

Reproduced with permission from Daily Environment Report, 14 DEN 26, 02/07/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

CORPORATE RESPONSIBILITY

CONFLICT MINERALS

After the Securities and Exchange Commission's adoption of the conflict minerals rule in 2012, business trade groups filed a lawsuit challenging the degree to which the agency could require supply chain transparency and reporting. Observers expect a ruling by the U.S. Court of Appeals for the District of Columbia Circuit by the end of May. Whether the outcome fully or partially modifies requirements for companies, pressure from activist groups can be expected to continue. Before the SEC's rule came to fruition, consumer activism had brought much attention to how some armed groups in the Democratic Republic of Congo and adjoining countries benefit from the trade of certain minerals in consumer electronics while violating human rights. Companies awaiting the legal outcome should file their reports, considering the activists' long-term plans for review and analysis of conflict minerals disclosure, the author says.

Conflict Minerals—You Have More to Worry About Than Just the SEC

BY DYNDA THOMAS, PARTNER, SQUIRE SANDERS

For years, activist groups have been calling attention to certain minerals that are contained in many consumer electronics, raising awareness that certain armed groups in the Democratic Republic of Congo and adjoining countries benefit financially from the mining and trade of some of these minerals. Worse yet, those groups engage in horrific human rights violations as a tactic in their armed struggle.

The awareness of the connection between consumer electronics and human rights violations led Congress to include a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act that required the Securities and Exchange Commission to issue a rule mandating investigation and disclosure of the use of conflict minerals.

Once the conflict minerals provision was included in the Dodd-Frank Act in 2010, companies in all industries

became focused on the supply chain transparency and reporting requirements that were being considered by the SEC. After a protracted rulemaking process, the SEC adopted the final conflict minerals rule in August 2012.

Because the final rule requires transparency throughout a company's entire supply chain, reporting companies and non-reporting companies alike are affected by the rule's inquiry and analysis requirements.

Legal Challenges. Shortly after the conflict minerals rule was adopted, the National Association of Manufacturers, the Chamber of Commerce, and the Business Roundtable filed a legal challenge to the rule, arguing that the SEC had exceeded its rulemaking authority when it enacted some of the specifics of the rule and that the required disclosure violates reporting companies' First Amendment rights. The legal challenge was rejected by the U.S. District Court for the District of Columbia in July 2013 (*Nat'l Ass'n of Mfrs. v. SEC*, D.D.C., No. 13-cv-635, 7/23/13; 143 DEN A-23, 7/25/13).

The U.S. Court of Appeals for the District of Columbia Circuit is now considering the appeal of the district court's ruling.

Although the timing of the Court of Appeals decision is unknown, observers expect the decision to be handed down before May 31, 2014—the date by which SEC-reporting companies must file their first conflict minerals disclosure. In the meantime, however, companies are well advised to continue in earnest their supply chain review, any required due diligence and the drafting of their filings so they are prepared regardless of the result of the appeal.

If the legal challenge is unsuccessful, the rule will continue as written, and companies whose products contain conflict minerals will be required to file a report on Form SD and a Conflict Minerals Report, if applicable, describing their reasonable country of origin inquiry and their due diligence on the source and chain of custody of the conflict minerals in products they manufacture or products that are manufactured for them. If the legal challenge is partially successful, there could be changes to certain requirements in the rule, but the required analysis and supplier engagement is likely to be similar to what is currently required. If the legal challenge is successful and the rule is vacated in its entirety, companies would be relieved of the obligation to file conflict minerals disclosure with the SEC. However, that would not be the end of the matter.

Even if the legal challenge is utterly successful and the rule no longer applies, reporting and non-reporting companies will nevertheless have to consider what their customers will require even if there is no SEC reporting requirement. Companies will have to determine whether some conflict minerals supply chain transparency or responsible sourcing efforts may be needed to address their customers' requirements.

Involvement by Activist Groups. There is an additional set of stakeholders whose expectations about conflict minerals sourcing and reporting must be carefully considered: activist groups. Significantly, activist groups include nongovernmental organizations and activist consumers.

