COMMENTS

of

WASHINGTON LEGAL FOUNDATION

to the

U.S. SECURITIES AND EXCHANGE COMMISSION

Concerning

RECONSIDERATION OF CONFLICT MINERALS RULE IMPLEMENTATION (SECTION 1502 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT)

IN RESPONSE TO ACTING CHAIRMAN MICHAEL S. PIWOWAR'S INVITATION TO SUBMIT DETAILED COMMENTS IN HIS JANUARY 31, 2017 STATEMENT ON THE COMMISSION'S CONFLICT MINERALS RULE

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Acting Chairman Michael S. Piwowar
U.S. Securities and Exchange Commission
100 F Street, NE
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Re: Reconsideration of Dodd-Frank Act § 1502, the Conflict Minerals Rule

Chairman Piwowar:

Washington Legal Foundation (WLF) submits the following comments in response to your January 31, 2017 statement on the Commission's Conflict Minerals Rule, which invited comment "on all aspects of the rule and guidance [of April, 2014]." WLF appreciates the opportunity to renew our ongoing objections to this ill-advised rule. We welcome the Commission's revisiting—and, we hope—drastically altering or abolishing this regulation.

As you reconsider implementation of the Conflict Minerals Rule, WLF asks you to keep in mind three fundamental points: (1) the Conflict Minerals Rule has proved in practice to be an unmitigated failure. In fact, it has been wholly counterproductive, increasing rather than decreasing violence in the Democratic Republic of Congo; (2) the Conflict Minerals Rule imposes enormous and anti-competitive costs on publicly held U.S. companies; and (3) the Rule violates the U.S. Constitution—not just the First Amendment, as recognized twice over by the D.C. Circuit Court of Appeals, but also the Equal Protection Clause. For these reasons, WLF strongly encourages the Commission to withdraw this rule in its entirety.

To the extent that SEC cannot completely withdraw this rule, we advocate creating an exemption for smaller issuers from the compliance requirements and exempting *de minimis* users of conflict minerals. *See* Public Statement of Commissioner Daniel M. Gallagher, August 22, 2012. In addition, we encourage SEC "to consider whether its exemptive authority extends to converting the conflict minerals rule into a comply-or-explain requirement." Stephen M. Bainbridge, "Change Coming for SEC's Controversial Conflict Minerals Rule," *The WLF Legal Pulse*, March 2, 2017. https://wlflegalpulse.com/2017/03/02/change-coming-for-secs-controversial-conflict-minerals-rule/

Finally, we encourage the Commission to share the counterproductive nature of the Conflict Minerals Rule with Congress and the President. In so doing, SEC should encourage Congress to repeal the rule via the Congressional Review Act or otherwise. Meanwhile, SEC should request the President to make a determination under the law that waiving the Conflict Minerals Rule is in the U.S.'s national security interest, which would result in an initial waiver for up to two years.

I. Interests of WLF

Washington Legal Foundation is a non-profit, public-interest law firm and policy center based in Washington, DC, with supporters nationwide. Founded nearly 40 years ago, WLF regularly appears before federal administrative agencies (and courts) to promote economic liberty, free enterprise, a limited and accountable government, and the rule of law. WLF has a longstanding interest in the work of the U.S. Securities and Exchange Commission (SEC), especially as it relates to several specific WLF goals. These include protecting employees, consumers, pensioners, and investors from stock losses caused by abusive securities and class-action litigation practices; protecting the stock markets from manipulation; encouraging congressional and regulatory oversight of the plaintiffs' bar's conduct with respect to the securities industry; and enhancing investor confidence in the financial markets through regulatory and judicial reform measures. We believe SEC is best able to achieve these goals when it eschews regulation—like the Conflict Minerals Rule—that has nothing to do with maintaining the integrity of financial markets.

WLF has filed a number of comments with SEC on matters of public interest. Of greatest relevance, WLF filed comments on the proposed rules for implementing the conflict minerals reporting requirements, *i.e.*, what became the Conflict Minerals Rule (March 30, 2011; File No. S-7-40-10). In addition, WLF filed comments on proposed rules for implementing the enhanced compensation structure reporting requirements of Dodd-Frank (May 27, 2011; File No. S7-12-11). WLF also filed comments on proposed rules and forms for implementing the whistleblower provisions contained in Section 21F of the Securities and Exchange Act of 1934, as amended by Title IX of the Dodd-Frank Act (December 17, 2010; File No. S7-33-10). Most recently, WLF filed comments on Issues Raised at the Proxy Advisory Firm Roundtable (January 10, 2014; File No. 4-670).

