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Dodd-Frank and the Curious Case of Conflict Minerals

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In the final stages of the bill's development, an obscure provision was inserted into the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that seemingly had little to do with the statute's stated purpose. This last-minute addition–Section 1502–represents a bipartisan effort to limit trade in certain "conflict minerals" that may be used to finance violence in the Democratic Republic of Congo ("DRC") and its adjoining countries. To achieve this goal, Section 1502 requires publicly traded companies to disclose if their manufacturing process employs such conflict minerals. The minerals currently targeted by the rule—tantalum, tin, tungsten, and gold—play an important role in a wide variety of industries, from electronics and communications to semiconductors and jewelry, and they are found in products as diverse as cell phones, nuclear reactors, and light bulbs. The implications of this rule are significant: Section 1502 will undoubtedly impose substantial compliance costs on a wide range of companies and create potential Exchange Act liability for issuers. As the SEC prepares to promulgate final rules for implementing Section 1502 by the end of this year, it is important for companies to understand the impact of this provision and to develop a strategic response.

A. Summary of the Proposed Rule

The SEC has proposed a three-step disclosure framework for conflict minerals reporting. First, companies must determine whether they are subject to Section 1502. The Act only applies to Exchange Act issuers who file reports with the SEC and for whom conflict minerals are "necessary to the functionality or production" of goods that the issuer manufactures or contracts to be manufactured. Section 1502 applies to such issuers regardless of the amount of conflict minerals that are used, and issuers are subject to the rule if conflict minerals are necessary to the production process even if these materials are not included in the final product. However, the rule does not apply if only a tool or machine necessary to the production process contains conflict minerals.

The second step is for the issuer to ascertain whether the conflict minerals used in its manufacturing process originated in the DRC region. This inquiry must only provide a "reasonable basis" for the issuer to trace the origin of any particular conflict mineral used in its production. A detailed description of this examination and a summary of the results must be included in the issuer's annual report and on the company website. For companies that utilize conflict minerals from the DRC region or are unable to determine the country of origin, the issuer is required to undertake a more exhaustive investigation into the entire supply chain for these minerals and then submit a "Conflict Minerals Report" to the SEC summarizing this inquiry.

The third step provides additional guidance on the Conflict Minerals Report. This Report must describe the due diligence process undertaken to trace the source and chain of custody of the company's conflict minerals throughout the supply chain. Although the proposed rule does not prescribe specific standards for this inquiry, the SEC references guidelines from the Organisation for Economic Cooperation and Development's *Draft Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* report as a "good starting point." The issuer must have this Report certified by an independent private sector auditor. The Report must identify which of the issuer's products may have used conflict minerals and it must describe the specific facilities used to process those conflict minerals. Issuers are required to include this Report as an exhibit in their annual report and to make the Report available on the company website. Under the proposed rule, the Report will not be "filed" for purposes of Exchange Act liability but instead will only be "furnished" to the Commission; however, the provision's co-sponsors have noted that they are "deeply troubled" by this approach since they had intended that issuers be subject to the broader liabilities of the Exchange Act.

B. Analysis

1. Impact on Companies

In its commentary on the proposed rule, the SEC estimates that Section 1502 will lead to an annual compliance cost of more than $70 million dollars and that nearly 1,200 issuers will ultimately have to furnish a Conflict Minerals Report. Many companies have noted in their Comment Letters that these figures vastly understate the true costs of the provision. For example, the National Association of Manufacturers ("NAM") suggests that public companies and their suppliers will face costs between $9 and $16 billion because issuers will have to undertake onerous actions such as developing new IT systems, revising legal obligations, and developing due diligence programs for lengthy supply chains. NAM compared the conflict minerals disclosure to an analogous 2006 EU regulation that required companies to trace the use of certain hazardous materials in their production processes; this provision cost more than $32 billion for initial compliance and $3 billion annually thereafter. Moreover, the costs of this provision will extend beyond issuers subject to Section 1502, since companies throughout the supply chain will be forced to perform their own diligence and then report back to those issuers.

2. Timeline for Adoption and Implementation

Dodd-Frank required the SEC to issue final rules implementing the Conflict Minerals provision by April 15, 2011. This deadline has been delayed by the SEC and the Commission now intends to issue a final rule by the end of 2011. The SEC's timeline will likely be affected by a recent court decision striking down an unrelated SEC rule. In *Business Roundtable* v. S.E.C., 2011 WL 2936808 (D.C. Cir. 2011), the D.C. Circuit found that the SEC had acted "arbitrarily and capriciously" in implementing a Dodd-Frank rule regarding proxy access and emphasized that the SEC had failed to realistically assess the rule's effect upon efficiency, competition and capital formation. The enormous potential costs imposed by Section 1502 and the uncertain benefits of the rule—as suggested by several recent articles—may make it difficult for the SEC to satisfy the analysis required by the D.C. Circuit. Although *Business Roundtable* may not prove fatal to the conflict minerals provision, it will likely delay final implementation of Section 1502 while the SEC makes sure that its proposed rule can withstand judicial scrutiny.

Despite the impact of *Business Roundtable*, it is unlikely that the SEC will extend its deadline for the final rule beyond 2011. The initial Conflict Minerals Report must be filed as part of the issuer's annual report for the first full fiscal year following promulgation of the SEC's final rules. Any delay past the end of this year would therefore imply that issuers with a December 31 fiscal year-end would not be required to furnish their initial report until the filing of their 2013 annual report.

C. Action Steps

As an initial matter, companies that report to the SEC should determine whether their manufacturing process employs the use of any conflict minerals and whether such minerals originated in the DRC region. Companies that utilize conflict minerals from the DRC region should begin developing a due diligence approach for their supply chain, including discussions with an independent auditor to certify the process and interviews with suppliers to identify particular risks. Issuers should also consider discussing Section 1502 with industry representatives in order to develop an industry-wide approach for tracing these minerals.

Actions already undertaken by several prominent companies can also provide guidance for firms. For example, Motorola has revised its contracts to require suppliers to trace and certify the origin of minerals used in its manufacturing. Other companies such as Apple and Intel have agreed to the "Conflict-Free Smelter program" which requires mineral processors to certify that their purchases do not contribute to conflict in the eastern Congo.

D. Conclusion

As the numerous Comment Letters on the proposed SEC rule make clear, the implementation of Section 1502 will involve many complex issues for a diverse mix of companies and industries. Even though the SEC has not finalized its conflict minerals rule and a number of key provisions in the Proposed Rule remain undefined, issuers would be prudent to examine the impact of this rule on their business and to prepare for its implementation.

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Note to readers: This Article is intended to provide a high-level overview of Section 1502. As such, several important details of the rule are beyond the scope of this paper. As one example of a significant issue that is not discussed, the proposed rule allows for different treatment of conflict minerals from recycled and scrap sources than from mined sources. Companies are encouraged to review the SEC commentary on the proposed rule for a more in-depth analysis of the regulation.