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Securities

Nearly all stakeholders whose products or packaging use “conflict minerals” are in agreement that no conflict minerals they use should come from sources that benefit militias in the eastern Democratic Republic of Congo region, where conflict and abuses continue, writes David J. Levine, partner in the International Trade Practice of the law firm McDermott Will & Emery LLP. Nevertheless, the SEC and industry groups are working to ensure that the rules do not place an untenable regulatory burden on companies. Until the rules are finalized, any company using tungsten, tantalum, tin, or gold at any point in their production process should implement strict supply chain due diligence measures now, Levine says.

‘Conflict Minerals’ Law to Impose New Supply Chain Challenges for Companies

BY DAVID J. LEVINE

Introduction

Even as global supply chains become ever more Byzantine, a new U.S. law and proposed implementing rule of the Securities and Exchange Commission will add another wrinkle: Companies whose products use “conflict minerals” must understand—and control—their supply chains to an unprecedented degree and will be required to comply with extensive new reporting requirements.

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Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted last July (Dodd-Frank) imposes these requirements in an effort to undercut funding of militias that have devastated the Democratic Republic of Congo (DRC) for the past several years. As with other provisions of Dodd-Frank, Congress assigned implementing responsibility for section 1502 to the SEC, which regulates public companies but has little expertise in international affairs. Therein lies a source of confusion for companies trying to plan for the impending requirements: the SEC final rulemaking has been delayed while the agency figures out how to implement the law faithfully without binding companies to unworkable measures.

Section 1502 of the act specifically targets four mineral resources that provide the region’s militias with significant revenues: tungsten, tantalum, tin and gold (three Ts and G or 3T+G) as well as the ores from which they are derived. Through section 1502, Congress sought to bring transparency to, and thereby to curtail, the conflict minerals trade by requiring companies to report on their use.

Last December, the SEC published and sought comments on a proposed implementing rule, which hewed

closely to the legislative language. The proposal would require companies who use any of the 3T+G in their products to file an audited “Conflict Minerals Report” with the SEC each year to demonstrate that no conflict minerals they used were from sources that benefited the militias in the DRC region. The SEC’s statutorily imposed deadline to finalize the rule passed in the spring, but the final rule still remains unpublished. The SEC and interested companies and industries have demonstrated continued uncertainty about the final rule, as highlighted in a day-long public roundtable hosted by the SEC on Oct. 18, 2011, at which SEC commissioners, staff, and numerous industry representatives exchanged ideas and concerns. The SEC is working to adopt the new rule as soon as practicable. This article alerts companies to the key requirements and likely regulations so that they can prepare adequately by answering the critical questions: who, what, and when.

Who Is Affected?

Section 1502 applies to “issuers” for whom conflict minerals are “necessary to the functionality or production of a product” “manufactured or contracted to be manufactured by” the issuer.

Issuer. The regulations will apply to any public company required to file annual reports with the SEC under sections 13(a) or 15(d) of the Exchange Act, 15 USC §§ 78m(a), 78o(d). Companies not subject to these provisions will not be subject to the conflict minerals regulations.

Necessary to the functionality or production of a product. The breadth of products potentially covered by the law will depend on how the SEC defines “necessary to the functionality or production of a product” in its final rules. In its proposed rules, the SEC defined “necessary to production” to mean any intentional inclusion of conflict minerals in a good’s production process, regardless of whether any conflict mineral is actually contained in the final product. Based on the proposed rule, companies would not need to be concerned about whether any conflict minerals might exist in tools used in the production process. Similarly, the SEC proposed to define “necessary to functionality” to mean any intentional inclusion of a conflict mineral in a good, a standard that could subject to the new regulations mere embellishments or nonfunctional design elements on a product. Moreover, the SEC did not include a *de minimis* threshold in its proposed rule, meaning that any use of conflict minerals, no matter how small the quantity, would subject a company to the new requirements—an important point, since many applications require only a small amount of any conflict minerals.

Jewelry and electronics industries, among others, anticipate application of the rules to their products that clearly contain conflict minerals. Yet, the potential universe of affected businesses goes further. For example, as amplified by a representative of a large food products company at the SEC Roundtable, any company whose products are packaged in tin may be affected, regardless of the products so packaged.

Manufacture or contract to manufacture. Companies “responsible for” the manufacture of products would be subject to the new regulations—possibly an expansive range of businesses. For example, in its proposal, the SEC included mining operators within the definition of manufacturers. The scope of affected parties will also

be shaped by the definition of “contract to manufacture.” The proposed rule limits its application to companies with influence over sourcing decisions and to those who order generic products to be made and sold under their own brands. The latter may gain a reprieve, though, as the SEC indicated a willingness to consider exceptions from the requirements companies who order from manufacturers who themselves comply with the new regulations. As indicated at its roundtable, the SEC remains undecided as to how the rules will apply in a few circumstances of special importance to certain industries, including the use of “off-the-shelf” parts and of scrap or recycled materials. Unless and until the SEC specifically limits its final rules, companies are well advised to consider that such circumstances will be covered by the requirements.

What Is Required?

Tracking the Supply Chain.

If a company falls under the rules *i.e.*, if it is an issuer that manufactures or contracts to manufacture products for which conflict minerals are necessary to the functionality or production—it will need to determine whether any of the conflict minerals in its products originated in the DRC or any adjoining country (Angola, Burundi, Central Africa Republic, Congo Republic, Rwanda, South Sudan, Tanzania, Uganda, or Zambia). For any company able to determine using a “reasonable country of origin inquiry” that all conflict minerals used in its products originated outside this DRC region, it will merely need to certify this in its annual report to the SEC.

