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Legal Update

SEC Proposes Revised Disclosure Rules for Resource Extraction Issuers

On December 18, 2019, the US Securities and Exchange Commission (SEC) proposed rules for the reporting of certain payments by resource extraction issuers (the "proposed rules").[1] The proposed rules represent the third attempt by the SEC to promulgate rules mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added Section 13(q) to the Securities Exchange Act of 1934 (Exchange Act), directing the SEC to issue rules requiring resource extraction issuers to include in an annual report information relating to any payment made by the issuer, a subsidiary of the issuer, or an entity under the control of the issuer to a foreign government or the US federal government for the purpose of the commercial development of oil, natural gas, or minerals.

The SEC first adopted rules under Section 13(q) in August 2012.[2] The 2012 rules were the subject of litigation and were vacated in July 2013 by the US District Court for the District of Columbia.[3] In response, the SEC adopted new disclosure rules in June 2016.[4] The 2016 rules were subsequently disapproved by Congress under the Congressional Review Act, or CRA, and the President in February 2017, which had the effect of vacating the 2016 rules and sending the SEC back to the drawing board, as under the CRA the SEC is not permitted to reissue the same rules in "substantially the same form" or issue new rules that are "substantially the same" as the disapproved rules. In crafting the proposed rules, the SEC considered the objections to the 2016 rules raised by members of Congress in connection with their disapproval under the CRA. In particular, the SEC took into consideration concerns that the rules would impose undue compliance costs on companies, undermine job growth, burden the economy and impose competitive harm on US companies relative to foreign competition.

In the proposed rules the SEC has endeavored to satisfy the requirements of the CRA, including by:

- exempting smaller reporting companies and emerging growth companies from reporting;
- lowering the burden, costs and competitive impacts associated with reporting by allowing disclosure at the national and major subnational political jurisdiction (as opposed to the contract level under the 2016 rules);

- increasing the de minimis reporting threshold to include both a project threshold and an individual payment threshold;
- adding two new conditional exemptions for situations in which a foreign law or pre-existing contract prohibits disclosure;
- eliminating reporting for entities or operations as to which the issuer has a proportionate interest; and
- extending the deadline for reporting.

As was the case with the 2016 rules, the proposed rules will be set forth in new Item 2.01 of Form SD titled "Resource Extraction Issuer Disclosure and Report." Form SD is the same form currently used for conflict minerals reporting. In a departure from the 2016 rules, however, information reported under Item 2.01 will now be "furnished" rather than "filed," thus excluding the disclosures made from liability under Section 18 of the Exchange Act. The information and documents furnished in or with the Form SD will not be deemed to be incorporated by reference into any filing made under the Securities Act of 1933 or the Exchange Act unless the issuer specifically incorporates it by reference into such filing.

Comments on the proposed rule are due by March 16, 2020.

Compliance Date Extension and Subsequent Due Date

The proposed rules would require a resource extraction issuer to file a Form SD for fiscal years ending no earlier than two years after the effective date of the final rules. The SEC proposes to select a specific compliance date that corresponds to the end of the nearest calendar quarter following the effective date of the final rules. As an example, the proposing release explained that if the rules had been adopted, rather than proposed, on December 18, 2019, the compliance date for an issuer with a December 31, 2019, fiscal year end would have been Tuesday, May 31, 2022 (i.e., 150 days after its fiscal year end of December 31, 2021, taking into account the Memorial Day holiday).

After the transition period, the proposed rules provide for the Form SD to be due before March 31 in the following calendar year, for issuers with calendar years ending on or before June 30, and no later than March 31 in the second calendar year following the most recent fiscal year for issuers with fiscal years ending after June 30.

Reporting Persons

All resource extraction issuers will have to make the payment disclosures, without regard to whether they are domestic or foreign issuers. The definition of "resource extraction issuer" remains the same as previously, and means an issuer that is required to file an annual report with the SEC pursuant to Section 13 or 15(d) of the Exchange Act and that engages in the commercial development of oil, natural gas or minerals. "Commercial development of oil, natural gas, or minerals" is defined as exploration, extraction, processing and export of oil, natural gas or minerals, or the acquisition of a license for any such activity. However, under the proposed rules, smaller reporting companies and emerging growth companies are exempt from compliance. In 2018, the SEC amended the definition of "smaller reporting company" to significantly expand the number of registrants that qualify.[5]

Resource extraction issuers must disclose payments made by a subsidiary or other entity that it controls, as well as direct payments made by the issuer. In the proposed rules, the SEC defines "control" to mean that the issuer consolidates the entity under the accounting principles applicable to the financial statements included in the resource extraction issuer's periodic reports filed pursuant to the Exchange Act and eliminated the 2016 rules requirement that issuers also report

proportionate payments made by an issuer's proportionately consolidated entities or operations.

