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New Conflict Minerals Rules Require Dramatically Expanded Supply Chain Due Diligence

By Gregory Husisian

A little-noted aspect of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires that publicly traded companies take steps to verify and to publicly report their use of so-called "conflict minerals." Although the Dodd-Frank Act was enacted several years ago, in the wake of the 2008 financial crisis, the SEC now has issued final regulations implementing the Art's requirements.[1]

As a result, any companies regulated by the SEC (including foreign companies that issue American Depositary Receipts) now have special compliance obligations related to conflict minerals. More specifically, the SEC final rule imposes controls on: (1) domestic companies requiring reports pursuant to sections 13(a) and 15(d) of the Securities and Exchange Act, including domestic companies, foreign private issuers, and smaller reporting companies; that (2) also manufacture or contract to manufacture products that contain a conflict mineral "necessary" for the functionality or the production of the products.[2]

These minerals are used in a great number of products, including many electronics. Further, because the certification requires that issuers reach deep into their own supply chains for conflict minerals inquiries, the end result is a set of due diligence requirements that will impact many companies that are not U.S. issuers, including through indirect application to non-U.S. and privately held companies that directly or indirectly sell to such issuers. The rules accordingly are expected to have a major impact on how companies source such products.

The SEC rule, in accordance with the Dodd-Frank requirements, establishes a disclosure-based regime. To comply, companies must: (1) determine whether they are covered by the rule; (2) conduct a reasonable country-of-origin inquiry; (3) engage in supply chain due diligence; and (4) comply with any associated reporting requirements. More specifically, companies that are impacted by these requirements will need to go through the following four-step process:

Step 1: Determining Coverage

The first step is to determine whether the rules reach the company. Coverage arises if the company: (1) files reports under section 13(a) or section 15(d) of the 1934 Security and Exchange Act; and (2) manufactures, or contracts to manufacture, products with conflict minerals that are necessary to the production or functionality of a product. These minerals are as follows:

- Columbite-Tantalite (Coltan);
- Cassiterite;
- Wolframite; and
- Gold.

The Conflict Minerals regulations also cover the derivatives of these minerals, which include tantalum, tin, and tungsten, as well as any other minerals or derivatives that the Secretary of State determines are financing conflict in the so-called "Covered Countries."[3]

A company that only services, maintains, or repairs a product containing conflict minerals is not considered to be "manufacturing" a product. Nor is one that mines conflict minerals. More ambiguity, however, arises for companies that engage in contract manufacturing activities. The SEC may deem a company to be contracting to manufacture a product based on the degree of influence it exerts over the materials, parts, or components to be included in the products containing conflict minerals.[4]

In applying this standard, the company needs to consider the full scope of its activities. If the company is only specifying or negotiating contractual terms with

[1] *See* Securities and Exchange Commission, "Conflict Minerals," 77 Fed. Reg. 56,274 (Sept. 12, 2012).

[2] 77 Fed. Reg. 56,274, 56,285-88.

[3] Covered Countries include the Democratic Republic of the Congo, plus the neighboring countries of Angola, Burundi, the Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia. 77 Fed. Reg. 56,274, 56,275.

[4] 77 Fed. Reg. 56,274, 56,279-80.

a manufacturer, is only affixing brands, marks, logos, or labels to a generic product manufactured by a third party, or is only servicing, maintaining, or repairing a product manufactured by a third party,[5] then these activities are not likely to be considered sufficient control of the manufacturing process to make the company the equivalent of a manufacturer. By contrast, taking steps to give exact parameters for manufacture, especially if the instructions include the inclusion of a conflict mineral, likely would suffice.

In addition to identifying coverage, the company also needs to determine whether the conflict mineral is one that is necessary to either the product's "functionality" or "production." The SEC has offered the following guidance to help define these two terms:

- Necessary to Product Functionality. The company needs to evaluate whether a conflict mineral is contained in or intentionally added to the product (or any component of the product), and necessary to the product's generally expected function, use, or purpose. Where the conflict mineral is incorporated for purposes of ornamentation, decoration, or embellishment, as with gold, this "functionality" analysis should consider whether the primary purpose of the product is ornamentation or decoration.[6]

- Necessary to Product Production. To make this determination, the company should evaluate whether: (1) a conflict mineral is contained in the product as a result of an intentional addition to the product's production process; and (2) whether that addition is "necessary" to produce the product as it is constituted. The evaluation should include an evaluation of any component of the product.[7]

If the company does not manufacture or contract to manufacture products with conflict minerals that are necessary to the functionality or production of the product, then the inquiry can stop. The company is not subject to the Conflict Minerals Rule and does not have to file a Form SD or take any further steps to comply. Otherwise, the company should proceed with a country-of-origin inquiry.

