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ALERT

Conflict Minerals and Supply Chain Compliance

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EU Reaches Political Understanding on Conflict Minerals Regulation – An Overview and Take-aways for Downstream Companies

Attorneys
Michael R. Littenberg
Amanda N. Raad
Katerina Sandford
Emily K. Burke
Julia L. Chen

Late last Wednesday, the European Union reached agreement on the broad framework of a conflict minerals regulation. In this Alert, we describe some of the key terms of the regulation and what it means for the downstream.

Please visit the new Ropes & Gray Supply Chain Compliance and Corporate Social Responsibility Resource Center for EU source documents relating to the regulation.

The Lead-Up to Last Week's Agreement

Last week's political understanding was the culmination of several years of work. In 2010, after the adoption of Section 1502 of the Dodd-Frank Act, the statute requiring the adoption of the U.S. Conflict Minerals Rule, the European Parliament passed a resolution calling for the EU to adopt its own regulation.

In March 2013, the European Commission launched a public consultation, in which it solicited views on a possible legislative initiative. Michael Littenberg, one of the authors of this Alert, participated in that process.

Following the completion of its public consultation, in March 2014, the Commission proposed a voluntary self-certification scheme focused on the 400+ direct importers of tin, tantalum, tungsten and gold ("3TG") into the European Union.

In accordance with the EU's legislative process, the Commission's proposed regulation was submitted to the EU Parliament. Within the Parliament, the Committee on International Trade ("INTA") was tasked with reviewing the regulation. INTA did not feel that the Commission's proposed regulation went far enough. In its final report, INTA recommended mandatory certification of EU smelters and refiners and voluntary compliance measures for importers of 3TG and companies further downstream, i.e., importers and manufacturers of components and finished products.

Some constituencies in the Parliament advocated for an even more expansive approach. In its floor vote on May 20, 2015, the Parliament ultimately voted in favor of a regulation that would extend mandatory obligations to both importers of 3TG and companies further downstream.

Notwithstanding the Parliament vote, under the EU's legislative process, the Parliament and the European Council must reach agreement on final regulations. Within the Council, there was a split over a mandatory versus voluntary approach and which portions of the supply chain should come under the regulation. Trilogue negotiations – among the Commission, the Parliament and the Council – to come up with a final compromise regulation commenced in late 2015.

The trilogue negotiations were accompanied by a significant amount of lobbying. As expected, NGOs and socially responsible investor constituencies argued for a broad mandatory regulation applicable to the entire 3TG supply chain, while industry advocated for a more targeted, less burdensome approach. Lobbying remained intense until the end. For example, on the eve of the political understanding, a group of more than 125 NGOs and other civil society actors sent an open letter to the Dutch Presidency of the Council and the EU member states, encouraging them to

adopt a regulation that would require all companies bringing 3TG into the EU, in whatever form, to engage in supply chain due diligence.

The Road Ahead – Next Steps

The preparation of a final regulation that tracks last week's political understanding, and that fills in the additional details, now begins. This process will involve technical meetings and one or more additional trilogue sessions. The Dutch Presidency of the Council has pledged to conclude the informal legislative negotiations before its term ends on July 1. Further trilogues under the Slovak presidency may be required.

Once the text of the final regulation is completed, it will be submitted to the Parliament and the Council for adoption. The European Commission's press release indicates that this will occur "in the coming months."

As a regulation (in contrast to a directive), the EU's conflict minerals legislation will be directly and uniformly applicable in all member states from its effective date, without the need for the member states to draft and adopt separate national legislation.

The Final Regulation – What We Know So Far

Although there is high-level agreement on the final regulation, the official press releases are fairly thin on specifics. Some additional color was provided at the EU press conference announcing the political understanding. However, the Parliament and the Council have both indicated that some of the details of the regulation still are under discussion.

Based on the press conference, press releases, various Commission, Parliament and Council proposals and our one-on-one conversations, here is what we know about the final regulation, what we expect and what still may need to be worked out.

Subject Companies

As described below, the EU has taken a different approach than the U.S. Conflict Minerals Rule. The U.S. rule imposes due diligence and disclosure requirements on public companies, which then in turn place pressure on their supply chains to conduct due diligence, provide information and source responsibly. The EU approach instead seeks to regulate further up the supply chain.

