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Dodd-Frank Conflict Minerals Provision: Legal, reputational and practical implications

By

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The Dodd–Frank Wall Street Reform and Consumer Protection Act[1] was signed into law on 21 July 2010. Section 1502 of the Act (Dodd-Frank section 1502) mandates the Securities and Exchange Commission (SEC) to promulgate disclosure and reporting regulations regarding the use by publicly-traded companies of conflict minerals from the Democratic Republic of Congo and adjoining countries (together the "DRC countries").

Initially the SEC had until 15 April 2011 to issue final rules. However it was announced on 12 April 2011, without giving any reason, that these rules would only be released between August and December 2011. The SEC has however published valuable comments[2] on Dodd-Frank 1502. These comments are useful to get a better understanding of what will be expected from issuers once the final rules come into effect.

1. What are conflict minerals?

Conflict minerals are several minerals enumerated by Dodd-Frank section 1502: **columbite-tantalite** (coltan), **cassiterite**, **gold**, **wolframite** or their derivatives. The Secretary of State can determine any other mineral, or its derivatives, to be conflict minerals if they are financing conflict in the DRC countries.

The DRC countries include the Democratic Republic of Congo and adjoining countries that share an internationally recognised border with the Democratic Republic of Congo. The countries are: Angola, Burundi, the Central African Republic, the Republic of Congo, Uganda, Rwanda, Sudan[3], Tanzania and Zambia. Hence 10 countries in Africa are directly concerned by the implementation of section 1502 of the Dodd-Frank.

Products that do not contain minerals that directly or indirectly finance or benefit armed groups in the DRC countries may be labelled "DRC conflict free". If the issuer's product contain conflict minerals that do not directly or indirectly finance or benefit armed groups, the issuer may describe this product as "DRC conflict free", whether or not the minerals originated from the DRC countries[4]. However, according to the proposed rules, conflict minerals that an issuer is unable to determine did not originate in the DRC countries are not "DRC conflict free"[5] .

[1] Pub.L. 111-203, H.R. 4173.
[2] Federal Register, Securities and Exchange Commission, Vol. 75, No 246, 23 Dec. 2010, Conflict Minerals, Proposed Rules.
[3] It will be "South Sudan" once this new country has been internationally recognized.
[4] Federal register, op. cit., p. 80950.
[5] Federal register, op. cit., p. 80972.

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2. What are the companies concerned?

Dodd-Frank section 1502 applies to publicly-traded companies[6] for whom conflict minerals are "necessary for the functionality or production of a product" which is directly manufactured by the issuer or which has been contracted to be manufactured for the issuer[7]. This definition includes retail issuers which contract for the manufacturing of products and over which they have influence about the manufacturing of the product. The rules will also apply to issuers selling generic products under their own brand name or a separate brand name when the issuers have contracted with another party to manufacture the products specifically for them.

Retail issuers will however be exempted if they only sell the products of third parties, provided those retailers have no contract or other involvement regarding the manufacturing of those products or if those retailers do not sell those products under their brand name or a separate brand established by them and do not have those products manufactured specifically for them.

Finally, the SEC is of the view that the rules should be applicable to issuers that mine conflict minerals when they extract those minerals[8].

3. What are the duties of these companies under Dodd-Frank section 1502?

3.1 Technical audit of the products content

The issuer must first determine, via a technical audit, if the product concerned contains conflict minerals which are necessary for its functionality or for its production. While the SEC does not propose to define what should be regarded as necessary for the functionality or the production of a product, it however provides that a product is covered by the rules "without regard to the amount of the mineral involved"[9]. In addition, the SEC expects to include in its rules final products which do not ultimately contain conflict minerals, but for which a conflict mineral was intentionally included in their production process and was necessary to that process. On the other hand, conflict minerals necessary to the functionality or the production of a physical tool or machine used to manufacture a product would not be considered necessary to the production of that product even if that tool or machine is necessary to producing the product.

If the technical audit conducted by the issuer concludes that no conflict minerals are necessary for the functionality or the production of a product manufactured by the issuer or contracted to be manufactured for the issuer, the latter will not be required to take any further action, make any disclosures or submit any reports[10].

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[6] The disclosure or reporting rules will apply to any issuer, domestic or foreign, which files reports with the SEC under the Securities Exchange Act of 1934 (15 U.S.C. 78m), with no exemption for smaller reporting companies (Federal register, op. cit., p. 80950). The SEC is not proposing to extend the rules beyond reporting companies (Federal register, op. cit., p. 80951).
[7] Federal register, op. cit., p. 80952.
[8] Federal register, op. cit., p. 80953.
[9] Ibidem.
[10] Federal register, op. cit., p. 80950.

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Should the technical audit conclude that conflict minerals are necessary for the functionality or the production of a product manufactured by the issuer or contracted to be manufactured for the issuer, the latter will have to determine whether these conflict minerals originated from the DRC countries.

