Conflict Minerals Compliance: Observations and Recommendations for 2014 and Beyond

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Observations and recommendations related to compliance with Rule 13p-1 under the Exchange Act, the conflict minerals rule.

Rule 13p-1 under the Exchange Act and Form SD (referred to together as the conflict minerals rule) require a significant number of SEC reporting companies to make specialized disclosure and conduct related diligence concerning certain minerals and their derivative metals (referred to as conflict minerals) contained in the companies' products. The first reports under the rule are due May 31, 2014. Because that date falls on a Saturday in 2014, the first filing deadline is extended to June 2, 2014 under General Instruction B.2 to Form SD and Exchange Act Rule 0-3(a). This disclosure must cover the 2013 calendar year, with limited exceptions.

Since the conflict minerals rule was adopted in 2012, many companies have made significant progress toward being ready to comply with the rule, including by:

- Determining whether the rule applies to them.
- Putting together compliance teams.
- Developing compliance procedures.
- Engaging in product filtering and vendor outreach.
- Validating vendor responses to company outreach efforts.

Some companies have even already prepared initial drafts of their Form SD and accompanying conflict minerals report. Despite this, there is still much work to be done in addressing the requirements of this complex rule. In light of this, this Article offers observations on conflict minerals compliance efforts so far, and recommendations for companies to consider as they continue compliance work.

For an overview of the conflict minerals rule, see Practice Note, Conflict Minerals Diligence (0-510-6930).

COMPLIANCE IS ABOUT MORE THAN JUST DATA GATHERING AND REPORTING

If a company is required to conduct detailed supply chain due diligence under the conflict minerals rule, it generally must do so in conformity with a nationally or internationally recognized due diligence framework. The only framework that currently satisfies this requirement is the Organisation for Economic Co-operation and Development's *Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* (OECD guidance). This five-step framework, including supplements, contains approximately 40 different discrete compliance procedures to consider, implement and document for "downstream" companies (companies that first obtain conflict minerals after they have been smelted or refined). Many companies should expect NGOs, socially responsible investors and other responsible sourcing constituencies to scrutinize how they describe their diligence measures in their conflict minerals reports, including whether the measures they describe conform to the OECD guidance.

Whether or not a company is required to itself report under the conflict minerals rule, it may be part of the supply chain of a reporting company that is required to report, and therefore will be indirectly affected by the rule (for a discussion of this, see Practice Note, Conflict Minerals Diligence: Who Must Conduct Conflict Minerals Diligence? (0-510-6930)). Reporting and nonreporting companies in this supply chain intermediary position must be mindful of contractual requirements, customer policies and vendor codes of conduct requiring them to implement due diligence procedures consistent with the OECD guidance. These companies should also expect some (although probably a small number of) customers to spot-check vendor compliance programs in 2014, including for their conformity to the OECD guidance.

Technical compliance with the OECD guidance will take on additional importance once a company is required to obtain an independent private sector audit under the conflict minerals rule (for information on the audit requirement, see Practice Note, Conflict Minerals Diligence: Conflict Minerals Audit (0-510-6930)). For most companies, an audit will be required beginning with the 2015 compliance period. In January 2014, the American Institute of Certified Public Accountants (AICPA) published guidance on the procedures that may be followed by audit firms.

RECOMMENDATION

Perform a "gap assessment" to determine what gaps exist between your company's compliance program and the requirements of the conflict minerals rule and the OECD guidance. This can be done either internally or with the help of a third party legal or other consultant.

A MULTI-DISCIPLINARY TEAM IS NECESSARY

At many companies, efforts to comply with the conflict minerals rule so far have taken place mostly in the company's supply chain organization. This is natural, considering that many companies have so far been focused on determining which products fall with the scope of the rule, gathering data and validating vendor responses to company inquiries. However, as companies move into the next phase of compliance, additional company functional areas must take on a larger role. For example:

- A company's legal department, and at some companies, its finance department, must be involved in the preparation of the Form SD and conflict minerals report.
- Internal audit may be involved with assessing the adequacy of the substance and documents of the compliance program.
- If a company has these functions in-house, investor relations and corporate social responsibility (CSR) should be involved as the company begins drafting disclosure and developing a communications strategy.

