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The Quest For 'Conflict Minerals' Accountability

Law360, New York (May 13, 2011) -- Last year, the U.S. Securities and Exchange Commission proposed new reporting and supply chain due diligence requirements relating to the use of "conflict minerals." According to SEC estimates, the new requirements would impact nearly 6,000 international trading companies, including manufacturers (and, in some cases, retailers) of technology, telecommunications, aerospace, automotive, electronics, industrial, jewelry and children's toy products, to name a few.

The proposed regulations would implement the "conflict minerals" disclosure requirements directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 1502 of the Dodd-Frank Act amends Section 13 of the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. § 78.

New subsection (p) of Section 13 is intended to limit trade in minerals originating from sources controlled by armed groups operating in the Democratic Republic of Congo (DRC) and adjoining countries and to decrease the violence funded by such trade.

The SEC's notice of proposed rule-making (NPRM) was published on Dec. 23, 2010. Comments are available on the SEC's website and at www.regulations.gov. The Dodd-Frank Act required the SEC to publish final rules by April 15. After a deluge of comments, however, the SEC has delayed implementation of a final rule until at least the August-December time frame of this year.

Summary Of The New Requirements

A few key aspects of the NPRM follow.

Who and what is covered?

- The proposed requirements would apply to any issuer of U.S. securities who is otherwise required to file a report with the SEC if "conflict minerals" are necessary to the functionality or production of a product that they manufacture or contract to be manufactured. Companies that are otherwise exempt from filing reports with the SEC or whose products do not contain conflict minerals would be exempt from the new reporting requirements.

- Conflict minerals are: columbite-tantalite (coltan) (tantalum), cassiterite (tin), wolframite (tungsten) and gold.

What is required?

- Covered issuers would be required to determine and disclose in their annual reports to the SEC and on their public websites whether their manufactured goods contain conflict minerals (or their derivatives) that originated in the DRC or adjoining countries.
- Issuers whose products include DRC or adjoining country conflict minerals would also be required to conduct "supply chain due diligence" in an effort to certify that their conflict minerals do not "directly or indirectly finance or benefit armed groups" in the DRC or adjoining countries.
- Any required supply chain due diligence efforts and conflict minerals certifications must be documented in a "Conflict Minerals Report" that must be accompanied by a certified private-sector audit.
- The reporting issuer would be required to submit the report and audit to the SEC filing and post them on its public website.

Timing

Initial disclosures and reports are due at the end of the first full fiscal year following the promulgation of final regulations. The SEC was originally scheduled to publish its final rules in April, meaning that covered companies with a May 31 fiscal year-end would have been required to report on conflict mineral usage occurring as soon as June 1. The delay does not change the timing for companies with a Dec. 31 fiscal year-end because the final regulations are expected by the end of December. Accordingly, companies with a Dec. 31 fiscal year-end will likely be required to report on activities occurring from Jan. 1 to Dec. 31, 2012.

Many of the comments submitted to the SEC by industry representatives have urged a phased in implementation of the new reporting requirements based on the logistical difficulty of tracing conflict minerals through diffuse supply chains. The comments of the National Association of Manufacturers (NAM), for example, suggest full implementation by 2015 and the creation of an “unknown origin” certification in the interim. At this time, however, there is no indication that SEC will adopt staggered implementation in its final rules.

Potential Penalties

The Dodd-Frank Act does not set forth proposed penalties for failure to comply with the new reporting requirements. The NPRM, however, indicates that failure to comply, including the submission of an "unreliable" report, will be subject to liability for violations of Sections 13(a) or 15(d) of the Exchange Act. Penalties for such violations may be injunctive, civil or criminal and may also extend to individual executives of the issuer. The NPRM does not propose penalties for the direct or indirect support of armed DRC or adjoining country groups.

Conflict Minerals Will Cover Many Industries

The NPRM describes each of the subject minerals, its common derivative and its uses as follows:

- Cassiterite is the metal ore that is most commonly used to produce tin, which is used in alloys, tin plating and solders for joining pipes and electronic circuits.
- Columbite-tantalite is the metal ore from which tantalum is extracted. Tantalum is used in electronic components, including mobile telephones, computers, videogame consoles and digital cameras, and as an alloy for making carbide tools and jet engine components.
- Gold is used for making jewelry and, due to its superior electric conductivity and corrosion resistance, is also used in electronic, communications and aerospace equipment.
- Wolframite is the metal ore that is used to produce tungsten, which is used for metal wires, electrodes and contacts in lighting, electronic, electrical, heating and welding applications.

The focus of the regulations is on the use of the common derivatives of the listed minerals, commonly referred to as the “3T-G” minerals, i.e., tungsten, tantalum, tin and gold. The Dodd-Frank Act empowers the secretary of state to designate additional "conflict minerals" as necessary.

