SQUIRE PATTON BOGGS

WAKEUP CALL TO SUPPLY CHAIN MANAGERS AND COMPLIANCE OFFICERS OF COMPANIES DOING BUSINESS IN THE US

The week of August 17, 2015 has been a wakeup call to supply chain managers and compliance officers of companies doing business in the United States. On August 19, 2015, a consumer filed a putative class action against Costco Wholesale Corporation and several of its suppliers in *Monica Sud v Costco Wholesale Corporation, et al.*, Case No. 3:15-cv-03783, US District Court for the Northern District of California, citing violations of the company's disclosure under the California Transparency in Supply Chains Act, and on August 18, 2015, the US Court of Appeals for the District of Columbia Circuit issued a highly anticipated decision in *National Association of Manufacturers, et al. v. SEC, et al.*, No. 13-5252 related to the Securities and Exchange Commissions' Conflict Minerals Rule.

We discuss these cases and suggest steps supply chain managers and compliance officers, across all industries, may want to consider in strengthening global compliance efficiently and effectively.

Ruling on Conflict Minerals Rule

On August 18, 2015, the US Court of Appeals for the District of Columbia Circuit issued a highly-anticipated decision regarding the legal challenge to the Securities and Exchange Commissions' (SEC) Conflict Minerals Rule. The court confirmed its 2014 ruling in *National Association of Manufacturers, et al. v SEC, et al.*, No. 13-5252 (D.C. Cir. April 14, 2014), that the Conflict Minerals Rule violates the First Amendment to the extent it requires entities to state that their products have "not been found to be 'DRC conflict free.'"

That ruling was followed by musings on what the SEC's next step will be, whether companies should continue with their conflict minerals compliance programs, and whether companies will have to provide independent private sector audits (IPSA) for reporting year 2015. As of today, we strongly advise companies to continue with their conflict minerals compliance programs, implement the improvements they planned for 2015, review their existing processes carefully, and consider undertaking "readiness assessments" of their procedures and disclosures. In addition, it would be prudent to budget the cost of an IPSA in case one is required for calendar year 2015.

But, while those questions are important and the answers will impact companies' conflict minerals activities immediately, there is a more ominous shadow being cast by supply chain transparency/ethical sourcing laws (like the Conflict Minerals Rule and the California Transparency in Supply Chains Act): the shadow of potential litigation.

Recent Class Action Citing California Transparency in Supply Chains Act Violation

On August 19, 2015, a consumer filed a putative class action against Costco Wholesale Corporation and several of its suppliers in the US District Court for the Northern District of California (styled *Monica Sud v Costco Wholesale Corporation, et al.*,Case No. 3:15-cv-03783), asserting that prawns from Southeast Asia that Costco sold to consumers were farmed using forced labor.

The plaintiff further alleges that Costco's use of forced labor is inconsistent with its California Transparency in Supply Chains Act disclosure. Costco's Supply Chain Disclosure stated among other things that Costco "has a supplier Code of Conduct which prohibits human rights abuses in our supply chain." The Disclosure also stated that Costco conducts supply chain audits and imposes consequences to prevent and correct violations. The plaintiff's complaint alleges consumer fraud and other violations, claiming damages "in excess of US$5 million."

Ethical Sourcing Activism

Although it is not the only example, a striking case of negative consumer activism around conflict minerals sourcing relates to Nintendo. Nintendo, a Japanese electronics company, is not an SEC reporting company, and it is therefore not subject to the SEC conflict minerals reporting requirements. In a 2010 report issued by the Enough Project, Nintendo was ranked last on the list of large electronics companies with respect to its progress toward removing illegitimately sourced 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 its policy statement to actually trace the sourcing of conflict minerals in its supply chain.

Shortly after the 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 campaigns and an active public awareness campaign against Nintendo continued through 2012. In January of 2013, Nintendo significantly reduced its sales outlook on its Wii U game console – perhaps reflecting reputational damage from the activists' efforts. In its 2012 report, the Enough Project indicated that, in contrast to Nintendo, all of the other large electronics companies included in its report had demonstrated some progress in their efforts toward responsible sourcing of conflict minerals.

Activists have been expanding their focus to other industries. Non-governmental organizations and activist consumers have already demonstrated their ability to bring attention to ethical sourcing issues and to mobilize large numbers of consumers who state that their purchasing decisions are influenced by success or progress toward ethical sourcing.

Supply Chain Transparency/Ethical Sourcing Regulations

The SEC's Conflict Minerals Rule, the California Transparency in Supply Chains Act of 2010, and the UK Modern Slavery Act 2015 are not the only supply chain transparency and ethical sourcing regulations or industry guidelines. But these regulations and other guidelines, including the textile industry "Cotton Pledge," and the UN Guiding Principles on Business and Human Rights require or encourage disclosure by companies about their responsible sourcing practices. All of these are fundamentally "name and shame" regimes, and most do not include significant enforcement penalties. But the resulting disclosures provide consumers, non-governmental organizations (NGOs) and "socially responsible investors" with information that can serve as the basis for litigation, demonstrations or social media campaigns.