RECOMMENDATIONS

- Determine whether the company has involved all internal personnel necessary for the next phase of conflict minerals rule compliance.
- Prepare a clear, achievable timetable and responsibility checklist so that all team members know what is expected of them.
- Because many new members of the conflict minerals rule compliance team may not be familiar with the conflict minerals rule and OECD guidance, additional education will probably be necessary for them to fulfill their responsibilities.

INCREASING FOCUS ON RESPONSIBLE COMMODITIES SOURCING

Other countries and several US states have begun their own responsible sourcing initiatives. For example, the European Commission is expected to propose conflict minerals legislation in the first quarter of 2014. This legislation is expected to cover the same minerals as the conflict minerals rule, but to apply to conflict areas worldwide (instead of being limited to Central Africa). Canadian conflict minerals legislation has also been introduced. Although it currently seems unlikely that the Canadian legislation will be enacted in the near future, its introduction underscores that encouraging responsible conflict minerals sourcing is not just a US initiative.

To date, two US states, California and Maryland, have adopted conflict minerals legislation. Two other US states, Connecticut and Massachusetts, have proposed their own conflict minerals legislation. If the ongoing legal challenge to the conflict minerals rule is successful and the rule is vacated, additional states may propose their own conflict minerals legislation to try to fill the void (for more information on the legal challenge to the conflict minerals rule, see Practice Note, Conflict Minerals Diligence: Legal Challenge to Section 1502 and the Conflict Minerals Rule (0-510-6930)). Future legislation may require disclosure or may place restrictions on procurement by state agencies from, or the investment of state funds in, companies that do not meet responsible conflict minerals sourcing requirements.

The legislative focus on responsible sourcing is not limited to conflict minerals. In recent years, there has been increased focus on responsible sourcing of other commodities, including cocoa, cotton and timber. Companies should expect the focus on responsible commodities sourcing to increase further, whether in the form of legislation or pressure from NGOs, socially responsible investors and other stakeholders.

RECOMMENDATION

Companies should implement a flexible and scalable conflict minerals compliance program that at a minimum can accommodate legislation covering other areas of the world and ideally additional commodities. This positions the company to effectively and efficiently meet new responsible sourcing demands that may arise.

A NEW YEAR MEANS A NEW COMPLIANCE PERIOD

The conflict minerals rule requires companies to report on a calendar year basis. Therefore, even though the first report is not due until mid-2014, a new compliance period began on January 1, 2014. Last year was a baseline year for most companies. It took many companies a significant portion of the year to determine how the rule applies to their business and which products are in scope, and to organize and begin their vendor outreach. As expected, relatively few vendors currently have detailed information on their supply chains, which in turn has made it difficult for reporting companies to obtain detailed information on the ultimate source of the conflict minerals in their products.

NGOs and socially responsible investors recognize that compliance will continue to evolve. They do not expect perfection in the first year, or even the first few years. However, they do expect companies to:

- Articulate a plan for progressive improvement to their compliance efforts.
- Implement that plan.

Reporting companies that purchase in-scope products, raw materials or product components from supply chain intermediaries also recognize the evolving nature of responsible minerals sourcing. However, supply chain intermediaries should expect some larger customers to be increasingly focused on their suppliers' conflict minerals compliance programs. These customers are likely to focus on:

- The progress a vendor has made in tracing its supply chain.
- The vendor's strategy for improvement.

RECOMMENDATION

In 2014, companies should focus on how to improve the efficiency and effectiveness of their conflict minerals compliance programs. As part of this process, companies should determine what steps to take this year

to further enhance supply chain traceability so that in this and future years vendors provide more complete information. This may require a company to proactively work with its vendors, among other things.

