AUTOMOTIVE SECURITIES

THE IMPACT OF THE DODD-FRANK ACT ON AUTOMOTIVE COMPANIES THAT UTILIZE "CONFLICT MINERALS"

by J. Bryan William and Bradley J. Wyatt*

August 2011

Background

The Dodd-Frank Act (the "Act") was signed into law on July 21, 2010. Section 1502 was included to help curb violence and other human rights violations in the Democratic Republic of Congo (the "DRC") and neighboring countries (Angola, Burundi, Central African Republic, Congo Republic, Rwanda, Sudan, Tanzania, Uganda, and Zambia) (collectively the "DRC countries").

Under Section 1502, a public company that manufactures products using conflict minerals must disclose the source(s) of its conflict minerals on its website and in annual reports filed with the SEC. The term "conflict mineral" is defined in the Act to include the following: (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 DRC countries. The Secretary of State is also required to produce a map of mineral-rich zones, trade routes, and areas under the control of armed groups in the DRC countries.

Proposed SEC Rule

The SEC issued a proposed rule to implement Section 1502 on December 23, 2010.[1] This rule is sometimes referred to by the SEC as the "Conflict Minerals Provision." The public comment period for this rule was extended from January 31, 2011 to March 2, 2011. The SEC received over 500 written comments and a final rule is expected to be promulgated by the end of 2011.

Enforcement of the new rule will take effect one year after it is published in final form. Any annual reports relating to fiscal years ending on or after one year from the date of the rule's final publication will have to include the new disclosures required by the rule. Notably, only companies that file reports with the SEC pursuant to Sections 13(a) or 15(d) of the Exchange Act ("public issuers") are subject to Section 1502 and the proposed SEC rule. Private and non-U.S. companies are exempt.

The SEC has proposed a three-step test for the Conflict Minerals Provision:

(1) A public issuer is subject to the Conflict Minerals Provision only if it is one for which "conflict minerals are necessary to the functionality or production of a product manufactured by such [issuer]." If an issuer does not satisfy this criterion, the issuer would not be required to take any action, make any disclosures, or submit any reports. An issuer that does satisfy this criterion moves on to the second step.

(2) The issuer must determine, after a reasonable country-of-origin inquiry, whether its conflict minerals originated in the DRC countries. If the issuer determines that its conflict minerals did not originate in the DRC countries, the issuer would disclose this determination, along with the country-of-origin inquiry it used in reaching this determination, in the body of its annual report and on its website. If, however, the issuer determines that its conflict minerals did originate in the DRC countries, or if it is unable to conclude that its conflict minerals did not originate in the DRC countries, the issuer would disclose this conclusion, along with the results of its country-of-origin inquiry, in its annual report and on its website. The issuer would also need to satisfy the requirements of the third step.

(3) An issuer with conflict minerals that originated in the DRC countries, or an issuer that is unable to conclude that its conflict minerals did not originate in the DRC countries, must furnish a Conflict Minerals Report (the "Report"). In the Report the issuer would be required to provide, among other information, a description of any of its products that contain conflict minerals that it is unable to determine did not "directly or indirectly finance or benefit armed groups" in the DRC countries.

All issuers furnishing a Report must certify that they obtained an independent private sector audit of the Report and must furnish as part of the Report the audit report of the independent private sector auditor.

Issuers using recycled or scrap conflict minerals must still furnish a Conflict Minerals Report subject to special rules that allow for the omission of some otherwise required information. However, issuers that obtain conflict minerals from a recycled or scrap source may consider those conflict minerals to be "DRC conflict free."

Implications for Automotive Companies

The SEC expects public issuers to perform due diligence on the source and supply chain of conflict minerals, although the SEC has declined to provide any specific standards or guidance regarding the nature of the due diligence to be performed. However, the SEC did note two possible sources of due diligence standards, the Organisation for Economic Cooperation and Development and the United Nations Group of Experts for the DRC.[2]

The effect of the proposed rule on automotive suppliers could be substantial, because automotive manufacturers would not be able to rely on undertakings performed by suppliers to determine whether

conflict minerals are used in the supply chain without performing their own due diligence. This means that automotive suppliers may have to increase the allocation of resources devoted to helping manufacturers document and verify the supply chain.

