Westlaw Journal
WHITE-COLLAR CRIME
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 26, ISSUE 9 / JUNE 2012

Expert Analysis

Dodd-Frank 'Conflict Minerals' Rules: Simple Steps to Stay Ahead

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If anticipation could kill, the ranks of Securities and Exchange Commission and compliance counsel would be thinning by the day. But relief — for better or worse — may be on the horizon. Rumors continue to fly from Capitol Hill and beyond that the SEC soon(ish) will promulgate its long-awaited "conflict minerals" rules, as required by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

THE GOALS

To understand the rules' purpose, we first have to consider the historical context giving rise to their birth.

At their core, the rules represent an effort to cut off financial support for the militias and rogue military units active in the mineral-rich Democratic Republic of Congo and its neighboring countries, including Rwanda, Uganda and South Sudan. There is little dispute that these armed factions are responsible for well-documented atrocities committed during the ongoing Congolese civil war. Indeed, since 1998, some 5 million people have died as a result of the conflict.

The ruthless armed groups responsible for these atrocities historically funded themselves, at least in part, by operating and illicitly taxing mines and mineral transportation routes. In light of estimates that the Congo produces some 6 percent to 8 percent of the world's tin and between 15 percent and 20 percent of the global tantalum supply, it is easy to see why the armed groups would seek control over these considerable sources of wealth.

The stated intent of the conflict-minerals provisions, then, is to legislate increased transparency of company sourcing practices and, thereby, encourage a *de facto* embargo against the armed factions' sources of wealth. The hoped-for net result of this governmental intervention is reduced funding for those intent on perpetuating the ongoing cycles of violence and bloodshed.

CHARACTERIZED BY CONTROVERSY

The SEC initially proposed the rules back in December 2010. Since their unveiling, the proposed rules have met with a good deal of controversy. The finalization of the rules has been delayed and delayed again while the SEC solicited and waded through mountains of public comments from industry groups, interest groups and individuals. In addition to reviewing these comments, the SEC has held a series of meetings and roundtable

What To Do Now: SEC Proposed* Dodd-Frank Conflict Mineral Rules

Company publicly traded or otherwise required to file reports with the SEC?
- NO → The Rules will not apply
- YES ↓

Does Company "manufacture" a product?
- Includes retailers having "any influence" over manufacturing, as well as sellers of "branded" products

- NO → The Rules will not apply
- YES ↓

Conflict Minerals (generally tin, gold, tantalum, or tungsten or any other minerals or their derivatives determined by the Secretary of State to be financing conflict in Democratic Republic of Congo) "necessary" to product's "functionality"?
- Includes process of production and end product
- No *de minimus* exception
- Includes recycled materials

- NO → The Rules will not apply
- YES ↓

Company must conduct "reasonable country of origin" inquiry to determine if Conflict Minerals originated in (1) the Democratic Republic of the Congo or (2) an adjoining country

→ Conflict free?
- YES → Disclose efforts on internet and in Form 10-K and maintain corresponding documentation
- NO OR UNABLE TO DETERMINE ↓

Prepare annual "Conflict Minerals Report"
- Describe diligence practices
- Disclose products containing Conflict Minerals
- Include in Form 10-K and post on internet

WHAT TO DO NOW?

Create conflict minerals risk profile
- Monitor SEC rule-making
- Develop preliminary list of products potentially containing Conflict Minerals
- Review key supplier documents and agreements
- Conduct targeted interviews of personnel with supply chain oversight
- Identify and prioritize the potential problem areas and ways to address them

Design and implement a practical supply chain compliance program
- Consider Conflict Minerals Code of Conduct setting forth expectations for employees and transaction partners (including suppliers)
- Consider a Conflict Minerals Code of Conduct and questionnaires for suppliers
- Create supplier compliance database
- Develop a risk management plan

Train In-House Attorneys and employees
- Begin preparing best-practices Conflict Minerals Rules training programs for employees with supply chain management and oversight
- Begin preparing customized training for key suppliers with greatest risk exposure

*To be updated upon SEC approval of Final Rules

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May 2012

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discussions at which stakeholders of all stripes sought to ensure that their priorities are reflected in the final rules.

Part of the delay can no doubt be traced to the significant practical and financial ramifications for companies within the rules' ambit. Consider, for example, that during a May 10 hearing before the House Financial Services Committee, representatives from the National Association of Manufacturers and the Association Connecting Electronic Industries testified the total compliance costs to businesses are likely to be between $9 billion and $16 billion. Particularly during these trying economic times, compliance sticker shock is clearly setting in.

That said, earlier this spring a letter from U.S. Sen. Patrick Leahy, D-Vt., suggested that promulgation of the final rules was imminent. This, in turn, prompted the SEC to respond that it expects to publish the final rules this June.

SO WHAT IS A COMPANY TO DO?