The SEC does not consider oilfield service issuers to be resource extraction issuers if they merely provide products or services that support the exploration, extraction, processing or export of such resources. However, if the oilfield services issuer makes a payment to a government on behalf of a resource extraction issuer, the resource extraction issuer will have to disclose such payments.

Required Disclosure

As was generally the case under the previously proposed Item 2.01 rules, pursuant to new proposed Item 2.01 of Form SD, absent an exemption, a resource extraction issuer must annually disclose the following information regarding its most recently completed fiscal year:

- type and total amount of payments, by payment type, made for each project;
- type and total amount of payments, by payment type, for all projects made to each government;
- total amount of the payments made, by payment type;
- currency used to make the payments;
- fiscal year in which the payments were made;
- business segment of the issuer that made the payments;
- governments that received the payments, and the country in which each such government is located;
- project of the issuer to which the payments relate;
- particular resource that is the subject of commercial development;
- method of extraction used in the project; and
- major subnational political jurisdiction of the project.

The payment information must be provided on a cash basis. The required disclosure does not have to be audited. The Form SD is required to contain a brief statement in the body of Form SD directing investors to the payment information contained in an exhibit to the form. The exhibit must provide the payment information using the XBRL interactive data standard.

The proposed rules would require disclosure with respect to an activity or payment that, while not within the specified disclosure categories, is part of a plan or scheme to evade disclosure required by Section 13(q) of the Exchange Act.

Alternative Reporting Regimes

As was the case under the previously proposed 2016 rules, resource extraction issuers may satisfy disclosure obligations under Item 2.01 of Form SD by including, as an exhibit, a report complying with the requirements of any alternative reporting regime to which it is subject that the SEC deems to be substantially similar to the requirements of Section 13(q). The alternative report must be the same as the one prepared and made publicly available pursuant to the requirements of the approved alternative regime, subject to any necessary changes set forth by the SEC.

When relying on alternative reporting, the issuer must state in the body of Form SD that it is relying on the alternative reporting provision of Form SD, identifying the alternative reporting regime for which the report was prepared. The alternative report must be provided in XBRL format. An English translation of the entire report must be filed if the alternative report is in a foreign language.

A resource extraction issuer may follow the submission deadline of an approved

alternative jurisdiction if it files a notice on Form SD-N on or before the due date of the otherwise applicable Form SD of its intent to file on such basis. If the issuer fails to file such notice on a timely basis or if it files the notice but does not file the alternative report within four business days of the alternative jurisdiction's deadline, it will not be allowed to rely on the alternative reporting rules for the following fiscal year.

The SEC indicates that it anticipates making determinations about whether a foreign jurisdiction's disclosure requirements satisfy Section 13(q) either on its own initiative or pursuant to an application submitted by an issuer or a jurisdiction. In connection with the 2016 rules, the SEC recognized the following alternative reporting regimes as meeting the substantially similar requirement:

- the European Union's accounting directive (Directive 2013/34/EU) as implemented in a European Union or European Economic Area member country;
- the European Union's transparency directive (Directive 2013/50/EU) as implemented in a European Union or European Economic Area member country;
- Canada's Extractive Sector Transparency Measures Act; and
- the US Extractive Industries Transparency Initiative (but only with respect to payments made to the US federal government and only to the extent the issuer complied with the original 150-day deadline of the resource extraction issuer payment disclosure rules).

Delayed Reporting

The proposed rules contain several bases for delayed reporting in specified circumstances.

Exploratory Activity. The proposed rules permit resource extraction issuers to delay disclosing payment information related to exploratory activities until the Form SD with respect to the associated development or extraction activities that is filed for the fiscal year immediately following the fiscal year in which such exploratory activity payment is made. Exploratory activities for the purpose of this delayed reporting include all payments made as part of:

- identifying areas that may warrant examination;
- examining specific areas that are considered to have prospects of containing oil and gas reserves; or
- a mineral exploration program.

