

## *Hot Issues Alerts – Law Firms*

# Update On Financial Reform Bill's Supply Chain Security And SEC Reporting Requirements For Products That Incorporate Congolese "Conflict Minerals"

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On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act). Among the many provisions of this vast legislation was one requiring corporations to report to the U.S. Securities and Exchange Commission (SEC) whether their manufactured goods contain "conflict minerals" mined in the Democratic Republic of Congo (DRC) or in adjoining countries and, if so, to provide a description of the supply chain security measures that such corporations have taken regarding the source and chain of custody of these minerals. This provision, intended to discourage the use of certain minerals benefiting armed groups in this

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region, will increase SEC and supply chain security compliance costs for a wide array of manufacturing firms, including many that import foreign-made products into the United States. The purpose of this article is to provide an overview of the new law and recent developments surrounding the SEC's anticipated promulgation of regulations to implement the law.

### **Reporting Obligation**

The applicable provision of the Financial Reform Act is Section 1502, which sets forth an amendment to Section 13 of the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. § 78m. Under new sub-section (p) to Section 13 of the Exchange Act, titled "Disclosures Relating to Conflict Minerals Originating in the Democratic Republic of Congo," covered persons must report annually to the SEC whether "necessary" conflict minerals incorporated into manufactured goods originated in the DRC or in an adjoining country. Under sub-section (p)(2)(B) of the amendment to the Exchange Act, "necessary" is defined as "necessary to the functionality or production of a product manufactured by such person."

Section 1502 directs the SEC to promulgate regulations requiring covered per-

sons to provide to the SEC certain information annually. Each such annual report must contain –

- a declaration whether any "necessary" conflict minerals originated in the DRC or in an adjoining country (sub-section (1)(A));
- if so, a report detailing the measures taken to exercise due diligence with respect to the source and chain of custody of such minerals (sub-section (1)(A)(i)) and describing any products that are not "DRC conflict free" (sub-section (1)(A)(ii));
- a certified private-sector audit concerning the above-referenced report (sub-section (1)(B)).

Section 1502(e)(4)(A) defines "conflict minerals" as encompassing columbite-tantalite (coltan), cassiterite, gold, wolframite or their derivatives. Notably, sub-section (e)(4)(B) also empowers the U.S. secretary of state to designate other minerals or their derivatives as "conflict minerals."

### **Who Must Report**

Section 1502 of the Financial Reform Act sets forth a broad, but vague, reporting requirement. Sub-section (p)(1)(A) of the amendment to Section 13 of the Exchange Act provides that "any person described in paragraph (2)" is subject to the conflict minerals reporting requirements. Paragraph (2), in turn, provides that a person is so described if the person is "required to file reports...pursuant to paragraph (1)(A)" of the same sub-section. The definition of covered persons is, thus, circular and is not – unlike the version of the bill passed by the Senate – clearly linked to any other provisions of the Exchange Act that might clarify the scope of applicability. Accordingly, Section 1502 seems likely to generate con-

fusion among firms potentially subject to the conflict minerals reporting requirements, including some U.S. importers, and it appears that only the SEC rulemaking process will clarify the scope of a covered “person.”

### SEC Rulemaking And Congressional Reporting

Section 1502 instructs the SEC to promulgate implementing regulations within 270 days after the day of enactment into law of the Financial Reform Act. Among the SEC’s many challenges in doing so will be to clarify the applicability of Section 1502’s reporting requirements and how, if at all, these requirements relate to existing SEC disclosure obligations. The SEC will also have to devise a process for addressing those persons that are required to report but cannot ascertain the origin of the minerals contained in their products. Yet another implementation challenge for the SEC will be to clarify the meaning of what is “necessary to the functionality or production of a product manufactured by” a person – a key concept in triggering reporting obligations.

Section 1502 also imposes congressional reporting obligations on a number of executive branch agencies. Under subsection (c)(1)(a), the U.S. secretary of state must, within 180 days of enactment into law, supply to relevant congressional committees a strategy to address the linkages between human rights abuses, armed groups, mining of conflict minerals and commercial products.

Further, under subsection (d), the comptroller general of the United States must, within one year of enactment of the Financial Reform Act, submit a report to the relevant congressional committees addressing the rate of sexual and gender-based violence in war-torn areas of the DRC and adjoining countries. The comptroller general of the United States is also directed by subsection (d) to submit to Congress annual reports, beginning two years from the date of enactment, assessing the effectiveness of Section 1502.