As described above, even before the conflict minerals rule was adopted by the SEC, nongovernmental organizations and individual consumers were becoming increasingly sensitive to the presence of conflict minerals

in consumer electronics. This sensitivity led to petitions and protests against the use of such minerals in consumer products if sellers were not able to confirm that the minerals contained in them were from legitimate mining sources. Social media have played a significant role in informing and directing opinion such that some end-users insist on responsible manufacturing processes and materials sourcing as a basis for their purchasing decisions.

Separate and apart from the SEC's disclosure rule, this wave of consumer activism combined with pressure from nongovernmental organizations to force electronics companies to evaluate and change conflict minerals policies to avoid damage (or repair damage) to their brand reputation and to protect sales.

The Enough Project, RAISE Hope for Congo, and the Responsible Sourcing Network are among the most prominent nongovernmental organizations that drive public awareness and promote responsible sourcing of conflict minerals. The Enough Project and the Responsible Sourcing Network authored a September 2013 report, *Expectations for Companies' Conflict Minerals Reporting*, which details what nongovernmental organizations expect companies to investigate and disclose about the conflict minerals in their products.

It is important to note that the expectations stated in the Enough Project report go beyond what the SEC rule requires. The report calls for certain conflict minerals policies and programs, describes steps the groups expect companies to take to determine the actual source of their conflict minerals, outlines the due diligence process that should be undertaken to determine the sources of conflict minerals and advocates the steps that should be taken to ensure a conflict-free Congo.

Significantly, the report notes that nongovernmental organizations frown on policies that impose a de facto embargo on minerals from the Congo to attain "conflict-free" status. The Enough Project report indicates that activist groups will "publicly acknowledge" companies that actively demonstrate efforts to address conflict minerals sourcing and to make progress with such efforts over time. It is unclear how such a public acknowledgment would be made or how it would be expressed.

De Facto Embargo. The Enough Project report's position on de facto embargoes is especially concerning because some companies have concluded that the only way to assure conflict-free status is to avoid sourcing from the region entirely. Everyone agrees that a "Congo-free" approach defeats the purpose of the rule. However, more companies are adopting conflict-free policies and are requiring their suppliers be conflict-free. Many suppliers, especially those outside of the electronics sector, have just commenced the long and complex process of supplier engagement. There is no doubt that for complex products with multi-leveled supply chains, gaining full visibility into materials sourcing will take years to accomplish and may not be possible even after dedicating significant time and resources.

Furthermore, tools that could assure legitimate sourcing are not fully developed and are not yet available for all minerals. Armed groups, whose continued financing depends on the trade in these minerals, are constantly developing new ways to obstruct the tracing of minerals. As a result, many companies feel com-

pelled to source only from outside the covered countries to assure that their minerals are indeed conflict-free.

In addition, because of the two levels of disclosure required by the SEC rule, the cost and burden of additional due diligence, supplier engagement, reporting, and auditing apply to conflict minerals that come from or may come from a covered country. In contrast, if a company has determined that its conflict minerals do not come from a covered country (or that they have no reason to believe that they may have come from a covered country), much more limited inquiry and reporting obligations apply, and no audit is required. As a result, companies feel an obligation to their shareholders to adopt a policy that responds to the requirements of their customers without incurring excessive costs, and they impose a de facto embargo on sourcing of conflict minerals from covered countries. In fact, de facto embargoes may start to extend to other minerals and other regions in anticipation of new responsible-sourcing requirements that are being considered by other regulators and governments. If more companies do feel compelled to limit their sourcing in this way, those limitations will harm the legitimate mining that the responsible sourcing rules and policies are intended to protect.

Intel and Nintendo—A Cautionary Tale. Those questioning whether concern about nongovernmental organizations and activist consumers is justified need look no further than Intel and Nintendo for examples of the potential impact of activists groups on brand value and business results.