Other common compliance issues that companies will need to focus on include:

- The timing of conducting their vendor survey.
- Steps to mitigate supply chain risk relating to responsible minerals sourcing.
- Incorporation of conflict minerals compliance into new product launches and vendor onboarding.

THE LEGAL CHALLENGE TO THE RULE CONTINUES, BUT IS (FINALLY) DRAWING TO A CLOSE

As with other rules made under the Dodd-Frank Act, the conflict minerals rule was challenged in court. The District Court for the DC Circuit upheld the rule in July 2013. As expected, the decision was appealed to the Court of Appeals, and oral arguments for the appeal were held on January 7, 2014. The court is expected to render its decision sometime before the first conflict minerals report is due, although there is no requirement that it do so. If the rule is upheld, companies that postpone or slow down their compliance efforts pending the court's decision are unlikely to be able to complete their work on time. If the rule is vacated, many companies may nevertheless continue their compliance efforts.

Many larger companies, both in the electronics industry and various other industries, intend to continue implementing their traceability and responsible sourcing initiatives for the minerals covered by the rule. This will put pressure on the entire public and private company supply chain to continue to implement their own compliance programs. Other constituencies, including NGOs, socially responsible investment funds, public pension funds and consumers, likely also will put pressure on companies to maintain responsible sourcing momentum. Therefore, while the SEC filing requirement may be postponed (at least temporarily), other elements of many companies' compliance programs will continue.

RECOMMENDATION

Companies should continue moving forward with their compliance programs. The resolution of the legal challenge may take time, and regardless of its outcome, companies are likely to face other pressures to responsibly source conflict minerals.

REPORTING INVOLVES MORE THAN JUST GETTING THE FACTS DOWN ON PAPER

Like many other SEC disclosure requirements, Form SD is not a blank form to be mechanically filled in. Instead, significant judgment will go into preparing the filing. Companies will need to prepare disclosure that is tailored to their particular facts and circumstances. The SEC has also indicated that companies have flexibility on how they craft certain disclosures. In some respects, what must be disclosed is open to interpretation.

RECOMMENDATIONS

- If your company has not already started drafting conflict minerals disclosure, it should do so now. Even companies that are still collecting and analyzing vendor data generally have a good sense of what the final conclusions from their vendor outreach will be. Reasons to begin drafting disclosure now include:
  - because Form SD and the conflict minerals report are new filing obligations, the draft filing probably will go through many revisions and layers of review, especially at larger companies;
  - there will most likely be different views internally on what the disclosure should say;
  - for many companies, the preparation and review of conflict minerals disclosure will coincide with proxy season and the preparation and filing of the first quarter Form 10-Q, when some team members will have significant competing demands on their time; and
  - with draft disclosure on paper, companies can better evaluate how their compliance efforts may be perceived by external constituencies, and if needed will have the time to further enhance and describe compliance procedures.
- Determine who will sign the Form SD. Form SD must be signed by an executive officer, as defined in Rule 3b-7 under the Exchange Act (for more information on the definition of executive officer, see Practice Note, What's in a Name? Disclosure Implications for "Officers," "Executive Officers" and "Named Executive Officers" under SEC Rules (4-520-1256)). Also determine who else must sign off on the filing (such as the legal department or the disclosure committee or audit committee) and what back-up the signatory and other relevant internal constituencies will require as part of the sign-off process.
- A limited number of companies are expected to be required to obtain an independent private sector audit under the conflict minerals rule for 2013, since most companies should be able to rely on the "DRC conflict undeterminable" exception from the audit requirement (for more information on this exception, see Practice Note, Conflict Minerals Diligence: Disclosure about Company's Products and Conflict Minerals Origin (0-510-6930)). However, companies should determine whether they want to voluntarily put their program through an external compliance review or gap analysis before filing. A company that opts to do this must complete its internal compliance efforts earlier. This year, market practice in this regard is mixed.
- Put together a filing calendar that sets out key dates and responsibilities.

