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*The End of Arm's Length: New Laws Force Deep Supply Chain Knowledge*

by

John R. Taylor II

Submitted in partial fulfillment of the requirements of the

King Scholar Program

Michigan State University College of Law

under the direction of

Professor Bruce Bean

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## The End of Arm's Length: New Laws Force Deep Supply Chain Knowledge

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### **I. Introduction**

The complexities of global supply chains, and the challenges of managing them, have never been greater. A number of recent events have shown the ways in which global supply chains are far more interconnected, and fragile, than commonly thought. The tsunami that struck Japan in 2011 disrupted automobile production worldwide.<sup>2</sup> Floods in Thailand in late 2011 disrupted the worldwide supply of hard drives.<sup>3</sup> What is truly shocking about these incidents is the fact that relatively local, isolated events can have a pronounced global effect on the entire world supply chain for every product in an industry. Many companies were not aware how vulnerable their supply chains were prior to these incidents.<sup>4</sup> This lack of knowledge related to supply chain vulnerability to disasters shows the way in which companies may have a shallow knowledge of the exact origins of components of their products or their products themselves.

Many people assume that companies can easily identify every item in their supply chains and all component parts, perhaps all the way back to raw materials. Recent incidents make it clear, however, that for many companies the length of their supply chain knowledge is the end of the arms length transaction with a supplier. For instance, Pratt & Whitney, a division of United

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<sup>1</sup> JD/MBA Candidate 2013, Michigan State University College of Law. I would like to thank Professor Bruce Bean for his guidance and feedback as my advisor for this paper. I would also like to thank Professor Kevin Saunders who provided helpful comments on this paper. Finally, I wish to thank Achille Mutombo, an LLM Fulbright scholar at MSU College of Law, who was kind enough to share his paper on how local miners in the Congo who are not involved in any conflict are harmed by Section 1502 of the Dodd-Frank Act.

<sup>2</sup> Robert Wright, *Supply Chain: Tsunami, Floods, and Storms Move Logistics Up the Agenda*, FINANCIAL TIMES, January 24, 2012, available at: <http://www.ft.com/intl/cms/s/0/754e8758-407a-11e1-9bce-00144feab49a.html#axzz2Mn8TYGLd>.

<sup>3</sup> *Id.*

<sup>4</sup> Kathleen Ellis, *The Aftershocks of Vulnerable Supply Chains*, INSURANCE JOURNAL, June 27, 2011, available at: <http://www.insurancejournal.com/news/national/2011/06/27/204170.htm>.

Technologies, recently began investigating its supply chain after it was discovered that one of its subsidiaries falsified test results regarding titanium quality for airplane parts.<sup>5</sup> The falsifications took place over 15 years and are expected to include more than 40,000 parts.<sup>6</sup> Similarly, in a widely reported story, Apple supplier Foxconn has been accused of various worker abuses including the use of underage labor and unsafe working conditions, which apple would, presumably, never allow.<sup>7</sup>

The difficulty of tracing source materials and ensuring those materials comply with prescribed specifications can be difficult – and the consequences widespread. This is exemplified perfectly in the recent scandal in Europe in which horse meat was found in ground beef in meals served at restaurants, schools, and hospitals, as well as in frozen supermarket meals.<sup>8</sup> This scandal, though likely not a significant health risk, has worried consumers across the globe.<sup>9</sup> Similarly, several years ago, consumers were also concerned about lead paint that was found in US children’s toys that were manufactured in China.<sup>10</sup>

What these incidents show is that, while a company may have the best of intentions regarding the management of its supply chain, there is still a great deal of complexity, and uncertainty, in the supply chain. Many companies operate on an “arm’s length” model without knowledge of the conduct of their suppliers. The aforementioned incidents show that companies do, in fact, need to

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<sup>5</sup> Brian Dowling, *Pratt Reviewing Five Engine Types with Titanium Parts*, THE HARTFORD COURANT, February 26, 2013, available at: <http://www.courant.com/business/hc-pratt-whitney-western-titanium-20130226-1,0,1784531.story>.

<sup>6</sup> Brian Dowling, *Pratt: Fraudulent Engine-Testing Scheme Uncovered in 2011*, THE HARTFORD COURANT, March 4, 2013, available at: <http://www.courant.com/business/hc-utc-pratt-and-whitney-testing-scheme-20130304,0,3311317.story>.

<sup>7</sup> Charles Duhigg & David Barboza, *In China, Human Costs are Built into an iPad*, N.Y. TIMES, (January 25, 2012), available at: [http://www.nytimes.com/2012/01/26/business/ieconomy-apples-ipad-and-the-human-costs-for-workers-in-china.html?\\_r=0](http://www.nytimes.com/2012/01/26/business/ieconomy-apples-ipad-and-the-human-costs-for-workers-in-china.html?_r=0).

<sup>8</sup> Michael Lee, *Q&A: Could the European horse meat scandal spread to the US?*, THE WASHINGTON POST, February 28, 2013, available at: [http://www.washingtonpost.com/lifestyle/food/qanda-could-the-european-horse-meat-scandal-spread-to-the-us/2013/02/28/20405510-81e3-11e2-a671-0307392de8de\\_story.html](http://www.washingtonpost.com/lifestyle/food/qanda-could-the-european-horse-meat-scandal-spread-to-the-us/2013/02/28/20405510-81e3-11e2-a671-0307392de8de_story.html).

<sup>9</sup> *Id.*

<sup>10</sup> Eric S. Lipton & David Barboza, *As More Toys Are Recalled, Trail Ends in China*, N.Y. TIMES, June 19, 2007, available at: [http://www.nytimes.com/2007/06/19/business/worldbusiness/19toys.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2007/06/19/business/worldbusiness/19toys.html?pagewanted=all&_r=0).

deepen their supply chain knowledge. However, when one considers that the average Dell computer contains hundreds of component parts from more than a dozen countries, the magnitude and expense of examining every tiny amount of material in each part comes into view.<sup>11</sup>

Rather than letting the market forces control this process, a variety of new laws are intended to require corporate social responsibility activities and mandate deep supply chain knowledge. A little-noticed provision in the Dodd-Frank Act, and the resulting SEC-promulgated rule, require companies to disclose the country of origin for certain minerals used in their products.<sup>12</sup> Similarly, the California Transparency in Supply Chains Act requires retailers and manufacturers with gross receipts of greater than \$100 million who do business in the State of California to disclose what they are doing to prevent slavery and human trafficking in their supply chains.<sup>13</sup> These laws are in addition to increased enforcement actions under the United States Foreign Corrupt Practices Act and the U.K. Bribery Act 2010 which each impose additional burdens further down the supply chain for alleged bribery.<sup>14</sup>

The California Act and Section 1502 have laudable goals – stopping the genocide and civil war in the Democratic Republic of the Congo, and eradicating human trafficking. While this paper may be critical of the ways in which these laws go about attempting to achieve those goals, nothing here is intended to imply these goals should not be pursued. Rather, the paper seeks to address the difficulties in compliance at a time when companies don't always have enough basic supply chain knowledge to react to natural disasters and ways in which each of these laws could

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<sup>11</sup> Christopher G. Campbell & Laura T. Vogel, *Five Tips for Preventing Problems*, 52 NO. 7 DRI FOR DEF 85 (2010).

<sup>12</sup> See Dodd-Frank §1502, 15 U.S.C. S78m(p) (West 2013).

<sup>13</sup> See Cal.Civ.Code § 1714.43(a)(1) (West 2013).

