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The SEC's Final Rule on Conflict Minerals: Reporting Requirements for Companies

Darren Fenwick August 30, 2012

Executive Summary

On August 22, the U.S. Securities and Exchange Commission, or SEC, adopted regulations for Section 1502, the provision of the Dodd-Frank financial reform law that deals with conflict minerals from the Democratic Republic of Congo, or DRC. The trade in these minerals fuels a conflict that continues to cause suffering among the people of eastern Congo. These regulations, which will be implemented during a phase-in period by hundreds of companies over the next four years, have important implications for the advocacy community. Many companies will have to comply with the law, but how they comply will depend in part on (1) how narrowly or expansively companies and the SEC interpret the final rule and (2) how effective non-governmental organizations, faith-based groups, and other human rights advocates are at monitoring company compliance. This is the first of a series of briefs on the implementation of Section 1502, including the impact on the ground in Congo, and it describes the key aspects of the reporting requirements under the law.

Background

The violent conflict in eastern Congo is being facilitated by a trade in conflict minerals that is worth hundreds of millions of dollars per year. Armed groups mine and sell the minerals on the international market in order to purchase arms and maintain their control over the region. Tin, tungsten, tantalum and gold—the minerals specified in the SEC's rules—are critical to industrial and technological products worldwide, including mobile telephones, laptop computers, aircraft, industrial machinery, and digital video recorders.

The purpose of Section 1502 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, is to address "the exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo [which is] helping to finance conflict characterized by extreme levels of violence in the eastern Democratic Republic of the Congo."[2]

According to Margot Wallström, the former U.N. Special Representative on Sexual and Gender Based Violence:

"More than 200,000 rapes have been reported since war began in the Democratic Republic of the Congo more than a decade ago. The eastern part of the country has been labeled the rape capital of the world. Control of Congo's natural resources and minerals has always been contested, and these vast riches have fuelled the country's conflicts. They have helped enrich militant groups, who have employed sexual violence as a tactic of war. One such resource, coltan, is so widely used in mobile phones that it has been said that we are all carrying a piece of the Congo in our pockets. But conflict minerals cannot be allowed to continue fuelling conflict and the consequent sexual violence. Although it is complicated to track conflict minerals, this cannot become an excuse for not trying. After all, neither American nor European consumers want their MP3 players and mobile phones to be funding gang rape in Africa."

Section 1502 was designed to help reduce this source of funding by requiring companies that have access to American markets to disclose certain details about their supply chains. Specifically, the legislation requires those companies that file annual reports with the SEC to exercise due diligence on the source and chain of custody of the conflict minerals in its products.

Below is a brief summary and analysis of the final rule.

Reporting Requirements

The reporting requirement is comprised of several steps that include (1) determining whether a company is a manufacturer or contracts to manufacture, (2) determining whether the company has conflict minerals necessary to the production or functionality of its products, (3) determining the origin of the conflict minerals in its products and (4) conducting due diligence. As a preliminary matter, Section 1502 only applies to a company that (1) files an annual report with the SEC and (2) has conflict minerals in its products. Generally, companies that file annual reports with the SEC are publicly traded, that is, it offers its stocks/bonds and other securities to the general public through a stock exchange. If a company determines that it is an "issuer" ("files an annual report with the SEC") then it must determine whether it has conflict minerals in its products. If it does not have conflict minerals in its products then Section 1502's reporting requirements do not apply.

If a company is an issuer and has conflict minerals in its products, Section 1502 applies. Below is a summary of the inquiry an issuer must undertake, as detailed in the final rule, if the company determines that it is an issuer and that it has conflict minerals in its products.

1. Manufacture/Contract to Manufacture

After determining that a company is an issuer and that it has the specified minerals in its products, the issuer must (a) determine whether it is a manufacturer of its products that contain the specified minerals or (b) whether it contracted a third party to manufacture its products that contain the specified minerals.

The SEC did not define "manufacture." The SEC believes that definition is commonly understood.[3] If an issuer determines that it is not a manufacturer, i.e., it did not manufacture products that contain tin, tungsten, tantalum, or gold, Section 1502 may still apply if the issuer contracted a third party to manufacture its products that contain these minerals.