3.2 Reasonable country of origin enquiry

Dodd-Frank section 1502 does not prescribe how issuers should determine if their necessary conflict minerals originated in the DRC countries. Therefore, the SEC is of the view that a reasonable country of origin enquiry is to be conducted into the minerals' origins[11].

If this enquiry concludes that the conflict minerals necessary to the functionality or production of a product manufactured or contracted to be manufactured by the issuer did not originate from the DRC countries, the issuer will have to disclose this negative determination in its annual report, and on its website, along with a description of the enquiry the issuer undertook to support such a determination. In addition, the issuer will have to maintain reviewable records of its findings.

The SEC has chosen not to provide guidance on what should be a reasonable country of origin inquiry[12], in order to allow issuers the flexibility to use inquiry standards that are best suited to their circumstances. However, "one way", says the SEC, for an issuer to satisfy these standards is to receive "reasonably reliable representations from the facility at which its conflict minerals were processed that those conflict minerals [...] did not originate in the DRC countries", provided the issuer may "reasonably believe these representations to be true based on the facts and circumstances"[13]. Similar representations may also be indirectly provided by the declaration of the issuer's suppliers, although what can be deemed reasonable now, adds the SEC, may well change over time as traceability techniques improve.

Depending on the facts and circumstances, we believe that a reasonable country of origin enquiry will have to be as scrupulous as possible. This is because (1) it has the potential to liberate the issuer from further disclosures or reports under Dodd-Frank section 1502 and (2) it does not have to be independently audited, therefore exposing the issuer to a greater reputational risk should the results of the enquiry be inaccurate or unreliable.

In this context, the inquiry in the country or countries, where the necessary conflict minerals originated from or transited through, will *ad minima* require an audit of the issuer's suppliers or of the facility (smelter) where the conflict minerals were processed[14] in order to asses the source and the chain of custody of those minerals. If this audit does not allow the issuer to conclude that its necessary conflicts minerals did not originate from the DRC countries, the issuer may have to conduct on-the-ground investigations from the mine up to the smelter. This includes the itineraries followed for the transportation of the conflict minerals.

[11] Federal Register, op. cit, p. 80969.
[12] Ibidem.
[13] Ibidem, p. 80957
[14] This will not required, says the SEC, if the smelter has been nationally or internationally certified as DRC conflict free.

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In summary, depending on the facts and circumstances, a reasonable country of origin enquiry may or will require the issuer to take the following actions:

i. Audit of the suppliers' declarations
ii. Audit of the smelter's representations
iii. On-the-ground investigations in the area(s) where the conflicts minerals originate from or transited through
iv. Reputational risk analysis to determine the reliability of these investigations
v. Disclosure of negative determination (if any) in the issuer's annual report and on its website
vi. Maintain reviewable records of the aforesaid negative determination

3.3 Conflict Minerals Report

If the issuer knows - after a reasonable enquiry or without a reasonable enquiry in the country of origin - that its necessary conflict minerals did originate from the DRC countries or is unable to conclude that they did not, the issuer will have to (1) disclose this conclusion in its annual report and on its website; (2) furnish an independently audited Conflict Minerals Report to the SEC; and (3) make that report and the audit thereof available of on its website, along with the Internet address on that website.

The Conflict Minerals Report must include:

i. a description of the measures taken by the issuer to exercise due diligence on the source and chain of custody of the conflict minerals
ii. a description of the product(s) manufactured or contracted to be manufactured for the issuer and which contain minerals that directly or indirectly finance or benefit armed groups in the DRC countries
iii. the facilities used to process the conflict minerals
iv. the country of origin of the conflict minerals
v. the efforts to determine the mine or location of origin with the greatest possible efficiency

The SEC underlines that due diligence involves performing the investigative measures that a reasonably prudent person would perform in the management of his or her own property[15]. It also notes that conducting a reasonable country of origin inquiry could be "less exhaustive than the due diligence"[16]. Beyond that, the SEC has opted "not to dictate the standard for, or otherwise provide guidance concerning, due diligence that issuers must use in making their supply chain determinations"[17]. In terms of conflict minerals, due diligence has not been defined by any legal instrument. However, various models have been developed by the OECD (Due Diligence Guidance for Responsible Supply Chains Of Minerals from Conflict-Affected and High-Risk Areas, 2010), the United Nations (Final Report of the Group of Experts on the Democratic Republic of the Congo, 2010) and by Global Witness (Do no Harm Report, Excluding conflict minerals from the supply chain, 2010).

[15] Ibidem, p. 80949.
[16] Ibidem, p. 80957.
[17] Ibidem, p. 80961.

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Due diligence is "an on-going, proactive and reactive process through which companies can ensure that they respect human rights and do not contribute to conflict"[18]. According to Global Witness, the purpose of due diligence is to make sure companies "know and show that [their] conditions of trading [are] legal and legitimate at all times"[19]; otherwise, they have to source their minerals elsewhere.