<sup>14</sup> John Rupp et. al., *The Briber Act and Foreign Corrupt Practices Act: Potential Traps for the Unwary in Corporate Transactions*, BLOOMBERG LAW: PRACTITIONER CONTRIBUTIONS (2012), available at: <http://about.bloomberglaw.com/practitioner-contributions/the-bribery-act-and-foreign-corrupt-practices-act-potential-traps-for-the-unwary-in-corporate-transactions-by-john-rupp-ian-redfearn-and-mark-herman-covington-burling-llp/>.

be made more effective while simultaneously putting less of a burden on private enterprise. Both of these laws, rather than setting specific prohibitions for the use of conflict minerals or forced labor, instead follow what some commentators have called a “name-and-shame” approach.<sup>15</sup> The effectiveness, or ineffectiveness, of this approach will also be discussed.

This paper will discuss who is affected by these laws, what the laws require, the projected compliance costs, as well as who the enforcing agencies will be. It will explore potential problems and unintended consequences stemming from these laws. It will also examine what may be more effective ways of reaching the purported goals of each of these laws. Finally, this paper will offer practical advice for companies that may be required to comply with the reporting requirements of these laws.

## **II. The Dodd-Frank, Act Section 1502**

### **a. Who is affected and what does Section 1502 require?**

#### **i. Introduction**

The Dodd-Frank Act, passed largely in response to corporate securities trading fraudulent scandals, contained a provision unrelated to preventing financial fraud. This provision mandates disclosure of the purchase of certain minerals from the Democratic Republic of the Congo and other neighboring countries known as “Covered Countries.”<sup>16</sup> This disclosure requirement held that any corporation required to file reports under the Securities Exchange Act of 1934 must also file a report regarding its use so-called conflict minerals if those minerals are “necessary to the functionality or production of a product manufactured by such [corporation].”<sup>17</sup> The rule further

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<sup>15</sup> Karen E. Woody, *Conflict Minerals Legislation: The SEC’s New Role As Diplomatic and Humanitarian Watchdog*, 81 *FORDHAM L. REV.* 1315, 1344 (2012).

<sup>16</sup> See Dodd-Frank §1502, 15 U.S.C. S78m(p) (West 2013).

<sup>17</sup> *Id.*

directs the Securities and Exchange Commission to promulgate regulations for annual disclosure of whether conflict minerals are necessary and, if so, to submit a report detailing if those minerals originate from a Covered Country.<sup>18</sup> While the Democratic Republic of the Congo is the most often mentioned in connection with this rule, and in this paper, it seems worth mentioning that the other Covered Countries are Angola, Burundi, the Central African Republic, Rwanda, South Sudan, Tanzania, Uganda, and Zambia.<sup>19</sup>

The impact of this rule is perhaps shown by the volume of the public comments in response to the proposed rule. The SEC received thousands of comments regarding the proposed rule for the conflict minerals provision.<sup>20</sup> As Karen Woody notes in her article *Conflict Minerals Legislation: The SEC's New Role as Diplomatic and Humanitarian Watchdog*, the SEC first issued proposed regulations in December 2010.<sup>21</sup> After receiving thousands of comments and holding a roundtable discussion, as well as conducting economic analysis, the SEC issued the final rule on August 22, 2012.<sup>22</sup>

## ii. The Final Rule

The final rule holds that any company required to file reports under Section 13(a) or Section 15(d) of the 1934 Act is required to comply with the rule.<sup>23</sup> For the purposes of this paper, companies that must comply with this law will be referred to as “Issuers” or “Covered Companies.” The rule expressly notes that domestic companies, foreign private issuers, and smaller reporting companies can all be “Covered Companies.”<sup>24</sup> This rule, limited by the

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<sup>18</sup> *Id.*

<sup>19</sup> Jane C. Luxton, *The New SEC Conflict Minerals Rule Challenge in Compliance*, 16 No. 11 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 1 (2012).

<sup>20</sup> Karen E. Woody, *Conflict Minerals Legislation: The SEC's New Role as Diplomatic and Humanitarian Watchdog*, 81 *FORDHAM L. REV.* 1315, 1328 (2012).

<sup>21</sup> *Id.* at 1328.

<sup>22</sup> *Id.*

<sup>23</sup> Conflict Minerals Final Rule, 77 *Fed. Reg.* 56,274, 56,287 (Sep. 12, 2012).

<sup>24</sup> *Id.*

jurisdiction of the SEC, appears to create a potential business situation in which public reporting companies are placed at a disadvantage when compared to non-reporting companies. The costs of complying with current securities laws, both in financial terms and in terms of complexity have been well documented and need not be recited here.<sup>25</sup> The conflict minerals provision adds yet another cost and a great deal of complexity for issuers.

It also seems probable that, while not required strictly to comply with the Final Rule, many companies will nonetheless have to comply because companies they supply are forced to comply.<sup>26</sup> For instance, if a company is a Covered Company that is forced to comply, and it has suppliers who need not comply, the Covered Company is likely to demand the non-Covered Company's assistance in complying with the rule and tracing the original of any covered minerals. In fact, many non-public companies have already begun receiving letters from their customers requesting such assistance in complying with Section 1502.<sup>27</sup>

The SEC's final rule begins a three-part analysis that determines the applicability of the rule.<sup>28</sup> For the first step, an issuer must determine whether it is subject to the requirements of the conflict minerals provisions.<sup>29</sup> Those who are required to comply are those for whom "conflict minerals are necessary to the functionality or production of a product manufactured by such person."<sup>30</sup> If an issuer does not meet this definition, there is nothing further it needs to do. No

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<sup>25</sup> For a discussion of compliance costs related to the Sarbanes-Oxley Act of 2002, *see generally* William C. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"*, 55 EMORY L. J. 141 (2006).

<sup>26</sup> Jane C. Luxton, *The New SEC Conflict Minerals Rule Challenge in Compliance*, 16 NO. 11 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 1 (2012).

<sup>27</sup> Jane C. Luxton, *The New SEC Conflict Minerals Rule Challenge in Compliance*, 16 NO. 11 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 1 (2012).

<sup>28</sup> Conflict Minerals Final Rule, 77 Fed. Reg. 56,274 (Sep. 12, 2012).

<sup>29</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,279.

<sup>30</sup> *Id.*

disclosure is required.<sup>31</sup> If an issuer does meet this requirement, it must proceed to the second step.<sup>32</sup>

The second step requires an issuer to conduct a reasonable country of origin inquiry regarding the origin of conflict minerals.<sup>33</sup> To satisfy this requirement, an issuer must conduct an inquiry regarding the origin of its conflict minerals that is reasonably designed to determine “whether any of its conflict minerals originated in Covered Countries.”<sup>34</sup> This inquiry must also be undertaken in good faith.<sup>35</sup> If, after the inquiry, the issuer knows or reasonably believes that the minerals did not originate in one of the conflict countries, the issuer must then prepare a specialized disclosure report to briefly describe the reasonable country of origin it used in the inquiry.<sup>36</sup> Noticeably absent from this rule is what would constitute a “reasonable inquiry” under this step.

If the issuer has knowledge or reason to believe that the minerals originated in a prohibited country, the issuer must move to the third step.<sup>37</sup> This step requires an issuer to exercise due diligence on the source and chain of custody of its conflict materials using a nationally or internationally recognized framework.<sup>38</sup> During this process, the issuer should attempt to determine if its minerals originated from a listed country but did not support or benefit armed groups.<sup>39</sup> If an issuer cannot state that its minerals did not originate from a Covered Country or

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,280. Conflict minerals are defined in the final rules as including cassiterite, columbite-tantalite, gold, wolframite, and their derivatives. *Id.* at 56,285. The definition may also be expanded if the Secretary of State determines that additional minerals are financing the armed conflict in Covered Countries. *Id.*

<sup>34</sup> Jane C. Luxton, *The New SEC Conflict Minerals Rule Challenge in Compliance*, 16 No. 11 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 1 (2012).