The SEC's proposed rule defined "contract to manufacture" to include an issuer that has "any influence" over the products it contracted to be manufactured for it.[4] The final rule narrows that definition. The final rule excludes from the definition of contract to manufacture an issuer that only affixes its logo, brand, or mark to a generic product manufactured by a third-party.[5] This point received a great deal of media attention immediately following the adoption of the final rule because of concern over whether the final rule excluded a large number of issuers. It should be noted, however, that the proposed rule went beyond congressional intent by requiring an issuer who has any influence over its product to be subsumed by the definition of "contract to manufacture."

A retailer that has no influence over its products was never meant to be implicated by the rule. Section 1502's reporting requirements were meant to apply to those retailers that have influence over, among other things, the design, quality, and life-expectancy of a product manufactured for it.[6] Companies will determine whether they have to report based on its facts and circumstances. Advocates will be watching closely those issuers that file Section 1502 specialized disclosures, as well as those that do not, in order to ensure that those companies the rule was intended to reach are in compliance.

2. Necessary to the functionality or production of a product

After an issuer determines that is a manufacturer or that it contracts to manufacture a product that contains the specified minerals it must then determine whether those minerals are necessary to the functionality or production of the product, whether the product is manufactured by the company itself, or contracted to be manufactured by a third party.

The SEC provides guidance but no definition for these terms. The final rule provides examples of when a mineral might be necessary to the functionality of a product or to the production of the product. It might be possible, for example, for an issuer that has manufactured or contracted to manufacture a phone that has a gold decorative

plate on the back to avoid reporting on that mineral if the gold is not "necessary to the functionality of the product." This is significant because issuers determine which of the products satisfy this definition based on guidance provided by the SEC. This means that some issuers who may have to report might define these terms in such a manner to avoid reporting on its products. Conversely, if the primary purpose of a product is decoration, and that product contains gold, then the rule states that the reporting requirements apply.

3. Reasonable Country of Origin Inquiry

After an issuer determines that it is a manufacturer or that it has contracted to manufacture a product and the specified minerals in its product are necessary to the functionality or production of the product then the issuer must undertake a "reasonable country of origin inquiry." The results of that inquiry must be disclosed. If, after conducting the reasonable country of origin inquiry, the company determines its minerals did not originate in the covered countries (the DRC and adjoining countries) or it reasonably believes the minerals may not have originated in the covered countries, or finds that the minerals originated from recycled or scrap sources, it has no further reporting requirements. The reasonable country of origin inquiry and the results of that inquiry and/or the method by which the company determined the minerals came from recycled or scrap sources must be described in its specialized disclosure. If the company determines that its minerals did originate in the covered countries or may have originated in the covered countries, then it proceeds to the next and final step, conducting due diligence.

The advocacy community will have to monitor the reasonable country of origin inquiry closely because it appears that an issuer could design a reasonable country of origin inquiry that does not result in a conclusion about where the specified minerals in its products originated. In this case, an issuer would not have to conduct due diligence because the due diligence step is triggered when an issuer knows or has reason to believe the specified minerals come from the covered countries. It would appear that the final rule would not require an issuer whose reasonable country of origin inquiry was "reasonably designed" and done in "good faith" but was inconclusive, i.e., the issuer was unable to determine country of origin or whether the minerals came from recycled or scrap sources, to conduct due diligence. The advocacy community will have to review an issuer's report closely to ensure the reasonable country of origin inquiry was designed to obtain country of origin information or information about whether the material came from recycled or scrap sources. The SEC also makes clear that a reasonable country of origin inquiry does not equal 100 percent certainty about all of the specified minerals in an issuer's products. For example, if an issuer uses gold and determines the origin of the majority of the gold in its products, but not all (there is a small amount still unknown), did not originate in the covered countries then an issuer can claim that all of the specified products that include gold, even the small unknown amount, are conflict free.[7]

4. Due Diligence

If an issuer determines that the minerals in its products originated in the covered countries or if it has reason to believe the minerals originated in the covered countries then it must conduct due diligence. The final rule does not prescribe the type of due diligence an issuer must undertake. However, an issuer's due diligence must conform to a nationally or internationally recognized due diligence framework, like the Organization for Cooperation and Economic Development's, or OECD, Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. If, after conducting due diligence, it determines that its minerals do not originate in the covered countries or it has reason to believe its minerals did not originate in the covered countries or are from recycled or scrap sources a conflict minerals report is not required. However, the company must disclose, in its specialized disclosure form, the reasonable country of origin and due diligence utilized in making its determination that its minerals did not originate in the covered countries or that the minerals were from recycled or scrap sources.

