COMMITTEE ON FINANCIAL SERVICES
MONETARY POLICY AND TRADE SUBCOMMITTEE

HEARING ON "DODD-FRANK FIVE YEARS LATER: WHAT HAVE WE LEARNED FROM CONFLICT MINERALS REPORTING?"

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Chairman Huizenga, Ranking Member Moore and members of the Subcommittee, thank you for the invitation to appear before you today. My name is Karen Woody. I am an Assistant Professor of Business Law and Ethics at the Kelley School of Business at Indiana University. I have researched and written about the mandate and role of the Securities and Exchange Commission, particularly in enforcing Section 1502 of Dodd-Frank.[1] I also teach classes on corporate and securities law. I am honored to appear before you today, along with this panel of distinguished experts.

My remarks are focused on the SEC's role in implementing and enforcing Section 1502. In particular, I will address the suitability of the SEC as the agency tasked with promoting humanitarian policy objectives, and the implications of extending disclosure mandates similar to the conflict minerals disclosure requirement.

Background

The Securities and Exchange Commission was founded in 1934 and bestowed by Congress with a three-pronged mission: (1) protecting investors; (2) maintaining fair, orderly, and efficient markets; and (3) facilitating capital formation. The focus of the mandate is the creation and preservation of market integrity. In other words, the SEC was created to help assure investors that their investments are safe. Markedly absent from this congressional mandate is any administrative authority or charge to effect international, diplomatic, or human rights-oriented goals.

The mandate is met, in theory and practice, by the establishment of a rigorous disclosure regime. Disclosure regulations assist with the accurate valuation of securities, boost investor confidence, and incentivize corporate managers to behave diligently. The SEC mandate -- market transparency, fairness, and investor protection -- is achieved through this dissemination of material information to investors.

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[1] *Conflict Minerals Legislation: The SEC's New Role as Humanitarian and Diplomatic Watchdog*, 81 Fordham L. Rev. 101 (2012); *Securities Laws as Foreign Policy*, 15 Nev. L. J. 297 (2014).

As the SEC states on its own website: "The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it."[2]

Companies are required to make certain statutorily-mandated disclosures, triggered by events such as issuing new securities or electing new management. In addition to these disclosures, publicly traded companies must disclose any information considered *material.* Neither Congress, the SEC, nor the Supreme Court defined "material information" until 1976, when the Court held that a material fact is one that "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[3] This was generally understood to mean information that significantly affected a company's financial performance and consequently translated into stock market gains or losses.

The SEC, through its regulations, also has implicitly defined material information as information that bears on the *economic* value of an investment. The SEC's understanding of the materiality standard is that a reasonable investor "generally focuses on matters that have affected, or will affect, a company's *profitability and financial* outlook."[4]

<u>SEC's Inability to Regulate or Measure Humanitarian and Diplomatic Goals</u>

Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act is not a financial regulation, but rather a provision aimed at ending the atrocities of a war occurring seven thousand miles from Wall Street. Indeed, the SEC's proposed rule stated exactly that point:

> It appears that the nature and purpose of the Conflict Minerals Provision is for the disclosure of certain information to help end the emergency humanitarian situation in the eastern DRC that is financed by the exploitation and trade of conflict minerals originating in the DRC countries, *which is qualitatively different from the nature and purpose of the disclosure of information that has been required under the periodic reporting provisions of the Exchange Act*.[5]

Assigning the SEC with oversight of conflict minerals disclosure is well beyond the SEC mandate and overextends the agency in ways that could prove harmful to its sole mission: investor and market protection, and capital formation.

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[2] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation,* SEC, http://www.sec.gov/about/whatwedo.shtml (last visited Nov. 12, 2015)
[3] *TSC Industries v. Northway, Inc*., 426 U.S. 438 (1976).
[4] Memorandum from David B.H. Martin, Dir., Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, to Laura Unger, Acting Chair, U.S. Sec. & Exch. Comm'n (May 8, 2001) (emphasis added).
[5] Conflict Minerals Proposed Rule, 75 Fed. Reg. 80,948, 80,960 (proposed Dec. 23, 2010) (codified at 17 C.F.R. pts. 229, 249b) (emphasis added).