- The regulation will require the approximately 20 EU smelters and refiners ("SORs") that process 3TG to conduct due diligence if they are sourcing from conflict-affected and high-risk areas.
- In addition, the regulation will require direct importers of 3TG into the European Union to conduct due diligence if they are sourcing from conflict-affected and high-risk areas. In 2014, the Commission estimated that there were more than 400 market participants at this juncture in the minerals supply chain, consisting of approximately 300 traders and more than 100 component manufacturers.
    - Small volume importers will be exempted. Although the threshold for reporting has not yet been announced, the EU has indicated that the regulation is expected to cover more than 95% of minerals and metals importers.
    - As the final regulation is fleshed out, also expect more detail concerning the following:
        - The extent to which importers will be required to disclose information to member state competent authorities, immediate downstream purchasers and the public.
        - Whether third-party audits of importers will be required and under what circumstances.

  - Whether there will be a "certified responsible importer" or equivalent concept in the final regulation.

- EU member states' competent authorities will be responsible for ensuring compliance and for determining penalties for non-compliance.

- The regulation will not require due diligence by manufacturers, importers and sellers of finished products and components. However, as discussed below under "Reporting and Disclosure," some of these companies will be encouraged to make voluntary disclosures.

In-Scope Minerals

- The regulation is limited to 3TG.

- However, unlike the U.S. Conflict Minerals Rule, which contains a generic definition, consistent with the EU's approach to date, the final regulation is expected to include an annex that contains a more detailed product description of the specific ores, concentrates and metals that will come within the scope of the regulation.

- Although the Annex will largely overlap with the definition in the U.S. rule, it may be broader in some respects. For example, during the trilogue negotiations, a proposal was made to include, among other things, tin oxides and chlorides within the scope of the regulation.

Geographic Scope

- Consistent with the Commission's original proposal, the regulation will apply to minerals sourced from conflict-affected and high-risk areas worldwide. This approach also is consistent with the OECD Guidance. In contrast, the focus of the U.S. Conflict Minerals Rule is limited to the Democratic Republic of the Congo ("DRC") region.

- The regulation will contain a general principles-based definition of what it means to be a conflict-affected and high-risk area. In addition, according to the political understanding, the Commission will select experts via a tender procedure to draw up an indicative and non-exhaustive list of areas and other due diligence issues to be addressed in a "Handbook for the operators" to be developed by the Commission. This follows on a draft handbook that was published last year.

Due Diligence Framework

- SORs and importers will be required to utilize the OECD Guidance framework for their due diligence.

Recognition of Existing Due Diligence Schemes

- Existing industry due diligence schemes will be recognized, subject to certain conditions. The recognition process is expected to be described in the regulation.

Excluded Mineral Content

- Recycled metals will be excepted out, although the specifics still need to be fleshed out. The definition is likely to mirror that in the OECD Guidance.

- Existing stocks of minerals will be grandfathered. The Council previously had proposed using the January 31, 2013 date in the "outside the supply chain" exception contained in the U.S. Conflict Minerals Rule.

- Mineral by-products will not come within the scope of the regulation. What constitutes a by-product is expected to be defined in the final regulation.

Reporting and Disclosure

- Prior iterations of the regulation contemplated publication by the Commission of lists of responsible importers and SORs. As noted earlier, private and public disclosures also may be required by importers.

- EU manufacturers and sellers that are subject to the Non-Financial Reporting Directive will be encouraged to report on their sourcing practices based on a new set of performance indicators to be developed by the Commission. These companies also will be able to join a registry or transparency database to be set up by the Commission and report voluntarily on their due diligence practices. As described at the press conference, in addition to creating greater transparency, this is intended to create "peer pressure" to report and engage in due diligence.

Effective Date

- The regulation will contain a transition period before compliance is required. The mandatory regulation adopted by Parliament contemplated a two-year transition period before effectiveness.

Subsequent Review

- The Commission will be required to review and report on the effectiveness of the regulation, taking into account both its impact on the ground and compliance by EU firms. If the regulation does not have the desired effect, the Commission is to consider additional mandatory measures. During the press conference, it was indicated that the review will occur "in a couple of years," presumably measured from the effective date.

Incentives to Promote Transparency

- The Commission will develop incentives to promote transparency. Although details have not been released, the following items indicate some of the public thinking to date of the Commission and the Parliament:

    - In 2014, the Commission indicated that it will require in its public procurement contracts for finished goods that contain 3TG that vendors comply with the OECD Guidance.

    - When it initially proposed the regulation in 2014, the Commission indicated that it contemplates visible recognition for the efforts of EU companies who source responsibly from conflict-affected countries or areas. At the time, the Commission also called upon EU member states to separately develop complementary national initiatives relating to consumer information and labeling.