Step 2: Conducting a Country-of-Origin Inquiry

Once a company has determined that it is subject to the Conflict Minerals Rule, it must conduct a reasonable "country-of-origin" inquiry to determine whether any of the conflict minerals used in the company's products originated in the Covered Countries of the DRC,[8] plus the neighboring countries of Angola, Burundi, the Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia.[9] The company can satisfy the country-of-origin inquiry by obtaining representations indicating that the conflict minerals did not originate in the Covered Countries or, alternatively, came from recycled or scrap sources. So long as the representation is authoritative, there is no need to try to trace such conflict minerals back to the original production source.

If a company determines that its conflict minerals either did not originate in the Covered Countries, or else came from recycled or scrap sources, then it must report that determination to the SEC using Form SD.[10] The company also is required to disclose this information on its publicly available website, including by providing a link to its website in the Conflict Minerals Disclosure section on Form SD. By contrast, if the company's country-of-origin inquiry indicates that any of its conflict minerals may have originated in the Covered Countries, and are not from recycled or scrap sources, then the company must proceed with supply chain due diligence.

Step 3: Conducting Supply Chain Due Diligence

If the reasonable country-of-origin inquiry reveals that the company either knows or has reason to believe that any of its conflict minerals originated in the Covered Countries, then the company is required to conduct a due diligence review of the source and chain of custody for these minerals. The review must be conducted under a nationally or internationally recognized due

[5] 77 Fed. Reg. 56,274, 56,281.
[6] 77 Fed. Reg. 56,274, 56,279.
[7] 77 Fed. Reg. 56,274, 56,280-81.
[8] 77 Fed. Reg. 56,274, 56,280-81.
[9] 77 Fed. Reg. 56,274, 56,275.
[10] 77 Fed. Reg. 56,274, 56,361-62.

diligence framework for that particular conflict mineral. The only framework recognized for that purpose is the Organization for Economic Co-operation and Development's ("OECD") "Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas."[11]

Step 4: Preparing a Conflict Minerals Report.

If a company determines its conflict minerals did not originate in the Covered Countries, or else came from recycled or scrap sources, the company can so report on Form SD. Otherwise, the company must prepare a Conflict Minerals Report to be filed as an exhibit to Form SD. The SEC rule requires that the company retain an independent, private-sector auditor to review the methodology of the audit, to express a conclusion regarding whether the due diligence undertaken by the company conforms with the standards of the rule, and whether the due diligence described is a true and accurate summary of the due diligence process that actually occurred.[12]

The Conflict Minerals Report must contain: (1) a discussion of the due diligence review of the supply chain sourcing and chain of custody for the company's conflict minerals; (2) a statement that the company has obtained an independent private sector audit; (3) the independent audit report prepared by the auditor; and (4) a description of any products that are not "DRC conflict free," as well as the facilities used to process the conflict minerals in those products, the country of origin of the conflict minerals, and the efforts undertaken to determine the mine or original location or origin.[13]
If the company cannot determine if its products are "conflict free," the company must describe the products that contain the minerals, the facilities used to process the conflict minerals in those products, the country of origin of the conflict minerals (if known), and the efforts that the company undertook to determine the mine or original country of origin.[14] The company also is required to disclose the steps it has taken or will take to mitigate the risk that its conflict minerals benefit armed groups and the steps it will take to improve its due diligence.[15]

Conflict Minerals Compliance

The rules described require a significant due diligence inquiry. Congress did not establish any *de minimis* criteria for the conflict mineral reporting requirements, meaning that even minor uses of conflict minerals impose the full conflict minerals inquiry. Congress also applied them not just to manufacturers, but also to retail companies that sell private label goods (provided they have influence regarding their manufacture or have products manufactured to their specifications). Notably, the rules cover both domestic and foreign companies equally, provided they are subject to SEC oversight under the Securities and Exchange Act.