WLF also litigates and appears as *amicus curiae* before federal courts in cases involving securities litigation. *See, e.g., Kokesh v. SEC*, No. 16-529 (U.S. Sup. Ct., dec. pending); *Timbervest LLC v. SEC*, No. 15-1416 (D.C. Cir., dec. pending); *Omnicare, Inc. v. Laborers District Council*, 135 S. Ct. 1318 (2015); *Halliburton v. Erica P. John Fund*, 134 S. Ct. 2398 (2014).

Similarly, WLF's Legal Studies Division has produced and distributed timely publications on securities regulations and the SEC. Some of WLF's most recently published works in this area include: Andrew J. Morris, *Is the Clock Running out on SEC's Unchecked Pursuit of Disgorgement Penalties?* (WLF LEGAL BACKGROUNDER, March 10, 2017); Lawrence S. Ebner, *Unconstitutionally Appointed Administrative Law Judges Continue to Haunt SEC* (WLF LEGAL BACKGROUNDER, February 24, 2017); and Daniel M. Gallagher, *Shareholder Proposals: An Exit Strategy for the SEC* (WLF WORKING PAPER, September, 2015).

II. The Conflict Minerals Rule Has Proved an Unmitigated Failure in Practice.

Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376, 2213 ("Dodd-Frank"), enacted on July 21, 2010, requires publicly traded companies to investigate the sources of certain minerals used in their products and to publicly disclose information about their investigations to the SEC (in a report) and the public (via a

company's website). The purpose of this requirement is to discourage purchases of so-called conflict minerals with the object of reducing violence in the area where the minerals are mined—chiefly the Democratic Republic of Congo (DRC). The provision has been characterized as a "name and shame" law. *See* Thomas Armstrong and Beth J. Kushner, "SEC's 'Conflict Minerals' Proposal Is Constitutionally Suspect," WLF LEGAL BACKGROUNDER, Vol. 26, No. 11, April 22, 2011, p. 1. http://www.wlf.org/publishing/publication_detail.asp?id=2241

In a federal lawsuit, the National Association of Manufacturers, among others, raised several legal challenges to the SEC rule implementing this section of the Dodd-Frank law. On appeal, the U.S. Court of Appeals for the District of Columbia Circuit disagreed with most of those challenges. However, it struck down as a First Amendment violation the portions of the rule requiring companies to identify their products as "DRC conflict undeterminable" or "not found to be 'DRC conflict free.' " The D.C. Circuit's original decision came down on April 14, 2014. After a panel rehearing, the D.C. Circuit reaffirmed its initial judgment on somewhat different grounds in a decision dated August 18, 2015.

In response to the D.C. Circuit's original decision, SEC's staff issued guidance on April 29, 2014, indicating:

> For those companies that are required to file a Conflict Minerals Report, the report should include a description of the due diligence that the company undertook. If the company has products that fall within the scope …, it would not have to identify the products as "DRC conflict undeterminable" or "not found to be 'DRC conflict free,'" but should disclose, for those products, the facilities used to produce the conflict minerals, the country of origin of the minerals and the efforts to determine the mine or location of origin.

Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule, Keith F. Higgins, Director, SEC Division of Corporation Finance. In other words, SEC construed the D.C. Circuit's decision to permit all of the work—and compliance cost—that goes into determining whether a company's products are (or are not) DRC conflict free and only prohibit forcing companies to identify the products accordingly.

1. Section 1502 Has Increased Violence in the Democratic Republic of Congo.

In the words of the law's sponsor, Rep. Barney Frank, § 1502 meant to "cut off funding to people who kill people." Stephanie Slade, "Dodd-Frank at 5: How Financial Reform Led to Bloodshed in the Congo," Reason.com, Hit & Run Blog, July 21, 2015. By reducing demand for conflict minerals, the logic ran, Congress could reduce funding to the militias in DRC that prey on the abundant mining revenue. Reducing the militias' funding, it was thought, would reduce the amount of violence the militias would wreak on the surrounding villages. Unfortunately, the theory has not worked out in practice. Instead, careful empirical research shows, as the Conflict Minerals Rule depressed revenue, militias have fought more against each other and looted more from surrounding villages than they had previously. Both dynamics result in more violence against innocent civilians.

