Third Time a Charm? SEC Re-Proposes Resource Extraction Disclosure Rules

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Current proposal is the third attempt by SEC to implement Dodd-Frank mandate

On December 18, the SEC proposed **rules** that would require resource extraction companies to disclose payments made to foreign governments or to the U.S. federal government for the commercial development of oil, natural gas, or minerals. This proposal is the third attempt by the SEC to implement the resource extraction disclosure rules mandated by the Dodd-Frank Act.

Background of the proposal

The SEC is mandated by Section 13(q) of the Securities Exchange Act of 1934 which was adopted as part of the Dodd-Frank Act (the "Exchange Act") to issue resource extraction disclosure rules. Previous attempts by the SEC to enact similar rules have been unsuccessful. The first set of resource extraction disclosure rules were adopted in August 2012 but, following an industry challenge, were overturned in federal court which found that the SEC had "misread" the statute by requiring public disclosure of the information and that the SEC's denial of an express exemption for disclosures prohibited under foreign law was arbitrary and capricious. A revised set of resource extraction disclosure rules adopted by the SEC in June 2016 (the "2016 Rules") were disapproved by a joint resolution of Congress pursuant to the Congressional Review Act in 2017. The cost of compliance, disclosure of project-level sensitive business information and competitive disadvantage were among the reasons cited by those who supported the disapproval of the 2016 Rules.

While the SEC is mandated to re-propose the rule, pursuant to the Congressional Review Act the SEC may not issue a new rule that is "substantially the same" as the disapproved rule. Hence the proposal makes a number of changes to its earlier iterations, such as broadening the definition of a "project" that would require disclosure, adding exemptions for smaller reporting companies and emerging growth companies and providing newly public companies with a one year grace period. While the new proposal continues to mandate public disclosure of such payments, the SEC commented in its proposing release that it is "requesting comment on an alternative approach that would allow for confidential filing and would release information only through an anonymized, aggregated compilation."

Highlights of the proposal

The proposal would require a domestic or foreign company that files a Form 10-K, 20-F or 40-F to disclose payments made to a foreign government or to the U.S. federal government if the company engages in the commercial development of oil, natural gas, or minerals.

The proposed rules include several changes compared to the 2016 Rules vacated pursuant to the Congressional Review Act. For example, the proposed rules would:

- expand the definition of the term "project" to no longer reference a specific project, but to reference a matter defined by three factors: the type of resource, the method of extraction and at the national and major subnational political jurisdiction where the commercial development of the resource is taking place, leading to disclosure that is less specific;
- increase the threshold of "not *de minimis*";
- add conditional exemptions for when a foreign law or a pre-existing contract prohibits the required disclosure;
- add an exemption for smaller reporting companies and emerging growth companies, or "EGCs" and add relief for companies that have recently completed their U.S. IPOs;

- revise the definition of "control" to *exclude* entities or operations in which a company has a proportionate interest;
- limit the liability for the required disclosure by deeming the payment information to be furnished to, but not filed with, the SEC;
- permit a company to aggregate payments by payment type made at a level below the major subnational government level; and
- significantly extend the deadline for furnishing the payment disclosures.

Covered Entities

Under the proposal, the term "resource extraction issuer" would apply to U.S. and foreign companies that (1) file a Form 10-K, 20-F or 40-F with the SEC pursuant to Section 13 or 15(d) of the Exchange Act and (2) engage in the commercial development of oil, natural gas or minerals. Covered companies would also be required to disclose payments made by a subsidiary or other entity they control.

Registered investment companies, emerging growth companies, and smaller reporting companies would not be subject to the proposed rules. Voluntary filers also seem to be excluded.

