

Client Alert

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New Reporting and Audit Obligations for High-Tech and Other Manufacturers

On July 21, 2010, President Obama signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (“the Act”). Although most of the Act relates to the regulation of financial institutions, Section 1502 specifically affects electronic device manufacturers, other manufacturers who incorporate certain forms of tin and tungsten and gold into their products and any other manufacturers of goods using Conflict Minerals.

“Conflict Minerals” include columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives. The Act allows the U.S. Secretary of State to add to the list upon at least one year’s notice any other mineral or its derivatives found by the Secretary to be financing armed conflict in the Democratic Republic of the Congo (“DRC”).

Exploitation and trade of Conflict Minerals has been linked to the financing of particularly violent armed groups in the DRC and in adjoining countries. By enacting Section 1502 of the Act, Congress sought to raise public awareness that some manufacturers incorporate into popular and widely used electronic devices, such as cell phones, laptops and video games, metals mined from territories mired in armed conflict, genocide and human rights violations whose leaders sell these metals to raise funds to perpetuate these atrocities.

Under Section 1502, certain manufacturers and other companies will eventually be required to conduct due diligence on their own supply chain to learn whether they use Conflict Minerals originating in the DRC or an adjoining country. They then must disclose to the Securities and Exchange Commission (“SEC”) and post on their website whether they use Conflict Minerals which originate in the DRC or an adjoining country. Depending on the results of their diligence, companies may need to provide further information in a report to the SEC, hire an independent auditor to audit the results of management’s report and post the audited information on the company’s website.

This Client Alert addresses the new reporting requirements mandated by Section 1502 of the Act for certain companies that file reports with the SEC and provides recommendations for manufacturers and other entities affected by the Act to consider in anticipation of future SEC rulemaking. This Alert also discusses some questions left unanswered under Section 1502 that the SEC will presumably address through its rulemaking process.

Executive Summary

The key provisions under Section 1502 of the Act:

- apply to high-tech, electronics, and other manufacturers using Conflict Minerals who are required to file periodic reports with the SEC under Section 13 of the Securities Exchange Act of 1934 (the “Exchange Act”);
- depending on future SEC rulemaking, may also apply to other Conflict Mineral users who do not file periodic reports with the SEC including subsidiaries of issuers who do;
- will require annual SEC disclosure and other public disclosure on a manufacturer’s website about the origin of Conflict Minerals used in its products;
- apply to Conflict Minerals regardless whether they originate in the DRC or an adjoining country or not;
- require disclosure even if a manufacturer’s Conflict Minerals are “conflict free” (*i.e.*, did not directly or indirectly finance or benefit armed groups in the DRC or an adjoining country);
- do not sanction using Conflict Minerals originating in the DRC or an adjoining country in production, but instead mandate public disclosure of the origin of, and potentially the steps taken to identify the company’s source and supply chain for, them;
- will require companies to create internal controls to ensure they can document the full extent of their supply chain for Conflict Minerals;
- will require companies to obtain an independent audit of reports on their use of and supply chain for Conflict Minerals if their Conflict Minerals originated in the DRC or an adjoining country;
- afford manufacturers and others the opportunity to comment on SEC rulemaking.

SEC Reporting and Disclosure Requirements

Section 1502 of the Act specifically requires the SEC to promulgate regulations by April 17, 2011 (270 days after passage of the law) which will require companies for whom “conflict minerals are necessary to the functionality or production of a product [they manufacture]” to:

(1) disclose annually whether conflict minerals necessary to the functionality or production of a product they make “did originate in the Democratic Republic of the Congo or an adjoining country”; and

(2) if so, submit a report to the SEC that:

- (a) describes the measures taken by the company to exercise due diligence on the source and chain of custody of the conflict minerals; and

- (b) includes an independent private sector audit of its report conducted in accordance with standards established by the Comptroller General of the United States.

The report must identify which products manufactured or contracted to be manufactured are not “Conflict Free.” Conflict Free means that the product does not contain Conflict Minerals that directly or indirectly finance or benefit armed groups in the DRC or an adjoining country.

The report must also identify the:

- (a) entity conducting the private sector audit,
- (b) facilities used to process the conflict minerals,
- (c) country of origin of the conflict minerals, and
- (d) efforts to determine the mine or location or origin with the greatest possible specificity.

Section 1502 requires the person submitting the report to certify the audit and post the report on its Internet website. This provision also states that a required report will not satisfy the statutory requirements if it relies on a determination of an independent private sector audit or other due diligence processes previously determined by the SEC to be unreliable.

Manufacturers will have some time to prepare to disclose these Conflict Mineral reports to the SEC and to the public via their websites. A manufacturer’s first audited report isn’t due until its first full fiscal year that begins after the date the SEC promulgates regulations requiring Conflict Mineral reports.

