CONFLICT MINERALS: A SECOND-YEAR UPDATE

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Introduction

Last summer, I provided background and commentary in this newsletter (http://www.americanbar.org/content/dam/aba/publications/nr_newsletters/ihc/201408_ihc.authcheckdam.pdf) on the first year of reporting under the Securities & Exchange Commission's (SEC) Conflict Minerals Rule (77 Fed. Reg. 56,274 (Sept. 12, 2012), *available at* www.sec.gov/rules/final/2012/34-67716.pdf). The Conflict Minerals Rule implements section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. That provision was designed to force disclosure of the presence in manufactured products of four widely used metals that may have originated from the Democratic Republic of the Congo (DRC) and adjacent countries. Proceeds from illicit mining of these metals have funded violent warlords in their campaigns of human rights abuses in central Africa, and Congress intended that this new SEC reporting obligation would create pressure on manufacturers to source "responsibly."

The rule has proven complicated, burdensome, and difficult to put into practice, however. Manufacturers subject to SEC reporting requirements must conduct a "reasonable country of origin inquiry" if any of the "conflict minerals"—tin, tungsten, tantalum, or gold—are necessary to the production or function of their products, and there is no de minimis exemption. Trying to trace one component of a product through multiple links in an upstream supply chain, all the way back to a particular mine in Africa, is extraordinarily difficult for commodity metals. Industry organizations have sought to interpose at a chokepoint in each supply stream—the smelter—a "conflict free" certification program, but this effort is still a work in progress. In the meantime, manufacturers have been forced to rely on cooperation from their suppliers, who are in turn dependent on responsiveness from the next level up the supply chain, and so on. This is a continuing challenge, particularly when many of those upstream companies are not themselves subject to SEC requirements and lack a direct incentive to undertake time-consuming product line diligence. Other factors that have added to the complexity include ambiguous language in the rule, which has necessitated three sets of SEC Frequently Asked Questions (FAQ) documents to date, still-pending litigation, and unexpected collateral issues, such as the discovery of trade sanctions violations in the course of conducting supply chain sourcing inquiries.

Against this backdrop, the May 31, 2015, second-year filing deadline has now come and gone and companies should be well embarked on their current-year preparations for 2016 submissions. The Conflict Minerals Rule, as written, included a two-year phase-in process during which businesses could characterize the conflict minerals in their products as "DRC conflict undeterminable" and avoid conducting an independent private sector audit (IPSA), but that grace period ended at the end of calendar year 2014. While the question of whether the SEC can require specific disclosure language is still awaiting D.C. Circuit determination on panel rehearing, *National Ass'n of Manufacturers v. SEC*, No. 13-5252 (Nov. 18, 2014), *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/7D275C20F68032E885257D940054662A/$file/13-5252-1522829.pdf, most betting is that the SEC will prevail and companies should be planning for a heightened degree of compliance in their May 2016 filings. Meanwhile, the European Union has moved ahead with more stringent than expected conflict minerals legislation, activist groups are gearing up to rate company performance on a variety of metrics, and market pressure from corporate customers is driving even those with no reporting obligations of their own to assign this issue a high priority. For all these reasons, in-house counsel will have to keep conflict minerals in the category of matters requiring focused attention for the indefinite future.

Year-Two Reporting

Based on a review of filings to date, noteworthy aspects of the second-year submissions are as follows:

There is no official compilation of Conflict Minerals Rule reporting data, so tabulations of filings have to be constructed using information on the SEC's website (www.sec.gov/edgar) and interpretation of filings, with a resulting lack of complete precision. Also, last year close to 150 companies filed late, so final tallies can change, but the best count of filings in 2015, covering calendar year 2014 data, is 1272 as of the end of June. This number is lower than the 1328 submitted for calendar year 2013, which itself was far lower than the 6000 filings the SEC had predicted. Most practitioners in this area expected and saw increased compliance efforts among their clients in the second year, and some 50 new filers appear in the 2015 reports, compared to the prior year. The explanation for the decreased overall number remains a mystery; presumably the missing reporters plan to file late, found a way to make their products without using four common metals in even de minimis quantities, or decided to accept a higher level of business risk and ignore the rule.

As was the case last year, the overwhelming percentage of respondents relied on the expiring grace period language and said they were unable to determine whether their products contained conflict minerals traceable to mines involved in conflict. Only a small number of companies stated that their products were conflict-free, which requires an IPSA; by our count, five businesses submitted a compliant audit report.