    - The regulation adopted by the Parliament last year contemplated a "European Certificate of Responsibility" for downstream companies that voluntarily establish a responsible sourcing system for 3TG. The Certificate could be publicized on their website and to consumers.

Selected Take-Aways for Downstream Companies

In the few days since the political understanding was announced, we have fielded dozens of calls from nervous downstream companies. Some of our initial observations are below.

The U.S. Conflict Minerals Rule Will Continue to Be the Primary Driver of Compliance Programs

As indicated earlier, the due diligence requirements of the regulation will not apply to importers or sellers of finished goods or manufactured components. The requirements also are not directed at companies that manufacture or assemble products in the EU. Accordingly, the requirements of the U.S. Conflict Minerals Rule will, at least over the short- to mid-term, continue to drive the compliance procedures and programs of most downstream companies, whether they are public or private, large or small or located in the United States, the EU or elsewhere.

However, Some Manufacturers Will Need to Broaden Their Compliance Programs

Although the regulation will primarily apply to SORs and trading firms, some manufacturers also are direct importers of 3TG into the European Union and will therefore be required to comply with the regulation's due diligence requirements. As an initial matter, if they have not already done so, supply chain compliance personnel at companies with large EU manufacturing operations should determine whether they directly import 3TG into the European Union.

The inquiries under the regulation and the U.S. Conflict Minerals Rule will differ in two principal respects. First, 3TG may be defined somewhat differently under the two legislative frameworks. Second, as noted earlier, the EU regulation takes a more expansive view of what constitutes a conflict-affected and high-risk area. However, until the final regulation is released, we believe it is premature to prepare in earnest for compliance, especially since there is expected to be a transition period.

The Regulation Will Draw More Attention to Sourcing from Other Regions

The global focus of the regulation will over time draw more attention to other 3TG-producing areas of the world, outside of the DRC region, that may be conflict-affected and high-risk. To the extent other areas are recognized as conflict-affected and high-risk, we expect that many leading downstream companies will expand and refine their supply chain inquiries, policies and other procedures to take these areas into account, both to mitigate supply chain risk and as part of their responsible sourcing program. They will no longer break the world out into the DRC region and everywhere else. This will in turn put pressure on the rest of the supply chain to follow suit. We also expect that many leading downstream companies will over time expand their supply chain disclosures to specifically address their sourcing from these other areas.

There are likely to be good faith differences of opinion as to whether a particular area is conflict-affected and high-risk or how to demarcate the area, and the situation on the ground in a particular area can change quickly, further complicating a determination. In addition, in an about-face from prior Commission statements, the Parliament's press release indicates that the Commission will draw up a non-exhaustive list of areas. For all of these reasons, it is important for larger companies and industry associations to be part of this dialogue with governments, NGOs and other members of civil society.

EU and U.S. Legislation May Apply Differently to Mining and Metals Companies

A small number of companies that are public in the United States may find that they come within the scope of the regulation, even though their business activities are not in scope for purposes of the U.S. Conflict Minerals Rule. Companies that are engaged in mining and other activities customarily associated with mining do not come under the U.S. Conflict Minerals Rule, because that rule only applies to manufacturing activities. The U.S. Securities and Exchange Commission has put out guidance indicating that, for purposes of the U.S. rule, mining is not equivalent to manufacturing.

Expect Pressure on Responsible Sourcing of 3TG and Related Disclosure to Continue to Increase

The NGO community already has been highly critical of the political understanding regarding the scope of the regulation. Downstream companies that are not subject to the regulation or the U.S. Conflict Minerals Rule should expect that NGOs will continue to advocate for due diligence and disclosure, including through one-on-one

engagement, benchmarking studies and "name and shame" and social media campaigns. In particular, EU manufacturers and sellers that come within the scope of the Non-Financial Reporting Directive and that do not join the new Commission registry and report voluntarily on their due diligence practices are likely to receive pressure to do so. NGOs also may lobby for national legislation that addresses perceived gaps in the regulation, similar in approach to that which has been adopted or proposed relating to anti-human trafficking, especially in EU member states that were supportive of mandatory due diligence for the entire supply chain.

Although additional EU legislation is not imminent and it was difficult to reach agreement on the regulation, at the press conference, the INTA chair foreshadowed what may perhaps be ahead. He indicated that the regulation "opens the door for a new momentum in trade policy," and that the Parliament will look at other sectors and value chains to improve living conditions for workers and the environment in the entire value chain of products.

If you would like to learn more about the issues in this Alert, contact your usual Ropes & Gray attorney.

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