According to a study published in the University of Chicago Press's JOURNAL OF THE ENVIRONMENTAL AND RESOURCE ECONOMISTS ("JAERE"), "the probability of looting in policy territories increased by 176% after Dodd-Frank." Dominic P. Parker and Bryan Vadheim, "Resource Cursed or Policy Cursed? US Regulation of Conflict Minerals and Violence in the Congo," JAERE, Vol. 4, No. 1, p. 34, published online Dec. 7, 2016. The study further concluded that "the probability of a violence[-]against[-]civilians event increased by 44 to 132%. One interpretation of these findings is that Dodd-Frank … generated incentives for militias to loot." *Id.* at 41.

Whether because of greater looting, greater collateral damage from inter-militia violence, or some other reason, the fact remains: "The top-down decision to regulate 'conflict minerals' from the DRC did not reduce violence committed by militias during [the] period of study." *Id.* at 44. Instead, "in the short term, the policy appears to have backfired. … [T]he evidence indicates the policy increased the likelihood that armed groups looted civilians and committed violence against them." *Ibid.*

2. Section 1502 Has Increased Infant Mortality Rates in the DRC.

A forthcoming article in the JOURNAL OF LAW & ECONOMICS ("JLE") explores a different negative effect from the Conflict Minerals Rule, namely an increase in infant mortality. According to the authors, "Our most conservative estimate is that the legislation increased under-one mortality from a baseline mean of 60 deaths per 1000 births to 146 deaths per 1000 births [in affected villages], which represents a 143 percent increase." Dominic P. Parker, Jeremy D. Foltz, and David Elsea, "Unintended Consequences of Sanctions for Human Rights: Conflict Minerals and Infant Mortality." Forthcoming in JLE, Feb. 28, 2017, p. 3; *see also id.* at 19. There are several possible mechanisms through which the increase in infant mortality occurs:

> Qualitative reports from health NGOs and research from the eastern DRC … suggest Dodd Frank could have increased mortality through three channels. First, the law may have reduced income streams to families and communities previously dependent on artisanal mining. Second, the law may have disrupted public health provision and reduced mother access to health care facilities and services. Third, contrary to the policy's purpose, Dodd Frank apparently increased armed conflict during our time period of study, which could have adverse effects on infant mortality."

Id. at pp. 2-3. Not only did these effects occur in villages near where conflict minerals are mined. They also occurred near mines in the region where conflict-free minerals are mined due to an unintentional boycotting effect against all mines in the region. As the authors explain, "High transaction costs of following supply chains from source to product can produce unintentional boycotts. Rather than absorbing costs and the associated reputational risk of not appearing socially responsible, companies may simply choose to source elsewhere." *Id.* at 32.

The JLE study looks at—and rules out—alternative explanations for the observed increases in infant mortality. "This collection of results makes a strong case that a Dodd Frank induced

boycott rather than confounding factors, caused the higher mortality." *Id.* at 22. The negative effects on infant mortality are so profound that the authors suggest that they swamp any positive effects in reducing armed conflict in the region. "Dodd Frank would have to cause a large reduction in armed conflict, over a long period of time, in order to offset the 'short-run' increases in mortality rates induced by the legislation through other channels." *Id.* at 4.

Other reports indicate additional negative effects from Dodd-Frank on the socioeconomic well-being of civilians in the affected villages, including increased poverty, increased unemployment, and even reduced education as families pulled their children out of school for financial reasons. *See* Slade, "Dodd-Frank at 5," *supra*. Worse yet, in some cases unemployed miners have turned to joining the militias themselves as a means of survival. Hence, Dodd-Frank is spurring recruitment and furthering bloodshed in the very civil war the policy aimed to curtail. *See* Patrick Hannaford, "How the Dodd-Frank Act Has Caused Poverty and Fueled War in Africa," Reason.com, Hit & Run Blog, Dec. 4, 2014. Sometimes the children themselves, no longer enrolled in school, run off to join the militias themselves at ages as young as 14. *See* Sudarsan Raghavan, "How a well-intentioned U.S. law left Congolese miners jobless," THE WASHINGTON POST, Nov. 30, 2014.