This additional impact is exactly what the NGO and activist groups that promote these types of legislation and policy guidance intended. For example, a Zimbabwean activist group promoting the adoption of the UN Guiding Principles to address poor labor practices in mining in Africa makes clear that the end-goal of the Guiding Principles is not just disclosure, but changed corporate practices.

Indeed, since the first conflict minerals reports were filed in May 2014, NGOs, consumers and socially responsible investors have been critical of industry's overall compliance efforts, as well as the contents of conflict minerals filings. NGOs have also issued statements describing what they expect conflict minerals disclosures to include, which exceed the requirements of the Conflict Minerals Rule.

In assessing supply chain risks, business entities must consider not only traditional third-party vendor risk and their own efforts toward ethical sourcing. Businesses must also consider whether their industry may be the subject of activist or litigation focus with respect to supply chain transparency and ethical sourcing issues. Finally, businesses must review their specific situations to determine if particular stakeholders are likely to raise ethical sourcing concerns and how they might do so.

If nothing else, the new Costco litigation highlights the value of a robust compliance program that develops policies, engages suppliers, monitors supply chain practices, and takes remedial action to respond to identified risks.

Steps to Consider

Although well-structured corporate supply chain compliance programs are becoming more common, many companies may still be unfamiliar with how best to develop them. But even if developing and implementing an integrated compliance program that addresses the growing number of sourcing and supply chain risks is challenging, doing so will help protect brand value, reduce the likelihood of high-profile and costly litigation, and allow companies to respond to criticisms about their efforts toward ethical sourcing.

The number of supply chain transparency regulations is growing and their focus is widening. Attention to ethical sourcing of conflict minerals started with Section 1502 of the Dodd-Frank Act which led to the SEC's adoption of the Conflict Minerals Rule. Now, the EU is in the process of issuing its own conflict minerals regulations that are expected to expand the geographic scope of diligence and review. The momentum around efforts to eradicate human trafficking and slavery in supply chains has also led to the enactment of the California Transparency in Supply Chains Act of 2010 and the UK Modern Slavery Act 2015 which is based on the California Act.

To address these additional regions and issues of concern, compliance programs should be adjusted.

What should supply chain managers and compliance officers do now? They should consider developing an integrated compliance program and start with the following steps:

1. **Take an inventory:**

- Assess supply chain transparency statements on websites, to customers, and to third parties for accuracy, consistency, and for commitments for future action.
- Identify operations and supply chain elements that may pose the highest risk for slavery/human trafficking elements.

2. **Get ready:**

- Create or enhance a human trafficking/slavery working group to prepare for disclosure requirements under the California Transparency in Supply Chains Act and UK Modern Slavery Act. This is the first step in a comprehensive human trafficking/slavery compliance effort.

3. **Be aware:**

- The first reports under the UK Modern Slavery Act are due October 2015. A mere £36 million annual turnover (roughly US$56 million) and doing any amount of business in the UK will subject a business enterprise to the requirements of the Act. The UK government is expected to issue guidance that may provide some allowances for transition time before full disclosure is required. But it is critical to assemble an internal team, develop a corporate policy, reach out to suppliers, and identify risks of slavery and human trafficking in a company's own operations and in supply chains. This is a big job that will have to be completed with very little ramp-up time.
- In April 2015, the California Department of Justice identified and notified enterprises that it expected to post the California Transparency in Supply Chains Act disclosure on their websites. Companies should be prepared to post statements or explain why they are not subject to the Act.
- The SEC conflict minerals disclosure for calendar year 2015 will be due in May 2016, but the exact requirements and expectations of the SEC are not yet clear because of the status of the legal challenge.

4. **Be careful:**

- All supply chain transparency and ethic sourcing disclosures to the public, to customers, and to suppliers will receive increased scrutiny by NGOs, consumers, activists, and plaintiffs' law firms going forward.

5. **Consider consumer and investor risk:**

- Identify consumer or customer risk based on an analysis of the marketplace and customer requests.
- Socially responsible investors have talked about focusing on ethical sourcing issues. Senior management should assess the likelihood of such actions for their company.

Conflict Minerals and Ethical Sourcing Counseling & Risk Management

Dynda A. Thomas
Partner, Cleveland
+1 216 479 8583
dynda.thomas@squirepb.com

Public Policy

Joseph L. Brand
Partner, Washington DC
+1 202 457 6035
joseph.brand@squirepb.com

Aubrey A. Rothrock
Partner, Washington DC
+1 202 457 5620
aubrey.rothrock@squirepb.com

Supply Chain Counseling and Litigation

Sarah K. Rathke
Partner, Cleveland
+1 216 479 8379
sarah.rathke@squirepb.com

California Litigation and Class Actions

Mark C. Dosker
Partner, San Francisco
+1 415 954 0210
mark.dosker@squirepb.com

Stacie D. Yee
Partner, Los Angeles
+1 213 689 5135
stacie.yee@squirepb.com

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