<sup>35</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,280.

<sup>36</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,281.

<sup>37</sup> *Id.*

<sup>38</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,326.

<sup>39</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,317

recycled or scrap sources, the issuer must provide a Conflict Minerals Report.<sup>40</sup> The Conflict Minerals report must include a description of the due diligence taken, along with a description of the facilities used to process the conflict materials, the country of origin of the conflict minerals, and the efforts to determine the mine or location of original of the minerals.<sup>41</sup> The issuer must also have the report audited.<sup>42</sup>

The due diligence required The Conflict Minerals report, if necessary, must be filed as an exhibit to the Form SD.<sup>43</sup> The Form SD is the form promulgated by the SEC to be used by companies to report the information required by the Final Rule.<sup>44</sup>

If the due diligence does show that the minerals are conflict-free, the Conflict Minerals Report need not be filed but the Issuer's Form SD must include description of the due diligence and how the results shows the minerals are conflict-free.<sup>45</sup>

Interestingly, the aforementioned disclosure on Form SD only includes indexing on EDGAR, the SEC's document management system.<sup>46</sup> There is no requirement that the company disclose his information in any other place. This would tend to suggest that Section 1502 is targeted primarily toward investors as there is no requirement for disclosure in a place readily visited by consumers.

### **iii. Transition Period**

The final rule also includes a temporary transition period during which issuers need not disclose if their products contain conflict minerals or not but may instead include the designation

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<sup>40</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,281, 56,361.

<sup>41</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,321.

<sup>42</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,320.

<sup>43</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,281.

<sup>44</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,301.

<sup>45</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,320. In addition to the Final Rule, for a useful summary about the new SEC Form SD that is used for disclosure under the Conflict Minerals Final Rule, see

<sup>46</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,301.

“DRC conflict undeterminable.”<sup>47</sup> This distinction can be used if, after reasonable inquiry, the issuer cannot determine if the minerals are from a Covered Country or if the minerals financed or benefited armed groups in a covered country.<sup>48</sup> This distinction can also be used if, after reasonable inquiry, an issuer was unable to determine if the minerals originated in a covered country.<sup>49</sup> However, if the issuer knows that the conflict minerals directly or indirectly financed or benefited an armed group in the Covered Countries, the “DRC conflict undeterminable” designation may not be used.<sup>50</sup> The transition period is two years for all issuers and four years for smaller reporting companies.<sup>51</sup>

It appears that the transition period will be needed. A survey of American companies shows that just 11.3% of manufacturers with 17.1% of the electronics market had information on conflict minerals in their supply chains available as of November 2012.<sup>52</sup>

#### **b. Compliance Costs**

Karen Woody conducts a thorough survey of the estimates of compliance costs in her article. The SEC estimate for the cost of compliance for those affected is approximately \$3 to 4 billion to develop initial compliance programs.<sup>53</sup> The SEC estimated that the yearly compliance costs would be approximately \$207 to \$609 million.<sup>54</sup> In stark contrast to the SEC prediction, predictably, is the National Association of Manufacturers’ estimate which puts the cost of initial compliance between \$9 and 16 billion.<sup>55</sup>

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<sup>47</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,281.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 56,282

<sup>52</sup> Sri Jegarajah, *Conflict Minerals in Your Mobile – Why Congo’s War Matters*, CNBC, (November 26, 2012), available at: <http://www.cnbc.com/id/49961559>.

<sup>53</sup> Karen E. Woody, *Conflict Minerals Legislation: The SEC’s New Role as Diplomatic and Humanitarian Watchdog*, 81 *FORDHAM L. REV.* 1315, 1333 (2012); Conflict Minerals Final Rule, 77 Fed. Reg. at 56,334.

<sup>54</sup> *Id.*

<sup>55</sup> National Association of Manufacturers, *Testimony of Franklin Vargo, Vice President, International Economic Affairs, National Association of Manufacturers before the House Committee on Financial Services, Subcommittee*

Between these numbers is a Tulane study that performed an analysis of the economic model used by the SEC, as well as the model used by the National Association of Manufacturers.<sup>56</sup> The study found that the model used by the SEC likely underestimated the cost of compliance, whereas the model used by the National Association of Manufacturers likely overestimated.<sup>57</sup> A third model, utilized by the study, places the cost of compliance at \$7.93 billion initially.<sup>58</sup> One of the central differences in the third model is that it notes that many of the compliance costs will be borne by suppliers to issuers, as opposed to the issuers themselves, and, as such, a single supplier may serve multiple issuers which would reduce the total cost of compliance.<sup>59</sup>

### **c. Unintended Consequences**

Regardless of which model is used, it is obvious that complying with the SEC rule will be hugely expensive for American companies. The Tulane study makes an interesting comment on the projected costs of compliance noting that the nearly \$8 billion in compliance costs, “must be viewed relative to the size of the industries that depend on these minerals – including industrial, aerospace, healthcare, automotive, chemicals, electronics/high-tech, retail and jewelry sectors – and the trillions of dollars in wealth creation these sections combined generate.”<sup>60</sup> While it is true that the sectors that are affected account for trillions of dollars in revenue, the aforementioned revenue does not necessarily mean profits. The SEC rule has the short-term effect of increasing

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*on International Monetary Policy and Trade, on “The Costs and Consequences of Dodd-Frank Section 1502: Impacts on American and the Congo*, May 10, 2012, available at:

[http://www.nam.org/~media/D22FDCF63D134B6D9A973DEADDB17D30/Conflict\\_Minerals\\_Testimony.pdf](http://www.nam.org/~media/D22FDCF63D134B6D9A973DEADDB17D30/Conflict_Minerals_Testimony.pdf)

<sup>56</sup> Chris Bayer, *A Critical Analysis of the SEC and NAM Economic Impact Models and the Proposal of a 3<sup>rd</sup> Model in View of the Implementation of Section 1502 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act*, LAW PROFESSOR BLOGS (October 12, 2011), available at:

<http://lawprofessors.typepad.com/files/tulane-study.pdf>.

<sup>57</sup> *Id.* at 2.

<sup>58</sup> *Id.* at 32.

<sup>59</sup> *Id.* at 12.

<sup>60</sup> *Id.* at 32.

raw material acquisition prices for a variety of suppliers. These costs will either cut into the profit margins of the affected companies or, perhaps more likely, will increase the costs of American products which contain these materials.

### **i. A Competitive Disadvantage**

It doesn't seem difficult to argue that the SEC Rule amounts to a de facto tax on all products containing Conflict Minerals that are produced by Covered Companies. Curiously, and also problematically, this rule would appear to also put companies who are required to file reports under the 1934 Act at a competitive disadvantage compared to companies that are not subject to reporting requirements. If a company does not have to report, it needn't invest the time and capital in attempting to comply with these rules. It can continue to source from the cheapest possible supplier.

In addition to the ways in which companies may be placed at a competitive disadvantage, some companies also worry about the loss of a competitive advantage because of Section 1502. Information about a company's supply chain and its sourcing can often form the basis for a competitive advantage. For instance, some suppliers in the automotive sector who have been under tremendous pressure to obtain a cost competitive advantage wherever possible are worried that disclosure of information under the final SEC rule may in fact mean that they are required to disclose some details about their supply chains.<sup>61</sup> These details, if broadly disseminated, would allow competitors to learn the ways in which they have been able to reduce costs.<sup>62</sup>

### **ii. Potato Chip Compliance**

The final rule also does not contain a *de minimis* threshold which would allow for an exemption for products which contain a trace amount of conflict minerals. This means that a

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<sup>61</sup> Dustin Walsh, *African Violence Touches Automotive Supply Chain; Conflict Minerals Increases Costs, Red Tape*, CRAIN'S BUSINESS DETROIT (Sep. 24, 2012).

