global witness

Global Witness comment on SEC conflict minerals rule
29 August 2012

On 22 August the U.S. Securities and Exchange Commission (SEC) voted on the rules for the Dodd Frank Act's Section 1502 – a provision that aims to stop the minerals trade fuelling violence in eastern Democratic Republic of Congo (DRC).

Global Witness welcomes the long overdue publication of these rules but regrets that the SEC has caved in to industry pressure and introduced a temporary measure allowing companies to declare that they do not know where the minerals they use come from. This risks further delaying the point at which companies take responsibility for the impacts of their purchases on people in the DRC. Companies have known about the devastating impacts of the conflict minerals trade for over a decade. The idea of legislation to address it was mooted in 2008 and the Dodd Frank Act was passed over two years ago. Moreover, the rules were held up for 16 months beyond the deadline set by the statute in response to companies' lobbying and thinly-veiled threats to sue the SEC. There is broad agreement that the situation in eastern DRC requires urgent action and the SEC's decision to introduce a measure that could mean an additional two to four year delay is seriously misguided.

With the rules now issued, investors, consumers and the general public will be expecting prompt and transparent action from American firms. The SEC's unfortunate decision notwithstanding, the imperative now is for companies to implement the regulation and make sure they are not financing warring parties in DRC. Companies should do so immediately rather than waiting the further two to four years permitted by the law.

Global Witness is currently assessing the full implications of the rule. The following does not constitute a comprehensive analysis of the rule, but rather an initial comment on some of the key provisions relating to companies' implementation.

Who is covered?

The SEC met the intent of the law by choosing not to include a de minimis category in the final rule. This means that all companies using the covered minerals must implement Section 1502 regardless of the amount of mineral that they use in their products. The regulators have also resisted pressure for an exemption from companies that use gold.

The SEC's definition of 'contract to manufacture' may exempt certain companies from having to report on whether their products contain conflict minerals. This could apply to major electronics retailers, for example, who sell generic manufactured products under their own label. Exempting some of the country's biggest retailers, who have significant purchasing power and leverage over suppliers, is a regrettable move. Regardless of what the final rule says, all retailers should carry out checks on their supply chains to make sure they are not funding conflict in DRC, and report publicly to demonstrate to consumers what measures they have taken.

The mining industry is also exempted under the final rule, despite the fact that mining companies' critical position at the top of the supply chain brings them into direct contact with armed groups active in mineral-rich areas. This exemption is all the more misguided given the mining industry's track record globally of colluding with and paying off armed groups and security forces.

How do companies determine the minerals' country of origin?

The rule requires companies using tin, tantalum, tungsten or gold to carry out a 'reasonable country of origin inquiry' to establish whether their minerals originate from DRC or adjoining countries. This is a critical step because it determines which companies will then be obliged to do due diligence to find out if their mineral purchases are funding armed groups. If they are not compelled to carry out a country of origin inquiry to a credible standard, some issuers whose minerals *do* originate in DRC or adjoining countries may evade the law's requirement that they carry out due diligence.

Global Witness recommended that the SEC define the country of origin inquiry and set clear benchmarks for companies, for example by requiring issuers to publicly identify the facility that processed their minerals and to verify the processor's chain of custody documentation. Unfortunately, the final rule does not specify what the inquiry should consist of beyond mandating that it be reasonably designed and carried out in good faith. Moreover, issuers are not required to take into account all their suppliers and all minerals they are using when they carry out their inquiry. This could lead to companies failing to report on suppliers who *are* sourcing from DRC and neighbouring countries.

While the SEC does not set a clear benchmark for the inquiry, there is emphasis on the issuer's obligation to take into account red flags that could indicate a DRC or neighbouring countries origin. The rule 'does not allow an issuer to ignore or to be wilfully blind to warning signs or other circumstances' (p. 153). The SEC also expects issuers to publish their conflict minerals sourcing policy as part of their country of origin inquiry.

Most significantly, firms are required to publicly disclose their country of origin determination and describe the inquiry they carried out. The rule effectively asks issuers who have declared that their minerals do not come from DRC to clearly set out their reasoning in their Conflict Minerals Disclosure report so that interested parties can 'evaluate the degree of care the issuer used in making its negative determination' (p. 163).

What due diligence standard does the rule require?

Companies who find out that their products contain minerals from the DRC and adjoining countries must carry out due diligence on their supply chains and submit a Conflict Minerals Report to the SEC. Importantly, the due diligence obligation does not only concern companies who are certain of the origin of their minerals – it also applies to firms who have reason to believe they may have such minerals in their supply chains.

Global Witness and many other commentators urged the SEC to adopt the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas as the standard for companies to meet. The OECD Guidance has been endorsed by a broad group of companies, governments and NGOs, and the Congolese government has made its application a domestic legal requirement. Regrettably, the SEC decided against explicitly incorporating the OECD's five-step framework and the rule simply states that issuers' due diligence should conform to a nationally or internationally recognised due diligence framework.

The SEC has made clear, however, that the OECD guidance is currently the only such standard available to companies. They state 'The OECD's [due diligence guidance] satisfies our criteria and may be used as a framework for purposes of satisfying the final rule's requirement that an issuer exercise due diligence' (p. 206). Companies that do not follow the due diligence standard set by the OECD will struggle to demonstrate to investors, consumers and the public at large that they are genuinely compliant with the law and not fuelling armed violence in eastern DRC.

How are companies required to describe their products?

Section 1502 requires companies to describe their products as 'DRC conflict-free' or 'not DRC conflict free', following their country of origin enquiry and due diligence efforts. The SEC yielded to industry demands on a critical issue in allowing issuers to describe the origin of their products as 'undeterminable' for a period of two years – four years for smaller firms. This risks holding up implementation of a law which seeks to address an urgent humanitarian situation and is already years overdue. The SEC claims that the purpose of this category is to give issuers more time to establish due diligence mechanisms. In fact, companies have already had over two years since the law was passed to put due diligence measures in place in their supply chains. The SEC is effectively creating an incentive for companies to plead ignorance for a further two years.

Companies that choose to fall back on the undeterminable origin designation are required to carry out due diligence and publicly report on it in the annual Conflict Minerals Report submitted to the SEC. They are also obliged to describe what they have done to mitigate the risk of financing conflict in eastern DRC and the steps they have taken to improve their due diligence.

Use of the undeterminable description may be permissible under the law, but issuers would do well to consider the impact on their brands and their reputations. Companies using this category are likely to come under particular scrutiny from journalists, NGOs and others monitoring the trade in conflict minerals from the Great Lakes region.

What are the auditors expected to look at?

The statute requires issuers to commission an independent private sector audit of their Conflict Minerals Report. The final rule sets out the objective of the audit and the subject matter it is expected to cover. Auditors are required to check the conformity of the company's due diligence measures against the criteria set out in the nationally or internationally recognised due diligence framework adopted. Auditors must also verify that the company's description of their due diligence measures matches the process they have actually undertaken.

The fact that the final rule exempts companies that list the origin of their products as undeterminable from receiving an audit is a miscalculation on the part of the SEC. An audit designed to assess the company's due diligence measures against international standards is an excellent opportunity for improvement and could help the company move more quickly towards accurate determination of origin.