

## Implications of the Conflict Minerals Rule – Lessons Learned

On August 22, 2012 the Securities and Exchange Commission (SEC) adopted a rule implementing Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010<sup>1</sup>, (Dodd-Frank) which will require that public companies disclose the source of certain materials used in the production of their goods.

In addition to the compliance implications of the implementation of Section 1502, there may also be strategic implications since this action will provide stakeholders with new information to evaluate the social responsibility policies of companies and governments.

### The Conflict Minerals Rule

SEC Commissioners approved the form and rule pursuant to Section 1502 of Dodd Frank relating to the use of conflict minerals<sup>2</sup> (the conflict minerals rule) that mandates new annual reporting requirements affecting companies with products that contain, or if in the production process use, certain “conflict minerals.”<sup>3</sup> These conflict minerals are commonly referred to as “3TG” – tin, tantalum, tungsten, and gold – and are mined in identified areas of political unrest, defined as the Democratic Republic of Congo, or DRC, and adjoining countries (Covered Countries). The SEC estimates that approximately 6,000<sup>4</sup> companies could be impacted in the electronics, communications, aerospace, automotive, jewelry, healthcare device, and other manufacturing sectors. Companies that do not file with the SEC may also be affected if they are suppliers to companies filing with the SEC.



### Considerations for companies and their boards:

- Has your company developed a strategy to address conflict minerals? How does this strategy align with your brand and other corporate social responsibility initiatives?
- If relevant, has your organization determined the impact of gathering and reporting the information needed for the specialized disclosure form required to be “filed” as Form SD for conflict minerals reporting?
- Are key stakeholders in your organization currently collaborating to execute your strategy and incorporate regulatory considerations such as the conflict minerals rule into mergers and acquisitions, expansion plans, sourcing decisions, or new product development?
- Are key compliance and monitoring programs as well as reporting lines, accountability, and skill sets well aligned with the new conflict minerals rule and evolving social responsibility expectations?
- Have you determined how the supplier information collected will be leveraged when making future sourcing decisions and how this will impact initiatives such as new product development?

<sup>1</sup> <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>

<sup>2</sup> SEC Final Rule for Disclosing Use of Conflict Minerals, August 22, 2012, <http://www.sec.gov/rules/final/2012/34-67716.pdf>

<sup>3</sup> The term “conflict mineral” is defined in Section 1502(e)(4) of the Act as (A) columbite-tantalite, also known as coltan (the metal ore from which tantalum is extracted); cassiterite (the metal ore from which tin is extracted); gold; wolframite (the metal ore from which tungsten is extracted); or their derivatives; or (B) any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo or an adjoining country.

<sup>4</sup> Memorandum of Claihan Environmental presentation to SEC, December 12, 2011 <http://www.sec.gov/comments/s7-40-10/s74010-429.pdf>

Since the law was passed in 2010, companies have debated a number of issues including the long lead time required for compliance and how it might impact long-range business or supply chain planning. Companies further argued that their best efforts toward due diligence might not produce the results necessary to determine the origin of materials.

To allow more time for companies to meet the requirements of the conflict minerals rule, the SEC's final rule<sup>2</sup> allows companies to label the source of materials for certain products "DRC Conflict Undeterminable" and includes a two-year phase-in period and up to four years for smaller reporting companies<sup>5</sup>. Products marked "DRC Conflict Undeterminable" would not be subject to an independent third party audit<sup>6</sup> during the two or four year transition period.

Affected issuers are required to comply with the conflict minerals rule beginning with the calendar year ended December 2013 (regardless of when their fiscal year ends) by filing their conflict minerals disclosure and, if required, conflict minerals report on a new, specialized disclosure report or Form SD by May 31, 2014. The conflict minerals rule does not require that a company's Chief Executive Officer and Chief Financial Officer certify Form SD, however, the form is subject to liability under Section 18 of the Securities and Exchange Act of 1934(Act)<sup>7</sup>. The practical impact of the "filed" distinction is that reporting issuers may be held liable for "false or misleading statements" under Section 18 of the Act.

The conflict minerals rule requires several steps including:

- Conduct a reasonable "country of origin" inquiry that must be performed in good faith and be designed to determine whether any of the companies' materials originated in the Covered Countries or are from scrap or recycled sources.
- If the company concludes that the minerals originated from the Covered Countries are not scrap or recycled

*"We find this [OECD initiative] to be a very worthy tool. Although Section 1502 doesn't mandate a specific due-diligence process, the OECD's is the one already in place out there. We are using the OECD guidelines as a template."*

Large Automotive Company

then the company must undertake "due diligence" on the source and chain of custody of its conflict minerals and file a Conflict Minerals Report as an exhibit to Form SD, potentially subject to independent private sector audit<sup>6</sup>.

- The due diligence measures must conform to a nationally or internationally recognized due diligence framework, such as the due diligence guidance approved by the Organization for Economic Co-operation and Development (OECD).