Covered Activities

Like the 2016 Rules, the proposed rules define "commercial development of oil, natural gas, or minerals" as exploration, extraction, processing, and export of oil, natural gas, or minerals, or the acquisition of a license for any such activity. The proposal defines the relevant terms as follows:

- "Commercial development of oil, natural gas, or minerals" is defined in the proposal as "exploration, extraction, processing, and export of oil, natural gas, or minerals, or the acquisition of a license for any such activity." The proposal states that the definition is intended to capture only those activities that are *directly* related to the commercial development of oil, natural gas, or minerals, and not activities ancillary or preparatory to such commercial development. Accordingly, a company that is only providing products or services that support the exploration, extraction, processing, or export of such resources (e.g., hydraulic fracturing or drilling services) would not be a "resource extraction issuer" under the proposed rules. In addition, it does not cover transportation made for a purpose other than export.
- "Extraction": Consistent with the definitions adopted in the 2016 Rules, the proposal defines "extraction" as the production of oil and natural gas as well as the extraction of minerals.
- "Processing": The proposed definition of "processing" includes, but is not limited to, midstream activities such as removing liquid hydrocarbons from gas, removing impurities from natural gas prior to its transport through a pipeline and the upgrading of bitumen and heavy oil, through the earlier of the point at which oil, gas, or gas liquids (natural or synthetic) are either sold to an unrelated third party or delivered to a main pipeline, a common carrier, or a marine terminal. Processing also includes the crushing or preparing of raw ore prior to the smelting or refining phase. **It does not include downstream activities such as refining or smelting**.

Covered Payments

The proposal would require companies to disclose payments made to governments relating to the commercial development of oil, natural gas, or minerals by type and total amount per project.

A company would be required to disclose payments it makes directly, as well as payments made by its subsidiaries and other entities under its control if those entities' financial information must be consolidated under the accounting principles applicable to the company's financial statements included in its Exchange Act reports. Disclosure would not be required for the proportionate amount of the payments made by a company's proportionately consolidated, or non-consolidated, entities or operations.

As proposed, the types of payments related to commercial development activities that would need to be disclosed in Form SD are:

- taxes;
- royalties, fees and bonuses;
- dividends (excluding those paid to a government as an ordinary shareholder);
- payments for infrastructure improvements;
- community and social responsibility payments that are required by law or contract; and
- in-kind payments.

Disclosure would not be required for payment types such as commodity trading related payments, payments for government expenses, providing jobs or tuition to persons related to government officials, investing in companies created by officials or related persons, payments of fines and penalties or other similar payments. As under the 2016 Rules, the proposed rules would include an anti-evasion provision that requires disclosure with respect to an activity or payment that, although not within one of the categories of activities or payments specified under the proposal, is part of a plan or a scheme to evade the disclosure requirements.

Under the proposal, the payment disclosure must be made on a cash basis instead of an accrual basis and need not be audited.

Not *De Minimis* Threshold

Section 13(q) requires the disclosure of payments that are "not *de minimis*.' The proposal would increase the threshold provided for in the 2016 Rules for when a payment would not be *de minimis* and would therefore require disclosure. Pursuant to the proposal disclosure would only be required if the total payments made for a project are at least $750,000. In that case, only payments that equal or exceed $150,000, whether made as a single payment or a series of related payments, would need to be reported.

Modified Version of Project Reporting

In contrast to the 2016 Rules, the proposal revises the definition of the term "project" to require disclosure at the national and major subnational political jurisdiction, as opposed to the contractual, level. The proposed rules define "project" using the following three criteria: (1) the type of resource being commercially developed; (2) the method of extraction; and (3) the major subnational political jurisdiction where the commercial development of the resource is taking place. If the extractive activity is offshore, a company would need to disclose both that it is offshore and the nearest major subnational political jurisdiction. This definition of project would include commercial development activities using multiple resource types or extraction methods if such activities are located in the same major subnational political jurisdiction. By expanding the definition of "project," the proposal would reduce the competitive harm of disclosing contractual information.

The proposal would allow aggregated disclosure of payments made to subnational political jurisdictions (consistent with International Organization for Standardization codes.) For purposes of identifying the foreign governments that received payments at a level below the major subnational government level, the proposal would permit a company to aggregate all of its payments of a particular payment type without having to identify the particular subnational government payee. The company would only be required to identify the type of administrative or political level of subnational government that received the payments. In contrast, for payments made at the major subnational government level, the company would have to disclose the particular major subnational payee.

Exemptions from Compliance

The proposal includes two new exemptions for the reporting requirements where disclosure is: (i) prohibited by foreign law or (ii) conflicts with pre-existing contracts.

