SEC proposes revised payment disclosure rules for companies engaged in resource extraction

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The US Securities and Exchange Commission (the “SEC”) has re-proposed Rule 13q-1 and an amendment to Form SD to implement Section 13(q) of the US Securities Exchange Act of 1934 (the “Exchange Act”), which was added by Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The new rules would require "resource extraction issuers" to disclose annually payments that such companies (or their subsidiaries or entities under their control) make to a foreign government or the US federal government for the purpose of the commercial development of oil, natural gas or minerals. The SEC believes that these rules will increase the transparency of payments that resource extraction companies make to foreign governments and hold those governments accountable for their natural resource wealth. The rules would require companies to disclose the type and total amount of payments that they make to each government for each project.

Background of the payment disclosure rules

The SEC re-proposed these payment disclosure rules to replace rules it initially adopted in 2012 (the "2012 Rules"). In 2013, the US District Court for the District of Columbia (the "District Court") invalidated the 2012 Rules in a rare use of judicial oversight over the SEC's rulemaking. The District Court found that two aspects of the 2012 Rules were improper. First, it found that the SEC erred by stating that the Dodd-Frank Act required public disclosure and did not allow confidential disclosure, when, in fact, the statute gave the SEC discretion to decide whether to require public disclosure or permit confidential disclosure. Second, it found that the SEC acted arbitrarily and capriciously by failing to provide any exemption for resource extraction companies whose disclosure would violate a foreign law. The SEC chose not to appeal the District Court's decision and instead decided to rewrite and re-propose the resource extraction payment disclosure rules.

Overview of the new payment disclosure rules

The re-proposed rules are substantially similar to the 2012 Rules except that the SEC changed the rules to comply with the District Court's order. Nonetheless, even those changes are minor. Consistent with the 2012 Rules, the SEC used its discretion to require public, not confidential, disclosure, and there is still no blanket exemption for companies whose disclosure is prohibited by foreign law. Instead, the proposed rules allow companies to apply for exemptive relief on a case-by-case basis, which the SEC will consider based on several factors, which are discussed in greater detail below.

The SEC also added alternative reporting methods for companies who meet the requirements of other jurisdictions or disclosure regimes. The SEC noted in its proposing release that Canada and the European Union recently adopted resource extraction disclosure laws that reflect the 2012 Rules.[1] Further, in 2014, the United States became a candidate country for the Extractive Industries Transparency Initiative ("EITI"), which is a voluntary coalition of oil,

natural gas and mining companies, foreign governments and other organizations that is dedicated to improving transparency and accountability in countries rich with resources. Thus, under the proposed rules, if the SEC decides that other disclosure rules are substantially similar to the SEC's rules, companies could opt to comply with SEC reporting obligations in accordance with those reporting obligations rather than prepare a separate disclosure under the SEC's rules.

Companies covered by the rules

The disclosure requirements apply to all US and non-US companies that qualify as “resource extraction issuers”, i.e., companies that are (i) required to file annual reports with the SEC pursuant to Section 13 or 15(d) of the Exchange Act and (ii) engage in the commercial development of oil, natural gas or minerals.

The new rules would define commercial development of oil, natural gas or minerals to include: (a) exploration, (b) extraction (meaning the production of oil and natural gas as well as the extraction of minerals), (c) processing (including, without limitation, such activities as the processing of gas to extract liquid hydrocarbons, the removal of impurities from gas after extraction and prior to its transport through the pipeline, and the upgrading of bitumen and heavy oil, or the crushing and processing of raw ore prior to the smelting phase, but not refining or smelting), (d) export of oil, natural gas or minerals from the host country by a company with an ownership interest in the resource or (e) the acquisition of a license for any of the activities listed in items (a) through (d) above. The SEC also proposed an anti-evasion provision to require disclosure for any activity or payment that is part of a plan or scheme to evade the above disclosure.

Although the SEC did not limit the definition of commercial development to upstream activities, the final rules carve out certain downstream activities. According to the SEC, the definition is intended to capture only activities that are directly related to the commercial development of oil, natural gas or minerals, but not activities that are ancillary or preparatory, such as transportation activities (unless for export purposes), marketing activities or manufacture of a product (e.g., drill bits) used in the commercial development of oil, gas or minerals.