<sup>62</sup> *Id.*

wide array of products fall under the scope of the final rule. For instance, a bag of potato chips could be regulated under the final rule because the bag will often contain a trace amount of tin. One article notes that companies like Frito Lay have attempted to argue that their products should be exempt from compliance.<sup>63</sup> The SEC notes that by not including a *de minimis* exception even minute or trace amounts could trigger the need to disclose, however it defends its decision not to include a *de minimis* threshold by noting that disclosure would not be required unless the conflict mineral was necessary to the functionality of the product.<sup>64</sup> This, of course, all begs the question, “What is the functionality of a bag of potato chips?”

### **iii. A de facto Embargo and Chinese Monopoly**

As previously discussed, compliance is prohibitively expensive. If a company were economically rational, it would most likely try to avoid these costs, and therefore minerals, entirely. The Dodd-Frank provisions and the SEC rule have created a de facto embargo where few US companies are purchasing any minerals from the Congo.<sup>65</sup> At first blush this may seem a good result – if no US companies are purchasing minerals from the armed groups, then those groups should be financially devastated. The problem is that the armed groups are not operating the mines and selling minerals directly. Much of the mining in the Congo is done by small, artisanal miners who would usually sell their minerals to legitimate manufacturers.<sup>66</sup> Because these miners can no longer sell to legitimate manufacturers, they are forced to sell their minerals on the black market, which may be of greater benefit to the armed groups.<sup>67</sup> Because some miners are unable to sell their minerals to anyone, many mines have suspended operations

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<sup>63</sup>Heath E. Combs, *Laws Require Corporate Social Responsibility*, FURNITURE TODAY, March 5, 2012.

<sup>64</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,298.

<sup>65</sup> Jeremy C. Jeffrey, *Tungsten is Forever: Conflict Minerals, Dodd-Frank, and the Need for a European Response*, 18 NEW ENG. J. INT’L & COMP. L. 503 (2012).

<sup>66</sup> *Id.* at 510.

<sup>67</sup> *Id.*

entirely.<sup>68</sup> Additionally, those miners who are still producing minerals are receiving prices twenty to thirty percent less for their minerals.<sup>69</sup> Some have suggested that the increasing rates of joblessness have actually helped the armed groups recruit because fewer Congolese actually have jobs now.<sup>70</sup>

China appears to be attempting to strengthen its ties with the Congolese government, thus ensuring a steady supply of minerals. China has also sought to strengthen its relationship with the Congolese with a \$6 billion resources-for-infrastructure agreement.<sup>71</sup> Needless to say, the fact that prices have fallen in the Congo has also been favorable to the Chinese buyers. Predictably, these factors have led to the Chinese having a near monopoly on Congolese minerals.<sup>72</sup>

The goals of Section 1502 of the Dodd-Frank Act are laudable, even if these goals don't belong in the realm of corporate law. However, the execution of the laws shows that there are major flaws. The costs of compliance stand to be high, whereas the benefits appear to be questionable. It seems safe to assume that the United States Congress did not intend to give the Chinese a virtual monopoly on conflict minerals at a bargain price. It also seems likely that potato chip manufacturers were not intended to be included in the law the same way that cell phone manufacturers are included. Yet, these are the unintended consequences of Section 1502. Later in this paper, these issues will be revisited with potential improvements to the law.

#### **d. The SEC? Really?**

As anyone with a passing familiarity with securities regulation would have no doubt noticed by now, Section 1502 represents a radical departure from the traditional duties of the Securities and Exchange Commission. As one commentator notes, Section 1502 represents “a

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<sup>68</sup> Mary Kay Magistad, *Why Chinese Mineral Buyers are Eyeing the Congo*, PUBLIC RADIO INTERNATIONAL'S THE WORLD, October 26, 2011, available at: <http://www.theworld.org/2011/10/chinese-conflict-minerals-congo/>.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

historic shift away from the SEC’s mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.”<sup>73</sup> Mark K. Neville, in an article for the *Journal of International Taxation*, went as far as calling Section 1502 and related regulations part of a “miscellaneous grab bag at the tail end of this [Dodd-Frank] massive financial crisis legislation.”<sup>74</sup>

The test usually used to determine if something should be required for disclosure to the SEC was if such information would be considered “material” to the average investor.<sup>75</sup> While this information may be important from a humanitarian perspective, it is not included in what has traditionally been considered material for purposes of SEC disclosure. It could no doubt be important to individual investors if a company uses conflict minerals, however if the materiality standard were expanded in this way to include any humanitarian factors that a subgroup of investors may consider important, it seems that materiality would include virtually every decision regarding every aspect of a company. The ways in which disclosures could expand seems limitless: If a company keeps animals for any reason, are those animals humanely treated? For that matter, is an animal used anywhere in the supply chain? Does a company use energy from exclusively renewable sources? Does a company buy only union-made goods? It could be argued that because the conflicts minerals are required to be necessary to the functionality of the product to mandate disclosure, the information is useful to a rationale investor because the supply of these minerals is subject to disruption. However, expanding the definition of materiality in this way could require disclosure of anything necessary to the production process – cardboard for packaging, electricity used to run factories, and essentially any related production

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<sup>73</sup> David M. Lynn, *The Dodd-Frank Act’s Specialized Corporate Disclosure: Using Securities Law to Address Public Policy Issues*, 6 J. BUS. & TECH. L. 327, 330 (2011).

<sup>74</sup> Mark K. Neville, Jr., ‘*Diamonds are a Warlord’s Best Friend*’ – *Enforcing Human Rights in the Supply Chain*, 23 JITAX, 19, 20 (2012).

<sup>75</sup> See generally *Basic v. Levinson*, 485 U.S. 224 (1985).

input. The materiality standard, articulated in *Basic v. Levinson*, provides a much more useful, and practical, threshold.<sup>76</sup>

While the disclosure of this information may have a positive impact in helping companies, it flies in the face of what has traditionally been the mission of the SEC. In addition to charging the SEC with a duty for which it was not created, Section 1502 of the Dodd-Frank Act also sets up a slippery slope wherein the SEC is used to accomplish political and other social goals. There is no limit to what issuers could be forced to disclose, and no limit to the Federal powers over corporations.

### **III. The California Transparency in Supply Chains Act**

Section 1502 is not the only recent regulation that mandates supply chain knowledge. California has often been recognized as a “leader” in corporate regulatory law. Continuing this trend, California recently passed the California Transparency in Supply Chains Act of 2010 (the “California Act”).<sup>77</sup> The Act, which took effect on January 1, 2012, requires companies to disclose certain information on their efforts to combat forced labor and human trafficking.<sup>78</sup> The California Act is similar to a piece of legislation which failed to pass the United States Congress.<sup>79</sup> While these bills are different from one another and Section 1502 of the Dodd-Frank Act, they both have the common method of requiring companies to disclose their efforts in an attempt to encourage compliance with desired human rights standards.

#### **A. Who is affected and what is required?**

The California Act requires that “every retail seller and manufacturer doing business” in California with worldwide gross receipts in excess of one hundred million dollars is subject to

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<sup>76</sup> *Id.*

<sup>77</sup> Jonathan Todres, *The Private Sector’s Pivotal Role in Combating Human Trafficking*, 3 CAL. L. REV. CIRCUIT 80, 81 (2012).

<sup>78</sup> *Id.* at 82.