Finally, as discussed above, the conflict minerals provisions in Dodd-Frank extend not only to products and components used to finish the product, but also to those necessary to the manufacturing process. Thus, even public companies that are reasonably certain they do not use conflict minerals nonetheless may need to make an inquiry to confirm this fact at both the product and process levels.

The requirement to get certifications vastly expands the ambit of the rule, including to privately-held companies that are part of the supply chain of covered public companies. Such companies will need to conduct their own due diligence, chiefly because their public counterparts likely will request certifications. Thus, even if the supply chain is eight layers deep, each company in that chain may be required to undertake an analysis by its respective customer, regardless of whether it is publicly or privately held.

Determining what constitutes a "reasonable" inquiry is a decision that should be made using risk-based principles. The character of a reasonable inquiry may vary considerably depending upon the company's size, scope of operations, products, relationships with suppliers, and amount of Conflict Minerals consumed or used. In many cases, the company will need to rely heavily on supplier certifications. This is a reasonable

[11] See 77 Fed. Reg. 56,274, 56,282.
[12] 77 Fed. Reg. 56,274, 56,281.
[13] 77 Fed. Reg. 56,274, 56,281.
[14] 77 Fed. Reg. 56,274, 56,281-82.
[15] 77 Fed. Reg. 56,274, 56,281-82.

course of action so long as the representations were given in a fashion that makes it reasonable to assume that they are accurate. Keeping these considerations in mind, companies should also consider the following additional compliance measures:

- Tracing, when possible, conflict minerals back to the original smelter/refiner.
- Developing and implementing procedures to communicate Conflict Mineral compliance policies consistently to suppliers.
- Preparing a new compliance policy to document compliance with the Conflict Minerals Rule, whether as part of a supply chain management policy or as a stand-alone policy.
- Reviewing procurement policies and practices, supplier due diligence practices, and the tracking of supplier certifications to determine how these processes should be augmented to comply with the rule.
- Designating a single person or office to be in charge of Conflict Mineral compliance. This person should be in charge of overseeing supplier certifications, following up with suppliers who do not respond, preparing draft SEC certifications, and maintaining the company's current list of conflict minerals used in production or manufacture.
- Identifying each product manufactured and the products that are contracted out to third parties.
- Compiling a global list of the inputs used for production and manufacturing. Companies that have centralized databases for supply purposes may be able to draw on these resources. If such a resource is not available, the company may need to circulate internal questionnaires to develop this information.
- Incorporating Conflict Minerals compliance into contracts and purchase orders, including through certifications, inspection rights, supplier disclosures, reporting and cooperation requirements, and flow-down clauses to ensure the integrity of the reporting.
- Assembling a database of compliant suppliers who can be relied on for complaint sourcing.
- Developing policies for suspending or terminating non-compliant suppliers (which may require lining up alternative sources for supplied products).
- Covering Conflict Mineral compliance under company whistleblower policies.
- Commissioning third-party audits of supply chain due diligence.
- Reviewing other compliance procedures contained in the OECD due diligence, especially those companies that manufacture or produce using gold.[16]

In addition to these measures, companies should train relevant personnel to be alert for "red flags." Examples of red flags would include: (1) minerals that originate or have been transported through the Congo or neighboring areas; (2) sourcing from a country that is not known to have significant production of the conflict mineral; (3) sourcing from a company known to have lax conflict mineral compliance; (4) sourcing from a company known to operate in or near the conflict countries; (5) reluctance of a supplier to certify as to country of origin of a conflict mineral; and (6) a supplier's refusal to allow a country-of-origin audit.

Conclusion

The conflict minerals provisions are part of a broader trend to use the SEC power over issuers to effectuate U.S. foreign policy goals.[17] As a result, the inquiry required by the conflict minerals is a broad one. In many ways the requirements are just as broad for a supplier requested to provide a certification as they are for an issuer.

[16] *See* OECD, "OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (2010), *available at* http://www.oecd.org/fr/daf/inv/mne/mining.htm.

[17] Other examples include the newly-imposed requirement to disclose Iran-related business in quarterly and annual SEC filings, which is discussed in greater detail above.

Against this backdrop, a broad spectrum of companies is likely to confront the application of these rules, including many companies located outside the United States. For all such companies, the implementation of a conflict minerals compliance program that covers such topics as how to make a reasonable country-of-origin inquiry and how to manage supplier certification requirements, likely will be a prudent investment in regulatory risk management.