However, delayed payment reporting is permissible only for exploratory activities that were commenced prior to any development or extraction activities on the property, any adjacent property, or any property that is part of the same project.

Acquired Entity. If a resource extraction issuer acquires or obtains control of an entity that has not been subject to new Rule 13q-1 or the requirements of an alternative reporting regime's requirements in such entity's last full fiscal year, such resource extraction issuer will not be required to report payment information for that acquired entity until the Form SD filed for the fiscal year immediately following the effective date of the acquisition. Reliance on this accommodation must be disclosed in the body of the filed Form SD. If the acquired entity was itself required to file a Form SD prior to the acquisition, this delayed reporting exemption will not apply.

Initial Public Offering. If a resources extraction issuer has completed its initial public offering (IPO) in the US in its last full fiscal year, it will not be required to commence reporting payment information until the Form SD submitted for the fiscal year immediately following the fiscal year in which the registration statement for its IPO became effective.

Exemptions for Violations of Foreign Law or Pre-Existing Contracts

The proposed rules provide an exemption from reporting payments under circumstances where disclosure is prohibited by the laws of the jurisdiction in which a project is located, rather than requiring a resource extraction issuer to apply for exemptive relief from the SEC on a case-by-case basis. Under the proposed rules, the issuer would have to first take reasonable steps to use exemptions or seek relief under the applicable law of the foreign jurisdiction. If the issuer failed to obtain such exemption or relief, it would disclose in its Form SD the foreign jurisdiction and law preventing disclosure, as well as the efforts it engaged in to obtain relief and the results of those efforts. Finally, the issuer would be required to furnish as an exhibit to the Form SD a legal opinion from counsel opining on the issuer's inability to provide the required disclosure on Form SD without violating the foreign jurisdiction's laws. The exemption is not limited to pre-existing foreign laws.

The proposed rules also provide an exemption from reporting payments when the terms of a pre-existing contract prohibit disclosure. The exemption applies only to contracts that expressly include such terms in writing prior to the effective date of the proposed rules. Similar to the exemption for conflicts with foreign laws, the resource extraction issuer must first take reasonable steps to seek and use any contractual exceptions or relief (such as attempting to obtain consent) but would not be obligated to renegotiate the contract or compensate the other party for consent. If the issuer failed to obtain such relief, it would disclose in its Form SD the jurisdiction where it has excluded disclosure and the contract terms preventing disclosure, as well as the efforts it engaged in to obtain relief and the results of those efforts. The issuer would also be required to furnish as an exhibit to the Form SD a legal opinion from counsel opining on the issuer's inability to provide the required disclosure on Form SD without violating the applicable contractual terms.

Under circumstances not specifically covered by the foregoing exemptions, resource extraction issuers can apply to the SEC for exemptive relief on a case-by-case basis in accordance with the procedures set forth in existing Exchange Act Rule 0-12.

Other Key Terms

Payment. This term is defined for the purposes of the resource extraction issuer payment disclosure rules as a payment that is:

- made to further the commercial development of oil, natural gas or minerals;
- not *de minimis*; and
- one or more of the following: taxes, royalties, fees, production entitlements, bonuses, dividends, payments for infrastructure improvements and community and social responsibility payments that are required by law or contract.

De Minimis. As set forth in Form SD, "not *de minimis*" means any payment, whether made as a single payment or a series of related payments, that equals or exceeds $150,000, or its equivalent in the resource extraction issuer's reporting currency, subject to the condition that disclosure for a project is only required if the total payments equal or exceed $750,000 during the fiscal year covered by the Form SD. In the case of any arrangement providing for periodic payments or installments, a resource extraction issuer must use the aggregate amount of the related periodic payments or installments of the related payments in determining whether the payment threshold has been met for that series of payments and, accordingly, whether disclosure is required.