According to a Detroit News editorial, the National Association of Manufacturers has estimated that it will cost the manufacturing industry between $9 billion and $16 billion to put the new SEC regulations into effect.[3] Companies and industry groups (such as the Business Roundtable) have also noted that the infrastructure necessary to trace and audit supply chains is currently lacking. Based upon SEC comments, some industry participants believe that proper due diligence will require reviewing all product lines and production activities to determine if conflict minerals are used, an endeavor that could take issuers as far back as the rebel-controlled mines in the DRC. The SEC has estimated that 1,199 issuers will be required to file Reports and that the average cost of supply chain due diligence will be $16.5 million.

The use of conflict minerals is neither banned nor illegal, except that U.S. citizens may be prohibited from dealing with specifically identified individuals or entities that have been sanctioned by the federal government.[4] However, issuers that use conflict minerals from the DRC countries could face shareholder scrutiny, negative media and NGO attention, reputational damage, and consumer activist boycotts.

Gold, tantalum, tin, and tungsten obtained from and traceable to non-DRC countries such as India, China, and Russia would allow resulting manufactured products to be labeled "DRC conflict free." Furthermore, if any of an issuer's products contain conflict minerals that do not "directly or indirectly finance or benefit" armed groups in the DRC countries, the issuer may describe such products as "DRC conflict free" regardless of whether the minerals originated in the DRC countries.

Additional State Legislation

California Senate Bill 861, introduced in the California Senate on February 18, 2011, is an attempt to supplement the "name and shame" provisions of Section 1502 with real economic penalties. Under this proposed legislation, which has yet to be enacted, public companies that use conflict minerals from the DRC countries are ineligible to bid on or submit a proposal for a contract with any California state agency for goods or services.

Summary

The conflict mineral rule is complex and as yet unfinalized. Automotive companies, especially suppliers, should begin considering whether and how best to implement a supply chain audit to determine the use of conflict minerals in the manufacturing process and the ultimate source of these minerals. Additional client alerts containing regulatory guidelines will follow in the months to come once the SEC issues a final version of the rule.

- Conflict Minerals, 75 Fed. Reg. 80948 (Dec. 23, 2010) (to be codified at 17 C.F.R. pt. 229 and 249).

[2] The Organisation for Economic Cooperation and Development (the "OECD") is in the process of developing due diligence guidance for conflict mineral supply chains. See OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (2011), available at http://www.oecd.org/dataoecd/62/30/46740847.pdf. Also, on November 30, 2009, the U.N. Security Council adopted Resolution 1896 that, among other matters, extended and expanded the mandate of the United Nations Group of Experts for the DRC to create recommendations on due diligence guidelines for minerals originating in the DRC. See United Nations Security Council Resolution 1896 (2009) [S/RES/1896 (2009)], available at http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N09/624/53/PDF/N0962453.pdf.

[3] Editorial, Another burden on automakers, Detroit News, May 10, 2011, available at http://detnews.com/article/20110510/OPINION01/105100314.

[4] Executive Order 13413, 71 Fed. Reg. 64105, signed by President Bush in 2006, declared a national emergency in connection with the DRC human rights crisis. The Department of Treasury issued targeted sanctions in May 2009 to implement the Executive Order, prohibiting U.S. citizens from dealing with specific individuals and entities. There is no sanction against the DRC or its people, and it is lawful to purchase conflict minerals from unsanctioned sources.

FOR MORE INFORMATION, PLEASE CONTACT:

J. Bryan Williams, is a member in Dickinson Wright's Troy office and is also a member of the Conflict Minerals Work Group of AIAG. He can be reached at 248.433.7289 or jwilliams@dickinsonwright.com.

Bradley J. Wyatt, is an associate in Dickinson Wright's Ann Arbor office and can be reached at 734.623.1905 or bwyatt@dickinsonwright.com.

*The authors would like to thank Randolph Pistor, J.D. candidate University of Michigan 2012, for his contributions to this Client Alert.