The Act permits the President of the United States to suspend for two years the requirements to disclose Conflict Mineral reports, if doing so is in the interest of national security, and to terminate no earlier than July 21, 2015 the requirement altogether, if the President determines and certifies to an appropriate Congressional Committee that no armed groups continue to be directly involved in and benefiting from commercial activity involving Conflict Minerals.

Practical Considerations

Even before the SEC implements regulations, companies using Conflict Minerals may wish to:

- investigate whether they have a clear understanding of their supply chains for coltan, gold and the other potential Conflict Minerals and learn whether they have control over the supply chain from the time the Conflict Minerals are mined until final incorporation into their products;
- learn whether any of the Conflict Minerals they use may indeed finance or benefit armed conflict in the DRC and adjoining countries;
- if so, determine now whether they can find viable alternative sources of supply of these minerals from other countries including Canada and others; and

- plan whether they intend to comment on SEC rulemaking for Section 1502.

Frequently Asked Questions

Section 1502 appears to have been hastily added to the Conference Report and leaves a number of unresolved issues for the SEC to consider during its notice and comment rulemaking period.

Does Section 1502 apply only to issuers who file periodic reports with the SEC?

Although earlier versions of the bill would have covered companies **controlled** by periodic report filers under the Exchange Act, Congress ultimately left the application of Section 1502 unclear.

Section 1502 specifically applies to a “Person” as defined in the Act and refers possibly only to those companies required to file reports under Section 13 of the Exchange Act. However, because the scope of this definition is unclear, it remains uncertain whether subsidiaries of filers, who are not filers themselves, and other entities that use Conflict Minerals in their production, may ultimately be covered. It is expected that future SEC rulemaking will resolve this ambiguity.

Will certification under Section 1502 carry the same weight (i.e. securities law consequences) as Section 302 and Section 404 certifications currently required under the Sarbanes Oxley Act?

New Section 13(q) of the Exchange Act will require the Person submitting the audited report to certify the audit, but the Act does not provide any guidance as to who among the company’s officers, if any, must certify the report, what the certification must say and what the consequences are if the certification later proves erroneous. Companies may look to future SEC rulemaking (or to the courts) for clarity on these issues and whether analogous provisions of the Sarbanes-Oxley Act, such as the Section 302 and Section 404 certification requirements, will be drawn upon for guidance.

What will the scope of the required SEC disclosure about a manufacturer’s supply chain entail?

We recommend that manufacturers keenly follow and participate in SEC rulemaking to determine whether the SEC will require disclosure that may potentially give competitors insight into the manufacturer’s sources. Manufacturers may also want to borrow internal control and auditing techniques used to gauge their carbon footprint when thinking about how to uncover information from suppliers deep within their supply chain over which the manufacturers have no control.

Does my company’s gold, tin or tungsten escape regulation if I can prove it did not originate in the DRC or an adjoining country?

No. Unlike conflict diamonds which cannot be melted down and which retain their Kimberly registration (an international registration process which inscribes the place of origin on a diamond indicating whether it is a “blood diamond” coming from mines in and around the DRC), Conflict Minerals can be melted into ingots and can be transshipped through third countries in an attempt to conceal their

origin. Congress was likely aware of this when enacting Section 1502, and thus it placed the onus on all who use these metals to take steps to gain a clear understanding of the origin of the Conflict Minerals they use.

Manufacturers should also monitor reaction to the new law and future regulations from the international community since, unlike the Kimberly process, the U.S. has taken the initial steps on the regulation of Conflict Minerals without first establishing an international framework for the regulation of these minerals. Also, further regulation could later address the commodities trading industry since Section 1502 only applies to manufacturers.

To facilitate public comment, the SEC has provided a series of e-mail links on its website at <http://www.sec.gov/spotlight/regreformcomments.shtml>. Submitted comments will also be posted on the SEC's website.

Undoubtedly, the SEC's rulemaking should address these and other questions. Recently, the SEC announced a new process whereby the public will be able to comment before it proposes regulations implementing the Act. The SEC hopes the new process will provide expanded opportunity for public comment and greater transparency and accountability. The SEC also expects to hold public hearings on selected topics.

Advance comments on the Conflict Minerals legislation may be submitted to the SEC at http://www.sec.gov/cgi-bin/ruling-comments?ruling=df-title-xv-specialized-disclosures&rule_path=/comments/df-title-xv/specialized-disclosures&file_num=DF%20Title%20XV%20-%20Specialized%20Disclosures&action=Show_Form&title=Specialized%20Disclosures%20-%20Title%20XV%20Provisions%20of%20the%20Dodd-Frank%20Wall%20Street%20Reform%20and%20Consumer%20Protection%20Act.

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