Project. In a significant departure from the 2016 rules, the proposed rules define a "project" based on three criteria: (1) the type of resource being commercially developed; (2) the method of extraction; and (3) the major subnational political jurisdiction where the development is taking place. The 2016 rules defined a project as operational activities governed by a single contract, license, lease, concession or similar agreement that formed the basis for payment liabilities with a government. The modified definition of project under the proposed rules is intended to lessen the risk that issuers might be required to disclose sensitive competitive information about underlying contracts, licenses or concessions as well as reduce compliance burdens and costs by allowing greater aggregation of payment disclosure (e.g., within major subnational political jurisdictions).

Commercial development of oil, natural gas or minerals. As noted above, the proposed rules define this term as the exploration, extraction, processing and export of oil, natural gas or minerals, or the acquisition of a license for any such activity. This term plays a significant role in the proposed rules, both in identifying a resource extraction issuer and for determining the payments that must be disclosed. In turn, the terms exploration, export, extraction and processing are critical to an understanding of what constitutes commercial development of oil, natural gas or minerals, although of these terms, the SEC has only defined export and extraction in the proposed rules.

Export. This term is defined for the purposes of the proposed rules as the movement of a resource across an international border from the host country to another country by a company with an ownership interest in the resource. The definition of export expressly excludes the movement of a resource across an international border by a company that *both*:

- is not engaged in the exploration, extraction, or processing of oil, natural gas, or minerals; and
- acquired its ownership interest in the resource directly or indirectly from a foreign government or the US federal government.

The proposed rules also specify that export does *not* include cross-border transportation activities by an entity that is functioning solely as a service provider, with no ownership interest in the resource being transported.

Extraction. This term is defined as the production of oil and natural gas, as well as the extraction of minerals.

Processing. While processing is not defined in the proposed rules, an instruction to Item 2.01 of Form SD provides the following non-exclusive list of midstream activities that are included in the term:

- midstream activities such as the processing of gas to remove liquid hydrocarbons;
- removal of impurities from natural gas prior to its transport through a pipeline; and
- upgrading of bitumen or 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.

According to this instruction, processing also includes the crushing and processing of raw ore prior to the smelting phase, but does not include the downstream activities of refining or smelting.

Foreign government. The proposed rules define this term as a foreign government, a department, agency or instrumentality of a foreign government, or a company at least majority-owned by a foreign government. This term includes a foreign national government as well as a foreign subnational government, such as the government of a state, province, county, district, municipality or territory under

a foreign national government. However, "Federal Government" means only the US federal government and does not include subnational governments within the United States.

Additional Instructions

The instructions to Item 2.01 of Form SD permit the issuer to report the payments either in US dollars or in the issuer's reporting currency. If payments are made in currencies other than US dollars or the issuer's reporting currency, the issuer can choose one of three available methods of determining how the currency conversion should be calculated. When calculating whether the *de minimis* threshold has been exceeded, a resource extraction issuer may be required to convert the payment to US dollars, even though it is not required to disclose those payments in US dollars (for example, when a resource extraction issuer is using a non-US dollar reporting currency). In these instances, the resource extraction issuer may use any of the three permitted methods for calculating the currency conversion as long as it uses a consistent conversion method for all currency conversions within a particular Form SD filing and discloses the conversion method that it uses.

The instructions provide examples of types of "bonuses" (signing, discovery and production bonuses) and "fees" (license fees, rental fees, entry fees and other considerations for licenses or concessions) covered by the rules, as well as specifying that royalties include unit-based, value-based, and profit-based royalties. Another instruction clarifies that payments for taxes levied on corporate profits, corporate income and production are intended to be disclosed, but not payments for taxes levied on consumption, such as value-added taxes, personal income taxes or sales taxes.

According to the instructions, if dividends are paid to a host government in lieu of production entitlements or royalties (such as where a national oil company owns shares of a holding company formed to develop the resources), the dividends must be disclosed. However, dividends paid to governments holding common or ordinary shares of the issuer need not be disclosed so long as the government is treated the same as all other shareholders.

Additionally, an instruction clarifies that resource extraction issuers must disclose in-kind payments — such as making a payment to the host government expressed in quantities of crude oil. The issuer must determine the monetary value of the in-kind payment and tag the information required for currency disclosure as "in-kind." The instruction permits the issuer to value the in-kind payment at cost or, if cost is not determinable, at its fair market value, and requires a brief description of how the issuer calculated the monetary value.