Referring to the OECD Guidance, the SEC thinks that issuers should *describe* the due diligence used in making their determinations. In particular, the SEC expects the issuers, whose conduct conformed to a nationally or internationally recognized set of standards of, or guidance for, due diligence regarding conflict minerals supply chains, to *provide evidence* that they used due diligence in making their supply chain determinations. If an issuer is not able to provide all the information required by the Conflict Minerals Report, such as its conflict minerals' country of origin, the SEC expects the issuer to provide *as much of the required information as possible*, for instance a description of the measures it took to exercise due diligence on the source and chain of custody of its conflict minerals.

The OECD due diligence model, which enjoys some sort of international consensus, is based on a five-step approach. Its purpose is to mitigate the risk of worsening the violence committed in Eastern DRC by *non-state* armed groups. The model requires:

i. a clear supply chain policy to be adopted and broadly communicated to the suppliers and the general public
ii. a series of measures to be designed to mitigate the risks of supporting armed groups and to measure improvement
iii. a risk strategy to be designed and implemented by companies by either (1) continuing trade along with risk mitigation efforts; (2) suspend trade whilst pursuing measurable risk mitigation or (3) disengaging with the supplier if risk mitigation failed or is unfeasible or unacceptable
iv. an independent third-party audit of the supply chain due diligence
v. a public disclosure of the companies due diligence policies and findings

Issuers subject to Dodd-Frank section 1502 typically belong to *downstream companies* (smelter to retailer). According to the OECD model, these companies should primarily "identify the risks in their supply chain by assessing the due diligence practices of their smelters/refiners"[20], whereas *upstream companies* (mine to smelter) are expected "to clarify the chain of custody and the circumstances of mineral extraction, trade, handling and export". However, Dodd-Frank section 1502 does not restrict the scope of due diligence to the mere audit of the smelters/refiners. Indeed, it goes far beyond that particular step within the chain of custody, as section 1502 explicitly requires the issuer to identify the "source" and the "chain of custody" of its necessary conflict minerals, including the location of the mine "with the greatest possible specificity".

[18] OECD, Due Diligence Guidance for Responsible Supply Chains Of Minerals from Conflict-Affected and High-Risk Areas, 2010, p. 7.
[19] Global Witness, Do no Harm Report, Excluding conflict minerals from the supply chain, 2010, p. 4.
[20] OECD, op. cit., p. 28.

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Dodd-Frank section 1502 therefore requires a much more comprehensive due diligence process than the one proposed by the OECD. It requires issuers to report on the source and the course of their necessary conflict minerals, from the~~ir~~ mine(s) of origin to their suppliers or ~~to~~ their contractors' suppliers.

As part of the due diligence, the Conflict Minerals Report must be independently audited by a private company in accordance with the standards established by the Comptroller General of the United States.

As a result, the issuer will or may have to take the following actions:

a. Taylor a supply chain policy according to issuer's business model
b. Asses risks in the issuer's supply chain
c. Define measures to mitigate the risks of supporting armed groups operating in the DRC countries
d. Define the indicators to measure improvement with regard to the risks identified in the issuer's supply chain
e. Design and implement a strategy to respond to these risks
f. Monitor, update and track performance of risk mitigation efforts
g. Describe the products which contain conflicts minerals
h. Audit of the smelter's representations
i. Audit of the suppliers' declarations
j. Implement changes in supply contracts
k. On-the-ground investigations about the source and the chain of custody of the minerals to indentify:

    - the country or countries of origin of the conflict minerals
    - the location of the mine with greatest possible specificity
    - the itinerary of the minerals from mine to issuer
    - the circumstances of extraction, trade, handling and export of the minerals
    - the linkage analysis between the necessary minerals and conflict

l. Compile the Conflict Minerals Report
m. Organize an independent audit of the Conflict Minerals Report
n. Furnish the report and the audit to the SEC
o. Disclose the Conflict Minerals Report on issuer's website, along with the Internet address on that website.
p. Review the previous findings for the next fiscal year

Conclusion

Dodd-Frank 1502 section creates specific risk factors due to the facts that (1) it is technically very difficult to determine the origin of conflict minerals and (2) the legal requirements so far remains unclear, particularly as far as the reasonable country of origin enquiry and the due diligence process are concerned.

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In addition, the way these requirements will be interpreted by the SEC must still be tested on the basis of real-life cases to get further clarity as to what kind of due diligence measures will be deemed "reliable" in the eyes of the authorities and also with respect to customers, media, NGOs and issuers' shareholders due to the complexity and the unpredictability of the tasks which will be imposed on the issuers once the final rules have been promulgated by the SEC, we believe that concerned companies should start as soon as possible with the process of identifying the source of their potential conflict minerals.

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