### SEC’s Current Plan to Implement Section 1502<sup>1</sup>

The SEC’s current plan is to issue a notice of proposed rulemaking in November or December 2010. To carry out the 270-day statutory requirement for a final rulemaking, the SEC reports that its plan is to issue one in the April–July 2011 timeframe. Toward that end, and since the law’s enactment, the SEC, through its Division of Corporate Finance, has encouraged private parties to submit on-line comments on Sec-

tion 1502 and has entertained meetings with the private sector. Various industry and NGO representatives have submitted comments or participated in meetings, including those in the information technology, jewelry, legal, precious metals and retail sectors.

### October 4, 2010, Comments From Sen. Durbin And Rep. McDermott<sup>2</sup>

Two of the authors of Section 1502 submitted comments to the SEC in order to “clarify the Congressional intent” of the new law. In an October 4, 2010, letter, Sen. Richard J. Durbin and Rep. Jim McDermott addressed the law’s policy, their understanding of what “necessary to the functionality or production of a product” means, what “manufactured by such person” means, and what the breadth is of the due diligence and private-sector audit requirements. The message of this letter is clear: the SEC should interpret the law broadly.

With regard to the policy, the senator and congressman reiterated that the main goals are to reduce the price of black market conflict minerals (by reducing demand) and to end human rights abuses. Surprisingly, in construing what “necessary to the functionality or production of a product” means, they encouraged the SEC to reject a de minimis exception as “overly generous.” Instead, they insisted that this phrase should, with very limited exceptions, broadly include “all uses” of the conflict minerals. Furthermore, addressing the issue of whether retailers should be exempt from the term “manufactured by such person,” they endorsed a policy that retailers should be covered if they “contract for the manufacture of goods or influence product design.” Perhaps in an attempt to resolve the dilemma over what companies are covered persons under the Exchange Act (thus requiring a report), they noted in passing that the law impacts “[a]ll companies registered with the SEC.” Finally, they also affirmed their adherence to a broad due diligence obligation, “regardless of a manufacturing company’s business model,” and to a requirement that the private-sector audit be conducted by an unaffiliated party and that the auditor have expertise in conflict minerals and sourcing.

### International Developments

The Organization for Economic Cooperation and Development (OECD) has created a draft “Due Diligence Guidance for Responsible Supply Chain Management of Minerals from Conflict-Affected and High-Risk Areas.”<sup>3</sup> This draft Guidance sets forth how companies can identify and better

manage risks throughout the entire mineral supply chain, from local exporters and mineral processors to the manufacturing and brand-name companies that use these minerals in their products.

The draft Guidance is not yet final and has not been approved or endorsed by the OECD or its members. It was recently reviewed during the Consultation on Responsible Supply Chain Management of Conflict Minerals in Nairobi, Kenya, which was jointly organized by the OECD and the International Conference on the Great Lakes Region (ICGLR).<sup>4</sup> Representatives of the U.S. government and private industry participated in the consultation, during which the ICGLR countries and some members of private industry called on the U.S. SEC to rely on the draft Guidance in drafting the new mineral supply chain due diligence reporting requirements. According to the OECD, the draft Guidance, which was endorsed by ministers from 11 African countries during the consultation, will now be put forth for adoption at the ICGLR’s Special Summit of Heads of States in November 2010. While the scope of the draft Guidance is arguably broader than any due diligence standards that the SEC may endorse or require in the context of Section 1502, it appears that the final version of the Guidance could, at a minimum, inform any Section 1502-related due diligence standards.

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As the SEC prepares to issue proposed rules implementing section 1502, many ambiguities remain, including whether only SEC-registered persons are covered by the reporting requirements, what “necessary to the functionality or production of a product” and “manufactured by such person” mean, whether a de minimis exception will apply, and what the scope is of the due diligence and private-sector requirements. While the SEC will certainly address these and other issues through the proposed and final rulemaking process, companies that are potentially affected by the new law’s broad language would be wise to continue to monitor developments closely.

<sup>1</sup> The SEC’s current plan is available at the following: <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtm#11-12-10>.

<sup>2</sup> The comments are contained in a letter available at the following: <http://www.sec.gov/comments/df-title-xv/specialized-disclosures/specializeddisclosures-22.pdf>.

<sup>3</sup> The draft is available at <http://www.oecd.org/dataoecd/13/18/46068574.pdf>.

<sup>4</sup> See the Corporate Responsibility section of the OECD’s website at <http://www.oecd.org> for details regarding the Nairobi Consultation.