III. The CMR imposes huge, anti-competitive costs on U.S. public companies.

Section 1502 applies only to those companies required to file periodic reports with the SEC and that require certain minerals to manufacture their products. Yet the law does not require the federal government to publicly reveal the names of foreign and private companies whose products contain conflict minerals but who have failed to disclose this information. Companies directly affected by the Conflict Minerals Rule are in a better position than WLF to describe the difficulty of the compliance process and the enormous cost associated with compliance. That said, one 2015 report from Tulane University put the total cost of compliance per issuer for one year at just below $546,000. *See* Bainbridge, *supra*, citing the Tulane report. <http://www.payson.tulane.edu/sites/default/files/content/files/TulanePaysonS1502PostFilingSurvey.pdf>

WLF is in a position to objectively observe that the Conflict Minerals Rule advantages foreign companies over American ones. Because domestic publicly traded companies are required to report exhaustively detailed data on their company websites, and foreign companies need not do so, the rule imposes far greater costs on U.S. companies. By requiring only a general review of foreign companies that will not be made public, the law places U.S. companies at a competitive disadvantage, since their products do not have to support the substantial compliance costs of determining whether they have a "conflict free" supply chain.

In addition, the Conflict Minerals Rule imposes greater costs on public companies than private ones. Ordinarily it is not a problem that SEC's rules and regulations affect public and private companies differently, because the regulations treat public companies different in ways that are relevant to the financial integrity of the markets. That is, the rules have a rational and substantive reason to require different disclosures from publicly held companies. The same cannot be said when it comes to the Conflict Minerals Rule. Because Congress is using SEC to regulate something that has nothing to do with financial regulation, the differential impact on public and private companies

is not justified and arguably violates the Equal Protection Clause. *See* Armstrong and Kushner, "SEC's 'Conflict Minerals' Proposal Is Constitutionally Suspect," at p. 4, n. 14.

IV. The CMR violates the First Amendment and Other Constitutional Provisions.

WLF's 2011 comments on the Conflict Minerals Rule detailed the First Amendment problems with the SEC's proposed rule. WLF's April 22, 2011 LEGAL BACKGROUNDER, cited *supra* p. 4, likewise explained why the rule violates the First Amendment. The Commission ignored WLF's objections when they were made. However, the D.C. Circuit Court of Appeals subsequently agreed with WLF's criticisms and struck down a portion of the rule on First Amendment grounds. SEC's responsive guidance minimized the impact of the D.C. Circuit's decision by still requiring companies to collect and report all of the information about their supply chains. Hence, the costs are still incurred even though the companies are spared from having to indict their own supply chains where they discover (or cannot rule out the presence of) conflict minerals.

Upon further review, SEC need not take such a limited response to the court's finding of unconstitutionality. Rather, relying on that decision, SEC could consider that the statutory scheme has been frustrated to the point that continuing to demand strict compliance with the information-gathering requirement of the statute no longer makes sense. Hence, as suggested at the outset of these comments, SEC could create an exemption for smaller issuers from the compliance requirements and exempt *de minimis* users of conflict minerals. In addition, SEC could consider using its exemptive authority to replace the current rule with a comply-or-explain regime. And, finally, SEC could gather all of the information demonstrating the utter failure of the Conflict Minerals Rule and appeal to Congress and/or the President to take further steps to repeal § 1502 altogether.

V. Conclusion

For the foregoing reasons, WLF urges the Commission to take all steps necessary to reduce the regulatory burden on the nation's public companies of complying with the Conflict Minerals Rule under Dodd-Frank—and, if possible, to abolish the rule entirely. The Commission should do everything in its power to apprise itself of the economic consequences of the proposed regulations and prevent its regulation from counterproductively increasing violence when the entire point of the statutory provision was to reduce violence. WLF appreciates the opportunity to submit these comments and thanks the Commission for the opportunity to provide meaningful feedback.

Respectfully submitted,

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