The rules will apply to all covered companies regardless of the size of the company or the extent of business operations constituting commercial development of oil, natural gas or minerals and regardless of whether or not a government owns or controls such companies. There are also no exemptions from the rules for smaller reporting companies or non-US companies that qualify as “foreign private issuers”.

Types of payments to be disclosed

The disclosure obligations will apply to any payment:

- that a company makes to the US federal government or a foreign government (including a foreign national government or a foreign subnational government (a state, province, county, district, municipality or territory) or a company that is at least majority owned by a foreign government);
- that a company makes in cash or in kind;
- that a company makes to further the commercial development of oil, natural gas or minerals;
- that is not *de minimis* (defined as any payment, whether a single payment or a series of related payments, that equals or exceeds US$100,000 during the most recent fiscal year); and
- that is one of the following types of payments in the commonly recognized revenue stream for the commercial

development of oil, natural gas or minerals:

- taxes levied on corporate profits, corporate income and production, but not taxes levied on consumption, such as value added taxes, personal income taxes or sales taxes;
- royalties;
- fees (including, without limitation, license fees, rental fees, entry fees and concession fees);
- production entitlements;
- bonuses (including, without limitation, signature, discovery and production bonuses);
- dividends that are paid to a government in lieu of production entitlements or royalties, but not dividends paid to a government as a shareholder of the issuer as long as dividends are paid to the government on the same terms as other shareholders; and
- payments for infrastructure improvements, such as building a road or railway.

The proposed rules do not include in the types of covered payments a broad category of “other material benefits” because the SEC did not determine that any other material benefits were part of the commonly recognized revenue stream. Similarly, the proposed rules would not require the disclosure of social or community payments, such as payments to build a hospital or schools.

The proposed rules capture payments not only by a resource extraction issuer but also by its subsidiaries and entities under its control. Therefore, a company that engages in joint ventures or contractual arrangements will need to consider whether it has control over its counterparties. Whether a company has “control” is based on accounting principles under GAAP or IFRS, which is a change from the 2012 Rules, which had defined "control" based on Exchange Act Rule 12b-2. A company has "control" of another entity if it consolidates that entity in the financial statements included in the company's Exchange Act reports. If the company proportionately consolidates an entity, it has to report that entity's payments on a proportionate basis.

Method and content of required disclosure

Covered companies must disclose the required payment information annually on Form SD, which form is used for specialized disclosure outside a company's periodic or current reports, such as disclosure regarding conflict minerals under Rule 13p-1. Thus, this disclosure is separate from a company's Exchange Act annual reports on Forms 10-K, 20-F or 40-F, as the case may be. Such information must be presented in Exhibit 2.01 to Form SD. The required exhibit must be formatted using the XBRL (eXtensible Business Reporting Language) interactive data standard. Disclosure in the exhibit must include the following information regarding payments:

- the total amount of the payments, by category;
- the currency used to make the payments;
- the financial period in which the payments were made;
- the business segment of the resource extraction issuer that made the payments;
- the government that received the payments and the country in which the government is located; and
- the “project” of the resource extraction issuer to which the payments relate.

In addition, under the proposed rules, a resource extraction issuer must provide and electronically tag the type and total amount of payments made for each project and the type and total amount of payments made to each government. The proposed rules also add the requirement that companies tag the particular resource that is the subject of commercial development as well as the subnational geographic location of the project.

The term “project”, while undefined in the 2012 Rules, is defined in the proposed rules as "operational activities that are governed by a single contract, license, lease, concession, or similar legal agreement, which form the basis for payment liabilities with a government." Companies may treat as a single project multiple agreements that are "operationally and geographically interconnected" even if the terms of the agreements are not substantially similar. In addition, the SEC has proposed a non-exclusive list of factors to determine if agreements are operationally and geographically interconnected. These factors include: "(a) whether the agreements relate to the same resource and the same or contiguous part of a field, mineral district, or other geographic area; (b) whether the agreements will be performed by shared key personnel or with shared equipment; and (c) whether they are part of the same operating budget."