Again this year at least one company reported the unfortunate discovery that gold in its supply chain was traceable to North Korea, a country subject to U.S. trade sanctions.

While electronics companies continue to set a high bar for specificity and explanation of the scope of their compliance efforts, other industrial sectors show much greater variability in their reporting, both across and within manufacturing classifications. These kinds of differences will likely be the subject of watchdog group attention.

Key Takeaways

After two reporting cycles, a few observations stand out from the SEC filings and other developments:

1. The Conflict Minerals Rule is not going away. The D.C. Circuit's November 2014 order on rehearing directed the parties to submit supplemental briefs on three questions, all focused on First Amendment aspects of the SEC's required conflict minerals disclosure language. Notably, the court did not extend the scope of the rehearing to the underlying rule, which it firmly upheld in its April 2014 opinion, including a conclusion that the lack of a de minimis exemption is justified, *National Ass'n of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir. 2014). Similarly, efforts to eliminate the rule through an amendment to the Dodd-Frank Act have little chance of success. Any businesses that have held off making a required filing in the hope that the rule will be invalidated or overridden should rethink that strategy immediately.

2. Concern about SEC enforcement is the least of a company's worries. While at some point, the SEC will doubtless begin enforcement efforts against conflict rule noncompliance, businesses should be far more concerned about the risks they face of customer dissatisfaction, targeting by nongovernmental organizations (NGOs) and activist shareholders, and adverse publicity resulting in brand vulnerability. In an April 2015 report, two NGOs, Global Witness and Amnesty International, claimed that 80 percent of the 2014 Conflict Minerals Rule filings failed to meet the minimum requirements of the law. While others have sharply criticized this analysis and challenged its conclusions, it is a sample of the kind of scrutiny that will be brought to bear by so-called watchdog groups. Another NGO, the Enough Project, has

singled out the electronics and jewelry sectors for conflict minerals ratings, and successfully orchestrated widespread negative public relations campaigns and attention-getting events at shareholder meetings; it is looking toward other sectors next. Yet another group, the Responsible Sourcing Network, recently published performance measures that it will use in examining SEC filings and other conflict minerals "indicators" in public reports. And even beyond the NGO and investor community, some of the strongest pressure is coming from heavy-hitter downstream corporate customers, who are demanding that their suppliers provide information and revise purchasing practices to conform to the customer's transparency and corporate social responsibility programs.

3. The SEC is not the only sheriff in town. Supply chain accountability is an expanding concept, and businesses need to be aware of an array of obligations that have been or will most likely be adopted by multiple authorities. In late May 2015, the European Union surprised most observers with a much stronger conflict minerals regulation than previously proposed. The new measure will impose mandatory due diligence requirements on importers, smelters, and refiners, certification standards on smelters and refiners, and disclosure obligations on companies that use conflict minerals in their products; the required disclosure will include not only the presence of conflict minerals but also an explanation of efforts the business has made to address risks that its purchases are supporting conflict. In contrast to the SEC rule, the EU's scheme is broader in two respects. First, it covers all companies that use conflict minerals, not just those that are publicly traded and file SEC reports. Second, it extends beyond mines in central Africa to any area that is "in a state of armed conflict," which is very broadly defined.

Within the United States, several states have adopted procurement criteria that disqualify bidders that fail to meet conflict minerals expectations or others that apply to elimination of human trafficking and slavery. The federal government has adopted similar anti-human trafficking requirements for awarding government contracts, and the California Supply Chain Transparency Act requires companies doing business in that state to disclose their efforts to combat slavery and human trafficking. By no means least, businesses that are forced for various reasons to examine their supply chains must also be vigilant for violations of U.S. trade sanctions law and the Foreign Corrupt Practices Act, both of which carry severe penalties. Plainly, businesses need to coordinate the full range of supply chain accountability issues now in place and integrate these efforts into a corporate-wide risk-reduction program.

Conclusion

The Conflict Minerals Rule is part of a growing collection of federal, state, and international supply chain accountability regimes that corporations need to take very seriously and address in a careful, coordinated way. These obligations involve both legal and business risk, and companies with the most strategic outlook are integrating their risk-reduction efforts to maximize effectiveness and minimize costs. Savvy businesses that do this right can realize competitive advantages over other market players that are slower to recognize the opportunities that come with this new set of challenges.

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