The proposed conflict of law exemption would not require companies to apply to the SEC for exemptive relief, as the 2016 Rules required. A company seeking to rely on the exemption would first be required to take all reasonable steps to seek and use exemptions or other relief under the applicable laws. Having

failed to obtain such relief, the company would be required to make certain disclosures about its eligibility for relief and furnish a legal opinion regarding the conflict of law.

The proposed exemption for a conflict with a pre-existing contract would only apply when such terms are expressly included in writing in the contract prior to the effective date of the rules. The company would have to first take reasonable steps to obtain the consent of the relevant parties or to seek and use any contractual exceptions or relief to disclose the payment information. Having failed to obtain such relief, the company would be required to make certain disclosures about its eligibility for relief and furnish a legal opinion regarding its inability to provide such disclosure without violating the contract. The company's disclosure and its reliance on the exemption would be subject to staff review. This could pose a problem for recent public companies with contracts that went into effect after the effective date of the rule and would therefore not be eligible for the exemption.

Delayed Reporting Exemptions

The proposal includes targeted exemption for payments related to exploratory activities. Under the proposal, a company may delay disclosing payments related to exploratory activities until it submits a Form SD for the fiscal year following the fiscal year in which the payments were made.

Transitional relief would also be available for recently acquired companies that were not previously subject to reporting requirements under the Exchange Act or an alternative reporting regime. A company would not be required to commence reporting payment information for the acquired entity until it files its Form SD for the first full fiscal year immediately following the effective date of the acquisition.

A company that has completed its initial public offering in the United States would not be required to commence reporting payment information until the first fiscal year immediately following the fiscal year in which it completed its IPO.

Alternative Reporting

A company that is subject to the resource extraction payment disclosure requirements of an alternative reporting regime, which has been deemed by the SEC to require disclosure that satisfies the transparency objectives of Section 13(q), may satisfy its disclosure obligations by including, as an exhibit to Form SD, a report complying with the reporting requirements of the alternative jurisdiction. The company must make certain disclosures about the alternative report in its Form SD and the alternative report must be the same as the one prepared and made publicly available pursuant to the requirements of the approved alternative reporting regime, subject to changes necessary to comply with any conditions to alternative reporting set forth by the SEC.

Form SD Requirements

For any payment required to be disclosed, the proposed rules would require a company to provide public disclosure of the following information in an XBRL exhibit to Form SD using electronic tags:

- the total amounts of payments made: (i) for each category of payment type (e.g., taxes, royalties, etc.), (ii) for each category of payment type for each project and (iii) for each category of payment type for all projects paid to each government;
- the currency used to make the payments;
- the financial period in which the payments were made;
- the company's business segment that made the payments;
- the government that received the payments and the country in which the government is located;
- the project to which the payments relate;
- the particular resource that is the subject of commercial development;
- the method of extraction used in the project; and
- the major subnational political jurisdiction of the project.

The proposed rules provide that the SEC's staff will periodically make a separate public compilation of the payment information submitted on Forms SD available online, to the extent practicable.

While the proposal requires public disclosure of such payments, in its proposing release, the SEC stated that it is also considering, and is seeking comment on, the alternative approach of permitting covered companies to submit their annual reports on Form SD to the SEC non-publicly and using those nonpublic submissions to produce an aggregated, anonymized public compilation.

Reduced Liability

In contrast to the 2016 Rules, the proposal provides that the resource extraction payment disclosure provided on Form SD would be considered "furnished" with the SEC rather than "filed." Accordingly, the disclosure would not be subject to liability under Section 18 but would remain subject to liability under Section 10 of the Exchange Act and Rule 10b-5 thereunder.

Timing and Effective Date

The rule proposal includes a deadline that is longer than the deadline in the 2016 Rules. Under the proposal, if a company's fiscal year ends on or before June 30, it must furnish the information on Form SD no later than March 31 in the calendar year following its most recent fiscal year. If its fiscal year ends after June 30, it would have to furnish this required information no later than March 31 in the second calendar year following its most recent fiscal year. For example, a company whose fiscal year ends on June 30, 2020 would be required to furnish its Form SD no later than March 31, 2021 and a company whose fiscal year ends December 31, 2020, would be required to furnish its Form SD no later than March 31, 2022.

The proposal will have a 60-day public comment period following its publication in the Federal Register.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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