If a resource extraction issuer makes an in-kind production payment but then repurchases the associated resources within the same fiscal year, the issuer must report the payment using the purchase price (rather than at cost, or if cost is not determinable, fair market value). However, if such in-kind payment and subsequent repurchase are made in different fiscal years and the purchase price is greater than the previously reported value of the in-kind payment, the resource extraction issuer must report the difference in values in the later fiscal year (if the difference exceeds the *de minimis* threshold). In other situations, such as when the purchase price in a subsequent fiscal year is less than the in-kind value already reported, no disclosure relating to the purchase price is required.

Public Compilation

In accordance with the mandate of the Dodd-Frank Act, Rule 13q-1 provides that, to the extent practicable, the staff of the SEC will periodically make a compilation of the information required to be filed pursuant to the resource extraction rules publicly available online. While the proposed rules require resource extraction issuers to publicly submit information on Form SD, the SEC indicates that it is considering an alternative approach of permitting resource extraction issuers to submit annual reports on Form SD to the SEC confidentially and that the SEC would use those confidential submissions to produce an aggregated, anonymized compilation that would be made available to the public as an additional method of alleviating concerns about the competitive impacts of the disclosure. The SEC is requesting comment on whether the proposed rules sufficiently mitigate such competitive concerns that an anonymized compilation alternative is unnecessary.

Practical Considerations

Given recent history, it is possible that the SEC might adopt final rules in substantially the form proposed. Whether the final rules will also be the subject of successful litigation as were the 2012 rules, or Congressional action under the CRA, as were the 2016 rules, is unknown. Accordingly, to the extent they have not previously done so, SEC reporting companies involved in the oil, natural gas (including in export, midstream and processing) or mining industries should carefully assess whether they may be subject to the reporting obligations of the proposed rules, particularly when they have foreign or offshore operations and even if such activities are not the primary focus of their business.

There may be considerable start-up time and expense required to be ready to comply with the rules once finalized, including for IT consulting; travel costs; establishing new reporting and accounting systems; and training personnel on tracking, reporting and developing guidance to ensure consistency across reporting units. Some companies may need their accounting groups to develop new information systems, processes and controls. Other jurisdictions have adopted or proposed comparable payment disclosures rules, and some companies may possess existing systems, processes and controls for tracking and recording necessary payment information under such rules or for other purposes, such as compliance with the Foreign Corrupt Practices Act, in which case it is possible that only minor tweaks to existing controls and processes may be necessary. On the other hand, if it appears that significant modifications to a company’s systems and controls are needed to capture and report the requisite payment data, then the lead time to be prepared to comply will be significantly longer.

Resource extraction issuers should also begin the process of identifying foreign laws and contractual provisions that would be violated by compliance with the proposed rules and begin planning the reasonable steps necessary to avail themselves of an applicable exemption under the proposed rules in the event they are unable to obtain relief. We believe it would be most efficient to identify in advance legal counsel able to provide the required legal opinion exhibit to the Form SD in the event that utilizing such an exemption becomes necessary and to consult with them on the reasonable steps the issuer plans to take as a part of the exemption process. To prepare for compliance, companies that will need to report resource extraction payments under the SEC’s proposed rules may want to review the experience of companies that are reporting under similar payment regimes, such as the alternative reporting regimes that the SEC previously determined to be

substantially similar, as discussed above under "Alternative Reporting Regimes."

Companies that would be affected by the new resource extraction issuer disclosure rules should consider submitting comments to the SEC before the March 16, 2020, deadline. The filing of the disclosures contemplated by the proposed rules is not likely to begin before 2023; however, given the potential time and effort necessary to comply, it would be prudent to start planning for compliance as soon as possible.

For more information about the topics raised in this Legal Update, please contact the author of this Legal Update, William T. Heller IV, at +1 713 238 2684, or any of the following lawyers:

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Endnotes

[1] Available at https://www.sec.gov/rules/proposed/2019/34-87783.pdf

[2] Available at https://www.sec.gov/rules/final/2012/34-67717.pdf

[3] Available at https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2012cv1668-51

[4] Available at https://www.sec.gov/rules/final/2016/34-78167.pdf

[5] See SEC Release No. 33-10513 (June 28, 2018) [83 FR 31992 (Jul. 10, 2018)] available at https://www.sec.gov/rules/final/2018/33-10513.pdf

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