<sup>79</sup> *Id.* at 82

the disclosure provisions of this law.<sup>80</sup> With regard to “doing business” in California, it is defined as any company that is “actively engaging in any transactions for the purposes of financial or pecuniary gain or profit” and is organized or domiciled in the state, it has California income tax in excess of \$500,000, has real or personal property in the state that exceeds \$50,000, or the amount the corporations pays as compensation in the state is greater than \$50,000.<sup>81</sup> Gross receipts essentially means the total sales of a company with any accounting adjustments or reductions for cost of goods sold.<sup>82</sup> Whether or not a company is a “manufacturer” or “retailer seller” depends on the principal business activity code it files on its California tax return.<sup>83</sup>

Given the relatively broad meaning of the definition of affected companies shown above, the regulation is clearly sweeping, or perhaps sweepingly overreaching. It is estimated that 3,200 companies are directly affected by the regulation.<sup>84</sup> What gives the regulation broader effect, however, is the fact that the wholesalers and distributors for those companies, regardless of their size, will be asked to comply indirectly if their customers are required to disclose.<sup>85</sup> Much like Section 1502, there is a domino effect down the supply chain that requires companies to comply or face the loss of customers.

For the companies that are required to comply, the requirements of the law are fairly straightforward. A company is required to disclose its efforts to “eradicate slavery and human trafficking from its direct supply chain for tangible goods offered for sale.”<sup>86</sup> The disclosure should include a description of the company’s actions for each of the following: 1) engages in

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<sup>80</sup> Cal.Civ.Code § 1714.43(a)(1) (West 2013).

<sup>81</sup> Cal.Civ.Code § 1714.43(a)(2)(A) (West 2013). This incorporates by reference Cal.Rev. & T. Code § 23101 (West 2013).

<sup>82</sup> Cal.Civ.Code § 1714.43(a)(2)(A) (West 2013).. This incorporates by reference Cal.Rev. & T. Code § 25120 (West 2013).

<sup>83</sup> Cal.Civ.Code § 1714.43(a)(2)(C) & (D) (West 2013).

<sup>84</sup> Melissa Harman, *How Will California’s supply chain law affect you?*, SAN FERNANDO BUS. J. 69 (June 25, 2012).

<sup>85</sup> *Id.*

<sup>86</sup> Cal.Civ.Code § 1714.43(a)(1) (West 2013).

verification of product supply chains, 2) conducts audits of suppliers to evaluable compliance with company standards for human trafficking and slavery in supply chains, 3) requires direct suppliers to certify that materials are incorporated into the product comply with applicable laws regarding human trafficking and slavery, 4) maintains internal accountability standards and procedures for employees or contractors, 5) provides employees who have direct responsibility for supply chain management training on human trafficking and slavery.<sup>87</sup>

There is no private remedy for failure to comply with this law – the only remedy for a violation of this section is an action brought by the Attorney General for injunctive relief.<sup>88</sup> The required disclosure must be posted on the company’s website with a “conspicuous and easily understood link to the required information.”<sup>89</sup> If a company does not have a website, it shall provide consumers with written disclosure within 30 days of receiving a request for information from a consumer.<sup>90</sup> The fact that the law requires a response within 30 days of receiving a request from a “consumer” and the fact that disclosure is required on a prominent place on the company’s website highlights one of the apparent differences between the California Act and Section 1502. The California Act appears to be targeted toward affecting the behavior of consumers given that making the information readily in a conspicuous place is a priority. In contrast, Section 1502 requires disclosure on Form SD which will be filed with the SEC and will be available online from the SEC, which suggests investors are the intended target.<sup>91</sup>

Interestingly, the California Act does not require a company to do anything other than disclose what it is already doing to combat human rights abuses. As discussed *supra*, rather than impose an affirmative obligation to verify that the supply chain contains neither of these, the law

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<sup>87</sup> Cal.Civ.Code § 1714.43(c) (West 2013).

<sup>88</sup> Cal.Civ.Code § 1714.43(d) (West 2013).

<sup>89</sup> Cal.Civ.Code § 1714.43(b) (West 2013).

<sup>90</sup> *Id.*

<sup>91</sup> Conflict Minerals Final Rule, 77 Fed. Reg. at 56,301.

simply requires a company to disclose what it is currently doing. Essentially, a company could comply by doing very little, or nothing and disclosing that fact.

This provision is clearly a pure “name-and-shame” provision that is intended to “encourage” compliance from companies by informing the public about the company’s efforts. The only real power behind this law comes from if companies comply for fear of a public outcry. A publication by the law firm Jones Day seems to put it best, “A company theoretically could simply state that it does not take any action and still be in compliance with the Act. However, the negative public relations consequences of such a response may far outweigh the costs of implementation.”<sup>92</sup>

#### **b. How much will this cost?**

Because the California law does not contain a specific prohibition or specific affirmative duties for companies, the cost of implementation is not easily measured in billions of dollars in the same way Section 1502 of the Dodd-Frank Act. The author was not able to locate a direct cost estimate for this law and the companies effected. However, because the law is primarily a disclosure of existing efforts, numerous costs would likely come from having internal employees document the efforts that are already being taken. These costs are likely difficult to measure because those employees likely represent fixed costs – they would be employed by companies regardless of if the California Act was in force or not. Compliance would merely represent a reallocation of existing resources. Further, it seems difficult to assess the compliance costs as they would vary widely from company to company based on existing efforts, the number of employees involved, the complexity of the company’s supply chains, and related factors. Some

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<sup>92</sup>Jones Day, *California Transparency in Supply Chains Act: New Disclosure Requirements for Companies Doing Business in California to Take Effect January 1, 2012*, JONES DAY COMMENTARY (Nov. 2011), available at: <http://www.jonesday.com/files/Publication/2d2aa656-db14-4227-aec6-3464b6a117ea/Presentation/PublicationAttachment/173da43b-5ea6-4fe3-aafe-38c5cb6bb1e1/California%20Transparency.pdf>

companies may also expand their current efforts in combating human rights abuses in response to the law, however because efforts vary widely between companies this cost would be difficult to quantify in financial terms.

These estimated costs are, of course, excluding the potential costs of hiring outside counsel, consultants, or related service-providers to help facilitate compliance with these laws. Depending on a company's internal capabilities, the need for outside help may add significant costs.

**c. Will this work?**

As discussed *supra*, the California law requires only that companies disclose their efforts and relies entirely on public opinion as an enforcement mechanism. But do enough members of the public actually feel strongly enough about preventing and reducing human rights abuses that they will review multiple company's disclosure reports and adjust their behavior according to which companies have the most comprehensive efforts to eradicate human rights abuses? Would these people have done their own research anyway? The author was unable to locate empirical research relating to the content of a company's disclosure report and the potential growth or shrinkage in earnings or reduction in the company's stock price. No doubt such a report may eventually be produced when more data is available, but for the time being an anecdotal exploration of a related incident seems useful.

The National Public Radio Program *This American Life* ran a story by a contributor about potential labor abuses committed by a major Apple Corporation supplier, Foxconn.<sup>93</sup> The story, later retracted when it was found to have significant fabrications, detailed the ways in which Foxconn employees are forced to work in poor conditions, the ways in which minors may be

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<sup>93</sup> James Poniewozik, *This American Life's Apple Retraction: The Danger of Truthiness*, TIME (March 26, 2012), available at: <http://entertainment.time.com/2012/03/16/this-american-lifes-apple-retraction-the-danger-of-truthiness>.

employed illegally, and the potential poisoning of workers due to lax conditions.<sup>94</sup> More than a quarter million people signed a petition condemning these practices.<sup>95</sup> All signs pointed to problems for the famed tech company. It seems as though investor and consumer outrage would be consistent with the desired results under with the California Act or Section 1502, which seem to seek to use disclosure to effect behavior in this particular way. While there was much outcry initially about the abuses detailed in the story, large parts of the story were later discredited.<sup>96</sup> It does not appear that any sort of backlash ever appeared for Apple, however, despite the fact that even without the fabrications contained in the *This American Life* story, there were still numerous abuses detailed at Foxconn plants which produce Apple products.