In a 2010 report issued by the Enough Project, Intel ranked second among a list of large electronics companies on the basis of progress to positively invest in eastern Congo and remove conflict minerals from its supply chain. However, despite performing well compared to other electronics companies, the first Enough Project report stated that Intel was only 25 percent of the way “toward responsible sourcing on conflict minerals.” The intent of the rankings was to provide consumers with information they could use to make purchasing decisions. The information was also used by consumer activists, and Intel faced significant consumer protests about its conflict minerals policies and actions.

Following those protests, Intel, an SEC reporting company, took aggressive action and has since become a recognized market leader among electronics companies in conflict minerals responsible sourcing efforts. It piloted efforts to increase supply chain transparency, it required supplier participation in its efforts, and it aggressively mapped its microprocessor supply chain.

At a consumer electronics show in early January 2014, Intel announced that it was manufacturing the world’s first conflict-free microprocessor. Intel has been very public about its efforts to achieve a conflict-free supply chain by imposing supplier accountability and encouraging in-region sourcing. It acknowledged that its conflict-free announcement was the result of years of effort to track down, identify and finally audit more than 60 smelters of conflict minerals.

On the other side of the coin is Nintendo. Nintendo is a Japanese electronics company, probably best known for Mario Brothers video games and its Wii game system. It is not an SEC reporting company, and it is not itself subject to the SEC conflict minerals reporting requirements. In the 2010 report issued by the Enough

Project, Nintendo was ranked last on the list of large electronics companies on the basis of its progress toward removing conflict minerals from its supply chain. In 2011, Nintendo amended its Corporate Social Responsibility Procurement Guidelines to address sourcing of conflict minerals to include this strong statement: “We ban the use of conflict minerals and also prohibit our production partners from using any conflict minerals from the Democratic Republic of Congo and adjoining countries.” But a second Enough Project report, published in August 2012, continued to rank Nintendo last among electronics companies, stating that it had not made any known efforts to go beyond mere policy statements to actually trace the sourcing of conflict minerals in its supply chain.

Shortly after that second Enough Project report was issued, Walk Free, an antislavery activist group, threatened to protest a major New York City media event where Nintendo’s Wii U game console was to be previewed. Online petition campaigns and an active public awareness campaign against Nintendo continue to this day. While there is no way to know the real impact of these protests on sales, it is worth noting that in January of 2013, Nintendo significantly reduced its sales outlook. And no one would claim that public awareness of the accusations against Nintendo enhanced sales of Nintendo’s products.

The Enough Project indicates that all of the other large electronics companies included in its report have demonstrated some progress in their efforts toward responsible sourcing of conflict minerals. Presumably, it is this type of progress that activist groups are seeking. Although to date, activist groups’ attention has been focused on the electronics industry, the second Enough Project report affirms the need for additional efforts on responsible minerals sourcing in other industries, including automotive, aerospace, jewelry and industrial machinery. So, companies in all industries need to be aware that activist groups may be expanding their focus beyond electronics.

The long-term impact of public attention and the awareness campaigns by nongovernmental organizations and activist consumers is not yet clear. But, as companies prepare their conflict minerals reporting, they must consider the activists’ expectations and their plans to analyze and score conflict minerals disclosure.

The potential reaction of activist groups to companies’ policies and disclosures is a substantial concern. Nongovernmental organizations and activist consumers have already demonstrated their ability to bring attention to the conflict minerals issue and to mobilize large numbers of consumers who state that their purchasing decisions are influenced by success or progress with responsible sourcing of conflict minerals.

About the Author: Dynda Thomas is a partner at the international law firm Squire Sanders. She has extensive experience in the areas of project finance and mergers and acquisitions. She also leads the firm’s conflicts minerals team, which works with clients’ legal, procurement and compliance departments on developing policies, training executives and relevant client teams, planning communications with customers and suppliers, and proposing data gathering and retention policies related to conflicts minerals. The firm’s Conflict Minerals Law blog can be viewed at <http://www.conflictmineralslaw.com/>.