.3459 or tcurtin@cahill.com.

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[22] *Id.* at 23. Judge Srinivasan's opinion, concurring in part, did not join the part of the Court's opinion addressing the Association's First Amendment claim, opting, instead, to hold in abeyance the consideration of the First Amendment issue pending the en banc court's decision in *American Meat Institute* v. *United States Department of Agriculture,* No. 13-5281, regarding whether mandatory disclosure obligations can proceed under rational basis review in a similar context.

[23] Slip Op. at 23, n.14.

[24] *Id.* at 7-17. Specifically noting, "[a]n agency is not required to measure the immeasurable and need not conduct a rigorous, quantitative economic analysis unless the statute explicitly directs it to do so. *Id.* at 16. (internal quotations and citations omitted).

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