Many of the abuses in the story had been detailed by other media outlets at other times. *The New York Times* detailed the ways in which Foxconn mistreats its workers in many of the same ways described in the *This American Life* story. The *Times* article plainly states, “[u]nderage workers have helped build Apple’s products, and the company’s suppliers have improperly disposed of hazardous waste and falsified records, according to company reports and advocacy groups that, within China, are often considered reliable, independent monitors.”<sup>97</sup> The article further points out that Apple had been warned about these conditions.<sup>98</sup> Apple said in 2012 that it was making significant strides in improving factories.<sup>99</sup>

The information about Apple’s abuses was covered by the *Times* and was, and still is, readily available on the internet. However, over the year 2012, despite the fact that information

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<sup>94</sup> Erik Sherman, “*This American Life* Apple” Kerfuffle is Nonsense, CBS MONEY WATCH (March 19, 2012), available at: [http://www.cbsnews.com/8301-505124\\_162-57399856/this-american-life-apple-kerfuffle-is-nonsense/](http://www.cbsnews.com/8301-505124_162-57399856/this-american-life-apple-kerfuffle-is-nonsense/)

<sup>95</sup> Ian Sheer, et. al., *Radio Show Pulls Expose on Apple*, THE WALL STREET JOURNAL (March 19, 2012), available at: <http://online.wsj.com/article/SB10001424052702304459804577285713362126158.html>.

<sup>96</sup> *Id.*

<sup>97</sup> Charles Duhigg & David Barboza, *In China, Human Costs are Built into an iPad*, N.Y. TIMES, (January 25, 2012), available at: [http://www.nytimes.com/2012/01/26/business/ieconomy-apples-ipad-and-the-human-costs-for-workers-in-china.html?\\_r=0](http://www.nytimes.com/2012/01/26/business/ieconomy-apples-ipad-and-the-human-costs-for-workers-in-china.html?_r=0).

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

was available about Apple's potentially significant human rights abuses, Apple's share price did not decrease.<sup>100</sup> In fact, Apple's shares started around \$400 in January 2012 and climbed to more than \$700 a share in October 2012 before settling around \$550 in the last quarter of 2012.<sup>101</sup> The stock was up more than 31% and enjoyed stronger performance than 2011.<sup>102</sup>

The logic of the California Transparency in Supply Chain Act is that if information is available on a company's human rights failings, that company will be punished by consumers and investors for those abuses. Apple shows that may not be the case. The information about Apple's potential abuses has been available for quite some time but the vast majority of consumers and investors have seemed unwilling to punish Apple in any meaningful way for those abuses. It would seem that availability of that information is not enough to change consumer and investor behavior. The incident involving *This American Life* shows that there may be an initial outcry when a story like this is reported, however it is difficult to say if that effect is lasting given the circumstances of that incident.

The California Act has laudable goals and, unlike Section 1502 of the Dodd-Frank Act, it is probably not hugely expensive. Yet, there is little information on its actual practical effect on eradicating human rights abuses. While one could argue that because there is little harm, the law is probably harmless, it seems worth noting that this law may make it appear as though companies are putting effort forward for fixing this issues when they are, in fact, doing very little. Later in this paper, alternative and perhaps more effective methods of disclosure will be discussed.

#### **IV. Better Laws, Less Waste**

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<sup>100</sup> Jay Yarrow, *Chart of the Day: Surprise! Apple's 2012 was Better than Its 2011*, BUSINESS INSIDER (Jan. 2, 2013), available at: <http://www.businessinsider.com/chart-of-the-day-apple-stock-performance-2013-1>.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

What follows is a discussion of the potential ways in which the above-discussed laws could be improved, rewritten, or replaced to accomplish the same goals but more effectively.

### **A. Great Expense and Worthy Goals**

As previously discussed, Section 1502 of the Dodd-Frank Act represents a huge added financial burden for many companies. By all estimates, the compliance costs will reach into the billions of dollars and yet the benefits of this law are not as clear as its advocates would like to argue. Similarly, the California Act may also be marginally expensive and will produce questionable, if any, benefits.

This is not to say, however, that the goals of these laws are not worthy. Eradicating human rights abuse is a worthy goal that should be pursued. Ignoring the debate about whether these issues should be pursued at a corporate level as opposed to a political or religious level, there appear to be more effective and efficient ways of attempting to accomplish those goals. The following proposals borrow from other areas of law and policy to attempt to craft more effective means accomplishing the same goals.

### **B. Alternatives**

The proposals for more effective corporate-related law in this area, discussed below, are intended to begin a discussion about the ways in which laws can be used to effectively help combat human rights abuses. These are not perfect suggestions and are not intended as polished, refined policy recommendations.

#### **i. Improvements to the Current Laws**

There are a number of small steps that could be taken immediately to improve the effectiveness and efficiency of the existing laws. One of the most pressing options would seem to be the inclusion of *de minimis* threshold in the final SEC Rule promulgated under Section 1502.

As discussed supra, the lack of a *de minimis* threshold subjects companies in a wide array of industries who use conflict minerals incidentally to costly compliance requirements. It would also allow the SEC, and the public, to focus on companies who use a vast majority of the conflict minerals as opposed to only a small fraction of those minerals. However, the inherent difficulty with policing these minerals is that they are almost always used in very, very small amounts.

The California Act could also be improved by some kind of standardization of the ways in which companies present information in their required disclosures. The author reviewed a number of disclosures in preparing this paper.<sup>103</sup> Each presents information in a different way with a differing length with different terminology. These documents often read as though they were marketing documents. As much as possible, it would be helpful if this information were presented in a standard format which would allow those interested consumers to easily compare the human rights efforts of various companies. A good example for standardized disclosure documents would be any of the SEC required reporting schedules. For instance, SEC Form 13D provides information in an easily organized way that would allow a consumer to compare ownership information from different companies on the same form, or to view a single

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<sup>103</sup> See generally Gap Inc., *California Transparency in Supply Chains Act (SB 657)*, GAP INC. SOCIAL RESPONSIBILITY (2013), available at: <http://www.gapinc.com/content/csr/html/OurResponsibility/governance/SB657.html>, “Gap Inc. has a Code of Vendor Conduct (COVC or “code”) that all of our branded apparel vendors must abide by, which explicitly states that forced labor of any kind is strictly prohibited. Our COVC and the enforcement behind it is an important mechanism that brings our Human Rights Policy to life within our supply chain.”.

See also IBM, *IBM Response to the California Transparency in Supply Chains Act*, IBM RESPONSIBILITY (Jan. 3, 2012), available at: <http://www.ibm.com/ibm/responsibility/response.html>, (“As members of the Electronic Industry Citizenship Coalition (EICC), IBM and other member firms have demonstrated our commitment to environmental and social responsibility. Since 2004, IBM (and the EICC) has built upon the Code of Conduct which prohibits the use of forced, bonded, indentured labor or involuntary prison labor.”).

See also J. Crew, *California Transparency in Supply Chains Act*, J. CREW SOCIAL RESPONSIBILITY (2013), available at: [http://www.jcrew.com/flatpages/social\\_res\\_april4.jsp](http://www.jcrew.com/flatpages/social_res_april4.jsp), (“The Responsible Sourcing Program at J.Crew is in place to clearly communicate our expectations to our suppliers and to monitor and improve working conditions at the facilities that manufacture products for J.Crew...”).

company's information in an organized, familiar way. These allow a consumer to compare companies from different industries with vastly different supply chains quickly and easily.