The NPRM Broadly Interprets The Disclosure Requirement And Its Operative Terms

The SEC explains that it understands the Dodd-Frank Act's disclosure requirement to involve three steps:

- First, an entity must determine whether it is a "person described" within the meaning of the act.
- Second, a "person described" must make "a reasonable country of origin inquiry" to determine whether it sources conflict minerals that are "necessary to the functionality or production" of one of its products from any of the covered countries.
- Third, a covered person that determines that its products include necessary conflict minerals from the DRC or adjoining countries or that is "unable to conclude that its conflict minerals did not originate" in the DRC or adjoining countries must include with its annual report a Conflict Minerals Report documenting the supply chain due diligence efforts of the reporting entity, as well as a certified, third-party audit of such efforts. The Conflict Minerals Report must be published on the company's public website.

Person Described

The Dodd-Frank Act amends Section 13(p)(2)(A) and (B) of the Exchange Act to define a "person described" as one a) that "is required to file reports under Section 13(p)(1)(A)"; and b) for which conflict minerals are "necessary to the functionality or production of a product manufactured by such person."

The NPRM proposes to limit the definition of "person described" to issuers of securities that are otherwise required to file annual or quarterly reports with the SEC pursuant to Sections 13(a) or 15(d) of the Exchange Act. This means that the majority of publicly traded U.S. companies as well as some foreign private issuers of securities would qualify as "persons described."

However, companies that are exempt from the Section 13(a) and 15(d) reporting requirements are also exempt from the conflict minerals reporting requirements. The NPRM considers, but rejects, additional exclusions for smaller reporting companies (i.e., those worth less than $75 million) and nonexempt foreign private issuers.

The second part of the definition of "person described" is whether conflict minerals are "necessary to the functionality or production of a product manufactured by such person."

The NPRM interprets "manufacture" to include any issuers that directly manufacture or that contract for the manufacture of products incorporating conflict minerals. The SEC notes that it intends the rules to apply to any issuer that has "any influence over the manufacturing specifications" of products that they contract to have manufactured. This interpretation would likely include pure retailers that contract for the manufacture of products containing conflict minerals.

The SEC states that it will interpret "necessary" to mean "intentionally included in." The NPRM rejects an exclusion from the act's requirements for de minimis amounts of the covered minerals and includes minerals used during the production of a product, but not actually present in the final product. The SEC does not consider "necessary" to include tools or machinery used during the production of a product. Also excluded are recycled or scrap materials.

Reasonable Country of Origin Inquiry

The SEC's proposed rules would require reporting issuers to make "a reasonable country of origin inquiry" regarding the covered minerals incorporated in their products. The NPRM does not further describe "a reasonable inquiry." It does, however, state that reporting entities would be required to include in their annual reports, and to post on their websites, the steps taken, as well as to retain reviewable business records documenting the inquiry.

The Conflict Minerals Report

The Conflict Minerals Report is the most burdensome requirement of the act and the proposed regulations. The required elements of the Conflict Minerals Report under the proposed regulations are as follows:

- a description of all products that contain conflict minerals and either originate in the DRC or an adjoining country, or for which the origin is unclear.
- a description of the measures taken to exercise due diligence with respect to the source and chain of custody of such minerals and a certification as to whether or not such minerals "directly or indirectly finance or benefit armed groups" in the DRC or adjoining countries, including a list of the facilities used to process those conflict minerals, the country of origin of those conflict minerals and the efforts to determine the mine or location of origin with the greatest possible specificity of those conflict minerals.
- a certified private-sector audit report concerning the above-referenced report.

"Armed groups" are defined by identification "as perpetrators of serious human rights abuses in the annual Country Reports on Human Rights Practices under Sections 116(d) and 502B(b) of the Foreign Assistance Act of 1961." The issuers that would be required to submit a report must also post the entire contents of the report, as well as the required audit, on their public websites.

Supply Chain Due Diligence

The SEC declines to define "due diligence" or to "prescribe any particular guidance for conducting due diligence." The proposed regulations would require reporting issuers to describe their due diligence efforts. The SEC does indicate that due diligence conducted in conformity with a nationally or internationally recognized set of supply chain due diligence standards would likely provide evidence of due diligence. The NPRM makes specific note of draft due diligence guidance published by the Organisation for Economic Co-operation and Development (OECD).

Notably, the OECD guidance distinguishes between upstream and downstream companies when discussing supply chain and due diligence requirements. For example, the guidance allows downstream companies, following a thorough review, to rely on the due diligence process of upstream smelters in their supply chain.

Several other industry and regional initiatives are attempting to eliminate conflict minerals from manufacturing supply chains. Initiatives of note include the following.

- Electronics Industry Citizenship Coalition-Global e-Sustainability Initiative, or EICC-GeSI conflict-free smelter certification program which would require smelters to go through an audited certification process demonstrating that they only source conflict free minerals. The certification program is currently in a pilot phase and is limited to the tantalum industry.
- ITRI, the international tin industry association, is developing a similar program, the iTSCi, intended to audit and certify smelters who use conflict-free tin.
- The International Conference on the Great Lakes Region (ICGLR) is a regional initiative attempting to create a “bag and tag” program in which minerals produced in mines that have been certified as conflict-free would be electronically tagged to allow for tracking to the smelter.

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