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SPECIAL FEATURE

Section 1502: The Heart of Darkness and Dodd-Frank

By Stephen M. Honig

You wouldn't expect securities regulation to be driven by gender-based violence in the middle of Africa — but it is.

While compliance officers have been diving deep into Section 1502 of the Dodd-Frank Act, most corporate lawyers have avoided it like the plague.

Never has government policy involved the SEC in something so alien to its expertise. Section 1502 requires SEC regulation "not later than 270 days after the date of the enactment." But we are now more than 18 months from President Obama's signature on the statute and the SEC has yet to act.

The statute

Most sections of the Dodd-Frank Act are short and straightforward. One glance at Section 1502's four-and-a-half pages foretells trouble.

The section begins with a recitation of the "sense of Congress" that utilization of minerals from the Democratic Republic of the Congo helps finance violence in Eastern Congo, contributing to "an emergency humanitarian situation."

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The statutory response: an amendment to Section 13(p) of the Securities Exchange Act of 1934! The SEC, not the Department of Commerce and not the State Department and not any other agency with competency in this area, must promulgate regulations requiring issuers to determine whether "conflict minerals" originated in the Congo or any adjoining country (of which, alas, there are many).

If any reporting company (including foreign and smaller reporting companies) makes significant use of conflict minerals, the SEC must require a report describing due diligence taken to determine the source and chain of custody of the minerals, and including an "independent private sector audit of such report ... in accordance with standards established by the Comptroller General of the United States."

The report must describe the products manufactured or contracted to be manufactured, the identity of the entity conducting the audit, the processing facilities, country of origin, and efforts made to determine the mine or location of origin "with the greatest possible specificity."

The reporting company shall "certify the audit," and that certification "shall constitute a critical component of due diligence in establishing the source and chain of custody of such minerals."

The SEC itself is admonished to determine those auditors deemed to be "unreliable," an undertaking that surely exceeds the law school curriculum of the commission staff.

The interplay of disclosure and politics is startling. The statute provides that the secretary of state and the U.S. Agency for International Development will submit reports to Congress, including plans to promote peace, monitor and stop natural resource activities in the Congo that contribute to the activities of armed groups and human rights violations, and outline nation building for the Congo through development of stronger governance and economics.

A map from the secretary of state must indicate mineral-rich zones in the Congo, and an annual report by the comptroller general must cover the rate of gender-based violence in Congo war-torn areas.

Not later than two years after enactment, and annually thereafter, the comptroller general must submit an assessment of the efficacy of SEC reporting and issues encountered by the SEC, and the secretary of commerce must report within-two-and-a-half years, and annually thereafter, on the accuracy of the private sector audits.

Interpretation

Covered minerals include (subject to expansion by the government) tin, tantalum, gold and tungsten.

Which companies must comply? The SEC estimates that 6,000 companies must conduct an inquiry and that about 1,200 will need to conduct "supply chain due diligence."

The SEC is considering whether issuers must make disclosures within or separate from their annual reports, for example on Form 8-K or under an entirely new form.

Reporting must be made only where conflict minerals are included within a product or production process and "necessary to the functionality or necessary to the production" of that product.

Further, the rules apply only to companies that "manufacture or contract to manufacture" products.

The proposing SEC release, now languishing for over a year (SEC Release No. 34-63547, issued Dec. 15, 2010), avers that "manufacture" is a well-understood word.

What about companies that sell products that contain conflict minerals but do not themselves manufacture? What about retail stores? What does it mean to "contract to manufacture"?

According to the SEC release, reports must be made by issuers that have influence regarding the manufacture of products, and not pass-through retailers. An issuer ordering a custom product, sold under its own brand, must file. Conversely, a retailer selling generic third-party products with no involvement in the manufacture is not covered.

The statute presumes ability to gather information sufficient to determine a mineral's origin. What such information constitutes is not clear. Due diligence is required, doubling back on chain of custody. Even if from the Congo, is it directly or indirectly benefitting an armed group committing human rights abuses, as reported by the State Department?

What about recycled and scrap materials? How is it possible to trace mineral sourcing there? Companies must try and disclose their determination (or lack of determination). What industries are involved? Just about anyone that manufactures.

Tin is used in solder for pipes and circuits, automobiles, and steel plating. It is an alloy in bronze, brass and pewter. Every electronics, industrial equipment and construction company utilizes tin.

Tantalum is utilized in electronics, medical equipment, industrial tools and aerospace. Gold is not only in jewelry, but also in virtually all electronics and in aerospace. Tungsten is in electronics, lighting, industrial material, wires and welding.

Diligence resources

Trade groups have undertaken efforts to guide companies. Many larger companies have already begun their conflict minerals audit, identifying sources and presumably altering supply chains in order to avoid supporting the wrong vendors (and making embarrassing disclosures about it).

The Organization for Economic Cooperation and Development has generated "diligence guidance." The SEC release states that compliance with OECD (or another recognized guideline) would evidence adequate due diligence (but presumably not be conclusive?). The State Department has specifically endorsed the OECD guidance.

EICC-GeSI certifies smelters and created reporting template and dashboard tools.

The State Department has issued its map of conflict minerals, although the map was released in June 2011, is current only as of 2009 or 2010, and is not scheduled to be updated despite the fact that control of Congo areas is constantly changing.

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ITRI, an organization of major tin producers and smelters, is working on a certification plan. The Responsible Jewelry Council has developed certification systems for diamonds and gold. Organizations supporting the automotive, electronics and aerospace industries have provided or are working on guidance.

Dodd-Frank requires an "audit," but what is being audited? The process of diligence? Or the accuracy of determinations of origins of conflict minerals?

The Government Accountability Office announced that no new audits standards are needed, given existing federal auditing standards, but major accounting firms have submitted comment letters expressing confusion.

Mining is classified as a manufacturing activity under the proposed regulations. Mining groups objected, making the obvious argument that mining simply isn't manufacturing. The policy reasons for including mining nonetheless are clear.

The SEC's release discusses whether there should be a de minimus standard and exemptions or delays for foreign or smaller companies; none of those provisions appear in the statute. Should the regulation include a safe harbor for diligence, for example by reference to the OECD? Should there be a timing phase-in?

Practical issues

There is a lot of literature about conflict minerals online. The SEC at some point will issue definitive regulation, and given the draconian scope of Section 1502, those regulations will bite deeply.

Counsel might look at practicallaw.com for useful diligence materials and checklists. Reliance on trade groups provides not only guidance but also the argument that a particular industry's recognized diligence standard has been met.

Presuming final regulations are adopted as promised before June 30, year-end reporting issuers will need to make disclosures starting with annual reports for 2013, due in 2014. Non-year-end reporters may be on a faster track, and the SEC can always require reporting other than through proxy solicitation.

Given the success of the U.S. Chamber of Commerce in challenging the SEC in court (indeed, knocking out half of the SEC's proxy access regime), the pervasive scope of the conflict minerals regulations, and the SEC's struggle with what its regulations should contain, a court challenge to whatever the SEC promulgates cannot be ruled out.

Such a challenge may be difficult given the detailed statute, but no area of mandated disclosure will be more confusing, and subject to more interpretation, than the conflict minerals regulations.

One solution would be an end to violence in the Congo. The statute specifically gives the president the ability to terminate SEC reporting requirements, but that cannot occur earlier than July 22, 2015. NEIH

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