Further, the disclosure documents for the California Act could contain different categories of compliance. For instance, when discussing audits of the supply chain for the presence of human trafficking and forced labor, there could be different, standardized classifications for the type of audit conducted: supplier certification of the absence of forced labor, internal audit for the presence of forced labor, independently verified internal audit, or third-party audit. These categories would further simplify the dissemination of information for consumers.

## **ii. Human Rights Labeling**

Perhaps part of the problem with the way the California Law currently exists is that it requires a consumer who wants to research a company's reputation on human rights issues to go to the company's website and read about its efforts to human rights abuses, and to then go to another company's website and read about its efforts repeating the process until the consumer has enough information to make an informed buying decision. These reports are non-standard and often seem difficult to compare. Even if a consumer cares a moderate amount about these issues, there is a barrier to effectively using that information as planning and forethought would be required. For instance, a comparison of the J. Crew and Gap disclosures shows that the current form of these disclosures is of little value as many companies simply write that they are attempting to eradicate human trafficking in some generic, vague way.<sup>104</sup> There are no concrete,

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<sup>104</sup> The California Act sets out a list of five requirements that companies must meet in their disclosure statements. Cal.Civ.Code § 1714.43(c) (West 2013). A comparison of GAP's response and J. Crew's response to the first requirement helps to show the value, or lack thereof, in these disclosure reports. The first requirement is, "Engages in verification of product supply chains to evaluate and address risks of human trafficking and slavery. The disclosure shall specify if the verification was not conducted by a third party." Cal.Civ.Code § 1714.43(c) (West 2013).

GAP's disclosure provides, "Gap Inc. monitors nearly 100 percent of the garment factories that produce Gap Inc. branded apparel. We verify our product supply chains through both announced and unannounced visits to measure

quantitative metrics contained in the requirements of the California Act. Instead, GAP, J. Crew, and many others opt for marketing-style prose to describe their efforts. Further, it seems likely that the people willing to do such research would also likely be the people who would do such research regardless of the California law.

While a consumer may not be willing to specifically research companies before shopping, it seems more likely that consumers would be willing to consider human rights factors if they were presented during the shopping experience. For instance, say only the most die-hard consumers would be willing to research if a brand of tuna was dolphin safe before going to the grocery store. However, many consumers would be willing to check the label of a tuna brand before purchasing to make sure it is dolphin safe. In the same way, many consumers may not research if a vegetable company uses pesticides or if a meat company uses antibiotics before going to the grocery store, but those same consumers will buy groceries labeled “organic” and “antibiotic-free” if given the chance.

The same kind of idea could theoretically apply to other products and human rights abuses. A label could indicate that particular goods were produced in compliance with strict human rights standards. In this way, consumers would be able to gather the relevant information quickly, at the point of purchase, without the added barrier of needing to consider the need for

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factories’ compliance with our Code of Vendor Conduct, which includes strict prohibition of ‘forced labor ... or involuntary labor of any kind.’” Gap Inc., *California Transparency in Supply Chains Act* (SB 657), GAP INC. SOCIAL RESPONSIBILITY (2013), available at: <http://www.gapinc.com/content/csr/html/OurResponsibility/governance/SB657.html>

J. Crew’s disclosure provides, “We have a robust Responsible Sourcing Program in place to evaluate and address risks in our supply chain, including the risk of slavery and human trafficking. We have two full-time associates dedicated to social responsibility, and we partner with leading independent organizations to implement various aspects of our program, including conducting factory inspections, trainings and remediation in the facilities that produce our goods...All new factories are subject to inspection before any purchase orders are placed. Existing factories are typically inspected every 12 to 24 months unless follow-up is required, in which case we will inspect more frequently.” J. Crew, *California Transparency in Supply Chains Act*, J. CREW SOCIAL RESPONSIBILITY (2013), available at: [http://www.jcrew.com/flatpages/social\\_res\\_april4.jsp](http://www.jcrew.com/flatpages/social_res_april4.jsp).

this information before arriving at the store. There would not need to be a label to indicate that a good was produced with forced labor – the lack of a label indicating otherwise would likely be enough.

There would be numerous ways to certify that a product is “human rights friendly.” There could be voluntary standards with third-party auditing companies such as with organic food that would certify consumer goods. There could be a government agency that would review a company’s efforts and certify that they were human rights friendly. Or, if not a standalone agency, there could be specific requirements for labeling products as human rights abuse free and companies could label their products with this distinction, but there would be penalties for non-compliance.

It doesn’t seem unreasonable to say that given the choice between a good produced using slave labor and one produced not using slave labor, most Americans could chose the good produced in a human rights friendly way. The California Act attempts to give consumers the ability to make these informed decisions, however the barriers to using that information appear to be too high for most Americans. Making this information readily accessible at the point of purchase would make it more effective, and would do more to further the aims of the law.

The concept of labeling products could also be applied to conflict minerals under Section 1502. As discussed above, it seems that the requirements for Section 1502 are primarily intended to target investors as there does not appear to be emphasis on making the information readily available to consumers. It seems unlikely that all but the most devoted consumers will research a company’s Form SD disclosure reports to determine if they are conflict mineral free prior to entering the store to purchase those products. If products were labeled as “conflict-mineral” free in stores, consumers may choose products with this distinction when compared next to products

without such a distinction. Many consumers may oppose the use of conflict minerals and may oppose human rights abuses but may not have time to research the ways in which various companies treat these issues. Labeling offers consumers the opportunity to make informed decisions without creating a barrier of research that would come with an online or SEC disclosure.

While this labeling may be useful from a human rights perspective, there may also be commercial benefits for companies who chose to include this labeling. This kind of labeling could be particularly useful for companies who exist in largely commoditized industries where consumers have trouble differentiating between competing products. Where a consumer does not have strong brand loyalty, conflict-free or human rights violation-free labeling may be enough to swing a consumer's decision to purchase a particular product.

### **iii. Tax Incentives**

Though decried by many who advocate for the use of the free market, tax incentives are often used to achieve what are deemed to be socially or politically desirable goals. It seems like in preventing human rights abuses tax incentives could be used to help.

For instance, presumably without human rights concerns a company would only seek primarily to minimize the total landed cost of the minerals needed to produce its products. Disincentive for the use of conflict minerals could easily be offered by subjecting any and all materials from any of the Conflict Countries to a prohibitively high tariff. If the price of these minerals were held artificially high, companies would naturally seek less-expensive minerals from non-Conflict Countries.<sup>105</sup>

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<sup>105</sup> It would, of course, be an issue for the Departments of State and Defense to ensure the money actually went to humanitarian efforts as opposed to the conflicts.

Making these taxes effective, however, would require careful consideration and calibration of the incentives involved. The current tax system appears to attempt to accomplish this goal but given the current state of conflict mineral trading and the need for Section 1502, it appears the tariff system has failed. Currently, a container of tin ore from the Democratic Republic of the Congo costs \$6,500 whereas the same container of tin would cost \$200 if exported from Rwanda.<sup>106</sup> This means that many minerals are often transported to a different country before being exported.<sup>107</sup> Shannon Raj in *Blood Electronics: Congo's Conflict Minerals and the Legislation That Could Cleanse The Trade*, wisely suggests that a regional tariff would eliminate this incentive for smuggling and would help ensure greater transparency.<sup>108</sup> This idea seems wise, especially if the money gathered from these tariffs is used to support humanitarian efforts in the Congo and the other Covered Countries.