Companies may disclose payments at the entity level if the payment is made for obligations levied on the company at the entity level rather than at the project level. Thus, if a company has multiple projects in a host country, and that country’s government taxes the country on its income in the country as a whole and not with respect to a particular project or operation within such country, the company is permitted to disclose the resulting income tax payments without specifying a particular project associated with the payments. Thus, companies are not required to disaggregate payments for obligations that are levied at the entity level.

The rules do not require the disclosures to be audited or provided on an accrual basis.

In an effort to emphasize substance over form or characterization and to reduce the risk of evasion, the proposed rules also include an anti-evasion provision. The provision requires disclosure with respect to an activity or payment that, although not in form or characterization of one of the categories specified under the final rules, is part of a plan or scheme to evade the disclosure required under the rules.

Public filing

The SEC's new proposal still requires resource extraction issuers to disclose publicly their payments under the rule. The District Court stated that Section 13(q) gives the SEC discretion to require public disclosure or to permit confidential disclosure. However, the SEC chose to require public disclosure because it furthers the statutory goal of promoting international transparency. In addition, the SEC determined that the text, structure and legislative history of Section 13(q) support requiring public disclosure. As a result, companies that file under Rule 13q-1 cannot simply file confidentially with the SEC but must make public disclosures unless they seek exemptive relief from the SEC, which the SEC may grant on a case-by-case basis.

Exemption from compliance

The SEC's proposal also adds an exemption from compliance. This exemption does not automatically apply just because the SEC's required disclosure is prohibited by host country law. Instead, the SEC proposes to apply a case-by-case approach to exemptions and will consider exemptions upon request by a resource extraction company. To file such a request, a company must submit a written request to the SEC that both describes the payment disclosures it wants to keep confidential and the specific reasons that it merits an exemption. The SEC will consider many factors in deciding whether to grant the request, including an opinion of counsel regarding a foreign law's prohibition of the disclosure, whether the information is already publicly available and whether other companies have

disclosed similar information under similar circumstances.

Alternative reporting

The SEC's new proposal would allow companies to fulfill their disclosure obligations under the rule by complying with another country's rules or with the US EITI requirements. The SEC must first determine that those other rules are substantially similar to the SEC's rules under Section 13(q).

To determine if another country's rules or the US EITI disclosure requirements are substantially similar to the SEC's rules, the SEC proposes to consider several factors, including: (1) the types of activities that trigger disclosure; (2) the types of payments that must be disclosed; (3) whether the disclosure must be publicly filed and include the identity of the issuer; and (4) whether there are any exemptions allowed. The SEC has requested comment regarding whether any jurisdictions currently have payment disclosure rules that are substantially similar to the SEC's rules. If a company has already filed a disclosure for a substantially similar reporting regime, that company simply would need to file the substantially similar report as an exhibit to Form SD and identify the alternative reporting regime on which it is relying.

Disclosure to be filed not furnished

The payment disclosure on Form SD will be considered “filed” (instead of "furnished") with the SEC and therefore subject to heightened liability under Section 18 of the Exchange Act for material misstatements or omissions. However, the payment disclosure will not be deemed to be incorporated by reference into SEC filings unless the issuer does so affirmatively. The payment disclosure is also not subject to the annual officer certifications required under the Exchange Act.

Effective date

A covered issuer must file its Form SD electronically with the SEC on EDGAR no later than 150 days after the end of its fiscal year. An issuer will be required to comply with the new rules beginning with its first fiscal year that ends at least one year after the effective date of the rules.

Comment period

The public comment period is unusual because it is divided into two comment periods. The public may submit initial comments by January 25, 2016. Following that period, the public may provide reply comments to respond to issues raised in the initial comment period until February 16, 2016. The text of the SEC proposal, including information on the comment periods, is available at http://www.sec.gov/rules/proposed/2015/34-76620.pdf. The SEC intends to vote on the adoption of a final rule in June 2016 pursuant to an expedited rulemaking schedule.

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[1] Canada's payment disclosure law, the Extractive Sector Transparency Measures Act, is available at http://laws-lois.justice.gc.ca/PDF/E-22.7.pdf.

The European Union's payment disclosure law consists of two directives. Directive 2013/34/EU is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32013L0034.

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