For many companies whose products use conflict minerals, though, tracking their source will pose a difficult challenge. The SEC’s proposed rule did not define what constitutes a “reasonable country of origin inquiry.” Industry standards and external guidance, such as that recently published by the OECD and discussed below, provide some clues for the means and procedures companies may need to employ to meet this standard. Specific guidance from the SEC will be critical for some issues, such as whether a company will be entitled to rely on its suppliers’ representations regarding the use and/or source of conflict minerals. For now, companies subject to section 1502 are well advised to seek as comprehensively as possible to understand their supply chains, including the chain of custody (back to the mines) of conflict minerals used in their products.

Conflict Minerals Report.

Any covered company unable to determine that any conflict minerals it uses did not originate in the DRC or an adjoining country will be subject to the act’s reporting requirements.

In implementing section 1502, the SEC will require such a company to disclose in a distinct section of its annual report its conclusion that conflict minerals used in its products are sourced (or may be sourced) from the conflict area. The affected company will also be required to submit to the SEC, as an exhibit to its annual report, a fully audited Conflict Minerals Report, which must also be posted on the company’s public website.

The Conflict Minerals Report must set forth the measures taken by the company to exercise due diligence in the sourcing and chain of custody of any 3T+G that originated (or may have originated) in the DRC or an

adjoining country, to ensure that the minerals used are nevertheless “DRC Conflict Free,” *i.e.*, that the minerals utilized by the company did not directly or indirectly finance or benefit armed groups in the conflict zone. The Conflict Minerals Report will have to describe any products that are not affirmatively found to be “DRC Conflict Free,” as well as any facilities used to process them and their countries of origin. It must also describe the steps taken to trace the minerals back to their originating mine or location with the greatest possible specificity.

The SEC has not yet determined whether a specific due diligence standard will be required in the undertakings described in a company’s Conflict Minerals Report. One source of guidance for relevant tracking standards, cited repeatedly by participants in the SEC Roundtable is the OECD *Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* (OECD guide), which has been endorsed by the United Nations, the U.S. State Department, and other authorities.¹ While the SEC’s proposed rules already incorporated many of the broader recommendations of the OECD guide, such as public reporting of a company’s steps taken to understand and control its supply chain, the OECD guide goes further in prescribing specific tracking and due diligence measures. For example, the OECD guide suggests identifying and engaging “anchors” in a company’s supply chain and adopting a company-level (or industrywide) grievance procedure as an early-warning mechanism in discovering the presence of DRC-region-originating conflict minerals in the supply chain.

The proposed regulations would require companies to submit their Conflict Minerals Report to the agency and post it on the company’s website, accompanied by an independent private sector audit of the report. Without further details from the SEC at this time, companies are well advised to consider that their audit will require in-depth review of the company’s entire supply chain of 3T+G, likely necessitating early and proactive country-of-origin inquiries that can be audited in time for completing and submitting an annual report and a Conflict Minerals Report to the SEC.

With respect to “off-the-shelf” materials, the final SEC rule probably will adopt the proposal to allow companies that use scrap or recycled conflict minerals to certify their products are “DRC Conflict Free,” so long as they submit an audited Conflict Minerals Report to support the determination that the materials truly are scrap or recycled. Companies interested in this provision should monitor the final rulemaking closely on this point.

¹ See <http://www.oecd.org/dataoecd/62/30/46740847.pdf>.

When Will Requirements Take Effect?

Dodd-Frank required the SEC to issue final regulations implementing the conflict minerals provision by April 2011, which has obviously long since passed. Sen. Richard Durbin (D-Ill.), one of the key sponsors of the legislation, made clear in his testimony at the SEC Roundtable that Congress recognizes an inherent tension between its lofty goal of addressing a terrible human rights crisis in the DRC region and the costs and difficulties companies will face in complying with the law’s requirements. This tension is at the source of the continued delay by the SEC in finalizing its conflict minerals regulations. In light of the statutory imperative, the SEC now hopes to publish its final rule by Jan. 1, 2012. Accordingly, affected companies should expect to see the new requirements in place to cover their operations beginning in 2012 (2012 for companies on a calendar year, or fiscal year 2013).

Because of the complication—some have argued impossibility—of complying with new rules so quickly upon implementation, many companies have urged the SEC to adopt a phased-in approach to the statutory requirements. They argue that issuers need time to develop proper and robust compliance protocols before immediately being subject to full reporting requirements concerning conflict minerals whose source may remain indeterminate. Unless and until the SEC actually adopts such a phased-in approach, however, companies should assume that the full due diligence, auditing, and reporting requirements will be in place for operations beginning in 2012.

As illustrated by comments from industry representatives at the SEC Roundtable, many companies have already undertaken new and extensive measures to comply with the anticipated requirements, investigating their sourcing arrangements and working with their suppliers to adopt strict component tracking and due diligence standards.

Conclusion

Nearly all stakeholders are in agreement that steps should be taken to help prevent the ongoing conflict and abuses in the eastern DRC from being financed further by the conflict minerals trade. Nevertheless, the SEC and industry groups are working to ensure that the rules do not go too far by placing an untenable regulatory burden on companies. Exactly where the SEC strikes a balance will determine how onerous the final regulations will be for affected companies and industries. Until the rules are finalized, any company whose products (or packaging) use tungsten, tantalum, tin, or gold at any point in the production process is well advised to implement strict supply chain due diligence measures now.