The idea of a tax penalty for buying conflict minerals could be especially effective if coupled with a tax incentive for not doing so. Tax incentives also could be given to companies that voluntarily produce their products with non-conflict minerals. These kinds of incentives have been given, in recent memory, to all kinds industries and products from Hollywood films to plug in electric scooters to a special tax on rum imports that is used to support the American rum industry.<sup>109</sup> Companies who use non-conflict minerals and have that information confirmed by a third-party auditor could receive a deduction for the amount of the minerals purchased or a percentage thereof, or some related issue. While the mechanics of such an incentive are beyond the scope of this paper, the main idea is using the tax system to disincentive the use of conflict

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<sup>106</sup> Shannon Raj, *Blood Electronics: Congo's Conflict Minerals and the Legislation That Could Cleanse the Trade*, 84 S. CAL. L. REV. 981, 1031 (2011).

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> Brad Plumer, *From NASCAR to Rum, the 10 Weirdest Parts of the "Fiscal Cliff" Bill*, THE WASHINGTON POST (January 2, 2013), available at: <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/01/02/from-nascar-to-rum-the-10-weirdest-parts-of-the-fiscal-cliff-deal>.

minerals and incentive the use of non-conflict minerals. This is not to say that such an incentive structure will solve the underlying reason for the conflict, or even lessen the conflict. It would simply offer a more effective incentive structure than the current laws. However, such a tax structure may be subject to the same unintended consequences as discussed above.

This same idea could also be applied to human trafficking and forced labor. If a company could find a third-party audit which certifies its supply chain is free of human trafficking and forced labor, the company could be allowed certain favorable tax attributes. This may be difficult to measure and may result in false claims of human rights abuse free products, however the idea would be to create a further financial incentive for companies to avoid these kinds of labor. These incentives may also help defer the financial costs of eradicating forced labor and human trafficking in the supply chain.

#### **iv. Changing the culture**

Both the California Transparency in Supply Chains Act and Section 1502 of the Dodd-Frank Act are supposed to work because of the “name-and-shame” nature of each – when companies are forced to disclose their use of conflict minerals, or lack of efforts to eradicate human trafficking, in their supply chains, they will lose customers. Apple’s potential human rights abuses have been long decried in the media but the company has not yet paid a price for those abuses in terms of sales or support.

What would perhaps be more effective than requiring corporations to disclose potential abuses in their supply chains would be efforts to encourage consumers to become more educated about the goods and services they purchase. Much of the information that such “name-and-shame” provisions would require is already available, but consumers are not aware of it or do not actively make it part of their buying decisions. While not necessarily a government or corporate

initiative, such an effort to change the culture of American consumers to place a greater emphasis on supply chain transparency may be effective.

A forthcoming law review article suggests that consumers will continue to demand greater supply chain transparency, regardless of Section 1502 of the Dodd-Frank Act.<sup>110</sup> While it may be true that activist shareholder groups and human rights activists may continue to demand supply chain transparency, it does not appear that the vast majority of American consumers will demand such information, or will allow their behavior to be affected by the availability of such information.

Rather than focusing on increased corporate disclosure, efforts to curb these abuses should instead focus on increasing consumer awareness about these issues. Raising awareness could potentially change consumer culture and behavior in the United States as social norms changed to reflect an increase emphasis on social responsibility. Such an increase in awareness would impact consumer behavior, which would create natural market incentives for companies to eliminate these abuses. The use of this natural market incentive would mean the eradication of these abuses would be accomplished by the free market in an efficient manner and that companies who engaged in these abuses would be punished by consumers.

#### **V. What can companies do?**

Returning to the discussion started at the beginning of this paper about the increase complexity and risk of global supply chains, the new name-and-shame provisions of the afore-discussed laws seem to only complicate the already complex and burdensome task of managing the global supply chain.

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<sup>110</sup> Stephen Bainbridge, *Marcia Narine on the Conflict Minerals Disclosure Regime*, PROFESSORBAINBRIDGE.COM (March 18, 2013), available at: <http://www.professorbainbridge.com/professorbainbridgecom/corporate-social-responsibility/>

While it may not be true that American consumers will continue to push for supply chain transparency, it appears that American policy makers may continue to do so in an attempt to appear as though they are working to resolve humanitarian crises. Because of this, companies should continue to prepare for increasing disclosure requirements and begin to adjust their supply chains accordingly. Increase awareness and deeper supply chain knowledge may help companies comply with current and future laws. Even if that is not the case, this increase compliance will help companies identify potential problems in their supply chains sooner and therefore minimize potential costs.

In fact, there is evidence to suggest a number of leading companies appear to be increasing their efforts to remove conflict minerals from their supply chains, possibly as a preemptive measure for future issues. According to a recent report by a human rights advocacy group, The Enough Project, a number of leading companies have increase their efforts in recent years to remove conflict minerals from their supply chains.<sup>111</sup> The report notes that these companies, including Intel, HP, AMD, Acer, Dell, Apple and Microsoft, have all significantly improved their efforts.<sup>112</sup> The report, issued in 2012, notes that these companies have worked to reduce their use of conflict minerals despite delays in the SEC's promulgation of a rule related to Section 1502.<sup>113</sup>

In addition to any humanitarian benefits of reducing the amount of conflict minerals in a supply chain, there is also the added benefit of risk mitigation that comes with removing these minerals from one's supply chain. The Covered Countries for which Section 1502 of the Dodd-Frank act applies, as well as the types of countries in which human rights abuses are prevalent

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<sup>111</sup>Sasha Lezhnev & Alex Hellmuth, *Taking Conflict Out of Consumer Gadgets: Company Rankings on Conflict Minerals 2012*, THE ENOUGH PROJECT (Aug. 2012), available at: <http://www.enoughproject.org/files/CorporateRankings2012.pdf>.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

are also countries where political unrest would be more likely to disrupt a supply chain. For this reason, humanitarian concerns aside, companies should begin to reduce their footprint in these countries.

## **VI. Conclusion**

Even before Section 1502 of the Dodd-Frank Act, and the California Transparency in Supply Chains Act, many companies were experiencing difficulty in managing their supply chains and see the need for deeper supply chain knowledge. These laws introduce additional complexity and expense to already imperfect supply chains which will add significant compliance costs. While the goals of the law are inherently good, and while deeper supply chain knowledge would arguably be a positive thing for many companies, the requirements of each law lead to sub-optimization for both the involved companies and involved humanitarian issues. The compliance costs of Section 1502 are astronomical, while the benefits expressed a means of affecting consumer behavior may be questionable. Though less expensive, the benefits of the California Act are also questionable. In short, these laws are inherently good ideas with inherently poor execution.

In addition to being ineffective, Section 1502 of the Dodd-Frank Act also comes dangerously close to invading the domain of the states by attempting to regulate the ways in which corporations do business. While it does this through the guise of disclosure as opposed to actual regulation, it is clear that the law runs afoul of the purpose of the 1934 Act and the traditional mission of the SEC. Though the California Act

As discussed, there are a variety of ways that these laws could be replaced or improved. There are, of course, also a variety of policies ideas for how to address the root causes of the use

of conflict minerals, forced labor and other humanitarian issues that do not involve corporate law.

Perhaps the most helpful recommendation for US companies would be to encourage lobbying and education efforts for the public to have these laws replaced by policies that will actually attack the root causes of these human rights abuses as opposed to making corporations expend efforts to create the appearance that something is being done about the problem. If the goal of these laws is to alter consumer behavior, any laws enacted should work in ways that will actually impact consumer on a widespread level. If the goal of these laws is to affect investor behavior, the laws put in place should offer a direct or indirect financial means of making these less appealing investments.