When tasking an agency to work towards a goal outside of its mandate and outside of its expertise, the agency and the population it is designed to protect are losing out in two ways: (1) by losing the opportunity that the proper agency (i.e., one with the particular expertise and resources) and its experts would achieve the goal in a more efficient and more successful manner; and (2) by reducing the ability of the mis-tasked agency to do its best with the proper tasks it should be accomplishing. In other words, by tasking the SEC with regulation such as that of conflict minerals, one is foregoing the opportunity that another agency, such as the Department of State, can design a better solution to achieve the humanitarian goals of the provision. Moreover, there is an increased risk that the SEC will not have sufficient resources to accomplish the goals for which it was created; in practicality, this means that the risk of another Enron or Madoff scandal increases because the agency is overextended.

Even if the SEC had the resources and expertise to handle enforcement of Section 1502, the structure of the legislation is one that makes regulation ineffective. For instance, what is the consequence for a company that uses conflict minerals, and then complies with Section 1502 and discloses this fact? In such a situation, the SEC plays no role because the company has complied with regulatory standards. Ostensibly, a company can file a conflict minerals report with the SEC, publish the report on its website, and cross its fingers hoping that there is no public backlash that affects its bottom line or its brand. From a public international law standpoint, it would seem that the possibility of a remorseless, albeit SEC-compliant, company reduces the legislation to a toothless tiger.

Based on citizen outcry related to conflict minerals, however, it is very possible that the "name and shame" aspect of the legislation could prove to be effective in creating transparent supply chains. This would be a positive result, but one that does not reach the stated goal of the legislation. The stated goal of Section 1502 is reduction of violence in Congo. Unfortunately, the SEC is not capable of measuring or quantifying that goal, or assessing its progress towards that goal. The result of this is that the goal of the law is unrealized, while the SEC and issuing companies expend vast resources in an attempt to meet this inherently elusive goal.

<u>Effect of Increasing Disclosure Requirements for Nonmaterial Information</u>

Section 1502 added a provision to Section 13 of the Exchange Act of 1934. Section 13 of the Exchange Act includes the list of mandatory disclosures that issuing companies must make. Amending the securities laws, in this case Section 13 of the Exchange Act, to include the conflict minerals disclosure requirement is not in keeping with the traditional understanding or function of disclosure requirements. As I mentioned earlier, companies are required to disclose all material information. The ultimate question, therefore, is whether the use of conflict minerals is material information. In practicality, this question is moot because disclosure is now statutorily required, rather than being analyzed in principle. Meaning, the threat of noncompliance with the statute puts a company on the hook for disclosing information regarding conflict minerals, regardless of whether that information is actually material.

However, it is worth considering the implications of requiring disclosure of arguably nonmaterial information. Statutorily requiring disclosure, rather than trusting companies to perform a qualitative assessment of materiality of corporate information, can result in an overload of information for investors. In such a situation, an overabundance of information is functionally the equivalent of providing no information, because vast swaths of information cannot practically be processed by investors. Further, there is an increased risk that the principle-based analysis of materiality gets dismissed in favor of disclosure regime more akin to a Napoleonic code, in which companies merely will check the box for each statutorily-required disclosure.

Absent the statutory requirement in Section 1502, information about conflict minerals likely would not meet the threshold for materiality. Conflict minerals disclosure is not a financial disclosure. Disclosure of social and environmental information is typically not required because that information, to date, has not been regarded as relevant or material to the financial condition of a company. As I noted earlier, the SEC regulations, while not explicitly adopting an economic standard for materiality, implicitly define material information as that which bears on the *economic* value of an investment.

For example, consider the scenario in which a company files a conflict minerals report with a clear misstatement of fact, and is sued by a shareholder for that misstatement. The materiality question that would be paramount to the analysis of such a case is whether the shareholder could prove loss, or loss causation. Loss is typically proven by evaluating the change in stock price when the issuer makes various announcements, such as the corrective disclosure. In the case of conflict minerals, it seems unlikely that such a disclosure would drastically move a company's share price. As a result, a shareholder would not be able to prove that the misstatement of information was material enough to create any financial or economic loss.

Proponents of Section 1502 and other measures enhancing disclosure requirements point out that the general public's increased awareness of conflict minerals has rendered it material information. The general public, however, is not the constituency of the SEC; investors are. That is, the SEC was created to protect those who own Apple stock, not everyone who owns an iPhone. If the SEC administered its regulations with an eye toward protecting *all* citizens, rather than only shareholders, it would be difficult to maintain capital formation and to balance the requirements of the agency's mandate. For this reason, the SEC has never waded very far into regulation of human rights or foreign policy. Furthermore, requiring the SEC to enforce these disclosure requirements stretches thin an already overburdened agency, and demands that it oversee diplomatic and humanitarian regulations for which it lacks the subject matter expertise and enforcement resources.

Thank you again for the invitation to testify today. I welcome any questions you may have.