If an issuer's minerals did originate in the covered countries, it must complete a conflict minerals report. The report must include the due diligence undertaken by the company. This report must be audited and for the minerals in the specified products the issuer must disclose the processing facility, efforts to determine mine of origin with greatest specificity, and country of origin if (1) the minerals supported conflict directly or indirectly or (2) if the issuer does not know if the minerals originated in the covered countries after it conducts further due diligence or (3) if the issuer does not know whether the minerals supported conflict in the covered countries. Conversely, if an issuer determines that its minerals originated in the covered countries but did not support conflict directly or indirectly then it does not have to disclose efforts to determine mine of origin with greatest specificity, country of origin, or processing facility. In its conflict minerals report the issuer only has to disclose the due diligence it undertook in determining that its minerals came from sources that did not directly or indirectly support or finance conflict. The final rule creates this distinction to prevent stigmatizing clean minerals sourced from the covered countries.

Conclusion

Section 1502 is already having an impact. According to the U.N. Group of Experts on the DRC "requiring companies to exercise due diligence is effective. The Group's investigations in the DRC have shown that private sector purchasing power and due diligence implementation is reducing conflict financing, promoting good governance in the DRC mining sector, and preserving access to international markets for impoverished artisanal miners."[8]

In addition, numerous mechanisms exist to help issuers comply with the rule's reporting requirements. The OECD adopted due diligence guidelines to help companies source responsibly from conflict affected and high risk areas. These guidelines were developed by a multi-stakeholder group that included companies, governments (including the government of the Democratic Republic of Congo), and civil-society. Additionally, the Conflict Free Smelter program established by the Electronics Industry Citizenship Coalition, or EICC, is auditing tin, tungsten, tantalum, and gold smelters. These audits will designate smelters as conflict free. A list of conflict free smelters is publicly available for use by non-EICC companies to help them satisfy Section 1502's reporting requirements.

Section 1502 was not meant to solve all of Congo's ills, but the link between minerals, human rights, and the conflict in the east is clear. The situation in the east is a dire human rights and humanitarian crisis that deserves immediate and continued international attention. Section 1502 applies U.S. leverage to reduce the ability of armed groups to enrich themselves through the conflict minerals trade. These regulations aim to lessen violence and oppression in eastern Congo, thereby allowing an entry point for policy dialogue on other important issues like security sector and justice system reform as well as economic development.

Endnotes

1 The Guardian, "Conflict minerals' finance gang rape in Africa" Margot Wallström, 14 August 2010, available at http://www.guardian.co.uk/commentisfree/2010/aug/14/conflict-minerals-finance-gang-rape

2 The Brookings Institution, "Conflict Minerals: An Assessment of the Dodd-Frank Act," 3 October 2011, available at http://www.brookings.edu/research/opinions/2011/10/03-conflict-minerals-ayogu

3 SEC Final Rule on Conflict Minerals, page 60, available at http://sec.gov/rules/final/2012/34-67716.pdf

4 SEC Final Rule on Conflict Minerals, page 53, available at http://sec.gov/rules/final/2012/34-67716.pdf

5 SEC Final Rule on Conflict Minerals, page 65 para(b), available at http://sec.gov/rules/final/2012/34-67716.pdf

6 Submission by Senator Durbin and Representative McDermott to the SEC, page 2, 4 October 2010, available at http://sec.gov/comments/df-title-xv/specialized-disclosures/specialeddisclosures-22.pdf

7 SEC Final Rule on Conflict Minerals, page 150, available at http://sec.gov/rules/final/2012/34-67716.pdf

8 Submission by the U.N. Group of Experts on the DRC to the SEC, 21 October 2011, available at http://sec.gov/comments/s7-40-10/s74010-346.pdf