## Lessons Learned

*"Questions from our key customers were a bigger driver in getting us to act on conflict minerals than the SEC requirement itself."*

Electronic components manufacturing participant in a KPMG conflict minerals webcast

Early adopters of the proposed conflict minerals rule quickly learned that success is usually contingent upon strong and visible support from the C-suite as a first step followed by close collaboration between departments that have not typically established strong communication protocols. At least four corporate departments typically work together: supply chain/procurement, legal counsel, finance, and internal audit (and corporate social responsibility, if it exists in the company). For those companies subject to the conflict minerals rule, the supply chain analysis is usually applied to large numbers of suppliers and therefore works well with a risk-based approach.

The first step of a risk-based program has often been to set up a pilot project involving a single, manufactured product or a single business unit. Three Japanese electronics manufacturers are running pilot programs and large automotive manufacturers are due to follow suit in 2012<sup>8</sup>. Even a pilot approach is still likely to involve an extensive analysis of material flows and detailed component invoices.

<sup>5</sup> Defined in Rule 12b-2 under the Exchange Act, *Smaller Reporting Companies Regulatory Relief & Simplification, sec.gov*

<sup>6</sup> *KPMG's Defining Issues*

<sup>7</sup> *Securities Exchange Act of 1934*

<sup>8</sup> *"Taking Conflict Out of Consumer Gadgets" – Company Rankings on Conflict Minerals 2012, Sasha Lezhnev and Alex Hellmuth, enoughproject.org, August 2012*

Developing a risk rating protocol helps to manage large numbers of suppliers and is a leading practice. For example, large suppliers in a developed market such as North America and Europe may have an easier time providing the necessary information, however, suppliers that are privately owned and/or headquartered in an emerging market may have a tougher time and require more lead time.

Once companies have set up a risk-based compliance framework, another challenge that should be addressed is determining the origin of the minerals in their supply chain. Firms that are final assemblers or integrators have commercial and contractual relationships with their tier-one suppliers. Beneath this, however, there may be a dozen or more tiers of suppliers, each tier made up of a web of commercial agreements with confidentiality considerations.

But even a risk-based approach still requires significant lead time in order to meet the deadlines required by the conflict minerals rule. This in turn may require organizational, reporting, or accountability changes to be successful. As complexities become apparent, leading companies are moving quickly to assess necessary skills and enabling technology needs in order to move beyond a pilot program to a sustainable and auditable due diligence program.

*We have a very complex supply chain and determining whether we have DRC-derived minerals is going to be very time - and resource-intensive. This level of intervention in a very expansive and complex supply chain will drive a paradigm shift in business operations and the ability to meet these demands."*

#### Large Aerospace & Defense Contractor

While establishing these frameworks may have originally been motivated by a specific compliance need, leading companies have discovered the value of leveraging the effort more broadly. Analyses of the supply chain can be used to increase efficiencies and transparency that might be needed to meet increased stakeholder expectations and the advent of other social responsibility focused regulations<sup>9</sup>. The conflict minerals rule has many compliance implications but the strategic implications are just starting to become evident.

<sup>9</sup> *Conflict Minerals Provision of Dodd-Frank: Immediate Implications and long-term opportunities for companies*, KPMG LLP, August 2011



## Case Study: Leveraging a conflict minerals compliance process to develop leading business practices<sup>10</sup>

The following is a good example of how one company leveraged the considerable effort required to comply with regulation ahead of the final conflict minerals rule. Instead of simple compliance, the effort was used to optimize business processes and reevaluate supplier relationships in advance of a growth initiative.

KPMG recently assisted a U.S.-based, global manufacturer with more than 3,000 suppliers in instituting a rigorous “auditable” supply chain due diligence process to assess its risk exposure to conflict minerals. The ancillary objectives beyond the immediate compliance goal were to develop a process that could be extended to other corporate social responsibility initiatives in the future – one that would integrate with the company’s overall risk process (both from an internal audit and external audit perspective) and drive vendor accountability while improving the stability of their own supply chain.

### Getting Started

The company established a multidisciplinary team to address business implications of the rigorous compliance process. The team included legal, investor relations, procurement, corporate social responsibility, supply chain, and others within the company who typically handle large change management exercises.

### Compliance Strategy

The team developed a process to identify, survey, and risk rate suppliers that use 3TG metals in the manufacture of components used by this company. This was done using, in part, a KPMG proprietary tool that provided the mechanism to collect and analyze the results. Supplier information was synthesized into information that will be used to complete and maintain the annual report disclosure on conflict minerals.

### Looking for opportunities beyond traditional compliance

In the end, the company used this project to gain other significant benefits such as future supplier certification, establishing a process to respond to customer requests to provide information on the use of conflict minerals in the products sold, identifying opportunities for consolidation and supply chain cost reduction, and preemptive identification of risk due to sole-sourced suppliers. This company also saw value in positioning their market brand as “conflict free.”

<sup>10</sup> Public Policy Alert: Legislative complexity challenges traditional business and compliance strategies, KPMG LLP, July 2012

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