DISCLOSURE IS MORE THAN JUST THE SEC FILING

In addition to filing Form SD (in most cases, likely with an accompanying conflict minerals report) with the SEC, the conflict minerals rule requires companies to disclose certain information included in the filing on their websites (for more information on the web posting requirement, see Practice Note, Conflict Minerals Diligence (0-510-6930)).

RECOMMENDATIONS

- Determine where on the company website to place the conflict minerals disclosure. The conflict minerals rule does not specify where in particular on a company's website the disclosure must appear. A company might decide, for example, to put conflict minerals disclosure:

- on its investor relations website;
- with other CSR information; or
- under its own heading with a link from the website home page.

- Many larger companies prepare a CSR report or otherwise publish CSR information. Conflict minerals disclosure should conform with these other communications, both in content and timing.

THE AUDIENCE IS NOT JUST THE SEC

Many companies are focused only on what the SEC will think about their conflict minerals disclosure. Compliance with the requirements of the conflict minerals rule is of course important. However, the SEC is not expected to second-guess companies' good faith compliance efforts. The SEC is instead expected to give conflict minerals disclosure practice time to develop, as it has done with other new, complex rules.

At the same time, many constituencies other than the SEC will be focused on companies' conflict minerals disclosure. These constituencies will differ among companies but may include:

- NGOs.
- Socially responsible investors.
- Public and union pension funds.
- CSR research and ranking firms.
- Consumer groups and consumers.
- Customers.
- Competitors.
- Employees and prospective hires.

Many of these constituencies view compliance with the conflict minerals rule as a floor, rather than the ceiling, for what they expect of companies.

RECOMMENDATIONS

- Based on your company's industry, business and investor base, as well as your CSR profile and experiences with other CSR issues, determine:
  - the constituencies, if any, that are most likely to focus on your company's conflict minerals disclosure;
  - the message your company wants to communicate to these constituencies; and
  - the reaction this audience is likely to have after reviewing your company's conflict minerals disclosure.
- Consider whether to make supplemental disclosure concerning your conflict minerals sourcing that goes beyond the minimum requirements of the rule. This may be done in the Form SD and conflict minerals report or through other channels. In thinking about this, consider particular expectations for companies' reporting expressed by external constituencies (for example, as in the Enough Project and the Responsible Sourcing Network's report, Expectations for Companies' Conflict Minerals Reporting).
- For some larger companies, it may make sense to proactive engage with key external stakeholders.

COMPLIANCE CAN CONTRIBUTE TO THE BOTTOM LINE

For most companies, 2013 was the year for getting up to speed on the conflict minerals rule and beginning to implement their compliance programs. If a company met these goals, it was satisfied. By contrast, in 2014, many companies intend to proactively seek a quantifiable return on their compliance investment, beyond the soft return of helping to reduce armed conflict in the eastern Democratic Republic of the Congo. Supply chain experts predict that companies will be able to recoup their compliance investment many times over, especially because compliance with the conflict minerals rule has been significantly less costly for many companies than initially feared.

RECOMMENDATIONS

- Companies should determine whether the data they are gathering as part of complying with the conflict minerals rule may be used for other business purposes. Some companies have already begun to do this. For example, in 2013, some companies used data collected as part of conflict minerals rule compliance as a starting point for assembling a centralized database of vendor compliance personnel. This enabled these companies to more efficiently disseminate compliance communications and track vendor responses across other compliance initiatives. Some companies with decentralized procurement functions have used data gathered in conflict minerals compliance efforts to identify:
  - common vendors across business units;
  - opportunities for volume pricing and vendor consolidation; or
  - pricing discrepancies among business units.
- A company should also consider whether its compliance efforts can position it at a competitive advantage. For example, some component suppliers with robust conflict minerals compliance programs may want to position this to their customers as mitigating supply chain risk. Some other companies that are far along with their conflict free sourcing efforts have also publicized it. In January 2014, at the Consumer Electronics Show, the chief executive officer of Intel Corporation announced that Intel's processors are now conflict free. In February 2014, Apple Inc. announced that it is sourcing tantalum from conflict-free sources. These announcements were widely picked up in the press.

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