In addition to watchfully waiting for the SEC's issuance of the implementing rules, proactive companies and their counsel in the interim should closely examine the language of the Dodd-Frank Act itself and generally assess what impact, if any, the anticipated rules are likely to have on their operations and compliance functions.

Although the final rules may differ significantly from the proposed rules deconstructed in the accompanying flow chart, especially as a result of the public comments received, it is clear that the provisions will apply only to companies that are publicly traded or otherwise required to file reports with the SEC.

As illustrated in the accompanying flow chart, if a company is covered it must first determine whether it "manufactures" a product within the meaning of the Dodd-Frank Act. The SEC's comment period has brought significant feedback regarding exactly what it means to "manufacture" a product, but the agency's comments make plain that it will construe the term broadly. The SEC's December 2010 proposed rule release, in fact, notes that Congress intended the rules to apply "to issuers that directly manufacture products and to issuers that contract the manufacturing of their products for which conflict minerals are necessary."

The rules represent an effort to cut off financial support for the militias and rogue military units active in the mineral-rich Democratic Republic of Congo and its neighboring countries.

Providing some additional specificity, the SEC stated that it intends the rules to cover retailers that have "any influence regarding the manufacturing of" the products they sell and retailers that sell "under their own brand name or a separate brand name that they have established, regardless of whether those issuers have any influence over the manufacturing specifications of those products."

It therefore appears that companies not meeting one of these requirements, or that "sell only the products of third parties if those retailers have no contract or other involvement regarding the manufacturing of those products," fall outside the rules' ambit.

On the other hand, those companies covered by the rules, as touched on above, will have to determine whether the enumerated "conflict minerals" (generally tin, tantalum, tungsten, gold and their derivatives) are "necessary to the functionality or production" of their products. Here again, the comment process has highlighted a significant schism between business groups and activists.

The activists want to drive as many companies as possible into the rules' embrace in order to satisfy their asserted humanitarian objectives. Companies, in contrast, feel the rules threaten to unfairly place a significant vetting burden on them simply because of some peripheral product or process within their supply chains. While many prominent industry groups have urged the SEC to adopt measures such as a *de minimis* exception to the rules, and to apply a standard of commercial reasonability, neither Dodd-Frank itself

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nor the proposed release contains such an exception or adopts such a standard. Activist groups, indeed, have vocally opposed such limitations on the act's sweep.

If conflict minerals are necessary to the production or functionality of a company's products, the company must then undertake a "reasonable inquiry" into the origin of the conflict minerals to determine if they originated in the Democratic Republic of the Congo or an adjacent country. Both industry groups and activists agree that guidance from the SEC is especially needed in this critical area, though each side has its own views on what that guidance should be.

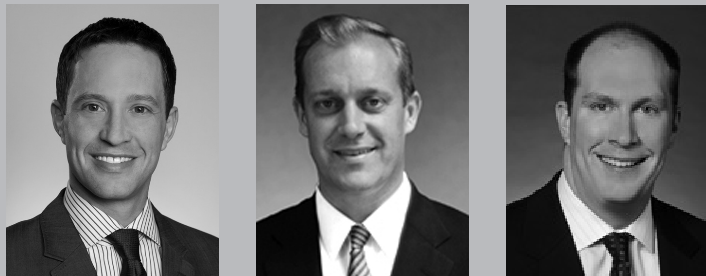
Congress intended the rules to apply "to issuers that directly manufacture products and to issuers that contract the manufacturing of their products for which conflict minerals are necessary."

What is more clear, though, is that the results of the "reasonable inquiry" will dictate whether the company must either simply disclose to the SEC and the public the scope of its inquiry efforts or prepare and publish an annual "conflict minerals report." If the reasonable inquiry reveals that the company's conflict minerals are "conflict-free," the company need only disclose that fact and disclose the scope of its vetting efforts. But, if the company is unable to determine the origin of its conflict minerals, or is able to confirm that its conflict minerals are from the DRC area, it must then prepare the conflict minerals report.

And while it is certain that the precise contours of corporate responsibility will come into tighter focus after the rules are finally adopted, companies should consider doing several things now to be prepared. For example, by applying familiar principles of compliance and risk mitigation, companies can develop a conflict-mineral risk profile that includes listing potentially affected products, reviewing key supplier contracts and speaking with company officials having supply chain oversight responsibilities.

Also, given that the rules' broad objectives are, in fact, already known, companies can and should make substantial progress on designing and implementing supply chain compliance programs that include supplier diligence processes, questionnaires and certifications, as well as possible alternative sources for the listed materials. Such programs should, of course, also encompass conflict-minerals policies and codes of conduct for suppliers, and a mechanism to track compliance with them.

Finally, training. Now is the time for companies to begin training not only key individuals with supply chain responsibility, but also key partners and suppliers, on best practices to recognize and address conflict-mineral risks. Although the rules may not yet be final, smart companies with known risk exposure are well-advised to avoid unpleasant surprises by engaging in compliance offense.



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